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Department of the Treasury  
Washington, DC 20224

Third Party Communication: None  
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Person To Contact:  
, ID No.

Telephone Number:

Refer Reply To:  
CC:PSI:B02  
PLR-106799-05

Date:  
August 4, 2005

Legend

X:

Fund:

Dear :

This responds to a letter dated January 20, 2005, and subsequent correspondence, submitted on behalf of X, by its authorized representative requesting rulings concerning and related to the qualification of Fund as a pooled income fund under § 642(c)(5) of the Internal Revenue Code.

X is a tax-exempt organization described in §170(b)(1)(A)(iii) (an organization the principal purpose or functions of which are the providing of medical or hospital care). X created Fund to finance the construction of new buildings.

The Fund will lease land from X. The Fund will lease such land and the buildings thereon to X for a twenty-five year period on a net-net basis. All such net rental income will be distributed to, and entirely taxable to, the income beneficiaries of the Fund.

Section 1.642(c)-5(a)(2) of the Income Tax Regulations provides that notwithstanding any other provision of chapter 1, a fund which meets the requirements of a pooled income fund as defined in § 642(c)(5) and § 1.642(c)-5(b), shall not be treated as an association within the meaning of § 7701(a)(3). Such a fund, which need not be a trust under local law, and its beneficiaries shall be taxable under part I,

subchapter J, chapter 1 of the Code, but the provisions of subpart E (relating to grantors and others treated as substantial owners) of such part shall not apply to such fund.

Section 4 of Rev. Proc. 2005-3, 2005-1 I.R.B. 118, 122, lists issues on which the Service ordinarily will not issue letter rulings. The issues include whether a pooled income fund satisfies the requirements of § 642(c)(5) and whether a transfer to a pooled income fund is deductible as a charitable contribution under §§ 170(f)(2)(A), 2055(e)(2)(A), and 2522(c)(2)(A). In lieu of seeking the Service's advance approval of the pooled income funds, taxpayers are directed to follow the sample trust provisions for a pooled income fund in Rev. Proc. 88-53, 1988-2 C.B. 712. By following the sample provisions contained in Rev. Proc. 88-53, taxpayers can be assured that the Service will recognize the trust as meeting all the requirements for a pooled income fund under § 642(c)(5), provided the trusts operate in a manner consistent with the terms of the trust instrument and provided it is a valid trust under local law.

The sample declaration of trust and instruments of transfer in Rev. Proc. 88-53 are intended to meet all the applicable requirements for a pooled income fund under § 642(c)(5). However, they are not intended to preclude other permissible provisions in the governing instruments. Provisions that vary from the sample provisions will not adversely affect the Fund's qualification as a pooled income fund if those provisions are consistent with the requirements in § 642(c)(5) and § 1.642(c)-5. In the present case, the Fund's declaration of trust contains four provisions that are not addressed in Rev. Proc. 88-53. Because these provisions are not addressed in Rev. Proc. 88-53, we are ruling on whether these provisions would adversely affect the qualification of the Fund as a pooled income fund if it otherwise qualifies under § 642(c)(5).

Section 1.2 of the Fund's trust agreement provides that a donor may retain in the Donor Agreement the power exercisable only by Will to revoke or terminate the income interest of any designated beneficiary other than X. Income interests are otherwise irrevocable. This provision does not impact X as the charitable remainder beneficiary.

Section 1 of the sample declaration of trust in Rev. Proc. 88-53 states that each donor transferring property to the Fund shall contribute an irrevocable remainder interest in such property to Public Charity.

Section 1.642(c)-5(b)(2) provides in part that the donor may retain the power exercisable only by will to revoke or terminate the income interest of any designated beneficiary other than the public charity.

Therefore, the provision in § 1.2 of the Fund's trust agreement will not adversely affect the qualification of the Fund as a pooled income fund if it otherwise qualifies under § 642(c)(5) because that provision restricts the power of the donor to revoke or terminate the income interest of any designated beneficiary other than X only by Will in accordance with § 1.642(c)-5(b)(2) and the provision does not impact X as the charitable remainder beneficiary.

Section § 3.4 of the trust agreement provides that income for the quarter in which death occurs which is attributable to those Units as to which the decedent was a beneficiary shall be prorated to the date of his death.

