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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person:

Telephone Number:

In Reference to:

Date: OCT 4 1999
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E.I.N.:

LEGEND:

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A1:

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B1:

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D:

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X:

Y:

Z:

Dear Sir or Madam:

This is in response to a ruling request dated May 8, 1997, submitted on your behalf by your authorized representatives. You are seeking rulings on whether the payment of certain dividends to

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the limited partners of A and B, as more fully set forth below, results in unrelated business income by virtue of being income from debt-financed property as defined in section 514 of the Internal Revenue Code.

A and B are limited partnerships for federal income tax purposes. The general partner of both A and B is D. A and B were established to develop, own, manage, lease, operate and sell real estate projects (primarily office, residential and industrial buildings or mixed use properties containing office, residential, retail and/or hotel space) located outside the United States. The activities of A and B are conducted through operating entities that may or may not include local participants. The limited partners of A and B are organizations that are exempt from taxation under section 501(a) of the Code.

A and B, along with C, also a limited partnership whose general partner is D, and certain local participants, own equity interests in X, who have claimed classification as corporations for United States federal income tax purposes. X are involved in real estate development projects in X's country. The managing members (Managers) of X are corporations in which A, B, C, and certain local participants own equity interests.

A, B and C as borrowers, entered into a Credit Agreement with D as lender, and E, as agent. Loans under the Credit Agreement are to be secured by (i) D's right to make capital calls on the partners of A, B and C, (ii) the interests of A, B, and C in the capital commitments of their partners and (iii) a bank account maintained by A, B, and C with E, into which capital contributions of the partners of A, B and C are to be paid collectively (the "Collateral"). The Collateral does not include the real estate projects to be developed by the operating subsidiaries of A, B or C.

A, B and C have used some of the funds borrowed under the Credit Agreement (i) to make capital contributions to X for use in X's real estate development activities (the X borrowings) and (ii) to acquire a beneficial interest in Y (the Y borrowings).

The Credit Agreement provides that entities controlled by A, B and C may borrow funds under the credit facility. Such borrowing by controlled entities must be guaranteed by A, B and C.

A and B propose to do the following: A and B each intends to organize two wholly-owned foreign subsidiaries, A1, A2, B1, and B2 (together with X, the "Corporations"), each of which will elect to

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be classified as a corporation for United States federal income tax purposes. One wholly-owned subsidiary of each A and B (A1 and B1), and C1, a wholly-owned foreign subsidiary of C, will form and own equity interests in Z, which will elect to be classified as a partnership for United States federal income tax purposes. The other wholly-owned subsidiary of A and B (A2 and B2) each will make a loan to Z, indirectly through an intermediate entity. A, B and C will cause the Y interest to be transferred to Z. A and B will use capital contributions of their partners to repay in full the X and Y borrowings with interest thereon. No dividends will be received by A or B from the Corporations until the taxable year of A and B following the year in which the X and Y borrowings, respectively, have been repaid.

A1, A2, B1, and B2 each will borrow funds under the Credit Agreement to make an equity or debt investment in Z, as the case may be. With respect to X, X's Managers will borrow funds under the Credit Agreement on behalf of all the members of X. A and B will guarantee the loans made to A1, A2, B1, and B2, and A, B and C will guarantee the loans made to Managers for the benefit of X. The guarantees will be fully recourse to A, B and C, but the only security for such guarantees will be the Collateral. The loans will not be collateralized by assets of the Corporations, the Managers or Z. It is intended that (i) the Managers will repay the loans made to them for the benefit of X with cash from the real estate activities of X and (ii) A1, A2, B1 and B2 will repay the loans made to them out of interest and dividends, as the case may be, paid to them by Z. However, if income from these sources is insufficient to make required payments on the loans, A, B and C would be required to make payments under the guarantees. With respect to loans made to the Managers for the benefit of X, A, B, and C will indemnify the owners of X and the Managers.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations described in sections 401(a) and 501(c).

Section 512(b)(4) of the Code provides that in the case of debt-financed property (as defined in section 514), there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed as a deduction the amount ascertained under section 514(a)(2).

Section 514(b) of the Code defines "debt-financed property" as any property held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year

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or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition.

Section 514(c)(1) of the Code provides that the term "acquisition indebtedness" means with respect to debt financed property, the unpaid amount of (A) the indebtedness incurred by the organization in acquiring or improving such property, (B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and (C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

In Rev. Rul. 70-132, 1970-1 C.B. 138, an exempt employee's pension trust was the lessor of a parcel of unencumbered real estate. The lessee mortgaged its leasehold interest in connection with obtaining construction financing. The leasehold agreement, in addition to authorizing the lessee to mortgage its leasehold interest, obligated the trust to subordinate its fee interest to any leasehold mortgages. The trust had no direct or indirect personal obligation on any construction financing mortgage notes. The trust did, however, reserve the right to cure any default by the lessee. The ruling held that because the lessee and not the trust had incurred the indebtedness, the trust did not incur any business lease indebtedness. This ruling suggests that a different result could occur where the trust takes over the lessee's role under the construction mortgage or otherwise acquires a different interest in the leasehold improvements.

A's and B's indebtedness under the Credit Agreement was incurred in part in connection with their capital contributions to X, and, A's and B's acquisition of the Y interest. A and B hold their interests in X and the Y interest to produce income. Therefore, the interests of A and B in X and the Y interest, at the time of their acquisition, constituted debt-financed property in the hands of the limited partners of A and B.

Accordingly, part or all of any dividends received by A and B from X or income earned from the Y interest during a taxable year as to which there is an acquisition indebtedness with respect to A's and B's interests in X or the Y interest would be debt-financed income.

In this case, however, A and B have represented that there will be no acquisition indebtedness with respect to such interests during any year in which dividends from X or income from the Y interest are received by A and B. The loans made to A1, A2, B1 and B2 and for the benefit of X under the Credit Agreement are debts of A1, A2, B1, B2 and X, entities separate and apart from A and B, not debt of A and B. Under these circumstances, and except as noted below, A's and B's interest in A1, A2, B1, B2 and X will not be debt-financed property at any time during any taxable year in which dividends are received. Except as noted below, A's and B's guarantees of debt incurred by A1, A2, B1, B2 and on behalf of X under the Credit Agreement will not make A's and B's interests in A1, A2, B1, B2 and X debt-financed property.

Based on the information submitted and the representations made therein, we rule as follows:

> The distributive shares of the limited partners of A and B of dividends received from A1, A2, B1, B2 and X, in years following the year in which amounts borrowed by A and B under the Credit Agreement to make capital contributions to X and to acquire the Y interest are repaid in full, will not be debt-financed income includible in the unrelated business taxable income of the limited partners of A and B.

We are expressly not ruling with respect to income received by the limited partners of A and B in the event A or B (or their partners) are actually called upon to make payments to creditors with respect to the loan guarantees of debt of A1, A2, B1, B2 or X described above.

This ruling is based on the understanding that there will be no material changes in the facts upon which they are based.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited by others as precedent.

Please keep a copy of this ruling letter in your permanent records.

Sincerely,

Robert C. Harper, Jr.
Chief, Exempt Organizations
Technical Branch 3