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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **200619024**
Release Date: 5/12/06

Date: February 16, 2006

Contact Person:

Identification Number:

UIL 103.02-00
103.02-01
512.01-00

Telephone Number:

Employer Identification Number:

State =
College =
Date =

Dear :

This responds to your request for rulings, submitted by your authorized representative on behalf of College that: (1) the College qualifies as a political subdivision of State within the meaning of section 1.103-1(b) of the Income Tax Regulations for purposes of sections 103 and 115 of the Internal Revenue Code, and that (2), proceeds from the sale of certain real property will not be subject to tax as unrelated business income within the meaning of sections 511 through 514 of the Internal Revenue Code.

FACTS

You make the following factual representations. The College was created in Date as a community College district under state law. Under state law, the College is governed by a board of trustees (the "board") who are elected by the electors of the district. The board establishes policies and a budget for the College and is empowered under state law to impose an annual mill levy on the assessed value of the district for the regular support and operation of the College.

The College will sell a large piece of property to pay for the construction of a new residence hall. In 1994, two donors each gave an undivided one-half interest in a parcel of unimproved real property to the College. The College did not solicit or anticipate the

donated property, which was adjacent to other land the College owned at the time of the gifts. At the time the College submitted this ruling request, it had made no improvements to the property. When the College received the property, it had a street running through it that was not continuous. In 2004, the city began an extension/completion project to make the street a major 5-lane thoroughfare and informed the College that it will re-zone the property for commercial use. In 2005, the College granted the city's request for a permanent right-of-way to accommodate street construction, which includes asphalt, curb, gutter, sidewalk, water, sewer and street lighting.

The College plans to liquidate the property by subdividing it into 19 lots to offer for sale to individuals. It will create a preliminary development plat, a preliminary plat and a final plat of the property for submission to the city council. As a condition to subdivision approval, the city will require the College to make certain improvements on the property, including providing connections to the individual lots for electrical and natural gas utilities. It will also be required to provide telephone and cable television utilities, but will ask the buyers to repay those costs.

The College will offer the lots for sale in 2006, after approval and recordation of the final plat. The college does not plan to actively advertise or market the lots; it will simply post notices in the legal section of the local newspaper. If the lots do not sell within a reasonable period, the College will retain a local broker to sell the lots. It does not plan to make any other notification or advertising with respect to the property.

The College will use the proceeds from the sale of the lots to construct a new residence hall in 2007. It also plans to issue a local general obligation bond to raise construction funds for the hall.

Once before, in 1972, the College sold one other piece of land. After it sells this piece of property, it does not intend to sell or subdivide any of its remaining land or purchase any additional land other than for its own use.

RULINGS REQUESTED, as revised.

(1) College is a "political subdivision" within the meaning of section 1.103-1(b) of the Income Tax Regulations and within the meaning of section 115 of the Code.
(2) Proceeds from the sale of the property will not be subject to tax as unrelated business taxable income within the meaning of sections 511 through 514 of the Code.

LAW & ANALYSIS

Issue 1

The Code does not define the term "political subdivision." Section 1.103-1(b) of the regulations provides that the term "political subdivision" denotes any division of any state or local governmental unit that is a municipal corporation or that has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any state or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of these units.

Three generally acknowledged sovereign powers of states are the power to tax, the power of eminent domain, and the police power. Commissioner v. Estate of Alexander V. Shamberg, 3 T.C. 131 (1944), acq., 1945 C.B. 6, aff'd, 144 F.2d 998 (2d Cir. 1944), cert denied, 323 U.S. 792 (1945). It is not necessary that all three of these powers be delegated in order to treat an entity as a political subdivision for purposes of the Code. However, possession of only an insubstantial amount of any or all of the sovereign powers is not sufficient. All of the facts and circumstances must be taken into consideration, including the public purposes of the entity and its control by a government. Rev. Rul. 77-164, 1977-1 C.B. 20.

Consideration of these principles, as they apply to the facts of this case, leads us to conclude that College is a political subdivision of State under section 1.103-1(b) of the regulations. College was created pursuant to State law and is governed by the Board the members of which are elected by the electors of the District. Under State law, College is granted a wide variety of powers including the power to establish a budget and the power to tax for the support and operation of College.

Based on the information submitted and representations made, we conclude that College is a political subdivision of State for purposes of sections 103 and 115 of the Code.

Issue 2

Section 511(a)(2)(B) of the Code imposes a tax on the unrelated business income earned by state colleges and universities which are political subdivisions of any government.

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed which are directly connected with the carrying on of the trade or business.

Section 512(b)(5)(B) of the Code states that all gains or losses from the sale, exchange, or other disposition of property are excluded from unrelated business taxable income except stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of the trade or business.

Section 1.513-1(a) of the regulations defines the term "unrelated trade or business" as meaning any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its educational purpose or function constituting the basis for exemption.

Section 1.513-1(b) of the regulations explains that any activity conducted by an organization described in IRC § 511 which is carried on for the production of income and which otherwise possesses the characteristics required to constitute a "trade or business" within the meaning of section 162 of the Code, and which, in addition, is not substantially related to the performance of exempt functions, presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513, the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(2)(ii) of the regulations provides that in determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, activities that are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.

