



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CC:EBEO:Br5MBBlumenfeld
FREV-119358-98

August 25, 1999

MEMORANDUM FOR JAY ROTZ

OP:E:EO EXECUTIVE ASSISTANT
Attn: Charles Barrett and Robert Harper

FROM:


James L. Brokaw
Branch Chief CC:EBEO:Br5

SUBJECT: 

This responds to your memorandum of October 13, 1998 (OP:E:EO), requesting our comments on whether amounts derived from the sale of land by the  constitutes unrelated business taxable income under I.R.C. § 512(a)(1). In your memorandum, you indicate that  based on the holding in Junaluska Assembly Housing, Inc. v. Commissioner, 86 T.C. 1114 (1986), may be furthering its exempt purpose through the land sales.

ISSUE

Whether the  sale of land was substantially related to its exempt purposes?

CONCLUSION

We believe this is a relatively close case. The land sales in question do not contribute importantly to  exempt purposes and, therefore, these activities are an unrelated trade or business within the meaning of section 513 of the Internal Revenue Code. Thus, the income derived from the sales constitutes unrelated business taxable income under section 512(a)(1).

FACTS

PMTA: 01480

Pages 2-5 are withheld in full because the detailed facts and description of the entity cannot be redacted in a manner to avoid identifying the taxpayer.

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█████ for \$ ██████¹ After subtracting the cost of the land (\$ ██████), the cost of the improvements (\$ ██████) and closing costs of (\$ ██████), ██████ received net income of \$ ██████ from the sales. In ██████ sold ██████ lots for \$ ██████. The cost of the land, improvements and closing was \$ ██████, \$ ██████, and \$ ██████, respectively. There was also ██████ that cost \$ ██████. After taking these costs into account, the sales produced net income of \$ ██████.

In ██████, prior land transactions by ██████ were discussed in a technical advice memorandum. In that case, the Service concluded that frequency of the sales (████████ sold ██████ over a two-year period) was insufficient to deem lots as property sold in the ordinary course of business. Therefore, the Service ruled that sales were not subject to the unrelated business income tax because of section 512(b)(5).

The administrative file also contains a letter dated January 18, 1991 from ██████. ██████ is one of the entities that marketed and helped develop the ██████ project. The letter discusses a meeting that officers of ██████ had with ██████ concerning the development of the ██████ property. In his letter, ██████ writes that the ██████ development could be important for ██████ as it will provide "great opportunities to create a beautiful, well-planned community that can be a significant asset for the Institution, both aesthetically and financially."

ANALYSIS

Section 513 of the Internal Revenue Code provides that any trade or business of an exempt organization is an unrelated trade or business if it is regularly carried on and not substantially related (aside from an organization's fund-raising needs) to the advancement of the organization's exempt purpose. The meaning of the term "trade or business," as explained in the regulations, has the same meaning as the term has under section 162. The term, generally, covers the sale of goods or services provided to produce income. Treas. Reg. § 1.513-1(b). The issue that you asked us to consider in this case is whether the Institution's sale of land is substantially related to its exempt purposes.

To be an unrelated trade or business within the scope of section 513, a trade or business must not substantially relate to the exempt purpose or purposes of the

¹ The document lists another sale for \$ ██████. However, this sale is within the ██████ project but it was not one of ██████.

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organization. The regulations clarify that a trade or business relates to the exempt purpose only if the exercise of the trade or business activities has a causal relationship to the achievement of the exempt purpose. A causal relationship exists only if the trade or business contributes importantly to the achievement of the exempt purpose. Treas. Reg. § 1.513-1(d)(1). To determine whether the trade or business contributes importantly to the advancement of an exempt purpose, "the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve." Treas. Reg. § 1.513-1(d)(3). This determination is extremely fact sensitive and turns upon the facts and circumstances of each case. Texas Farm Bureau v. United States, 53 F. 3d 120, 125 (5th Cir. 1995).

██████████ asserts that the subdivision, improvements and sale of the lots to third parties are substantially related to its exempt purposes. In support of its position, ██████████ cites Junaluska Assembly Housing, Inc. v. Commr., 86 T.C. 1114 (1986). In that case, Junaluska Assembly Housing, Inc. ("Housing") applied to the Service for recognition as an organization exempt from taxation under section 501(c)(3). Id. at 1120. Housing was created and controlled by, Lake Junaluska Assembly, Inc. ("Assembly"), an auxiliary of the United Methodist Church ("Church") and a church itself. Id. at 1117. Assembly created Housing to construct, sell, or lease housing on 7.42 acres of land that it transferred to Housing. Id. Assembly operated and maintained grounds, including the land that it transferred to Housing, that the Church used as a gathering place of missionaries on leave, retired clergy, active laymen and pastors for religious services, religious seminars and religious training. Id. at 1118. Housing planned to construct 12 buildings containing 56 condominium units. Id. Housing maintained that it would neither advertise nor use a real estate agent to attract buyers. Id. Instead, Housing maintained that it would make the units available only to individuals involved in or supportive Assembly's activities. Id. Significantly, the court found that the current residents of Assembly's grounds served the Church by conducting worship services, teaching confirmation classes, providing counseling, etc. Id. at 1116

