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Department of the Treasury
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Date:
June 30, 2017

LEGEND

Foundation =
Area =
County =
Date 1 =
Date 2 =
x =

Dear :

This letter responds to a letter dated December 30, 2016, and subsequent correspondence, requesting rulings on the application of §§ 512 and 514 of the Internal Revenue Code[1] to Foundation in light of the Rezoning Services Agreement described below.

FACTS

Foundation is recognized as an organization described in § 501(c)(3) and is classified as a private foundation within the meaning of § 509(a).

Foundation owns real property (Property) that it leases to two business entities (Lease). Foundation represents that neither lessee is related to Foundation or to any disqualified person (within the meaning of § 4946(a)) with respect to Foundation. The Lease expires Date 1, with an option to extend the term until Date 2. Furthermore, Foundation

[1] The Internal Revenue Code of 1986, as amended, to which all subsequent "section" references are made unless otherwise indicated.

represents that there is no debt on the Property, that no part of the Lease is attributable to personal property, and that no part of the rent paid depends, in whole or in part, on the income or profits derived by any person from the Property.

The Property is located in Area, a rapidly developing part of County. To take advantage of that development, Foundation would like the Property rezoned for greater development density. To receive rezoning approval from County, Foundation would need to pay for and present a Conceptual Development Plan (CDP) for the Property and a Final Development Plan for at least one building on the Property.

The Property adjoins a parcel of real property owned by an affiliate of a developer that is unrelated to Foundation (Developer), which parcel (Developer's Parcel) Developer is seeking to have rezoned. Since it is likelier that County would approve a request to rezone both the Property and Developer's Parcel than a request to rezone the Property alone, and at less expense to Foundation, Foundation has engaged Developer to pursue rezoning of the Property on Foundation's behalf under the terms and conditions of a Rezoning Services Agreement (Agreement). As Developer acknowledges in the Agreement, Foundation has engaged Developer because of the reputation of one of Developer's principals (Rezoning Specialist) as an experienced real estate professional with a history of success in Area with respect to the rezoning of properties similar to the Property.

Under the terms of the Agreement, Foundation will be included as co-applicant on the rezoning application submitted by Developer to County. Developer will include Developer's Parcel with the Property on the rezoning application. The Agreement authorizes Developer to act as Foundation's agent in pursuit of the rezoning of the Property (Rezoning Process), including with respect to the filing of all necessary applications and submissions with County on behalf of Foundation. Developer agrees to diligently pursue the Rezoning Process in a manner consistent with the reputation and under the lead of the Rezoning Specialist, taking such steps as may be necessary to obtain approvals from the County Planning Commission, the County Board of Supervisors, and any other necessary governmental offices. Developer will be responsible for all aspects of the Rezoning Process, including all applications, submissions, drawings, proposals, negotiations, and presentations required for successful completion of the Rezoning Process (Successful Completion). Successful Completion will be deemed attained when the County Board of Supervisors has rezoned the Property to Area's planned urban district with a fully approved CDP allowing the Property to be redeveloped with at least 1,500,000 square feet of development, and all applicable appeals periods with respect to such rezoning and CDP have expired.

Under the terms of the Agreement, Developer agrees to update Foundation on the progress of the Rezoning Process and to meet with representatives of Foundation at least monthly. Developer agrees to consult with Foundation with respect to all material

aspects and details of the Rezoning Process, and no CDP for the Property, or any material changes thereto, will be submitted to County until first approved by Foundation. Developer, at its election, but subject to Foundation's prior written approval, may include in the Rezoning Process (in addition to Developer's Parcel which will be included) other parcels in the vicinity of the Property. Developer agrees, acting in good faith, to treat all parcels included in the Rezoning Process equitably and fairly, and in no event give preference or priority to Developer's Parcel or any other parcel in the Rezoning Process. The inclusion of Developer's Parcel or other parcels in the Rezoning Process does not alter the requirements for Successful Completion.

The Agreement provides that Developer will pay all costs of the Rezoning Process through Successful Completion except for application and submission fees attributable to the Property. Developer will maintain detailed written records of all third party costs it incurs in the Rezoning Process (Reimbursable Costs), and will provide Foundation with detailed monthly summaries of all Reimbursable Costs, together with written invoices evidencing payment of such costs by Developer. Foundation will reimburse Developer for the portion of the Reimbursable Costs applicable to the Property, but in no event will Foundation be obligated to reimburse to Developer an amount, in the aggregate, greater than a specified cap. Foundation will advance to Developer one half of its portion of the applicable Reimbursable Costs within fifteen days after receipt of written requests for such reimbursement, but Foundation will have no obligation to advance any such amounts to Developer more often than semi-annually. Promptly following Successful Completion, Foundation will reimburse Developer for the unpaid portion of the Reimbursable Costs payable by Foundation but not previously paid.