Section 7 of the sample declaration of trust in Rev. Proc. 88-53 states in part that the income interest of any beneficiary of the Fund shall terminate with the last regular payment of income that was made before the death of the beneficiary. The Trustee of the Fund shall not be required to prorate any income payment to the date of the beneficiary's death.

The provision in § 3.4 of the Fund's trust agreement will not adversely affect the qualification of the Fund as a pooled income fund if it otherwise qualifies under § 642(c)(5).

Section 7.5.7 of the Fund's trust agreement provides that the trustee has the authority to set up and maintain depletion or depreciation reserves for any Fund property by setting aside trust income to a depletion or depreciation reserve. Any depletion or depreciation deduction in excess of the income so set aside as a reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each. The trust agreement does not prohibit the trustee from investing in depreciable or depletable assets.

Rev. Rul. 90-103, 1990-2 C.B. 159, holds that if the trustee of a trust that otherwise qualifies as a pooled income fund is not required by the governing instrument or state law to establish a depreciation reserve fund with respect to any depreciable property held by the trust, the trust does not meet the requirements for a pooled income fund under § 642(c)(5)(A). In addition, the Rev. Rul. holds that if the trustee of a trust that otherwise qualifies as a pooled income fund is required by the governing instrument to establish a depreciation reserve fund with respect to any depreciable property held by the trust, but the depreciation to be added to such reserve is not required to be determined in accordance with GAAP, the trust does not meet the requirements for a pooled income fund under § 642(c)(5)(A).

Rev. Rul. 90-103 provides that if the trustee of an otherwise qualifying pooled income fund is not prohibited by state law from accepting or investing in depreciable or depletable property, the governing instrument must provide either that the trustee shall establish a depreciation or depletion reserve in accordance with GAAP or that the trustee shall not accept or invest in any depreciable or depletable assets.

Therefore, the third provision in § 7.5.7 of the Fund's trust agreement will not adversely affect the qualification of the Fund as a pooled income fund if it otherwise qualifies under § 642(c)(5) because that provision follows the requirements of Rev. Rul. 90-103 by providing the trustee with authority to set up and maintain depletion or

depreciation reserves for any Fund property by setting aside trust income to a depletion or depreciation reserve.

The amendment power in § 12.1 of the Fund's trust agreement states that X shall have the right to amend, in whole or in part, any or all of the provisions of this Agreement. However, no such amendment shall jeopardize the status of the Fund as a pooled income fund within the meaning of § 642(c)(5).

Section 13 of the sample declaration of trust in Rev. Proc. 88-53 states that the Public Charity shall have the power, acting alone, to amend this document and the associated instruments of transfer in any manner required for the sole purpose of ensuring that the Fund qualifies and continues to qualify as a pooled income fund within the meaning of § 642(c)(5).

The amendment power in § 12 of the Fund's trust agreement will not adversely affect the qualification of the Fund as a pooled income fund if it otherwise qualifies under § 642(c)(5).

X has also requested rulings that the buildings will be depreciated over 40 years under the straight line method and that depletion or depreciation deductions for a particular year will be allocable to the Fund's income beneficiaries to the extent that such depletion or depreciation deductions exceed the income set aside by the trustee for the depreciation reserves.

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business, or property held for the production of income.

Section 168(a) provides that generally the depreciation deduction provided by § 167(a) for any tangible property shall be determined by using (1) the applicable depreciation method, (2) the applicable recovery period, and (3) the applicable convention.

Section 168(d)(2)(A) provides that in the case of nonresidential real property, the applicable convention is the mid-month convention, as defined in § 168(d)(4)(B).

Section 168(g)(1)(B) provides, in part, that in the case of any tax-exempt use property, the depreciation deduction allowed under § 167(a) shall be determined using the Alternative Depreciation System (ADS).

Section 168(g)(2) provides that for purposes of § 168(g)(1), the ADS is depreciation determined by using—(A) the straight line method (without regard to salvage value), (B) the applicable convention determined under § 168(d), and (C) in the case of nonresidential real and residential rental property, a 40-year recovery period.

Section 168(g)(3)(A) provides that in the case of any tax-exempt use property subject to a lease, the recovery period used for purposes of § 168(g)(2) shall in no event be less than 125 percent of the lease term. The lease term is represented to be 25 years; 125% of the lease term is 30 years.

