TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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FEB 7 2003

T:EP:RA:T4

Ref No. 514.07-00

LEGEND:

Entity A	=
Entity B	=
Entity C	=
Entity D	=
Entity E	=
Entity F	=
Entity G	=
Entity H	=
Entity I	=
Lot 1	=
Lot 2	=
Lot 3	=
Lot 4	=
Taxpayer X	=
Taxpayer Y	=
Trust M	=
Trust N	=
Trust O	=

Dear :

This letter is in response to your ruling request dated April 19, 2001, concerning whether Entity B, satisfies the requirements of section 514(c)(9) to exempt income received by Trust M in connection with Lots 1 through 4 from the unrelated business income tax under section 512 of the Code.

The following facts and representations have been submitted:

Entity B was organized on April 19, 1999 as a Missouri limited liability corporation. Entity B's initial members were Trust N and Taxpayer Y. On or about May 24, 2000, Taxpayer Y transferred his membership interest in Entity B to Trust O.

On April 2, 1999, Entity B and Entity H entered into an agreement whereby Entity B was to purchase Lot 1 and Lot 2 and was granted an option to purchase Lot 3 and Lot 4 from Entity H. Lots 1 through 4 were undeveloped real estate in the State of Missouri.

On June 9, 1999, Entity B closed on its purchase of Lots 1 and 2 from Entity H. The purchase price was financed with a land acquisition and construction loan from a local bank. Entity B constructed a building on Lot 1 and Lot 2 and located tenants and executed leases for all space in Lot 1 and most of the space in Lot 2. Entity B also increased the cost of its acquisition and construction loan from the same local bank to make available funds for tenant finish and related costs on Lots 1 and 2.

On or about April 28, 2000, Taxpayer X and Taxpayer Y contacted Trust M regarding financing or investing in Lots 1 through 4. Trust M is a group trust under Rev. Rul., 81-100, 1981-1, C.B. 326, and is exempt under section 401(a) of the Code. Trust M holds plan assets of a number of different collectively bargained plans.

During Trust M's due diligence investigation relating to Lots 1 through 4, it was discovered that Entity H was a member of a controlled group of corporations, of which Entity G was the parent corporation. Additionally, it was discovered that Entity G and Entity I are controlled by the same group of family members such that Entity G, Entity H and Entity I are members of the same brother-sister control group pursuant to section 1563(a)(2) of the Code. Entity I contributes to several collectively bargained plans on behalf of its employees that invests a portion of each plan's assets in Trust M.

On November 14, 2000, Entity B arranged for an additional loan from the same local bank for Lots 1 and 2. The proceeds of these loans were distributed from Entity B to Trust N and Trust O.

On November 28, 2000, Trust M formed Entity F as a Maryland single member limited liability corporation, of which Trust M is the only member.

On November 29, 2000, Entity B conveyed Lot 1 to Entity C and Lot 2 to Entity D. Entity C assumed all acquisition and construction loans associated with Lot 1 and Entity D assumed all acquisition and construction loans associated with Lot 2. Both Entity C and D are Maryland limited liability companies. Neither Entity C nor Entity D made an election to be taxed as an association taxable as a corporation. Thus, the existence of Entity C and Entity D is ignored for federal income tax purposes.

On December 1, 2000, Entity B contributed all of its membership interests in Entity C and Entity D to Entity A in exchange for membership interests in Entity A. Simultaneously with Entity B's contribution to Entity A, Entity F contributed cash to Entity A in exchange for membership interest in Entity A. The cash contributed to Entity A by Entity F was used to repaid all acquisition and construction loans on Lots 1 and 2 except for $2,000,000. Taxpayer X and Taxpayer Y have personally guaranteed the remaining $2,000,000 to the local bank.

Entity A now wishes to borrow additional funds, which will be secured by Lot 1 and 2 and improvements on each respective lot. The proceeds of the new loan will be distributed to Entity F to reduce its capital contribution to Entity A.

On July 12, 2000, Entity E, an affiliate of Entity B to which the option to purchase Lots 3 and 4 had been assigned, purchased Lots 3 and 4 from Entity H. Entity E paid cash for part of the purchase price and obtained a land acquisition loan from a local bank for the balance of the purchase price.

On October 12, 2000, Entity E obtained a construction loan from the same local bank. The proceeds of the second loan were used to repay the acquisition loan for Lots 3 and 4.

On December 1, 2000, the members of Entity E contributed additional capital for Lots 3 and 4, and Entity E entered into a construction loan agreement with Trust M to build a building on Lot 3. The capital contribution from members of Entity E and the proceeds of the construction loan from Trust M were used to repay the construction loan from the local bank.

As part of the construction loan with Trust M, Entity E entered into a conversion agreement, which provides, in part, that after the building is completed on Lot 3, Entity E will contribute Lot 3 (and the improvements thereon) and Lot 4 to a newly formed limited liability company (Newco) similar to the legal structure created by Entity B on November 29, 2000. An affiliate of Trust M will then contribute an amount equal to Trust M's construction loan to Newco in exchange for a membership interest in Newco. The capital contribution of the Trust M affiliate will then be used to repay the Trust M construction loan. Newco will then obtain a loan from a third party to recover some of the equity capital created as a result of the construction of a building on Lot 4.

The following representations have been made:

1. Trust M is a group trust under Rev. Rul. 81-100, 1981-1C.B. 326, which is a tax-exempt retirement trust and meets the definition of a "qualified organization" under section 514(c)(9)(C) of the Code.
2. The price at which Entity B acquired Lots 1 and 2 from Entity H was fixed as of the date each such lot was acquired by Entity B from Entity H.
3. The value for which Entity B was credited with a capital contribution on its transfer of its membership interests in Entity C and D to Entity A was fixed as of the date of each contribution.
4. None of the amount of the indebtedness on which Entity C, Entity D or Entity A would be liable, the amount payable on such debt, or the time for making payments on any such debt, is dependent on future revenues, income or profits from Lots 1 or Lot 2.
5. Neither Lot 1 or Lot 2 is leased to Entity A or Entity H, nor a person related to either such person.
6. Entity B, the seller of Lots 1 and 2 to Trust M through its equity contribution to Entity A is not related to Trust M.

7. None of Entity B, Entity H or a related party to either provided financing in connection with the acquisition of Lot 1 or Lot 2.
8. The price at which Entity B purchased Lot 1 and 2 from Entity H was agreed upon and fixed before Entity B and Trust M discussed any business relationship.
9. The operating agreement of Entity A complies with the special partnership allocation requirements (i.e., the fractions rule) provided in section 514(C)(9)(E) of the Code.
10. The price at which Entity E acquired Lots 3 and 4 from Entity H was fixed as of the date each such lot was acquired by Entity E from Entity H.
11. The value for which Entity E will be credited with a capital contribution on its transfer of Lots 3 and 4 to Newco will be as fixed as of the date of each such contribution.
12. None of the amount of the indebtedness on which Lot 3, Lot 4 or Newco would be liable, the amount payable on such debt, or the time for making payments on any such debt, is dependent on future revenues, income or profits from Lots 3 or Lot 4.
13. Neither Lot 3 or Lot 4 is or will be leased to Entity E or Entity H, nor a person related to either such person.
14. Entity E, the seller of Lots 3 and 4 to Newco through its equity contribution to Newco is not related to Trust M.
15. None of Entity E, Entity H or a related party to either provided financing in connection with the acquisition of Lot 3 or Lot 4.
16. The price at which Entity E purchased Lot 3 and 4 from Entity H was agreed upon and fixed before Entity E and Trust M discussed any business relationship.
17. Both Entity A and Newco meet the requirements of section 514(c)(9)(E) of the Code.
18. When Entity B entered into a real estate purchase contract with Entity H on April 2, 1999, none of (i) Entity A, (ii) Newco, (iii) Entity F, or (iv) Trust M expected to own or be the owner in an entity which directly or indirectly owned Lots 1 through 4 that was being purchased from Entity H.

Section 514(a) of the Code provides that income generated from "debt-financed" property, not related to an exempt organization's purpose, is subject to the unrelated business income tax of section 512 of the Code in the same proportion in which the property is financed by debt.

Section 514(b) of the Code provides that "debt-financed" property is defined as all property held to produce income and for which there is "acquisition indebtedness" at any time in the tax year or during the prior 12 months if the property is sold during the year.

Section 514(c) of the Code provides that "acquisition indebtedness" generally includes debts incurred in acquiring or improving property.

Except as provided by Section 514(c)(9)(B) of the Code, Section 514(c)(9)(A) of the Code limits the definition of "acquisition indebtedness" to exclude indebtedness incurred by a "qualified organization" in acquiring or improving real property.

Section 514(c)(9)(C) of the Code defines a "qualified organization" to include trusts exempt under section 401 of the Code.

Section 514(c)(9)(B) of the Code provides that the exception under Section 514(c)(9)(A) of the Code will not apply to any organization, including a tax-exempt trust under section 401(a) of the Code, if any of the disqualifying tests are met: (i) the acquisition or improvement price is not fixed as of the date of acquisition or completion of improvement; (ii) the amount of indebtedness, or any other amount payable with respect to such indebtedness, or the time for making payments, is dependent on future revenues, income or profits from the property; (iii) the property is leased to the seller or a person related to the seller; (iv) the property is acquired by a tax-exempt trust under section 401 of the Code from a person related to the plan or leased back to a person related to the plan; or (v) the seller, or a related party to the seller or to the plan, provides financing in connection with the acquisition.

Specifically, the disqualification test of section 514(c)(9)(B)(iv) of the Code provides that the provision of section 514(C)(9)(A) will not apply if (iv) the real property is acquired by a qualified trust from, or is at any time after the acquisition leased by such trust to, any person who – (I) bears a relationship which is described in subparagraph (C), (E) or (G) of section 4975(e)(2) to any plan with respect to which such trust was formed, or (II) bears a relationship which is described in subparagraph (F) or (H) of section 4975(e)(2) to any person described in subclause (I).

Section 514(c)(9)(B)(vi) of the Code provides that the exception under Section 514(c)(9)(A) of the Code will not apply to any organization if the real property is held by a partnership unless the partnership meets the requirements of section 514(c)(9)(B)(i)-(v) and unless – (I) all of the partners of the partnership are "qualified organizations", (II) each allocation to a partner of the partnership which is a "qualified organization" is a "qualified allocation" (within the meaning of section 168(h)(6) of the Code), or (III) such partnership meets the requirements of section 514(c)(9)(E) of the Code.

Section 514(c)(9)(D) of the Code provides that rules similar to those in section 514(c)(9)(B)(vi) apply to teired partnerships.

Section 514(c)(9)(E) of the Code provides special partnership allocation requirements commonly referred to as the fractional rule.

Section 4975(e)(2)(E) of the Code provides that the term "disqualified person" means a person who is – an owner, direct or indirect, of 50 percent or more of – (i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation, (ii) the capital interest or the profits interest of a partnership, or (iii) the beneficial interest of a trust or unincorporated enterprise.

Section 4975(e)(2)(G) of the Code provides that the term "disqualified person" means a person who is – a corporation, partnership or trust or estate of which (or in which) 50 percent or more of – (i) the combined voting power of all classes of stock entitled to vote

or the total value of shares of all classes of stock of a corporation, (ii) the capital interest or the profits interest of a partnership, or (iii) the beneficial interest of a trust or unincorporated enterprise, is owned directly or indirectly, or held by person described in subparagraph (A), (B), (C), (D) or (E) of section 4975(e)(2) of the Code.

S. Rep. No. 96-4036 (1980) discusses the policy reasons for the enactment of Code section 514(c)(9)(B)(iv) to deny the real property acquisition indebtedness exemption where the property is acquired from a related party. Specifically "[t]his restriction is necessary because sales of property at bargain rates to the trust...would permit an employer to make indirect contributions to the trust in excess of the amounts otherwise permitted by the Code and obtain the effect of allowance of deduction (by the reduction in purchase price) for excessive contributions. This also could result in discriminatory contributions in favor of employees who are officers, shareholders or highly compensated employees as well as avoidance of limitations on contributions and benefits."

Entity H, the original seller of Lots 1 and 2, is a member of a controlled group of corporations that consists of Entity I, which invests a portion of its collective bargained plan assets in Trust M. In June 1999, Entity H sold Lots 1 and 2 to Entity B. In December 2000, Entity B transferred Lots 1 and 2 to Entity A for membership interests in Entity A. Also, Entity F acquired membership interests in Entity A in December 2000. Trust M, through Entity F is deemed a member of Entity A, which is the current owner of Lots 1 and 2. Since Lots 1 and 2 are currently owned by Entity A (a partnership), the issue is whether by application of section 514(c)(9)(iv) of the Code, Entity A will fail to satisfy all the requirements of the real property exception under section 514(c)(9)(B) of the Code and cause any income of Trust M attributable to Lots 1 and 2 to be subject to the tax on unrelated business income.

With regard to Lots 3 and 4, Entity B acquired an option to purchase Lots 3 and 4 from Entity H in April 1999. Entity B assigned the option to purchase Lots 3 and 4 to Entity E. In July 2000, Entity E purchased Lots 3 and 4 from Entity H. Entity E will eventually contribute Lots 3 and 4 for membership interests in Newco. Trust M will create a new entity that will also acquire a membership interest in Newco. Since Newco will eventually own Lots 3 and 4, will Newco fail to satisfy all the requirements of the real property exception under section 514(c)(9)(B) of the Code and cause any income of Trust M attributable to Lots 3 and 4 to be subject to the tax on unrelated business income.

Section 514(c)(9)(A) of the Code limits the definition of "acquisition indebtedness" to exclude indebtedness incurred by a tax-exempt trust under section 401(a) of the Code in acquiring or improving real property.

This exception does not apply to a tax-exempt trust under section 401(a) of the Code if any of the disqualifying tests of Section 514(c)(9)(B) of the Code are met. Additionally, the same disqualifying tests of Section 514(c)(9)(B) of the Code must be met by a partnership in which a tax-exempt trust under section 401(a) of the Code invests and unless – (I) all of the partners of the partnership are "qualified organizations", (II) each allocation to a partner of the partnership which is a "qualified organization" is a "qualified allocation"

(within the meaning of section 168(h)(6) of the Code), or (III) such partnership meets the requirements of section 514(c)(9)(E) of the Code.

Entity A has represented that it has satisfied all of the requirements of Section 514(c)(9)(B)(vi) of the Code except whether it acquired the property from a person related to Trust M or leased back to a person related to Trust M.

Entity E, the future owner of Newco has represented that Newco will satisfied all of the requirements of Section 514(c)(9)(B)(vi) of the Code except whether Newco will have acquired the property from a person related to Trust M or leased back to a person related to Trust M.

S. Rep. No. 96-4036 (1980) provides the policy reasons for the enactment of Code section 514(c)(9)(B)(iv) so as to deny the real property acquisition indebtedness exemption where a partnership owned by a tax-exempt trust under section 401(a) of the Code is used to acquired property from a related party which could not be acquired directly by the trust itself. The primary policy reason is to prevent sales of property at bargain rates to a tax-exempt trust under section 401(a) of the Code that would permit an employer to make indirect contributions to the trust in excess of the amounts otherwise permitted by the Code and obtain the effect of an allowable deduction (by the reduction in purchase price) where the Code would otherwise deny such a deduction.

Applying the policy reasons set forth in S. Rep. No. 96-4036 (1980) to Entity A and Newco, the provisions of section 514(c)(9)(B)(iv) would not be applicable to either Entity A or Newco. Lots 1 and 2 were sold to Entity B in June 1999. Entity E, through Entity B, acquired an option to purchase Lots 3 and 4 in April 1999. In July 2000, Entity E purchased Lots 3 and 4 from Entity H. At the time of purchase of Lots 1 and 2, Trust M was not affiliated with Entity B. At the time the option was acquired to purchase Lot 3 and 4 by Entity B, and at the time Lots 3 and 4 were actually purchase by Entity E, Trust M was not affiliated with Entity B or E. The correct application of Section 514(c)(9)(B)(iv) of the Code is whether Entity A acquired Lots 1 and 2 or Newco will acquire Lots 3 and 4 from a related party of Trust M (as defined in sections 4975(e)(2)(E) or (G) of the Code).

Additionally, the policy reason set forth in S. Rep. No. 96-4036 (1980) could not apply to the acquisition of Lots 1 through 4 since Entity I, a participating employer in Trust M could not have made an indirect contribution in excess of the amounts otherwise permitted by the Code and obtain the effect of an allowable deduction (by the reduction in purchase price) where the Code would otherwise deny such a deduction since Trust M was not a party to either transaction. Trust M did not and will not acquire an ownership interest in Lots 1 through 4 until after the time an indirect contribution could have been made.

Accordingly, Trust M, as a qualified organization under Section 514(c)(9)(C), is not excepted from the application of section 514(c)(9)(A) of the Code under section 514(c)(9)(B) of the Code, and is entitled to exclude from the definition of "acquisition indebtedness" the existing and additional loans with respect to Lots 1 through 4 under section 514(c)(9)(A) of the Code. Thus, no gross income is includible in computing

unrelated business taxable income for Trust as a result of the present or future loans on Lots 1 through 4.

This ruling assumes that Trust M satisfies the requirements of Rev. Rul. 81-100, 1981-1 C.B. 326.

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

This letter ruling was written by of this Group 4 who can be reached at

Sincerely yours,

Alan Pipkin
Chief, Employee Plans
Technical Branch 4

Enclosures:

Deleted Copy of this Letter
Notice of Intention to Disclose