The Agreement provides that, at any time before Successful Completion, Foundation has the right to terminate the Agreement upon delivery of written notice to Developer, the delivery of any Reimbursable Costs payable by Foundation but not yet paid, and, if Developer is not in default under the Agreement, the payment of a termination fee as full and final payment for Developer's work under the Agreement. If Developer achieves Successful Completion, the Agreement provides that Foundation will pay Developer a success fee. Either Developer or Foundation may elect by notice to the other party delivered no later than 90 days after Successful Completion is achieved to have the success fee be equal to x percent of the amount obtained by subtracting the original property value (as specified in the Agreement) from the rezoned property value (early success fee). If either party elects to proceed with the early success fee, Foundation agrees to pay Developer the early success fee within 30 days after determination of the amount of the early success fee. If neither party elects the early success fee, then the success fee will be an amount equal to 2x percent of the amount obtained by subtracting the original property value from the rezoned property value, which amount Foundation will deliver to Developer no later than the earlier of the closing of the sale of all or any portion of the Property by Foundation and the date that is 24 months following the expiration or termination of the Lease. If Foundation sells the Property prior to the date that is 24 months following the expiration or termination of the Lease, the rezoned

property value will be the purchase price net of all reasonable and customary closing costs, escrow fees, and transfer and recordation taxes paid by Foundation in connection with such sale, but excluding costs to pay off or release liens or encumbrances in such sale transaction. If Foundation does not sell the Property prior to the date that is 24 months following the expiration or termination of the Lease, or Developer is to be paid the early success fee, then the rezoned property value of the Property will be the fair market value of the Property as determined by the appraisal method set forth in the Agreement, less the costs of conducting such appraisal. If the rezoned property value is equal to or less than the original property value, the success fee will be zero dollars ($0.00). If Foundation sells a portion but not all of the property, the success fee will be based in part on the contract sales price (and be paid at the closing) and in part on the appraisal method set forth in the Agreement (and be paid after the determination of the fair market value of the remaining portion of the Property). For these purposes, "fair market value" means the fair market value as determined by an appraiser meeting the requirements set forth in the Agreement based on the highest and best use of the Property, based on the actual zoning of the Property, assuming there is no impediment to the immediate development of the Property and assuming an arms-length transaction between sophisticated parties.

Finally, if Foundation chooses to sell any or all of the rezoned Property following Successful Completion to any of four specified entities with a close association with Developer, Developer will receive an additional fee at the closing of such sale equal to one percent of the purchase price for the Property.

RULINGS REQUESTED

Foundation has requested the following rulings:

1. That the arrangement with the Rezoning Specialist and Developer, whereby initial fees and expenses are borne by Developer, to be later paid or reimbursed by Foundation, and whereby a success fee may be payable upon completion of the rezoning process, will not give rise to acquisition indebtedness within the meaning of § 514.

2. That, under the transaction contemplated, the receipt of lease proceeds from the Property will not be subject to tax as unrelated business taxable income within the meaning of §§ 511 through 514.

LAW

Section 511 imposes a tax for each taxable year on the unrelated business taxable income of every organization described in § 501(c)(3) and exempt from taxation by reason of § 501(a).

Section 512(a)(1) provides that the term “unrelated business taxable income” means the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it, less certain deductions that are directly connected with the carrying on of such trade or business, and subject to certain modifications.

Section 512(b)(3)(A) excludes from unrelated business taxable income (i) all rents from real property, and (ii) all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

Section 512(b)(3)(B) provides that subparagraph (A) does not apply—(i) if more than 50 percent of the total rent received or accrued under the lease is attributable to personal property described in subparagraph (A)(ii), or (ii) if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).

Section 512(b)(4) provides that, notwithstanding paragraph (3), in the case of debt-financed property (as defined in § 514), there shall be included, as an item of gross income derived from an unrelated trade or business, an amount ascertained under § 514(a).

Section 514(a) provides that an amount of the gross income with respect to debt-financed property shall be included as an item of gross income derived from an unrelated trade or business for purposes of computing under § 512 the unrelated business taxable income for any taxable year.

