



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

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Number: **200537038**  
Release Date: 9/16/2005  
TEGE:EO

Date: June 24, 2005

501.03-00  
501.03-33

Legend:

Foundation =  
State =  
U =  
V =  
W =  
X =

Dear \_\_\_\_\_ :

This is in reference to your ruling request dated September 4, 2002, concerning the federal income tax consequences stemming from your ongoing and proposed activities to promote economic development in State. You have constructed an "innovation and incubator center" funded through a combination of third party commercial lending and government grants. The intent is to attract high technology companies to State, creating not only employment opportunities but also demand for the post-secondary high technology education needed to build a skilled workforce. You plan to rent part of the innovation center at market rates to "anchor tenants," and other parts at below market rates to startup small businesses. You are concerned that receipt of market-rate rental income might give rise to liability for unrelated business income tax.

Facts:

Foundation is a nonprofit corporation established August 12, 1993, and has been found to be an organization exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Foundation has been classified as other than a private foundation under section 509(a)(1). Its purposes include improving use of educational technology in state schools, training educators, and educating unemployed and underemployed citizens to better take advantage of employment opportunities in emerging technological industries. In addition, Foundation supports using technology research as a catalyst for economic development, and advocates construction of office space for high-technology companies and related support services. In pursuing these objectives, Foundation manages a computer training program for students, teachers, and businesses; provides internships for high school and college students interested in high technology careers; manages a summer computer camp; establishes and monitors statewide technology standards for teachers; and develops training program for miners, laborers, and other occupations that have been impacted by technological change.

The region in which Foundation operates has been plagued by poverty, poor education, and low standards of living for more than a century. "The unemployment rates and poverty levels of the population are grim," Foundation says, adding that:

- (1) The local poverty level is almost one and a half times the national average;
- (2) Per capita income lags behind the national average due to lack of quality jobs;
- (3) The population and workforce are shrinking due to lack of jobs; and
- (4) High unemployment, infrastructure weaknesses mean bleak employment prospects.

Foundation has provided extensive statistics and other data reflecting high poverty levels (and high numbers of low-income households) within its service area, as well as population declines and grim employment prospects for its residents.

In promoting research, Foundation seeks to help meet the manpower needs of local high technology employers in such areas as product line engineering, biometrics and identification technologies, broadband and collaborative computing technologies, and information warfare security technology. Its "virtual company project" includes a model for operation of an online office. In addition, it has created testing standards for commercial off-the-shelf software used in architecture-based system development and maintenance, and has established advanced software reuse and architecture technology for the National Aeronautics and Space Administration. Another research project seeks to develop a technological resource center for high technology and communications businesses operating in State.

. The innovation center cost nearly \$13.4 million to build, and currently carries a mortgage. Foundation's approximate annual gross income from this building is U, and its net income is approximately V. The building's fair market value is in excess of its cost.

Further, Foundation has constructed a training center, in large part to meet the commercial space needs of a relocated company with a federal support services contract and the computer laboratory and training space sought by a regional college.

This building cost about \$2.4 million, and currently carries a mortgage. Foundation's approximate annual gross income from this building is W, and its net income is approximately X. The building's fair market value is in excess of its cost. Cash flow on both buildings has not been adequate to provide for sufficient reserves for facilities upkeep, and the lender has had to waive this requirement.

Foundation initially intended to use government and private grants and contributions to accomplish its exempt purposes. It wants to independently develop real property and use the resulting cash flow from leases to pursue such purposes. Since its inception, a small number of Foundation employees have been responsible for property management and office space development. "No professional real estate development or management company has been engaged," Foundation declares. Further, Foundation does not contemplate hiring a professional management company to oversee its existing or proposed real estate projects.

Foundation has said that it anticipates that a portion of its proposed new development will offer below-market rental rates. However, it asserts that the existing market-rate tenants act as "anchor tenants," which nurture smaller, entrepreneurial companies and bring more high-technology jobs to State. These jobs are vital to an improved standard of living in State, Foundation says. It has provided letters from the governor of State, the president of State's most prominent public university, and other state officials attesting to the importance of Foundation's role in economic development and its efforts to promote growth of high-technology businesses and jobs.

In addition, Foundation asserts that the private sector would not devote the resources needed to build this type of economic development project. Since State lacked a history of technology-based companies or workers, private investors would be unlikely to commit the millions of dollars needed for this type of venture. Thus, Foundation maintains it is not taking any opportunities away from would-be private investors.

Foundation further points out that the protective covenants for its technology park, coupled with the covenants required for grant funds issued by the U.S. Economic Development Administration, preclude its use for purposes other than technology-based economic development. Foundation emphasizes that it does not contemplate selling the site any time soon. "[W]ith a downtrodden [State] economy coupled with a history of slower than average growth, it is not fiscally prudent to consider a financial circumstance such that sale of the property would be necessary."

Foundation says it advances technology education, providing numerous computer training seminars for teachers and additional computer access to area residents. It funds internship programs for high school and college students, promotes workforce education and training programs through local universities, and sponsors ongoing courses and training on technological subjects.

Foundation asserts that State views its efforts as a "shining star" for economic development based on past accomplishments and future positioning to attract potential new employers.

Foundation says it supplements the work of several federal agency facilities and provides appropriate office space that would otherwise not exist in an economically disadvantaged area.

Foundation asks the Service to confirm its understanding that this development activity will not constitute debt financed property within the meaning of section 514(d) of the Code, that it will not subject Foundation to unrelated business income tax under section 511, and that it will not endanger Foundation's overall exempt status under section 501(c)(3).

Ruling Requests:

You have requested the following rulings:

- (1) The rental revenue earned by Foundation through publicly and privately financed real estate development projects, which includes to market-rate tenants, does not constitute unrelated debt-financed income under section 514 of the Code.
- (2) Foundation's participation in a public and privately financed real estate development project, which includes leases to market-rate tenants, furthers its exempt purpose by lessening the burdens of government under section 501(c)(3) of the Code.
- (3) Foundation's participation in a public and privately financed real estate development project, which includes leases to market-rate tenants, furthers its exempt purpose by providing economic development to an underprivileged local area under section 501(c)(3) of the Code.
- (4) Foundation's investments in small, technology-based companies, and its income therefrom, further its exempt purpose by providing economic development to an underprivileged local area under section 501(c)(3) of the Code.
- (5) Foundation's investments in small, technology-based companies, and its income therefrom, further its exempt purpose by lessening the burdens of government under section 501(c)(3) of the Code.
- (6) Foundation's investments in small, technology-based companies, and its income therefrom, does not result in unrelated business income under section 511(a)(1) of the Code, and further its exempt purpose by providing economic development to an underprivileged local area under section 501(c)(3) of the Code.
- (7) Foundation is not a private foundation, and instead is properly classified as a public charity under section 509(a)(2) of the Code.

Law:

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of organizations organized and operated exclusively for charitable and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 511 of the Code, in part, imposes a tax on the unrelated business income of organizations exempt from tax under section 501(c)(3).

Section 512(a)(1) of the Code defines “unrelated business taxable income” as gross income derived by any organization from any unrelated trade or business regularly carried on by such organization.

Section 513(a) of the Code defines an unrelated trade or business to include any trade or business, the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other exempt purposes.

Section 514(a) of the Code provides that in computing unrelated business taxable income under section 512, there shall be included certain amounts of income, less allowable deductions, derived from debt-financed property.

Section 514(b)(1)(A) of the Code excludes from the definition of “debt-financed property” for purposes of section 514 any property substantially all the use of which is substantially related (aside from the organization’s need for income or funds) to the organization’s exercise or performance of its exempt purpose.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that a tax-exempt organization operates exclusively for section 501(c)(3) purposes only if it engages primarily in activities that accomplish such purposes.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term “charitable,” as used in section 501(c)(3) of the Code, is used in its generally accepted legal sense, and is not limited by the separate enumeration in section 501(c)(3) of purposes that fall within the broad outline of “charity” as developed by judicial decisions. Thus, the term “charitable” includes relieving the poor, distressed, or underprivileged, lessening the burdens of government, and promotion of social welfare by organizations designed to lessen neighborhood tensions, eliminate prejudice and discrimination, defend human and civil rights secured by law, and combat community deterioration and juvenile delinquency.

Section 1.501(c)(3)-1(d)(5)(iii) of the regulations provides that scientific research is regarded as carried out in the public interest if such research is (b) performed for the United States, or any of its agencies or instrumentalities, or for a state or political subdivision thereof; or (c) directed toward benefiting the public.

Section 1.512(b)-1(c)(2) of the regulations provides that rents from real property and the deductions directly connected therewith shall also be excluded in computing unrelated business taxable income.

Section 1.513-1(d)(2) of the regulations delineates when a trade or business is “substantially related” to an organization’s exempt purpose. It provides that for the conduct of a trade or business to be substantially related to purposes for which an exemption was granted, producing

or distributing the goods or performing the services must contribute importantly to accomplishing those purposes.

Rev. Rul. 76-419, 1976-2 C.B. 146, holds that an organization that encourages businesses to locate new facilities in an economically distressed area, in order to provide more employment opportunities for low-income residents in the area, was organized and operated for the charitable purpose of promoting social welfare by organizations designed to relieve the poor and distressed, to lessen neighborhood tensions, or to combat community deterioration.

Rev. Rul. 74-587, 1974-2 C.B. 162, holds that an organization that devotes its resources to programs to stimulate economic development in high-density urban areas inhabited mainly by low-income minority or other disadvantaged groups qualifies for exemption under section 501(c)(3) of the Code. The organization made loans to and purchased equity interests in businesses unable to obtain funds from conventional sources. The investments were not undertaken for profit or gain, but to advance charitable goals. Funds for this program were obtained from foundation grants and public contributions. The organization was not penalized for benefiting non-needy taxpayers, as long as those taxpayers were instruments by which charitable purposes were accomplished.

Rev. Ruls. 85-1 and 85-2, 1985-1 C.B. 178, describe organizations that are lessening the burdens of government, and therefore qualify for exemption under section 501(c)(3) of the Code. These revenue rulings identify the following criteria to determine whether an organization's activities lessen the burdens of government: (1) whether a governmental unit considers the organization's activities to be its burden; (2) whether these activities actually lessen the burden of the governmental unit.

#### Analysis:

Foundation's primary purpose is to stimulate the economy of State, and particularly those regions of State that are economically distressed. Foundation seeks to create not only employment opportunities but also demand for the post-secondary education needed to build a skilled workforce. Rev. Ruls. 74-587 and 76-419 hold that an organization that encourages business development in an economically disadvantaged area meets the charitable purpose of promoting social welfare within the parameters of section 1.501(c)(3)-1(d)(2) of the regulations. Foundation was and continues to be organized to improve the economic conditions in State through the development of high technology industry. This purpose is consistent with Foundation's original grant of exemption and Rev. Ruls. 74-587 and 76-419.

Further, to the extent Foundation spurs economic development and assists in education, it lessens the burdens of government in keeping with Rev. Ruls. 85-1 and 85-2. Rev. Rul. 85-2 specifically states that a determination of whether an organization is lessening the burdens of government requires consideration of whether the organization's activities are activities that a governmental unit considers to be its burdens and whether such activities actually "lessen" such governmental burdens. An activity is a burden of government if there is an objective manifestation by the governmental unit that it considers the activity to be part of its burden. The fact that an organization is engaged in an activity that is sometimes undertaken by the

government is insufficient to establish a burden of government. Likewise, the fact that the governmental unit or an official thereof expresses approval of the organization and its activities does not establish that the organization is lessening the burdens of government.