Section 168(h)(1)(B)(i) provides, that for purposes of § 168, in the case of nonresidential real property, the term ‘tax-exempt use property’ means that portion of the property leased to a tax-exempt entity in a disqualified lease.

Section 168(h)(1)(B)(ii) provides that for purposes of § 168(h)(1)(B), the term “disqualified lease” means any lease of nonresidential real property to a tax-exempt entity, but only if—(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under § 103(a) and such entity (or a related entity) participated in such financing, (II) under such lease there is a fixed or determinable price purchase or sale option which involves such entity (or a related entity) or there is the equivalent of such an option, (III) such lease has a lease term in excess of 20 years, or (IV) such lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or a related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease [*i.e.*, a sale-leaseback or a lease-leaseback arrangement].

Section 168(h)(2)(A)(ii) provides that for purposes of § 168(h), the term “tax-exempt entity” includes any organization exempt from tax imposed by Chapter 1 of the Internal Revenue Code.

The property to be leased back to X is nonresidential real property. Under § 168(h), real property is tax-exempt use property if it is leased to a tax-exempt entity under a disqualified lease. Thus, the proposed lease of the improved nonresidential real property by Fund to X will be a disqualified lease if at least one of the four requirements provided in § 168(h)(1)(B)(ii) is met.

In this case, the leased structures will be built on land owned by and leased from X, a tax-exempt entity, for an unspecified term. After construction, the land and buildings will be leased to X for a term of 25 years.

Accordingly, the property which Fund will lease back to X will be tax-exempt use property because it will be leased to X, a tax-exempt entity, under a disqualified lease, *i.e.*, a lease with a term exceeding 20 years.

Therefore, under § 167(h) and 168(g) the building(s) are to be depreciated using a straight line method, a mid-month convention and a recovery period of 40 years. This ruling does not apply to any property that is not nonresidential real property within the meaning of § 168(h)(1)(B) and (E). Furthermore, depreciation deductions will be

allocable to the Fund's income beneficiaries to the extent that such depreciation deductions exceed the income set aside by the Trustee for the depreciation reserve.

X has also requested a ruling that the amounts distributed from the Fund that are includible in the gross income of an income beneficiary will be income to that beneficiary from a passive activity, within the meaning of § 469.

Under § 1.651(a)-1, because amounts in a pooled income fund may be paid or permanently set aside for purposes specified in § 642(c), the fund will be subject to §§ 661 and 662, which apply to complex trusts.

Under § 662(a), a beneficiary of a trust includes in gross income an amount equal to the amount of trust income required to be distributed currently to that beneficiary, plus other amounts properly paid, credited, or required to be distributed, but only up to that beneficiary's ratable portion of the trust's distributable net income ("DNI").

Under § 662(b), the amounts determined under § 662(a) have the same character in the hands of the beneficiary as in the hands of the trust. These amounts are treated as consisting of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI of the trust unless the governing instrument or local law specifically allocates different classes of income to different beneficiaries.

Section 469(a) provides for the disallowance of passive activity losses. Section 469(c)(2) provides that except as provided in § 469(c)(7), the term "passive activity" includes any rental activity.

Section 469(d)(1) defines a passive activity loss as the amount by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for that year.

Therefore, the rental of land and buildings by the Fund to X will be a passive activity under § 469(c). Because the excess of aggregate income from all passive activities over the aggregate losses from all passive activities will enter into the computation of DNI, then the characterization rule of § 662(b) will apply. Thus, if the Fund's gross income in any year from rental of the land and buildings exceeds its losses (including a ratable portion of the Fund's indirect expenses) in that year from rental of the land and buildings, amounts distributed from the Fund that are includible in the gross income of an income beneficiary for that year will be income to that beneficiary from a passive activity, within the meaning of § 469, in the same proportion as the Fund's net income from that rental that enters into the computation of the Fund's DNI for that year bears to the Fund's entire DNI for that year.

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transaction described above under any

other provision of the Code. No opinion is expressed concerning any other federal tax consequences of the formation or operation of the Fund, including whether the governing instruments meet all the requirements of § 642(c)(5).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the first return filed for the Fund. A copy is enclosed for that purpose.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Audrey W. Ellis  
Reviewer, Branch 2  
Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures

Copy of this letter  
Copy for § 6110 purposes

cc: