TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Contact Person:

Number: **201422027**
Release Date: 5/30/2014

Date: March 6, 2014

Identification Number:

UIL: 512.00-00
512.01-02
513.00-00
514.00-00
4943.00-00
4943.04-03

Telephone Number:

Employer Identification Number:

Legend:

Grantor/Trustee =
Apartment complex =
X =
Y =

Dear :

We have considered your ruling request regarding a transfer of assets from a disqualified person to a private operating foundation and whether it will result in excess business holdings under I.R.C. § 4943 or unrelated business taxable income ("UBTI") pursuant to § 512.

Facts:

You are recognized as exempt from Federal income tax under § 501(c)(3) and classified as a private foundation within the meaning of § 509(a)(1). You are a private operating foundation created pursuant to an irrevocable trust executed and created by the Grantor to award and fund college scholarships. The Grantor of the trust is your Trustee and substantial contributor.

Grantor owns Apartment complex and you represent that the property is not subject to any liens or indebtedness. Grantor intends to transfer ownership of the Apartment complex to you as a donation and without charge. You intend to hold and operate the Apartment complex. The Apartment complex is comprised of several hundred rental apartments and is typically fully rented. The Apartment complex annually generates several million dollars in net rental income.

City ordinances require the Apartment complex to provide two off-street parking spaces per apartment unit. None of the parking is available to the general public. Monthly rent for the tenants of Apartment complex includes some utilities, including cable TV and internet services that are provided to all units through the complex's proprietary system. Surface parking is provided at no additional charge in the basic monthly rent. Nearly all apartments are furnished with washers and dryers at no additional charge. The Apartment complex also provides coin-operated washers and dryers on-site for use of tenants without in-home laundry. Approximately one-quarter of the apartments use surface parking, while three-quarters of the apartments are designed with carports. While the Apartment complex does not record parking as a separate revenue stream, you estimated that the monthly revenue for the parking and coin laundry represents less than one percent of your gross revenue.

Requested Ruling:

Income from the operation of Apartment complex will fall within the definition "rent from real property" as provided in § 512(b)(3) for the purpose of it being excluded from unrelated business taxable income under § 511 and for the purpose of being excluded from the definition of "business enterprise" subject to taxation on excess business holdings under § 4943.

Law:

I.R.C. § 501(a) provides that an organization described in §§ 501(c) or (d) or 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under § 502 or 503.

I.R.C. § 501(c)(3) provides for the exemption from federal income tax of organizations that are organized and operated exclusively for charitable and educational purposes, no part of the net earnings of which inures to the benefit of any individual.

I.R.C. § 511 imposes a tax on the unrelated business taxable income (as defined in § 512) of organizations described in § 501(c) as exempt from taxation by reason of § 501(a).

I.R.C. § 512(a)(1) defines "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

I.R.C. § 512(b)(3) generally exempts from unrelated business taxable income rents from real property.

I.R.C. §§ 512(b)(4) and 514 generally impose income tax, notwithstanding the exception for rents under section 512(b)(3), on unrelated business taxable income from debt-financed property.

I.R.C. § 513(a) defines "unrelated trade or business" with regard to any organization subject to the tax imposed by § 511, as any trade or business the conduct of which is not substantially

related (aside from the need of such organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501, with certain exceptions.

I.R.C. § 513(c) provides that for purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

I.R.C. § 514 explains the special unrelated business tax rules for property that has been debt financed.

I.R.C. § 4943 imposes tax on a private foundation's excess business holdings in a business enterprise.

I.R.C. § 4943(c)(1) defines "excess business holdings," with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

I.R.C. § 4943(d)(3)(B) provides that "business enterprise" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources.

Treas. Reg. § 1.512(b)-1 provides that whether a particular item of income falls within any of the modifications provided in § 512(b) shall be determined by all the facts and circumstances of each case.

Treas. Reg. § 1.512(b)-1(c)(2)(ii) in part, excludes the following rents from unrelated business income under § 512(b)(3)(A) --- real property and personal property (as described in § 1245(a)(3)(B)) leased with real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease.

Treas. Reg. § 1.512(b)-1(c)(5) provides that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

Treas. Reg. § 1.513-1(a) defines unrelated business taxable income as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in § 512 ... unless one of the specific exceptions of § 512 or § 513 is applicable, gross income of an exempt organization subject to the tax imposed by § 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Treas. Reg. § 1.513-1(b) states in general that any activity of an organization subject to § 511 which is carried on for the production of income and which otherwise possesses the characteristics required to constitute trade or business within the meaning of § 162 --and which, in addition, is not substantially related to the performance of exempt functions-- presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of § 513 the term trade or business has the same meaning it has in § 162 and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Treas. Reg. § 53.4943-3(c)(3) specifies that a private foundation may not have any holdings in a sole proprietorship.

Treas. Reg. § 53.4943-10(a)(1) provides generally, that under § 4943(d)(3) the term "business enterprise" includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under § 513.

Treas. Reg. § 53.4943-10(c)(1) states that for purposes of § 4943(d)(4), the term "business enterprises" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources.

Treas. Reg. § 53.4943-10(c)(2) provides that gross income from passive sources, for purposes of this paragraph, includes the items excluded by §§ 512(b)(1) (relating to dividends, interest, and annuities), 512(b)(2) (relating to royalties), 512(b)(3) (relating to rent) and 512(b)(5) (relating to gains or losses from the disposition of certain property). Any income classified as passive under this paragraph does not lose its character merely because § 512(b)(4) or § 514 (relating to unrelated debt-financed income) applies to such income.

Analysis:

You requested two rulings concerning your acquisition of the Apartment complex. First, that the Apartment complex is excluded from the definition of a business enterprise subject to tax under § 4943 and secondly, that income from its operation will fall within the definition of "rent from real property" in § 512(b)(3) and thereby be excluded from the unrelated business income tax imposed by § 511.

Is the Apartment complex excluded from the definition of a business enterprise subject

to tax under § 4943?

Section 4943 imposes a tax on the excess business holdings of any private foundation in a business enterprise. Subsequent to the transfer of the Apartment complex from Grantor/Trustee to you, you plan to hold the entire income-producing property as a sole proprietorship. A private foundation generally cannot operate a business enterprise, other than a functionally-related enterprise or a business otherwise exempt, as a sole proprietorship, because such a holding, by definition, entails a 100 percent ownership precluded by the private foundation rules. § 4943(c)(3)(B); § 53.4943-3(c)(3). This would constitute excess business holdings subject to § 4943 excise tax if the Apartment complex were a business enterprise.

The term "business enterprise" in § 4943(d)(3) is defined by § 53.4943-10(a)(1) to include the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under § 513. However, the Internal Revenue Code carves out an exception for enterprises that generate passive income. § 4943(d)(3)(B), § 53.4943-10(c)(1). The term "business enterprises" does not include a trade or business that derives at least 95 percent of its gross income from passive sources. Rents from real property and incidental rents from personal property leased with the real property, are identified as "passive sources." § 53.4943-10(c)(2).

Your operation of Apartment complex will not constitute the operation of a business enterprise subject to the excess business holdings limitations of § 4943 if at least 95 percent of its gross income is passive. Whether a particular item of income falls within the modifications of § 512(b), such as rents from real property, or incidental rents from personal property leased with the real property, described in § 512(b)(3), depends on all of the facts and circumstances of the particular case. § 1.512(b)-1.

The Apartment complex provides some utilities in the basic monthly rent, including cable TV and internet. Including utilities in rent is a common practice in apartment complexes, where individual metering for water, gas, or electricity, and wiring for individual cable may not be available. Apartment complex supplies washers and dryers in most apartments, an example of incidental personal property leased with the real property.

The complex also provides a small number of coin-operated machines on-site for use by tenants without in-apartment units. You have stated that the income from the coin laundry averages 0.16% of gross income per year over a three-year period.

City ordinances require Apartment complex to provide at least two off-street parking spaces for each rental unit. The complex provides off-street parking for all x rental units. Covered parking comes with y units, for which there is a small additional charge in the rent. Surface parking is supplied to the other units at no additional charge. No parking spaces are available for rent to the general public. You have stated that the income from carport parking averages 0.14% of gross income per year over a three-year period.

Whether income from the coin laundry or the upcharge for carport parking is unrelated taxable

income will be discussed below. For purposes of § 4943 defining excess business holdings, even if we deem laundry and carport revenues **not** to be rents from real property, Apartment complex still generates more than 95% of its gross income from rents from real property, because you have stated that the revenue from the laundry and carport together only comprise 0.30% of the gross income from the Apartment complex. Therefore, Apartment complex is not a business enterprise pursuant to § 4943(d)(3)(B). Income from the operation of Apartment complex will not be subject to tax on excess business holdings under § 4943.