Section 514(b)(1) provides that the term “debt-financed property” means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year.

Section 514(c)(1) provides that the term “acquisition indebtedness” means, with respect to any 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.

ANALYSIS

Issue 1: Whether the Agreement with Developer, whereby initial fees and expenses are borne by Developer, to be later paid or reimbursed by Foundation, and whereby a success fee may be payable upon completion of the Rezoning Process, would give rise to "acquisition indebtedness" within the meaning of § 514(c).

Section 514(c)(1) defines "acquisition indebtedness" (with respect to any debt-financed property) to include the unpaid amount of the indebtedness incurred in acquiring or improving such property. Thus, for the Agreement to give rise to acquisition indebtedness, the Agreement must cause Foundation to incur indebtedness.

The word "indebtedness" is not defined in § 514. However, within the context of § 163(a), which allows as a deduction all interest paid or accrued within the taxable year on indebtedness, courts have generally held that indebtedness is an unconditional and legally enforceable obligation for the payment of money. See, e.g., Autenreith v. Comm'r, 115 F.2d 856, 858 (3d Cir. 1940); Kovtun v. Comm'r, 54 T.C. 331, 338 (1970), aff'd per curiam 448 F.2d 1268 (9th Cir. 1971).

Correspondingly, § 166(a)(1) allows a deduction for any debt which becomes worthless within the taxable year. Section 1.166-1(c) of the Income Tax Regulations provides that only a bona fide debt qualifies for purposes of § 166, and that a bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.

Although the Agreement obligates Foundation to reimburse Developer for Foundation's share of the costs that Developer may incur in the Rezoning Process, and to pay Developer a success fee in the event of Successful Completion, the Agreement, by itself, does not create an unconditional and legally enforceable obligation for the payment of a fixed or determinable sum of money. Therefore, the Agreement alone would not cause Foundation to incur indebtedness. Accordingly, the Agreement does not give rise to acquisition indebtedness with respect to the Property within the meaning of § 514(c).

Issue 2: Whether, in light of the Agreement, receipt of lease proceeds from the Property would be includible in Foundation's unrelated business taxable income under § 512(a).

Foundation receives rent from the Lease of the Property. Foundation represents that there is no debt on the property, that no part of the Lease is attributable to personal

property, and that no part of the rent paid depends, in whole or in part, on the income or profits derived by any person from the Property. Thus, under the provisions of § 512(b)(3), the rent received by Foundation under the Lease would be excludable in computing Foundation's unrelated business taxable income under § 512(a) unless includable under § 512(b)(4), which includes in unrelated business taxable income a portion of rents derived from debt-financed property as defined in § 514. Insofar as the Agreement does not give rise to acquisition indebtedness within the meaning of § 514(c), the Agreement will not cause the Property to be treated as debt-financed property within the meaning of § 514(b), or cause any part of the lease proceeds to be treated as unrelated debt-financed income within the meaning of § 514(a).

RULINGS

Based solely on the facts and representations submitted by Foundation, we rule as follows:

1. The Agreement will not give rise to acquisition indebtedness within the meaning of § 514(c) or cause the Property to be treated as debt-financed property within the meaning of § 514(b).

2. The Agreement will not cause the rents received under the Lease, otherwise excludable from Foundation's unrelated business taxable income as rents from real property under § 512(b)(3)(A), to be treated as unrelated debt-financed income within the meaning of § 514(a) or to be includable in Foundation's unrelated business taxable income within the meaning of § 512(a).

The rulings contained in this letter are based upon information and representations submitted by or on behalf of Foundation (accompanied by a penalty of perjury statement executed by an individual with authority to bind Foundation) and upon the understanding that there will be no material changes in the facts. This office has not verified any of the material submitted in support of the request for rulings, and such material is subject to verification on examination. The Associate office will revoke or modify a letter ruling and apply the revocation retroactively if there has been a misstatement or omission of controlling facts; the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or, in the case of a transaction involving a continuing action or series of actions, the controlling facts change during the course of the transaction. See Rev. Proc. 2017-1, § 11.05.

No opinion is expressed or implied concerning the federal income tax consequences of any other aspects of any transaction or item of income described in this letter ruling. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Foundation's authorized representative.

Sincerely,

Theodore R. Lieber
Senior Tax Law Specialist
Exempt Organizations Branch 1
(TEGE Associate Chief Counsel)