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

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

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Contact Person:

Identification Number:

UIL: 501.04-00 & 512.01-02

Telephone Number:

EIN:

Legend:

F=
D=
C=
H=
S=

Dear :

This is in reply to F's ruling requests under sections 501(c)(4) and 511 through 514 of the Internal Revenue Code.

Facts

F is exempt under section 501(c)(4) of the Code. F was formed specifically to provide financial assistance to D by financing, refinancing, acquiring, constructing, improving, leasing and selling buildings and public improvements, as well as purchasing or leasing land and other real and personal property, for the benefit of D.

D is a governmental district with high schools that were severely overcrowded. In 1998, F joined in a collaborative effort with D and C, a city located in D, to purchase land to develop into a construction-ready site for a new high school. F states the purchase of property for the new school, in 1998, was the result of the state department of education's approval for the purchase of a 135-acre property. This 135-acre property was chosen over two other properties even though only 80 acres was needed for the high school. The high school was constructed and opened in 2004.

Development of the high school site required extensive dirt removal and site stabilization. F, C and D collaborated to develop the property for D's high school. The improvements were required by a number of governmental entities, including D, C, the state department of education, and the state department of toxic control. One by-product of the development of the high school site was the creation of three adjacent surplus parcels: Lots A, B and C (the "Surplus Parcels"). The Surplus Parcels were created and enhanced by extensive grading mandated by the local authorities to prevent landslides on D's hill top location. F states the Surplus Parcels could not be used for educational facilities therefore; D had no use for the Surplus Parcels.

F states it did the minimum development work necessary to enable it to sell the Surplus Parcels to liquidate the balance of its investment in the property. F's development included obtaining government approval of a parcel map, provide utilities, pave streets, sidewalks, curbs, gutters and landscaping for slope stabilization and roadway medians.

F selected H, a national commercial residential developer, to purchase the Surplus Parcels. F will maintain certain continuing control in the surplus properties' future development through its approval-disapproval rights to ensure the properties are developed in a manner consistent and conducive with the adjacent public high school.

F is also planning to sell another unimproved surplus parcel known as S. S may be sold to D, if D deems the site usable as a special education or school facility, or to a third party if the site is unusable by D. F states if it does not sell to D, it will use the same considerations in selecting the prospective buyer/developer of S as were used in the H transaction.

F states there will only be two sales: the pending sale of the Surplus Parcels to H, which will close in 2005, and the proposed sale of S, as discussed above, which will occur in the near future.

F states it did not advertised the availability of the Surplus Parcels, other than by engaging a broker to liquidate the property at one time with one buyer, and it chose to sell to an experienced, national and qualified developer.

Rulings Requested

1. Income from the sale of the Surplus Parcels and S does not give rise to unrelated business taxable income within the meaning of sections 511 through 514 of the Code.

2. Sale of the Surplus Parcels and S will not adversely affect F's exempt status under section 501(c)(4) of the Code and does not adversely affect the ability of donors to F to deduct their contributions under section 170(c)(1).

Law

501(c)(4)(A**)** of the Code provides for the exemption of organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" with certain modifications, as the "gross income derived by any organization from any unrelated trade or business...."

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to tax by section 511, any trade or business the conduct of which is not substantially related (aside from the need of the 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 of its exemption under section 501.

Section 512(b) of the Code provides for certain exclusions, specific deductions, and other special rules in computing unrelated business income, in part as follows:

"(5) There shall be excluded 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 ..."

In Rev. Rul. 55-449, 1955-2 C.B. 599, it was concluded that the construction and sale of 80 houses by an organization, 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 business within the meaning of section 513 notwithstanding the fact that the organization did not plan to engage in further similar activities.

Rev. Rul. 59-91, 1959-1 C.B. 215, describes a corporation that sold a portion of its property it held as an investment. The property sold was subdivided into residential lots, graded, the streets surfaced, and the required drainage installed. In holding the gains realized from the sales of the lots constituted ordinary income, the ruling implies the sizeable improvements made in order to facilitate the sales led to the conclusion the property was held primarily for sale to customers.

In the case of Brown v. Commissioner, 143 F.2d (5th Cir.1944), the taxpayer owned 500 acres of unimproved land used for grazing purposes. Taxpayer decided to sell the land and subdivided it into lots, cut in streets, installed sewers, constructed gas and electric lines and engaged in other activities of the kind usually carried out by a real estate developer. Each year 20 to 30 properties were sold. The court held that the 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 sold 25 lots out of a tract of land previously used in his nursery business but now more desirable as residential property. Since the taxpayer made no active efforts to sell and did not develop the property, the court described the sale as "in the nature of the gradual and passive liquidation of an asset." Therefore, the income derived from the sales represented capital gains income, rather than ordinary income from the regular course of business as in the Brown case.