Rev. Rul. 55-449, 1955-2 C.B. 599 describes the construction and sale of 80 houses by a charitable foundation described in section 101(6) of the 1939 Code (the predecessor to section 501(c)(3)), over a period of 18 months for the sole purpose of raising funds for the support of a church. It held that, notwithstanding that the foundation did not contemplate engaging further in such activity, the activity constituted an unrelated trade or business.

Rev. Rul. 59-91, 1959-1 C.B. 215 describes a corporation that sold a portion of property it held as an investment. The property was subdivided into residential lots, graded, the streets surfaced, and the required drainage installed. In holding that the gains realized from the sales of the lots constituted ordinary income, the ruling implies the sizeable

improvements made in order to facilitate the sales led to the conclusion the property was held primarily for sale to customers.

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". By this standard, ordinary income would not result unless a sale purpose is of first importance.

In Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952), a taxpayer purchased land for cattle feeding, and, after holding it for four years, subdivided it and offered it for sale. He derived a substantial amount of his income from the sale of the lots. This Court explained that there is no fixed formula or rule of thumb for determining whether a taxpayer held property primarily for sale to customers in the ordinary course of his trade or business. Each case must rest upon its own facts. The Court identified a number of helpful factors to point the way, among which are the purposes for which the property was acquired, whether for sale or investment; and, continuity and frequency of sales as opposed to isolated transactions. The Court reasoned that while the purpose for which the property was acquired is of some weight, the ultimate question is the purpose for which it was held.

In Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), the taxpayer owned 500 acres of unimproved land used for grazing purposes. The taxpayer listed the land for sale with a licensed real estate broker whom the taxpayer authorized to subdivide the land and develop it for sale. The broker had the land platted and laid out into subdivisions. Although no improvements were made on the lots themselves, streets were cleared, graded, and shelled; storm sewers were put in at street intersections; gas and electric lines were constructed; and a well was dug. Each year 20 or 30 lots were sold. The Court held that the taxpayer was holding lots for sale to customers in the regular course of business. The Court stated that the sole question was whether the taxpayer was in the business of subdividing real estate. The fact that the taxpayer did not buy additional land did not prevent the sales activities from being a business.

In Houston Endowment v. United States, 606 F.2d 77 (5th Cir. 1979), the plaintiff's predecessor in interest constructed roads, water lines, sewers, and railroad tracks to enhance the land's marketability. The Court stated, "…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. Where 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 pre-existing 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."

In Farley v. Commissioner, 7 T.C. 198 (1946), the taxpayer purchased platted land to use in his nursery business. Twelve years later, the city built streets through the property that made it less useful for his business. Even though he made no active sales effort and made no improvements, he sold 25 and a half lots in one year. The court opined that the sales were essentially made "..in the nature of a gradual and passive liquidation of an asset."

In Adam v. Commissioner, 60 T.C. 996, (1973), acq. 1974-1 C.B. 1 (1974), the court held that an accountant did not hold property primarily for sale in a trade or business. He purchased 11 and sold 9 parcels of undeveloped land over four years. The Court provided guidelines that can be used to determine whether a taxpayer held land primarily for sale in the ordinary course of a trade or business. 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 of 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 are all useful in making this determination. No one factor is controlling but all are relevant facts to consider in what is basically a facts and circumstances test.

In Barrios Estate v. Commissioner, 265 F.2d 517 (2nd Cir. 1957) and in Buono v. Commissioner, 74 T.C. 187 (1980), the courts permitted a taxpayer to make "reasonable expenditures and efforts" for subdividing land, construction of streets, and provision of drainage to "liquidate" an investment.

As an organization described in section 511(a)(2)(B) of the Code, College is subject to section 511 regarding the imposition of tax on its unrelated business income. Under the facts provided, the College proposes to sell land that it acquired, unsolicited, from two donors twelve years ago. The city appears to be the primary initiator for the most important property improvements, including the re-zoning and construction of the new 5-lane boulevard. After these changes were made, the College decided to subdivide and sell the property to get funds to build a new residence hall in 2007. It will only make minimal improvements and will not actively market the property. The College has not subdivided any other property in the past and does not plan to do so in the future.

The set of facts described above leads to the conclusion that the College will not be holding the property primarily for sale to customers in the ordinary course of a trade or business, but will be making a passive and gradual disposition of a twelve-year old investment. The changes initiated by the city made the property less attractive as an

investment. These facts are distinguishable from Houston Endowment v. US, supra, where the taxpayers sold subdivided and well-developed properties at a profit over a short period to finance an exempt function; and, from Brown v. Commissioner, supra, where a taxpayer hired a broker, who subdivided and developed the property and sold 80 lots in three years, and, from Maudlin v. Commissioner, supra, where a substantial amount of a taxpayer's income was derived from selling property for many years. Thus, the facts in this case differentiate this situation from that of a taxpayer that holds property for sale to customers in the ordinary course of a trade or business for purposes of section 512(b)(5)(B) of the Code.

CONCLUSION

Based on the information submitted and representations made, we conclude that: (1) College is a political subdivision of State for purposes of sections 103 and 115 of the Code, and that (2) proceeds from the sale of the real property will not be subject to tax as unrelated business income within the meaning of sections 511 through 514 of the Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of our determination that College is a political subdivision of State including whether the College has the power to issue bonds that are exempt from interest under section 103 of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose.* A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

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,

Mike Seto
Manager, Exempt Organizations
Technical Guidance & Quality
Assurance Group 1

Enclosure
Notice 437