Does income from the operation of Apartment complex fall within the definition of "rent from real property" in § 512(b)(3,) thereby excluding it from unrelated business income tax under § 511.

An organization described in § 501(c)(3) that provides services for a fee will have unrelated trade or business taxable income if it meets the three conditions in § 1.513-1(a). The income must be from a trade or business, the trade or business must be regularly carried on, and the trade or business must not be substantially related to the organization's performance of its exempt function. The term "trade or business" generally includes any activity carried on for the production of income from the sale of goods or performance of services. § 1.513-1(b).

You have stated that you will hold and operate the Apartment complex indefinitely. Your request for ruling assumes that operating an apartment complex is an ordinary trade or business, as it is an activity carried on for the production of income from the performance of services, here leasing residential space, and that the activity will be regularly carried on. You do not assert that the activity is related to your exempt purpose, except for the revenue that it contributes to the scholarships you grant. You state that the issue is whether the revenue from this enterprise is rent from real property, excluded from the tax on unrelated business income by § 512(b)(3).

Income from rental of real property is excluded from the tax on unrelated business income by § 512(b)(3), unless the real property is subject to debt financing. §§ 514 and 512(b)(4). Here, the Grantor/Trustee is donating the property to you free and clear of any indebtedness. Because the Apartment complex is not subject to debt financing, income generated by rental of the Apartment complex itself will not be UBTI subject to tax by § 512(b)(4).

Whether income from the coin laundry or the apartment rental upcharge for carport parking is unrelated taxable income is a separate discussion. The regulations list examples of services provided in connection with the rental of space for occupancy which may be considered incidental to the lease of real property, and, thus, excluded from UBTI. § 1.512(b)-1(c)(5). However, services provided to occupants for their convenience, prevent the income from meeting the definition of rent from real property. Income in that case is UBTI, because it is not rent from real property.

According to this regulation, supplying maid service constitutes a service to an occupant for his convenience (as in a hotel), so income from a hotel room generates UBTI. In contrast, cleaning public areas of a multi-family residence or office building, or furnishing heat and light, and collecting trash are not considered services rendered to a particular occupant. These are

services provided for all tenants and visitors to a leased property and are required for the general maintenance and upkeep of the property. Occupancy of space in buildings providing such generalized services generates untaxed rental income from real estate.

Your city ordinances require off-street parking be provided to **all** residents of a residential complex as a condition of issuing an occupancy permit. Parking space is incidental to occupancy. Renters cannot opt out or lease these parking facilities to non-residents. However, some apartments come with designated carport parking spaces for which a small additional charge is added to the monthly rent. No personal or special services are provided with the parking spaces, whether covered or not. The roof on the carport is not a special service for the convenience of the occupant, but a characteristic of the real property. No services, such as a security guard, are provided, and covered spots are charged only a minimal monthly amount in the set rental rate. Therefore, any incidental payment for parking is excluded from UBTI as rent from real property.

In contrast, Apartment complex does actively operate a business --- the on-site coin-operated laundry facilities. While not uncommon in a residential complex, it is a service for the convenience of the renters whose units do not include washers and dryers. Residents could use commercial laundry and cleaning establishments off-site. It is more convenient for residents to have laundry facilities on-site, and Apartment complex generates income from the coin-operated machines in direct relationship to usage of the service. This income is unrelated business taxable income pursuant to § 512(a)(1) from which allowable deductions directly connected with carrying on such trade or business may be subtracted. § 512(a). If you continue to operate the coin-operated laundry facilities in the same manner once Apartment complex is donated to you, such revenue would be UBTI from which allowable deductions may be subtracted, as noted above.

Rulings:

1. Apartment complex is not a business enterprise and your ownership and operation of Apartment complex does not represent excess business holdings under § 4943.

2. Income from operation of the Apartment complex, including revenue attributable to parking spaces, falls within the definition of "rents from real property" and is not unrelated business taxable income subject to tax.

3. Income from the coin-operated laundry facilities provided on-site by Apartment complex, if operated in the same manner as described above, is not "rents from real property," but is unrelated business taxable income subject to tax pursuant to § 512.

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,

Mary Jo Salins
Manager, Exempt Organizations
Technical Group 4

Enclosure
Notice 437