Foundation works closely with State and its economic development authority. State considers the development of its economy to be a crucial burden, and its legislature has allocated money to Foundation to advance its work. In fact, the legislature has passed a statute which provides:

[T]hat in order to attract new business, commerce and industry to this state, to retain existing business and industry providing the citizens of this state with economic security and to advance the business prosperity of this state and the economic welfare of the citizens of this state, it is necessary to provide public financial support for constructing, equipping, improving, and maintaining economic development projects, capital improvement projects, and infrastructure which promote economic development in this state.

In implementing the statute, State has issued revenue bonds and created a special fund to provide grants (on a competitive basis) to economic development projects. Foundation submitted a grant proposal, and received substantial funding from the state legislature in the form of grant funding. State officials, including the governor and the president of the largest university in State, have written letters testifying to the importance of Foundation's role in developing jobs and fostering education of the workforce. The Department of Commerce also has praised Foundation's success in promoting economic development in State, while recognizing that so much more needs to be done, as State ranks among the highest in unemployment and lowest in per capita income. Accordingly, Foundation is performing work customarily done by state government, and is lessening the burdens of state government as provided by Rev. Ruls. 85-1 and 85-2.

As noted above, section 1.501(c)(3)-1(d)(5)(iii) of the regulations provides that scientific research is regarded as carried out in the public interest if such research is (b) performed for the United States, or any of its agencies or instrumentalities, or for a state or political subdivision thereof; or (c) directed toward benefiting the public. Examples cited in the regulation include research (1) carried on for the purpose of aiding in the scientific education of college or university students; (2) research carried on for obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; and (4) *research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.* [Emphasis added].

Moreover, Foundation's development and subsequent lease of two office buildings and the building of an addition to its training center to house high technology companies and a minimal amount of related support services are substantially related to the organization's exempt purposes. In Rev. Rul. 76-419, the organization developed real estate and leased the property to third parties in an effort to develop an urban economy. Foundation is acting in a similar manner to foster rural development. The project is expected to provide significant employment

in an underutilized area, both through construction activity and in long-term jobs to be created.

The Foundation's development project is financed through substantial commercial lending. Thus, the project would be considered debt-financed property, which would lead to the prospect of incurring unrelated business income unless there is an applicable exception.

However, since the project is inextricably intertwined with and related to the accomplishment of the Foundation's exempt purposes, the two buildings are not considered debt-financed property. Therefore, the rents received by Foundation will not be considered unrelated business income, and thus will allow Foundation to further its technology-based economic development charitable mission.

Rulings:

Therefore, we rule that:

- (1) The rental revenue earned by Foundation through publicly and privately financed real estate development projects, which includes leases to market-rate tenants, does not constitute unrelated debt-financed income under section 514 of the Code.
- (2) Foundation's participation in a public and privately financed real estate development project, which includes leases to market-rate tenants, furthers its exempt purpose by lessening the burdens of government under section 501(c)(3) of the Code.
- (3) Foundation's participation in a public and privately financed real estate development project, which includes leases to market-rate tenants, furthers its exempt purpose by providing economic development to an underprivileged local area under section 501(c)(3) of the Code.
- (4) Foundation's investments in small, technology-based companies, and its income therefrom, further its exempt purpose by providing economic development to an underprivileged local area under section 501(c)(3) of the Code.
- (5) Foundation's investments in small, technology-based companies, and its income therefrom, further its exempt purpose by lessening the burdens of government under section 501(c)(3) of the Code.
- (8) Foundation's investments in small, technology-based companies, and its income therefrom, does not result in unrelated business income under section 511(a)(1) of the Code, and further its exempt purpose by providing economic development to an underprivileged local area under section 501(c)(3) of the Code.
- (6) Foundation is not a private foundation, and instead is properly classified as a public charity under section 509(a)(2) of the Code.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited by others as precedent.

This ruling is limited to the applicability of the provisions of the sections of the Code as noted above. This ruling is based on the understanding that there will be no material changes in the facts on which it is based.

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,

Robert C. Harper, Jr.  
Manager, Exempt Organizations  
Technical Group 3