INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM

MAY 13 2014

Internal Revenue Service
Attn: EO Mandatory Review
MC 4920 DAL
1100 Commerce Street
Dallas, TX 75242

Number: **201438034**
Release Date: 9/19/2014

Taxpayer's Name: UIL Number: 501.03-05

Taxpayer's Address:

Taxpayer's ID No.:

Year(s) Involved:

Conference Held:

LEGEND:

Taxpayer	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
State 1	=

This memorandum responds to a request dated April 13, 2006, from TEGE Exempt Organizations Examinations for technical advice on the issues as presented below. Our findings are set forth below.

Issues

1 Is Taxpayer still an exempt organization under I.R.C. § 501(c)(3)?

2 If it still is exempt under § 501(c)(3), is it a school, another type of public charity, or a private foundation?

3 If it is a private foundation, is it a private operating foundation?

4 If it still is an exempt organization, does it have unrelated debt-financed income?

Facts

Taxpayer is a non-profit corporation incorporated in State 1. In Year 1 Taxpayer was recognized as exempt from federal income tax under § 501(c)(3) and as a public charity described in § 170(b)(1)(A)(ii). At the time of application, Taxpayer operated a private school; however its predominant activity became that of purchasing or leasing buildings, renovating the buildings, and leasing the buildings to unrelated non-exempt charter schools.

In Year 2, State 1 enacted a statute allowing for the creation of charter schools. Thereafter, Taxpayer modified its organizing documents and changed its purposes to include the ability to own and lease school facilities in specified areas of State 1 and other locations. Also, Taxpayer changed its activities. Instead of operating a private school, Taxpayer began assisting in the creation of charter schools first in State 1 and later in additional states. It formed new non-profit corporations and helped them to obtain charter school contracts. It also began acquiring facilities and leasing them to these charter schools.

In Year 4, Taxpayer was examined for fiscal year Year 3. Year 3 was several years before the current exam period. During that examination, Taxpayer was no longer operating a private school and instead was engaged primarily in leasing school facilities. Nonetheless, Taxpayer continued to claim public charity status as a school on its Forms 990. The examination of Year 3 was concluded with Taxpayer's receiving a "no change" letter.

Based on the documents submitted it appears that during the current exam period of Year 5, Year 6, and Year 7 Taxpayer's primary activity was the purchase or lease of school buildings that it then renovated, leased, and sub-leased to the charter schools. It served as landlord to 17 non-profit organizations that it had created. It charged rents based on the square footage of the property, using a fee slightly below what other landlords charge for similar properties. Taxpayer, in its capacity as lessor, supplied nothing more than the usual and customary landlord services such as janitorial assistance. Also, during the examination period, none of the corporations that leased property from Taxpayer had tax-exempt status. Subsequently, at least one of these corporations received recognition of exemption, although most of them remained not recognized as exempt. Taxpayer claimed public charity status as a school on its 990s during this time.

Also, during the exam period, Taxpayer operated an educational summer camp for nine weeks during the examination period. It generated income totaling approximately one-tenth of one percent (0.1%) of Taxpayer's total gross rental income.

Taxpayer described its evolution from a single private elementary school to a developer of school facilities:

> Its method of performing this mission has changed dramatically over time. [Taxpayer] once owned and administered schools in the [local] area, serving several hundred students. It now provides assistance, in various forms, to charter schools in six states, serving ten thousand students.

Another communication from Taxpayer regarding its activities states:

> [Taxpayer] started as an organization conducting schools. Pursuant to its initial purposes in its Articles of Incorporation, [Taxpayer] also locates buildings

suitable for schools, and purchases and leases buildings to charter schools. It is, thus, performing an activity indirectly that the charter schools could perform directly. It supports the charter schools in this manner.

Taxpayer's board was not composed of independent members. During the first year of the audit, there were two officers, married to each other, and one director. The next year, according to the Form 990 filed by the Taxpayer, it had five directors, two of whom shared the last name of the president and vice-president. During the last year of the audit, a business partner of the president and vice-president joined the board. All directors were paid.

Law

I.R.C. § 170(b)(1)(A)(ii) defines an educational organization as one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

I.R.C. § 501(c)(3) provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable or educational, or other recognized purposes.

Treas. Reg. § 1.103-1(b) provides the term "political subdivision" denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

Treas. Reg. § 1.501(c)(3)-1(a)(1) provides that, in order to be recognized as exempt from federal income tax under § 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section.

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

Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) provides that the term "educational" means the instruction or training of the individual for the purpose of improving or developing his capabilities or the instruction of the public on subjects useful to the individual and beneficial to the community.

Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii), Example 1, lists the following as examples of educational organizations under § 501(c)(3): a primary or secondary school, a college, or a professional or trade school which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Treas. Reg. § 1.502-1(b) provides that a subsidiary organization of a tax exempt organization may be exempt on the ground that the activities of the subsidiary are an integral part of the exempt activities of the parent organization. However, the subsidiary is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business if regularly carried on by the parent organization.

In Rev. Rul. 58-547, 1958-2 C.B. 175, a charitable foundation built a school building for a nursery school and leased the building to the nursery school. Both the charitable foundation and the nursery

school were tax-exempt under § 501(c)(3). The lease of property under ordinary commercial arrangements does not constitute the exercise of an educational or charitable function in and of itself. The ruling held that a lease by an exempt organization will not be considered substantially related to the exempt purpose of the lessor, solely because the lessee is an also an exempt organization.

Rev. Rul. 69-572, 1969-2 C.B. 119, found that an entity organized to construct and maintain a building on city land to house member organizations of a local community chest, with subsidy from the city, that paid nominal rent to the city, was operating for an exempt purpose. The construction was financed by contributions from the general public and non-interest bearing obligations to other charitable organizations. It distinguished Rev. Rul. 58-547 because the building supported the community chest by improving communications, facilitated coordination, made more efficient use of voluntary labor, and supported them with below cost rent and the exclusive use of the premises.

In Rev. Rul. 72-369, 1972-2 C.B. 245, an organization was formed to provide managerial and consulting services for nonprofit organizations exempt under § 501(c)(3) to improve the administration of their programs on a cost basis. An organization is not exempt merely because its primary activity and operations are not carried on for profit. The fact that services are provided at cost solely to exempt organizations is not sufficient to characterize an activity as charitable within the meaning of § 501(c)(3).

Commissioner v. Shamberg's Estate, 144 F.2d 998 (2nd Cir.1944), *cert. denied* 323 U.S. 792, 65 S. Ct. 433, 89 L. Ed. 631 (1945), found that the New York Port Authority was a political subdivision of the states of New York and New Jersey because it was created by a contract between the two states and maintained many sovereign powers including the power of eminent domain and police power. The Court defined power police as, "the preservation of the health, morals, or safety of the inhabitants of a community." The organization's police power consisted of the power to subpoena, the power to issue orders and enforce orders against persons within its jurisdiction, and the power to maintain a uniformed police force.

Commissioner v. White's Estate, 144 F.2d 1019, 1021 (2d Cir. 1944), found that the Triborough Bridge Authority was a political subdivision of the State of New York. The Authority was formed by state legislation. This legislation also delegated to the Authority powers to operate and maintain the toll bridges.

In Better Bus. Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Supreme Court held "that the presence of a single non-educational [exempt] purpose, if substantial in nature, will destroy the exemption [under § 501(c)(3)] regardless of the number or importance of truly educational [or other exempt] purposes."

Seagrave Corp. v. Commissioner, 38 T.C. 247 (T.C. 1962), the court found the volunteer fire departments were not political subdivisions. The court stated conceded that the fire departments "perform[ed] a public function in the sense that they perform[ed] the same function that is generally carried on by municipal fire departments." However, in reaching its conclusion, the court highlighted, "The relations between the fire companies and the municipalities they serve are purely voluntary. No power of the State could compel them to render any services and the State, or its political subdivision, the municipality, could not be compelled to accept their services. They are free associations created by the voluntary acts of their incorporators, and not by any legislative action. They can be dissolved at the will of the corporate members."

