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Charitable Ruling or Ruling for Charity?

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Taxpayers selling real property, desperately seek to avoid the characterization of that property as "dealer property." What is commonly referred to as dealer property is defined in the Internal Revenue Code as "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." In a typical case, the seller of real property is concerned that dealer property characterization will result in paying tax at ordinary income rates, rather than capital gains rates. Other taxpayers have special concerns: for example, real estate investment trusts are generally subject to a 100% tax on their profits from sales of dealer property, and charitable organizations are subject to "unrelated business income tax" on sales of dealer property.

The Internal Revenue Service recently issued Private Letter Ruling 200532057, dealing with this issue. The Taxpayer in question, a church, owned two contiguous properties for fifty years. The properties were used as a worship/fellowship building, an office/residence for the church offices and pastor, a gymnasium and a recreation hall. The Taxpayer's buildings were constructed in the 1940s and the facilities were not updated or remodeled and were behind modern codes for accessibility.

In 2002, the Taxpayer decided to remodel and update the existing buildings in preparing to remodel one of the existing structures, the Taxpayer discovered that due to the building's age, significant damage had been done to the building causing it to become unsafe to use. The Taxpayer's annual income and reserves were not sufficient to fund such renovations. The Taxpayer determined that the most appropriate means to finance the project was to sell part of the property in order to finance the necessary repairs, construction and improvements.

The Taxpayer's property was zoned for single family residences. The proposed plan called for a subdivision of the property into seven parcels, including six single family residences. One of the parcels would be retained by the Taxpayer. Under the proposed plan, local law required that the Taxpayer grade and construct 1,190 linear feet of new curb, gutter, sidewalk, drainage, water and electrical improvement. The Taxpayer planned to make the required improvements to the lots and then to sell the parcels, without additional improvement, to a developer or to individuals. The Taxpayer stated in its ruling application that this would be a one-time activity. The proceeds would be used by the church for its building and any excess would be used for building repairs and maintenance.

The Taxpayer requested a ruling that the proposed development and sale of the six bare lots to individuals would not be unrelated business taxable income and, therefore, would not be taxable to the Taxpayer.

Section 501(c)(3) of the Internal Revenue Code provides for the exemption from Federal income tax of certain organizations, including organizations that operate exclusively for religious purposes. However, section 511 of the Code imposes a tax on the unrelated business taxable income of these exempt organizations.

The Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, computed with the modifications provided in section 512(b).

The modifications described in section 512(b) of the Code exclude from unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property *other than* stock in trade, other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, and *property held primarily for sale to customers in the ordinary course of the trade or business*.

Under these provisions, if a charitable organization sells real property that is held primarily for sale to customers in the ordinary course of a trade or business (and the sale is not substantially related to the organization's exempt purpose), any gain from the sale is subject to tax as unrelated business taxable income. Therefore, as an exempt organization, the taxpayer in this ruling had even more riding on the dealer property question than typical taxpayers, *i.e.*, it would pay no tax if the property is *not* dealer property and the full ordinary income tax if the property *is* dealer property.

The ruling undertakes a brief survey of some of the vast authority relating to the dealer issue. In *Malat v. Riddell*, 383 U.S. 569, 86 S.Ct. 1030 (1966), the Supreme Court defined the standard to be applied in determining whether property is held primarily for sale to customers in the ordinary course of business. The Court interpreted the word "primarily" to mean "of first importance" or "principally."

In *Adam v. Commissioner*, 60 T.C. 996 (1973), the Tax Court provided guidelines to be used to determine whether real property is dealer property. The factors to be considered include (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 the improvements made to the property; (5) the proximity of the sale to the purchase of the land; and (6) the purpose for which the property was held during the taxable year.

In *Parklane Residential School, Inc. v. Commissioner*, T.C.M. 1983-139, an organization exempt under section 501(c)(3) of the Code had as its exempt function the operation of a school for mentally disabled children. The school entered into 22 transactions involving the purchase and sale at a profit of real properties over two years. The Court held that this activity was not substantially related to the exercise or performance of petitioner's exempt function (i.e., the operation of a school for mentally retarded children). Even though the profits were ultimately used to further petitioner's exempt function, the source of the funds was, in essence, an unrelated business. The Tax Court stated that the fact that the petitioner entered into 22 transactions belied any suggestion that the business was not regularly carried on.

In *Houston Endowment v. United States*, 606 F.2d 77 (5th Cir. 1979), the Court of Appeals stated that:

> Although a taxpayer may have acquired property without intending to enter the real estate business, what was once an investment or what may start out as a liquidation of an investment, may become something else. [W]here sales are continuous, the nature and purpose of a taxpayer's acquisition of property is significant only where sales activity results from unanticipated, externally introduced factors which make impossible the continued preexisting use of the realty. Original investment intent is pertinent, for example, when a taxpayer is coerced to sell its property by acts of God, new and unfavorable zoning regulations or other uncontrollable forces.

After discussing these and other authorities, the Private Letter Ruling summarized the facts of the situation before it as follows:

> Under the facts provided, [the Taxpayer] proposes to sell land that it acquired for its charitable purposes and which it has held for a significant period of time. Due to the Taxpayer's need to generate proceeds to fund necessary renovations, the Taxpayer determined that it is in its best interest to sell the land in order to fund these activities. The facts surrounding the [Taxpayer's] acquisition and sale of the property can be distinguished from those in *Parklane*, supra, where properties were purchased and sold at a profit over a short period of time in order to finance an exempt function that was not substantially related to the transactions. [The Taxpayer] will make only the improvements to the land as required by [the local government] in order to receive approval and make the property saleable. [The Taxpayer] plans to sell the lots to individuals after the required improvements. No other improvements are contemplated to enhance the sale of the property.

Then, citing the primary purpose test of *Malat*, the Service ruled that the proposed sale of the parcels to individuals or developers with the limited improvements described above would not constitute unrelated business taxable income.

Although some of the authority cited in the ruling relates to exempt organizations, the holding of the ruling turns on the more general question of whether the property sold was dealer property. Based on the fact that only improvements required by the local government to receive approval and to make the property saleable were made, and the long-term holding period of the property, and perhaps based on the relatively small number of sales contemplated, the Service concluded that the Taxpayer was not a dealer.

The reasoning behind this holding should, in theory, be equally applicable to ordinary taxpayers in similar factual settings. Despite this, it is hard to know how much weight to give this ruling. As a general matter, the Service does not often rule on dealer property issues, because of their inherently factual nature. The rulings the Service does issue in this area seem to go to exempt organizations, perhaps because such organizations may be hard pressed to proceed without a ruling. As a result, it is difficult to know whether to take away from this ruling a favorable IRS position on admittedly favorable and sympathetic facts, or merely leniency toward a charitable organization. Readers should know that all private letter rulings contain the following caveat: "This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent."