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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSISTANT DISTRICT COUNSEL, VIRGINIA-WEST
VIRGINIA DISTRICT, RICHMOND

FROM: Assistant Chief, Exempt Organizations Branch 2
Office of Division Counsel/Associate Chief Counsel (TE/GE)

SUBJECT:

This Field Service Advice responds to your memorandum dated March 20, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND
Taxpayer =

ISSUES
1. Is the transfer of property by an organization described in section 501(c)(3) of the Code to a liquidating trust a taxable transaction?

2. Is a proposed plan of reorganization provision that the organization shall retain its status as a tax-exempt entity after the reorganization without any further action on its part objectionable?

FACTS
We understand the facts to be as follows. The Taxpayer operates a hospital that is exempt from federal income tax as an organization described in section 501(c)(3) of the Code. The Taxpayer is in bankruptcy because of actions by its former president and CEO, who diverted hospital revenues to nonexempt purposes has

been indicted for various federal offenses relating to his diversion and mishandling of hospital funds.

The Taxpayer has proposed a plan of reorganization under Chapter 11 that provides for a liquidating trust to pay holders of general unsecured claims. The proposed liquidating trust will be funded in part with proceeds from the sale of commercial real estate unrelated to the operation of the hospital. In addition, the proposed liquidating trust will receive a portion of the proceeds from the Taxpayer's claims against two related corporations, which are also in Chapter 11 reorganization proceedings.

The Taxpayer intends to affiliate with a nonprofit corporation whose members include three other hospitals. The affiliation will guarantee an $ loan to the Taxpayer that will be used in part to satisfy the federal tax claims. The Taxpayer currently owes FICA and withholding taxes totaling approximately $.

<u>LAW AND ANALYSIS</u>

ISSUE 1:
The Taxpayer is transferring commercial real estate and other property unrelated to hospital operations to the liquidating trust. Section 501(a) of the Code provides, in part, that an organization described in section 501(c)(3) is exempt from federal income tax. Section 511 imposes a tax on the unrelated business taxable income (UBTI) of those organizations.

Section 512(a)(1) defines UBTI as the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less certain deductions, computed with modifications provided in section 512(b). Section 512(b)(5) excludes from the computation of UBTI all gains or losses from the sale, exchange, or other disposition of property (other than stock in trade or property held primarily for sale to customers).

However, section 512(b)(4) provides, in part, that income from debt-financed property (as defined in section 514) is not excluded under section 512(b)(5). Debt-financed property is property held to produce income and with respect to which there is an acquisition indebtedness. I.R.C. §514(b)(1). Debt-financed property does not include any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by the organization of its charitable or other purpose constituting the basis for its exemption under section 501. I.R.C. §514(b)(1)(A). Debt-financed property also does not include property used in unrelated trade or business. I.R.C. §514(b)(1)(B).

ISSUE 2
The proposed plan of reorganization provides that the Taxpayer will retain its exemption after the reorganization without the necessity of reapplying for recognition of tax-exempt status. Generally, when the exempt purpose of an organization remains the same after a reorganization and no new legal entity is created, its tax-exempt status is not adversely affected. See Rev. Rul. 67-390 (1967-2 C.B. 179). However, the creation of a new legal entity can occur even though there are no material changes in the organization's purpose or method of operation when, for example, the organization changes its state of incorporation after the reorganization, or changes its classification from unincorporated to incorporated. See id.

Section 7428 of the Code provides that only the U.S. Tax Court, the U.S. Claims Court, or the U.S. District Court (D.C. Cir.) may make a declaration with respect to the initial qualification or continuing qualification as an organization described in section 501(c)(3).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS
[redacted]

You have indicated that some of the property held by the Taxpayer and transferred to the liquidating trust is commercial real estate unrelated to the operation of the hospital. From the information provided, it appears that the Taxpayer's use of the property at issue may not be substantially related to its exempt purposes. In general, property is not substantially related to exempt purposes if less than 85% of the use of the property is devoted to the organization's exempt purpose. The extent to which the property is used for a particular purpose is determined based on the facts and circumstances. Treas. Reg. §1.514(b)-1(b)(1)(ii).

[redacted] I.R.C. §514(b). Unrelated debt-financed income is a portion of the gross income derived from use of the debt-financed property during the taxable year. This "debt-basis percentage" is the average amount of outstanding principal indebtedness on the property over the average basis of the property during the portion of the taxable year it is held by the organization. Treas. Reg. §1.514(a)-1(a)(1)(ii).

[redacted]

[redacted]

ISSUE 2:
The Taxpayer contends that it should retain its exemption after the reorganization without the need for reapplying for tax-exempt status. It is unclear whether that Taxpayer remains the same or a new legal entity is created after the reorganization. See Rev. Rul. 67-390 (1967-2 C.B. 179). [redacted]

[redacted]

REGINA L. OLDAK