In Adam v. Commissioner, 60 T.C. 996, (1973), acq. 1974-1 C.B. 1, the Tax Court analyzed the following factors in determining whether the taxpayer was engaged in the operation of a trade or business:

(1) the purpose for which the asset was acquired,
(2) the frequency, continuity, and size of the sales,
(3) the activities of the seller 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 during the taxable year.

In Adam and subsequent cases, the Tax Court found no one of these factors is controlling but all are relevant facts to consider in determining whether the sale of property occurred in the regular course of the taxpayer's business. See Houston Endowment, Inc. v. United States, 606 F.2d 77 (5th Cir.1979); Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir.1976); and Buono v. Commissioner, 74 T.C. 187 (1980).

In Malat v. Riddell, 393 U.S. 569 (1966), the Supreme Court interpreted the meaning of the phrase "held primarily for sale to customers in the ordinary course of the trade or business" under section 1221(1). The Service has often applied the principles derived under section 1221 to rulings interpreting the language of section 512(b)(5). 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.

Further, the courts have often held a taxpayer may make "reasonable expenditures and efforts" (such as subdividing land, construction of streets, the provision of drainage, and furnishing of access to such a necessity as water as part of the "liquidation" of an investment asset without being treated as engaged in a trade or business for purposes of Section 1221(1)). See Barrios Estate v. Commissioner, 265 F. 2d 517 (2nd Cir. 1957) and Buono v. Commissioner, supra.

Rev. Rul. 57-493, 1957-2 C.B. 314, describes a corporation organized to build a stadium and lease it to a school district, a political subdivision, which will eventually get title to such stadium. The revenue ruling states the corporation is entitled to exemption under section 501(c)(4) of the Code as an organization not organized for profit but operated exclusively for the promotion of social welfare. Contributions to it are deductible by donors to the extent provided by section 170 as contributions for the use of a political subdivision for exclusively public purposes.

Analysis

F did not acquire the 135-acre property for sale to individuals, but rather acquired the property for use in its exempt purposes. The state department of education determined the location and approved the purchase of the 135-acre property even though 80 acres were only needed for the construction of the new high school. As a result, F had the Surplus Parcels and S remaining that were not need for the accomplishment of its exempt purpose. F states various improvements to the property were required by a number of governmental entities in order to construct the new high school and one by-product was the creation of the Surplus Parcels. F did the minimum development to enable it to sell the Surplus Parcels to liquidate its investment in the property.

F is also planning to sell S. S may be sold to D, however, if D deems the site usable as a special education or school facility, it will be sold to a third party. If F does not sell S to D it

will use the same considerations in selecting the prospective buyer/developer of S as were used in the H transaction.

There will only be two proposed sales: the pending sale of the Surplus Parcels to H, which will close in 2005, and the proposed sale of S, as discussed above, occurring in the near future. F has not advertised the availability of the Surplus Parcels other than by engaging a broker to liquidate the property at one time with one buyer. F chose to sell to an experienced, national and qualified developer.

F is maintaining control over the development process to ensure a compatible environment for the adjoining high school. None of the development activity is undertaken directly by F. F is not performing any functions relating to the advertising or marketing of the property to the general public. It is clear F did not approach the sale of the Surplus Property or S in a manner typical of real estate sales, but rather as the liquidation of an investment held for exempt purposes.

Therefore, we conclude the Surplus Parcels and S are not held for sale in the ordinary course of business. Rather, this is a liquidation of an investment asset. We further determinate, consistent with the primary purpose test and facts and circumstances set out in Malat v. Riddell, supra, these transactions do not involve the sale of property in the ordinary course of business but rather represent the liquidation of investment assets.
The income from these transactions is excluded by virtue of the exclusion contained in section 512(b)(5) of the Code, since the sale of investment property is involved rather than property held in inventory or for the sale to customers in the ordinary course of a trade or business.
Accordingly, we conclude the real estate is not held in the ordinary course of any trade or business, and income derived from the sale of parcels described above will not be subject to tax as unrelated business income within the meaning of sections 511 through 514 of the Code, by virtue of the exception of section 512(b)(5).

Lastly, contributions to F are deductible by donors to the extent provided by section 170 as contributions for the use of a D, a political subdivision, for exclusively public purposes. See Rev. Rul. 57-493, supra.

Conclusion

1. Income from the sale of the Surplus Parcels and S does not give rise to unrelated business taxable income within the meaning of sections 511 through 514 of the Code.

2. Sale of the Surplus Parcels and S will not adversely affect F's exempt status under section 501(c)(4) of the Code and does not adversely affect the ability of donors to F to deduct their contributions under section 170(c)(1).

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.

Because this ruling letter could help to resolve any future questions about tax consequences of your activities, you should keep a copy of this ruling in its permanent records.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. You should keep a copy of this letter 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.

Sincerely,

Debra Kawecki
Manager, Exempt Organizations
Technical Group 1