



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Release Number: **201122025**

Release Date: 6/3/2011

Date: March 8, 2011

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL: 501.03-00; 512.00-00

Legend:

P =

N =

O =

M =

Dear _____ :

This is in response to your request dated June 28, 2010, for certain rulings as to the federal income tax consequences of a proposed sale of real property.

Facts:

You are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code ("Code") and you are classified as an organization described in sections 509(a)(1) and 170(b)(1)(A)(ii) of the Code.

You were created as a charitable trust under the will of N to establish and support O for education of the people of P. You currently educate large numbers of individuals annually. It was N's desire that you maintain the bequest of real property intact, selling property only when it was absolutely necessary. You still own most of the original bequest from N.

Your assets include property held for both charitable and non-charitable purposes. Property held for non-charitable purposes includes income-producing real property and securities held to provide for the continued maintenance and support for your charitable activities. At the end of your most recent fiscal year, your income was insufficient to fund your educational programs, requiring you to tap your reserve fund, defer planned capital improvements and repairs, and reduce overall administrative costs to make-up for this shortfall. A state authority that monitors your activities has recommended that you review and evaluate the advantages and disadvantages of diversification of your extensive real property holdings in light of your mission and goals. As such, you have identified a total of eight commercial real estate parcels that you propose to liquidate.

M is one of the eight parcels you have identified for liquidation. M is the only parcel that is the subject of this ruling request and any ruling rendered herein only pertains to M and not to any other parcel that may be discussed throughout this ruling. M was acquired by deed and you have held it for several decades. M is a parcel of land that is leased to the current commercial lessee, with the original ground lease amended and assigned to the current lessee. Although M is improved, the improvements were made by the previous commercial lessee, and the current lessee is required to make renovations to the improvements. The improvements are owned by the current commercial lessee. Your liquidation of M only entails the underlying leased-fee interest in the land and improvements, subject to the long-term ground lease. You have neither made any improvements to M, nor do you intend to make any improvements to M, with M being sold on an “as-is” basis.

You intend to offer M for sale to its current lease holder. Your marketing activities would consist of sending an offer letter to the lease holder, followed by an initial non-binding term sheet negotiated by you. Ultimately a formal purchase and sale agreement would be executed. The agreement would be based on standardized form term sheets and agreements. All sales will be cash sales, as you would neither offer a purchase-money mortgage nor accept an installment-sales contract. All sales will be on an “as-is” basis, and will not be sold to a party related to you. You will not repurchase M in the future. Should the lease holder decline your offer, you will undertake similar steps with respect to other strategic buyers, such as neighbors, who are familiar with the property and have a long-term interest in the area. If unsuccessful, you may seek non-strategic buyers and utilize the services of a broker. At all times, your marketing activities will be the minimum necessitated by the circumstances. Furthermore, potential buyers must agree that all sales terms are subject to final approval by your trustees, so as to verify sales are in accordance with both your tax-exempt purpose and the recommendations of the state authority that monitors your activities.

Although M is the subject of this ruling, you plan to liquidate a total of eight parcels of commercial real property, including M, to meet your educational funding requirements and asset diversification goals. You intend to liquidate all eight parcels within the next year. The size, frequency, and continuity of your total projected sales, consisting of the eight parcels including M, will be considered in this ruling only as to the affect they have upon the liquidation of M. This ruling does not address how the remaining seven sales will be treated under the Code. You may choose to request a ruling or rulings with respect to the remaining sales at a later time.

Rulings Requested:

1. Your sale of the leased-fee underlying M will not affect your status as an organization described in section 501(c)(3) of the Code.
2. Your sale of the leased-fee underlying M will not be treated as a sale of property held “primarily for sale to customers in the ordinary course of [a] trade or business” within the meaning of section 512(b)(5) of the Code and as such the sale proceeds will not be subject to the tax on unrelated business taxable income.

Law:

Section 501(a) of the Code generally provides an exemption from federal income taxation for any organization described in section 501(c)(3) of the Code.