The court found that the housing would be sold to buyers actively involved in Assemblies activities and held that the sales substantially furthered the exempt purposes of Assembly. The court warned, however, that it would reach a different holding if it found that the sales benefitted individuals that maintained minimal involvement in the organization's activities. The court framed its analysis as follows. "If petitioner's housing units are utilized substantially for vacation or recreational purposes or otherwise by individuals who do not have active roles in the planning, organization, operation of or participation in the Assembly's programs and religious activities, then a substantial nonexempt purpose would be served . . ."

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by those sales. An important element of the holding was the fact that Housing did not advertise to find buyers. Moreover, Housing screened prospective buyers to ensure that they would take an active role in Assembly's activities. Another factor was a concession by the Service that the housing units were in fact sold to alleviate a shortage of permanent housing for individuals involved in Assembly's activities. *Id.* at 1125, note 7. In addition to the screening, the court found that Housing imposed sufficient controls designed to attract property owners that would contribute importantly to Assembly's exempt purpose. For instance, the buyers in the event of a resale would be required to offer the housing unit to Assembly at the owner's lowest acceptable price. In addition, each subsequent buyer would take the property subject to Assembly's right of first refusal. Another important factor, in the court's opinion, was if a housing unit was leased, Assembly served as the rental agent. Finally, the court stated that Housing was not in competition with commercial developers since it was conducting its activities on property that it purchased from the Auxiliary to promote increased religious activities on the grounds.

██████████ asserts that the acquisition furthers its purposes by bringing people within its grounds as a place of meeting. Like *Junaluska*, ██████████ argues that the housing units enable it to bring in more people to participate in its educational programs. According to ██████████ no person would attempt or even consider purchasing a lot or house unless their principal intent was to become a member of ██████████ and a participant in its activities. ██████████ maintains that the high prices of the lots within its grounds, compared with those just outside its gates, and the limitations and restrictions placed on the construction and utilization of the property, showed that buyers are willing to sacrifice to be part of ██████████ community and participate in its activities.

The holding in *Junaluska* cited by ██████████ in support of its position is, we believe distinguishable from this case. The *Junaluska* decision was principally based on the court's finding that the condos would be sold to individuals actively involved in Junaluska's activities. Key to the holding, was the questionnaire the organization used to screen prospective purchasers. An organization should show that a trade or business has a substantial connection to its exempt purpose to avoid an "unrelated" classification. There was no indication in the *Junaluska* opinion that the real estate was marketed in a manner designed to maximize its sales price. Furthermore, the court emphasized that it would reach an opposite holding if the condos were used as vacation properties. In this case, to the contrary, ██████████ marketed the properties in a manner designed to attract the highest bid. The file also contains evidence that ██████████ emphasized its vacation qualities to attract prospective buyers. Finally, the file indicated that ██████████ acquired and sold the land, primarily, to raise funds. By its own words, ██████████ states

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that "funds from the land assets will combine to underwrite the goals of the decade."

Consequently, we find no compelling reason to conclude that the sales of the lots in question contribute importantly to [REDACTED] exempt purposes. Nevertheless, we do acknowledge that the file contains evidence that one of the purposes of the sales was to increase [REDACTED] potential clientele. However, the relationship between the sale of lots for single family homes and [REDACTED] goal of increasing attendance is somewhat tenuous. While the sales may slightly increase the [REDACTED] attendance base, no substantial causal relationship exists between the land sales and provision of, or even the participation in, [REDACTED] educational programs. [REDACTED] did not select buyers based upon their anticipated involvement in [REDACTED] activities. Rather, the sole criterion appears to be the amount of the buyer's offer. The fact that the eventual owners would have to buy a gate pass, during the summer season, to enter their properties is inconsequential. Many homeowner associations require similar fees. Furthermore, the Junaluska court indicated that it would reach a contrary conclusion if the condos were sold to individuals that merely contributed financial support to the Assembly. *Id.* at 1123, note 5. In our opinion, any benefit to [REDACTED] educational mission through the land sales is ancillary to the principal purpose of the sales, raising funds. The lots were marketed by [REDACTED] and its agents in a manner designed to maximize sales price. This is different from a situation where a university acquires and develops land because it lacks sufficient housing for its students. Offering purchasers to partake incidentally in [REDACTED] educational and cultural programs does not convert the business of selling land into an educational endeavor. [REDACTED] that the sales of land, in this case, constitute an unrelated trade or business.

With this memorandum we are returning your administrative file. If you have any questions about our conclusion or if you should need further assistance, please contact Michael Blumenfeld at 622-6070.

Attachment (1)