# General Counsel Memorandum 32594

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Memorandum to:

Mortimer M. Caplin

Commissioner of Internal Revenue

Attorney Advisor to the Commissioner

Reference is made to your memorandum dated September 26, 1962, asking us to prepare a legal opinion regarding three issues raised in connection with the above-titled case. The issues posed, as more fully crystallized in a telephone conversation some time ago, are: (1) Whether the Office of the Chief Counsel would have concurred in the exemption ruling issued by the Tax Rulings Division to the *** (hereinafter referred to as *** on March 1, 1957, had this office reviewed the case at that time. (2) Whether at this juncture, in the light of any new facts concerning the *** not previously known and considered and, in view of present Service policy with regard to cases similar to the subject one, this office would concur in revocation of the exemption previously granted the *** (3) Whether the *** if properly ruled to be exempt, is subject to the tax on unrelated business income under either section 511 or section 514 of the 1954 Code.

For reasons hereinafter given (1) we think that this office would have concurred in the exemption ruling in 1957; (2) we see no sound legal basis for revocation of the outstanding ruling at this time; and (3) assuming the *** was properly ruled to be exempt, it is our opinion that it is not subject to the tax on unrelated business income. As will be indicated, however, we believe consideration should be given to the possible application of section 482 of the Code with respect to one phase of the transactions here involved.

**FACTS**

The facts in this case are long and complex but may be summarized to the extent that they have a material bearing on the questions presented. Starting in the mid 1940's, *** the sole stockholder of *** (hereinafter referred to as *** , the assets of which consisted of (1) an aircraft business, (2) a movie production business, (3) a tool business having a value of more than half of the value of the corporation, (4) 100% of the stock of *** and (5) approximately 75% of the stock of *** explored several possible methods by which the aircraft business might be separated from the rest of the businesses. The proposed transactions included a partial liquidation, complete liquidation, and finally a tax-free split-up under section 355 of the 1954 Code. All these proposed transactions were ultimately abandoned, apparently because the Service had indicated that tax consequences which the parties wished to avoid would result. See, for example, the file in *** A-406005. The split-up was disapproved by the Service because *** would not give the assurance, which the Service requires as a matter of Departmental policy, that he had no present intention to liquidate either of the new corporations or to sell any of the stock of either of them. *** in his request for ruling, indicated the possibility of selling the capital stock of the corporation which would be carrying on the tool business in order to supply additional funds to the corporation carrying on the aircraft business.

At a conference held at the Treasury on December 17, 1951, *** , one of the attorneys for *** pointed out the reasons why it was felt desirable by *** to split up *** into two new corporations. He stated that the oil machinery business was so different from the other main business (aircraft) carried on by that corporation that it was important from a business point of view to put such two businesses into separate corporations. Thus, each business would be carried on by a separate board of directors. It was further pointed out that the executive head of the

aircraft business always had to obtain clearance from the Board of Directors of *** before he could make any firm commitments to the United States Government in connection with various businesses carried on with the Government and that the Air Force had objected to this time-consuming process.

Having failed to win the Service's approval in the above endeavors, the parties involved negotiated the following intricate transactions as shown by the papers filed with the Service in connection with *** application for exemption. On *** the *** was incorporated, and on the same day, and by the same incorporators, *** (hereinafter referred to as *** ) was incorporated. The *** charter puts control of its management in a single trustee, *** . On *** the following series of steps took place - (1) *** contributed to the *** certain intangible assets of its aircraft department (electronic division) such as patents, copyrights, processes, inventions, etc., with a basis to *** of *** and a fair market value, as stated on its 1953 tax return, of *** (2) *** sold to the *** at book value certain tangible and intangible non-fixed assets (having a book value of approximately *** ) of its aircraft department (electronic division) including cash, contracts, subcontracts, subcontractual rights, bills, notes, inventories (including finished goods valued at approximately *** and work in process of close to *** , and all perishable tools, materials, and supplies. It would appear that the fair market value of the assets sold was equivalent to their book value except as to inventories (which probably had a higher value). The *** paid for these assets by assuming liabilities with respect to them of approximately *** of the liabilities was for price redetermination of government contracts and the balance represented such accrued payables as taxes (excluding Federal income tax), wages, etc.) and the issuance of a three-year promissory note bearing 4% interest in the amount of approximately *** ; (3) *** leased to the *** for a period of 10 years and 6 months the real property in various localities used by the aircraft department including all machinery and equipment affixed to or with their situs upon such real property, with certain exceptions and subject to certain licenses and leases in favor of *** at a rental equal to the total amount of amortization and depreciation allowed *** on these leased properties; and (4) *** in turn, made a contribution to capital of its wholly-owned subsidiary, *** of all the intangible assets received as a gift from *** transferred to *** at book value (approximately *** all the assets it purchased from *** - *** in turn, assumed the approximately *** in indebtedness and issued *** shares of its common capital stock, without par, for the