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352, 357-358 (1978), the Tax Court held that when considering whether an organization qualifies for exemption under § 501(c)(3) (citations omitted):

> [T]he critical inquiry is whether petitioner's primary purpose for engaging in its sole activity is an exempt purpose, or whether its primary purpose is the nonexempt one of operating a commercial business producing net profits for petitioner. Factors such as the particular manner in which an organization's activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits are relevant evidence of a forbidden predominant purpose.

An organization's activities further a substantial non-exempt purpose and are presumptively commercial when the organization: competes directly with similar for profit businesses, uses profit-making formulas, engages in substantial advertising, has hours of operation are competitive with commercial enterprises, and lacks a plan to solicit donations. Living Faith, Inc. v. Commissioner, 950 F.2d. 365, 373-374 (7th Cir. 1991).

Texas Learning Technology Group v. Commissioner, 958 F. 2d 122 (1992) upheld decisions of the Commissioner and the Tax Court that an organization established to administer programs on behalf of eleven public school districts was not a political subdivision. First, it argued that it was a political subdivision on its own merits, specifically that its power to administer curricula for school districts constituted sovereign police power and its power to collect fees from school districts for constituted a sovereign assessment power. The court rejected this argument. Second, the organization argued that it should be classified as a political subdivision because it was an "integral part" of political subdivisions. The court responded, "To bestow political subdivision status on an entity, merely because it is an integral part of a political subdivision, would bypass the requirement that a political subdivision must be authorized to exercise some sovereign power. We refuse to throw out the sovereign power requirement for political subdivision status. Therefore, we find the 'integral part' cases inapplicable to a determination of political subdivision status." Id. at 127.

Council for Bibliographic and Info. Tech. v. Commissioner, 63 T.C.M. (CCH) 3186 (1992), involved an organization that provided solely bibliographic information and related computer support exclusively to its tax-exempt member libraries. The organization's activities were necessary and indispensable to the operations of its tax-exempt members. The court concluded that because the organization's activities bore a close and intimate relationship to the functioning of its tax-exempt members, it qualified for exemption as an educational institution under § 501(c)(3).

Analysis

Congress has granted exemption from federal income taxation under § 501(c)(3) to certain organizations that are organized and operated exclusively for exempt purposes. The presence of a single non-exempt purpose, if substantial in nature, will preclude exemption, regardless of the number or importance of exempt purposes. Better Bus. Bureau of Washington, D.C, 326 U.S. at 283.

Operating a school by maintaining a regular faculty and curriculum for a body of enrolled students is a well-recognized exempt purpose. See Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii), Example 1. Although Taxpayer operated a school in its initial years, it did not do so during the exam years. During this time, Taxpayer did not employ faculty, design curriculum, nor instruct students. Rather, Taxpayer's primary activity was financing, purchasing, renovating, and leasing school buildings. Leasing property is not inherently an exempt purpose, even if the lessee is an exempt organization and

needs the leased property in order to operate. Rev. Rul. 58-547. Leasing real estate is generally a non-exempt trade or business carried on for profit. Leasing may be an exempt activity only under certain circumstances, and none of these circumstances are present in Taxpayer's situation.

A business can be regarded as exempt if it is an integral part of the exempt activity of a related exempt entity. Council for Bibliographic and Information Technology, T.C.Memo. 1992-364. An organization may support a related exempt organization by conducting a commercial activity that is integral to the function of the exempt organization. For example, a subsidiary to a university may be recognized as exempt because it manages the university's power plant. Treas. Reg. § 1.502-1(b). Here, during the examination years, none of Taxpayer's tenants were recognized as exempt organizations. Thus, Taxpayer cannot assert that its rental activities were an integral part of related exempt organizations.

Also, an organization may conduct a business in a charitable manner to promote the exempt purpose of an unrelated exempt organization. In Rev. Rul. 69-572, an entity that leased space to exempt organizations at rents well below market levels was ruled as exempt. In contrast, Taxpayer charges rents that are only slightly below market rate. These payments cover Taxpayer's costs and have allowed it to amass a substantial surplus. Leasing properties at these rates lacks the donative element necessary to classify the activity as charitable. Rev. Rul. 72-369, Airlie Foundation, 283 F.Supp.2d at 65. Thus, even if the schools that rent from Taxpayer were exempt, the activity of leasing space to them is not an exempt purpose for Taxpayer.

Taxpayer's leasing activities are not only non-charitable, but also commercial. The manner in which a business is carried out indicates whether its purpose is exempt or commercial. Living Faith, 950 F.2d.at 372. If an organization competes with commercial entities, uses market pricing, and other terms, and accumulates a large surplus, it will be deemed to operate for commercial purposes. Taxpayer provides normal property services to its tenants, presumably in competition with for-profit landlords, and has accumulated a very large surplus. These factors lead to the conclusion that it is operating for commercial purpose. See B.S.W. Group, 70 T.C. at 358, Living Faith, 950 F.2d at 373. Therefore, Taxpayer's rental activity during the examination years constitutes a substantial commercial purpose, and this activity is fatal to Taxpayer's exemption. Better Bus. Bureau, 326 U.S. at 283.

Taxpayer argues that it is exempt as an integral part of governmental entities. This argument fails for the reason that the charter schools to which it provides services are not governmental entities.

Under Treas. Reg. §1.103-1(b), a governmental entity or political subdivision is any division of the government that is a municipal corporation or has been delegated the right to exercise part of the sovereign power of the government. See Texas Learning Technology Group v. Commissioner, 958 F. 2d 122 (1992). In order to fit this definition, an entity must have been in some way created by the state. In Commissioner v. Shamberg's Estate, 144 F.2d 998 (2nd Cir.1944) and Commissioner v. White's Estate, 144 F.2d 1019, 1021 (2d Cir. 1944), the transportation authorities found to be political subdivisions were formed by action of states. Governmental units created these authorities and determined their operations. In contrast, Seagrave Corp. v. Commissioner, 38 T.C. 247 (T.C. 1962), determined that volunteer fire departments were not political subdivisions. The court said that the mere act of carrying out what is usually a governmental function does not render a corporation as a political subdivision. It highlighted that private individuals, rather than the state, create and had the power to dissolve these volunteer fire departments. The charter schools to which Taxpayer provides leasing services are akin to the volunteer fire departments in Seagrave Corp., rather than the transportation authorities in Shamberg's Estate and White's Estate. They

have charter school contracts with governmental units, but they were created by action of private individuals, namely the individuals who control Taxpayer. Private individuals have the authority to change operations of these entities or dissolve them, without seeking approval of any governmental unit. The charter schools' connections with the government are only pursuant to contract. Thus, these charter schools are not political subdivisions or governmental units.

Because the charter schools are not political subdivisions, Taxpayer cannot claim exempt status as an integral part of political subdivisions.

Finally, Taxpayer claims to have conducted an educational summer program during some of the years under examination. However, Taxpayer's operation of this camp constituted only a minor portion of its time and resources, and thus this activity cannot be considered a substantial purpose or a basis for exemption. See § 1.501(c)(3)-1(a)(1); § 1.501(c)(3)-1(c)(1).

Because we find that the Taxpayer did not operate for an exempt purpose, we need not consider whether it is a school or another type of public charity, what its foundation status would be, or the effect of debt-financing on the taxability of its revenue.

Conclusion

Based on the above analysis, we recommend revocation of Taxpayer's recognition of exemption § 501(c)(3). I.R.M. § 4.75.13.5.3.1, states regarding the effective date of an organization's revocation, "The examiner must attempt to establish the date the organization first failed to qualify for exempt status." Based on the information before us Taxpayer was not operating as an exempt organization during its examination period. Accordingly, we recommend revocation effective July 1, 2001, the first date of the year of the examination, which discovered its change in activities.

We are not making a recommendation on the matter of relief from retroactive application of revocation under § 7805(b). The agent reviewing Taxpayer is recommending revocation only as of the first day of the years under examination, and Taxpayer has not recommended any alternative date. I.R.M. § 4.75.13.5.3.2.1 states that when revocation is due to a change in the facts of the organization "there is no need to request application of I.R.C. § 7805(b) relief." Thus, there is no need to consider § 7805(b) relief.

A copy of this memorandum is to be given to the organization. § 6110(k)(3) provides that it may not be used or cited as precedent.