Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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SIN 0512.00-00
SIN 0513.00-00 NO THIRD PARTY CONTACT
SIN 0514.00-00
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XXXXXXXXXXXXXXXXXXXX

Contact Person: XXXXXXXXXXXXXXXXXXX

Telephone Number: XXXXXXXXXXXX
XXXXXXXXXXXXX

In Reference to: OP:E:EO:T:3

Date: OCT 18 1999

Legend:
X= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
Y= XXXXXXXXXXXXXXXXXXXXXXXX
Z= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
T= XXXXXXXXXXXXXXXXXXXXXXXX
S1= XXXXXXXXXXXXXXXXXXXXXXXXX
S2= XXXXXXXXXXXXXXXXXXXXXXXXXX

Dear Applicant:

This is in response to your ruling letter dated June 30, 1999, as modified and amended by your letter of September 20, 1999, in which you request rulings under sections 501(c)(2), 511 512, 513, and 514 of the Internal Revenue Code with respect to a proposed transaction. Specifically you request us to rule as follows:

1. X's exempt status under section 501(c)(2) of the Code will not be adversely affected if it uses the cash proceeds of the S1/S2 note to pay off the T note, and invest the remaining amounts in long-term investments such as stocks and bonds, and uses the income from such investment (together with other income) to pay the expenses of owning and operating T, and remitting net income annually to Y in the form of rent-free use of T. Any income, in excess of the rent-free use, would be paid to Y periodically.

2. X will not be deemed to receive unrelated business taxable income under sections 511 through section 514 of the Code when X receives the cash proceeds of the S1/S2 note except to the extent that such proceeds constitute unrecognized gain on the sale of S1 and S2.

Facts:

X was incorporated to hold title to property, to collect income therefrom, and to turn such income over to Y and to Z, which is Y's affiliate. X is a titleholding company and is recognized as exempt from federal income tax under section 501(c)(2) of the Code. Y is recognized as exempt from federal income tax under section 501(c)(6) of the Code. Z is recognized

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X owned 100% of S1 and 50% of the joint venture which owned S2. S1 and S2 were rented to Y and Z and to other tenants. X purchased the other 50% interest in the joint venture which owned S2. Thus, after this transaction, X owned 100% of S2. X then sold both S1 and S2 to an unrelated third party.

X received cash and a five-year note (the S1/S2 note) for both S1 and S2. Upon Y's directions, X acquired T for cash and a note (the T note). Y and Z currently occupy 4 of T's 5 floors. Y and Z pay no rental payments to X.

Law:

Section 501(c)(2) of the Code recognizes as exempt an organization organized for the exclusive purposes of acquiring property and holding title to, and collecting income from such property, and remitting the entire amount of income from such property (less expenses) to an organization described in section 501(c) of the Code.

Section 1.501(c)(2)-1(a) of the Income Tax Regulations provides, in pertinent part, that a corporation described in section 501(c)(2) cannot have unrelated business taxable income as defined in section 512 other than income which is treated as unrelated business taxable income solely because of the applicability of section 512(a)(3)(C); or debt financed income which is treated as unrelated business taxable income solely because of section 514.

Section 1.501(c)(2)-1(b) of the regulations provides that a corporation described in section 501(c)(2) of the Code cannot accumulate income and retain its exemption, but must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501(a) of the Code.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(c).

Section 512(a)(1) of the Code 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 allowable deductions.

Sections 512(b)(1),(b)(2) and (b)(3) of the Code provide, in pertinent part, that there shall be excluded from unrelated business taxable income dividends, interest, annuities, royalties, and rents from real property.

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Section 512(b)(5) of the Code provides that there shall be excluded from unrelated business taxable income all gains from the sale, exchange, or other disposition of property, other than property which would properly be includible in inventory if on hand at the close of a taxable year, or property held primarily for sale to customers in the ordinary course of trade or business.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 514(a)(1) of the Code provides that there shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness (as defined in subsection (c)(7)) for the taxable year with respect to the property is of (B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of such property during the period it is held by the organization during such taxable year.

Section 514(b)(1) of the Code provides that for purposes of this section, 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 (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition), except that such term does not include--

> (A)(i) any property substantially all the use of which is substantially related (aside from the need of the 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 section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function designated in section 501(c)(3)), or (ii) any property to which clause (i) does not apply, to the extent that its use is so substantially related;

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Section 1.514(a)-1(a)(1)(v) of the regulations provides that if debt-financed property is sold or otherwise disposed of, there shall be included in computing unrelated business taxable income an amount with respect to such gain (or loss) which is the same percentage (but not in excess of 100 percent) of the total gain (or loss) derived from such sale or other disposition as:

(a) The highest acquisition indebtedness with respect to such property during the 12-month period, preceding the date of disposition, is of

(b) The average adjusted basis of such property.