Section 501(c)(3) of the Code provides in part for the exemption of organizations that are organized and operated exclusively for educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Treasury Regulations ("regulations"), states that for an organization to be exempt under section 501(c)(3), it must be operated exclusively for one or more of the purposes specified in such section.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for an exempt purpose only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(e)(1) of the regulations provides, in part, that an organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business as defined in section 513.

Section 511(a)(1) of the Code imposes a tax on the unrelated business taxable income of certain tax-exempt organizations, including charitable and educational organizations described in section 501(c)(3).

Section 512(a)(1) of the Code defines "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as defined in section 513(a)) regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b)(5) of the Code excludes from the computation of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business.

Rev. Rul. 55-449, 1955-2 C.B. 599, holds that the construction and sale of 80 houses by a foundation otherwise exempt under section 501(c)(3) of the Code over a period of 18 months for the sole purpose of raising funds for the support of a church constituted an unrelated trade or business within the meaning of section 513 because construction and sale of houses is a business of a kind ordinarily carried on for profit.

Rev. Rul. 59-91, 1959-1 C.B. 215, holds that where a taxpayer engages in extensive land development activities, such as lot subdivision, installation of utilities, and paving streets, all in

order to facilitate the sale and derive the maximum proceeds from the disposition of the property, the taxpayer is holding property for sale to customers in the ordinary course of trade or business.

In Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), the taxpayer owned 500 acres of unimproved land used for grazing purposes. To facilitate the sale of land, the taxpayer subdivided the land into lots, built streets, installed storm sewers, constructed gas and electric lines and undertook other activities of the kind usually carried out by a real estate development company. Each year 20 to 30 lots were sold. The court held that taxpayer was holding lots for sale to customers in the regular course of business.

In Farley v Commissioner, 7 T.C. 198 (1946), the taxpayer purchased platted land to use in his nursery business. Twelve years later, the city built streets through the property that made it less useful for his business. Even though taxpayer made no active sales effort and made no improvements, taxpayer sold 26 and a half lots in one year. The court opined that the sales were essentially made "in the nature of a gradual and passive liquidation of an asset" and not in the ordinary course of a trade or business.

In Malat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), the Supreme Court defined the standard to be applied in determining whether property is held primarily for sale to customers in the ordinary course of business. The Court interpreted the word "primarily" to mean "of first importance" or "principally." By this standard, ordinary income would not result unless a sales purpose is dominant.

In Mauldin v. Commissioner, 195 F.2d 714 (1952), the taxpayer initially purchased land not for resale to customers, but throughout the years subdivided the land and resold parcels sporadically, primarily as the market dictated. The court indicated that the taxpayer engaged in continuous sales and concluded that the property was held primarily for sale to customers as part of the taxpayer's business. The court stated that "[t]here is no fixed formula or rule of thumb for determining whether property sold by the taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business. Each case must, in the last analysis, rest upon its own facts. There are a number of helpful factors, however, to point the way, among which are the purposes for which the property was acquired, whether for sale or investment; and continuity and frequency of sales as opposed to isolated transactions."

In Adam v. Commissioner, 60 T.C. 996 (1973), acq. in result, 1974-2 C.B., the Tax Court held that a taxpayer who purchased 11 parcels and sold 9 parcels of undeveloped land over four years was not engaged in the trade or business of buying and selling land for purposes of section 1221 of the Code. The taxpayer utilized brokers to aid him in disposing of some of the land. However, neither the taxpayer nor the brokers ever sought out or solicited prospective buyers or advertised the properties for sale. The court analyzed the following factors to determine that the taxpayer was not engaged in the operation of the trade or business of buying and selling land:

- (1) the purpose for which the property was acquired;
- (2) the frequency, continuity, and size of the sales;
- (3) the activities of the owner in the improvement and disposition of the property;
- (4) the extent of improvements made to the property;
- (5) the proximity of sale to purchase; and
- (6) the purpose for which the property was held.

In Adam and subsequent cases, courts have found that no one of these factors is controlling but all are relevant to consider in determining whether the sale of property occurred in the regular course of a taxpayer's trade or business.

Analysis:

The issue in this case is whether the sale of M will be treated as a sale of property held "primarily for sale to customers in the ordinary course of [a] trade or business" within the meaning of section 512(b)(5) of the Code. Whether real property is held "primarily" for sale to customers in the ordinary course of an organization's trade or business is a facts and circumstances determination. See Mauldin v. Commissioner, *supra*, and Adam v. Commissioner, *supra*. In Malat v. Riddell, *supra*, the Court interpreted the meaning of the word "primarily" to mean "of first importance or principally."

You received M by deed many years ago. You have held M for a long period as an income-producing asset to fund your charitable activities. However, a state authority that monitors your activities has recommended that you review and evaluate the advantages and disadvantages of diversification of your extensive real property holdings in light of your mission and goals. Due to an increased need for educational funding and asset diversification for long-term asset stabilization, you desire to liquidate M. The time span between the initial deed of M to you and its projected sale is several decades. The long duration you held M is not a typical characteristic of a taxpayer holding property "primarily" for sale to customers in the ordinary course of its trade or business.

M is a parcel of land that is leased. The original ground lease pertaining to M was amended and assigned to the current lessee. Although M is improved, the improvements were made by the previous commercial lessee and the current lessee is required to renovate the improvements, with M sold by you on an "as is" basis. The improvements are owned by the current commercial lessee. Your liquidation of M only entails the underlying leased-fee interest in the land and improvements, subject to the long-term ground lease. As such, you have not performed nor plan to perform any development or improvement activities pertaining to M.

With respect to your activities in marketing M, your efforts will be restricted to offering M to the current lessee under a standard offers and terms agreement. Should the current lessee decline, you will make the same offer to strategic buyers, such as neighbors, who are familiar with the property and have a long-term interest in the area. Absent sales to these buyers, you may utilize a broker to offer M for sale to other parties and to negotiate the sale on your behalf. Thus, your activities with respect to marketing M will be limited, particularly if the current lessee agrees to purchase M.

We also consider the frequency, continuity and size of sales when determining whether an organization is holding property “primarily” for sale to customers in the ordinary course of a trade or business. Your ruling request pertains only to the sale of M. If considered in isolation, the sale of M could not be considered frequent or continuous because it is a one-time sale. However, because you intend to liquidate a total of eight parcels, including M, we must consider the entire group of eight parcels when considering the frequency, continuity and size of your projected total sales and how they affect the liquidation of M. Nevertheless, this ruling does not address how the remaining seven sales will be treated under the Code.

Your facts are distinguishable from those in Rev. Rul. 55-449, supra, in which a foundation constructed and sold 80 houses over a period of 18 months for the sole purpose of raising funds to support a church. They are also distinguishable from the facts in Brown v. Commissioner, supra, in which a taxpayer subdivided and developed property for the purpose of selling the property, then sold 80 lots. In both of these cases, the taxpayers’ efforts in acquiring and developing the properties for sale suggested that they were holding the property primarily for sale to customers in the ordinary course of a trade or business. In contrast, you propose to liquidate one property out of a total of eight. This property was received by deed and has been held for a very long time, and you plan to sell the property with no development or improvement activities, and with minimal marketing activities.

Accordingly, under the primary purpose test of Malat v. Riddell, supra, and the facts and circumstances test of Adam v. Commissioner, supra, we conclude that you do not hold your interests in M primarily for sale to customers in the ordinary course of a trade or business. Therefore, your sale of M will not generate unrelated business taxable income under sections 511 and 512(b)(5) of the Code, and will not adversely affect your exempt status under section 501(c)(3).

Conclusion:

1. Your sale of the leased-fee underlying M will not affect your status as an organization described in section 501(c)(3) of the Code.
2. Your sale of the leased-fee underlying M will not be treated as a sale of property held “primarily for sale to customers in the ordinary course of [a] trade or business” within the meaning of section 512(b)(5) of the Code and as such the sale proceeds will not be subject to the tax on unrelated business taxable income.

However, this ruling does not address the issue as to whether your sale of any additional parcels of real property, other than M, will be treated as a sale of property held “primarily for sale to customers in the ordinary course of [a] trade or business” within the meaning of section 512(b)(5) of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Theodore R. Lieber
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437