The tax on the amount of gain (or loss) included in unrelated business taxable income pursuant to the preceding sentence shall be determined in accordance with the rules set forth in Subchapter P, Chapter 1 of the Code (relating to capital gains and losses). See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

Rev. Rul. 76-335, 1976-2 C.B. 141 holds that a subsidiary of an exempt title-holding corporation whose exclusive purpose is the holding of title to investment property, collecting the income therefrom, and turning over such income, less expenses, to its parent, qualifies for exemption under section 501(c)(2) of the Code.

Rev. Rul. 77-429, 1977-2 C.B. 189, restates and updates Rev. Rul. 67-104 to provide, in pertinent part, that an exempt title holding corporation may retain part of its income each year to apply to indebtedness on property to which it holds title; the transaction will be treated as if the income had been turned over to the exempt parent and the latter had used such income to make a capital contribution to the title holding corporation which, in turn, applied such contribution to the indebtedness.

Rationale:

As provided in Rev. Rul. 77-429, supra, an exempt title holding corporation may retain part of its income each year to apply to indebtedness on property to which it holds title. In this case X will use part of the interest income and principal from the S1/S2 note to pay off the note on T. Under the circumstances, the transaction will be treated as if X turned income over to its exempt parents and they used such income to make a capital contribution to X. Accordingly, we conclude that X's exempt status under section 501(c)(2) of the Code will not be adversely affected if it uses the cash proceeds from the S1/S2 note to pay off T's note. Similarly, we conclude that X's exempt status will not be adversely affected if X uses its investment income to pay the expenses of owning and operating T. As stated

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in Rev. Rul. 76-335, supra, a titleholding corporation is not restricted to investing solely in real property. Therefore, investment of a portion of the S1/S2 note proceeds in stocks and bonds will not adversely affect X's exempt status.

Even though section 1.501(c)(2)-1(b) of the regulations requires X to turn over its annual income to Y and Z, we conclude that their rent-free use of T is analogous to X's making direct annual payments to Y and Z.

We conclude that X's retention of funds necessary for annual maintenance and renovation of T is also permissible since section 501(c)(2) of the Code explicitly permits the payment of such expenses by a title-holding corporation.

X's income from investments and its income from the S1/S2 note are excluded from unrelated business taxable income pursuant to section 512(b)(1) of the Code. However, since S1 and S2 were debt-financed, those portions of S1 and S2 which were not occupied by Y and Z generated unrelated business taxable income pursuant to section 514 of the Code. Therefore, a portion of any gain on the sale of S1 and S2 will be taxable.

Pursuant to section 1.514(a)-1(a)(1)(v) of the regulations, the taxable portion of the gain is the same percentage (but not in excess of 100 percent) of the total gain derived from the sale as the highest acquisition indebtedness with respect to such property during the 12-month period preceding the date of sale, is of the average adjusted basis of the property. In your case, because only a portion of S1 and S2 generated debt-financed rental income, only that portion of the gain from the sale which pertains to that part of S1 and S2 is taxable under this rule. Pursuant to section 1.514(a)-1(a)(1)(v) of the regulations, the tax on the amount of gain from S1 and S2 shall be determined in accordance with the rules relating to capital gains and losses as set forth in Subchapter P, Chapter 1 of the Code.

Conclusions:

We were not asked and we have not considered whether X's purchase of the 50% interest in the joint venture which owned S2, X's sale of S1 and S2, and X's purchase of T were arms-length transactions at fair market value.

Accordingly, based upon the information submitted and the representations made we rule that:

1. X's exempt status under section 501(c)(2) of the Code will not be adversely affected if it uses the cash proceeds of the S1/S2 note to pay off the T note, invests the remaining amounts in long-term investments

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such as stocks and bonds, and uses the income from such investment (together with other income) to pay the expenses of owning and operating T, and remitting net income annually to Y in the form of rent-free use of T. Any income, in excess of the rent-free use, would be paid to Y periodically.

2. X will not be deemed to receive unrelated business taxable income under sections 511 through section 514 of the Code when X receives the cash proceeds of the S1/S2 note except to the extent that such proceeds constitute unrecognized gain on the sale of S1 and S2.

This ruling letter 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 as precedent. We are sending a copy of this ruling letter to your key District Director and to your attorney.

Sincerely yours,

(signed)
Robert C. Harper, Jr.
Chief, Exempt Organizations
Technical Branch 3

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