approximately *** remainder, as consideration for the transfer; and subleased all the assets leased from *** for a like term at a total rental in the amount of *** payable monthly at the rate of *** month for the first 36 months and *** per month for the remaining 90 months of the term. [1] According to a protest brief filed on behalf of the *** as will be mentioned later, the rental scale calling for heavier payments during the first three years of the lease was based on several factors, including the certainty of near-term rental values as contrasted with the less certain values of a long-term basis. That *** is paying a reasonable rental may also be inferred from the fact that the same rental figures had been used and had apparently gone unquestioned in prior negotiations with *** for lease of the same assets at a time when *** was considering a proposed transaction, later abandoned for other reasons, involving a possible purchase of the electronic business from ***

On June 1, 1955, *** filed an application for tax exemption. In a letter dated November 29, 1955, from Tax Rulings Division, the *** was informed that exemption was denied for two reasons - (1) The transaction was not within the intendment of the provisions of the exemption statute as the ultimate effect was merely a split off of part of a taxable business into a separate operating entity for the purpose of siphoning off taxable income into an exempt organization to be used for charitable and scientific purposes. (2) A finding that *** was to use a substantial part of its income to discharge the *** note executed as part payment for the purchase of the assets from *** It has been the position of the Service that the use of income to retire an indebtedness incurred in the acquisition of property is considered to be accumulating income within the meaning of section 504. See Rev. Rul. 54-420, C.B. 1954-2, 129.

In retrospect, it appears to this office that neither of these two reasons was legally sufficient to support denial of exemption to the *** In the first place, there was not a split off of part of one taxable business into a separate operating entity for the purpose indicated but a transfer of an entire separate business (one of the businesses carried on by *** ) into a separate TAXABLE entity. *** which carried on the business, was wholly taxable under section 502 as a feeder corporation. The income was subject to tax, after allowable deductions, just as when it was earned by *** as a division of *** Secondly, in the light of additional facts furnished to the Service by *** it became apparent that section 504 did not apply to the *** because it was itself

actively engaged in medical research. Furthermore, it was represented by *** that none of its income was to be used in retiring the *** indebtedness.

As has already been indicated, on March 26, 1956, the *** filed a protest to the ruling of November 29, 1955. In the protest brief the *** attorneys rebutted the grounds which the Service had used to deny the *** exemption. In view of the additional facts and arguments presented in that brief, the Tax Rulings Division issued a ruling letter dated March 1, 1957, which revoked the previous denial of exemption and granted the *** tax-exempt status as an organization described in section 501(c)(3) of the 1954 Code. This letter was not submitted to the Office of the Chief Counsel for concurrence or comment.

This office cannot of course state with certainty which of the facts presently known by us were unknown and, hence, not considered by the Tax Rulings Division at the time it ruled the *** to be exempt. Assuming, however, that only those facts contained in the documents presently located in the administrative file were considered, then the facts hereafter mentioned, which can be gleaned only from *** 1953 tax return and a revenue agent's report dated February 25, 1955 concerning that year, were not then available. These facts include the following - (1) For purposes of its tax return *** (a), as previously stated, valued the gift to the *** at *** of which *** was applicable to the excess rental value and *** to the intangible assets, and (b) claimed and was allowed a loss deduction in the amount of *** on the sale of assets to *** (2) Since *** took a charitable contribution deduction of *** in connection with the gift to *** while the value of the intangible assets was stated to be *** then at least *** of the deduction can be said to have been attributable to the excess rental value.

**PROPRIETY OF GRANTING EXEMPTION IN 1957**

In March of 1957 the Service had not yet started formulating the strict rules with respect to the organizational and operational tests which were eventually to evolve into the more stringent regulations adopted on June 25, 1959, by T.C. 6391. The pertinent regulations under the 1939 Code which were made applicable to the 1954 Code as stop-gap regulations by virtue of T.D. 6091, C.B. 1954-2, 47, contained no detailed guidelines. Thus, it appears that the organizational qualifications of the *** would at that time have been deemed adequate by the Service.

The *** Articles, as amended, provide that "THIRD": The primary purpose and objective of this corporation shall be the promotion of human knowledge within the field of the basic sciences (principally the field of medical research and medical education) and the effective application thereof for the benefit of mankind." It then provides that in order to accomplish its primary purpose it shall have certain additional powers (which powers are enumerated), said powers, however, to be limited and restricted as to their use and exercise as may be required by its primary purpose and objective.

Although the Articles use the term "primary purpose" rather than "exclusive purpose" this does not appear to be such a grave defect as would have caused the *** to be denied exemption for failure to meet the "organizational test" as that test was being applied by the Service in early 1957. Furthermore, although its enumerated powers are quite extensive, they are limited to the accomplishment of its primary purpose, and because of this limitation, probably would not at that time have been considered inconsistent with the requirements of the "organizational test". At most, the Service would have required the *** to amend its Articles to eliminate or modify such powers before granting it exemption.

With respect to the "operational test", the record shows only that: (1) The *** appears to have limited itself to engaging in medical research and providing grants and fellowships for others to so engage. (2) Its only income has been the excess of rents it receives from *** over the rents and interest it pays to *** None of the income has been used to pay off its indebtedness to *** (3) It has been represented by all parties to the transactions here involved that this indebtedness will be liquidated either by the sale of the capital stock of *** or from additional contributions. No unrelated businesses were carried on as in the case of The John Danz Charitable Trust v. Commissioner (C.A. 9th 1955) 231 F.2d 673, 55-2, U.S.T.C. par. 9723. Thus,it seems clear that *** was capable of meeting the "operational test" in 1957.

Furthermore, it was the administrative judgment that the additional information submitted in *** protest brief was sufficient to overcome the Service's initial finding that it was organized primarily for tax avoidance purposes. But, note should be taken that *** submitted several financial schedules in connection with its application for exemption revealing that the Government contracts assigned from *** were subject to price redetermination, and that an

account in the amount of *** million was set up to cover this contingency. On the *** Company balance sheet for the year ending December 31, 1953, the amount is listed under current liabilities as follows: "Amount refundable on price revisions *** Also, in an accountant's report on *** for the fiscal year ending January 1, 1956, it was explicitly mentioned that *** sales were made to the Government and other customers under price redetermination contracts which provide for negotiation, from time to time, of revisions of sales prices. The file does not anywhere indicate that Tax Rulings considered the possible significance of price redetermination, [2] and, hence, we assume they did not. However, it is altogether conceivable that this office also would have disregarded the presence of this item because of the somewhat technical aspect of price redetermination. Since we are uncertain as to what our reaction to this matter would have been had we reviewed the ruling letter in 1957, we will defer discussion of price redetermination until later on when we consider the propriety of revoking *** exemption today. Congressman *** , as will be shown later, has since invited our attention to renegotiation which, however, is somewhat different from price redetermination.

Accordingly, premised on all the above considerations except price redetermination, it is our opinion that this office would have concurred with the Tax Rulings Division in granting tax-exempt status to the Institute had it been given the opportunity to review the case at the time exemption was granted.

**PROPRIETY OF REVOKING EXEMPTION TODAY - 1963**

The Service cannot now revoke the *** exemption on the ground that it does not meet the "organizational test" of the regulations because the organization was determined to be exempt prior to July 23, 1959, and it is not seeking a new determination of exemption. See section 1.501(c)(3)-1(b)(6) of the regulations. However, for purposes of reexamining the *** tax status, it will be necessary to consider the following factors: (1) *** claimed and was allowed (a) a loss on the sale of assets to *** and (b) a charitable contribution deduction for a small part of the rent differential of the property leased to *** and, in turn, subleased to *** and (2) In the light of Congressman *** inquiries, the question whether considerations relating to renegotiation of the government contracts awarded to *** but carried out by *** might be shown to be a substantial purpose for the formation of the ***

**LOSS DEDUCTION AND CHARITABLE CONTRIBUTION OF RENTS**

As previously mentioned, part of *** charitable contribution deduction for the year 1953 was attributable to the rent differential on the lease to *** See the discussion on page 5, supra. In I.T. 3918, C.B. 1948-2, 33, it was the position of the Service that permission to use and occupy property, granted to an exempt organization, does not qualify as a contribution deduction and, hence, the owner of the property is not entitled to deduct the value of such use and occupancy. It was found that such an arrangement does not constitute a gift of property. In the case of Priscilla M. Sullivan (1951) 16 T.C. 228 (A., C.B. 1951-1, 3), however, where the taxpayer conveyed property to the Red Cross in 1942 for the duration of the war or until they should cease using it, the Court held that an interest in property was transferred; accordingly, the deduction was allowed. In the light of our acquiescence in this case, it is logical to read I.T. 3918 as holding that it contemplates only situations where something less than an interest in property is transferred. Since a 10 1/2 year lease transfers an interest in property, in our opinion the contribution deduction was properly taken if the execution of the lease should in and of itself be considered to have effected the transfer. See Refund Litigation Division file, RL-164, in re: S. F. Shattuck v. United States, in which this office recommended the Department of Justice concede the allowance of a deduction with respect to a lease of a vessel to the U.S. Coast Guard.

As for the loss deduction claimed on the sales of assets to *** section 24(b) of the 1939 Code does not prohibit the recognition of such loss. Section 24(b)(1)(D) is not applicable because *** is not a trust. If the transaction had taken place a few days later, i.e., in 1954, however, section 267(a)(1) and (b)(9) would have prevented the recognition of such loss. As stated on page 38 of the Senate report (S. Rept. 1622, 83rd Cong., 2nd Sess. (1954)) - "The House and your committee's bill TIGHTENS PRESENT LAW by expanding the concept of related taxpayers to include *** (3) an exempt organization controlled by a person or his family. Dealings between these parties are no less subject to abuse than those covered by present law." (emphasis added)

True, *** may have arranged its affairs so that it would receive some tax benefit from the creation of *** in the loss and contribution deductions taken; however, the then applicable law squarely provided for the deductions taken and the cost involved (that of parting with its valuable

*** business) far exceeded the benefit derived. Accordingly, it is clear that revocation of exemption could not be sustained on this ground.

Collaterally, today the Service would probably give consideration to holding that the gift by *** to *** represented a constructive dividend to *** sole stockholder and *** sole trustee, *** See e.g., G.C.M. 32071 (August 14, 1961) in re: *** , I-85 and *** THE, I-187. Hence, to the extent of *** earnings and profits, the fair market value of the property constituting the gift would have been includible in the income of *** . In line with such an analysis, *** would have been denied, and *** allowed, a charitable contribution deduction to the extent allowed by the predecessor of section 170 of the 1954 Code. Probably this would have been the best approach to take back in 1953. If we had proposed so to rule, it would probably have prevented the transaction from being consummated because of the adverse tax consequences to *** individually. It is presently too late to take such a position because we are now barred by the statute of limitations from opening up *** return for the year 1953. This return was audited, a deficiency assessed on other grounds, and the return and the administrative file copy of the report destroyed under the returns disposal program. It should be pointed out, however, that this approach was not developed until after the statute of limitations had already run and, to date, is untested in the courts. See also T.I.R. No. 457 of March 4, 1963, Announcement 63-36, I.R.B. 1963-11, 27.

**RENEGOTIATION AND PRICE REDETERMINATION.**

Congressman *** Chairman of the House Select Committee on Small Business stated the following on page 15947 of the Congressional Record (Vol. 108, No. 147, dated August 20, 1962):

> I wonder whether the ring-around-rosy that took place on December 31, 1953, really did not have something entirely different behind it - and that is, renegotiation. Through the lease and sublease, *** wound up paying *** more in rent than *** would have had in

depreciation and other charges for the leased assets if *** had stayed put. The *** will become a higher figure by the time the sublease expires. *** has big contracts from the Government.

Was not the effect of these transactions to step up costs on Government contracts for *** by this *** To put it another way, by the steps taken on December 31, 1953, didn't *** save *** from renegotiation? ***

A representative of this office had the opportunity to inspect the Renegotiation Board's records on renegotiation of *** and *** for the years here pertinent. It was found that for the years 1948 through 1953 *** did not derive any excessive profits so that there was no excess in profits to be eliminated through renegotiation. Also, for the years 1948 and 1949 *** had received its clearance notices prior to December 31, 1953. Therefore, even if the Service could deny exemption to an organization one of whose purposes is to reap a renegotiation benefit, we see no likelihood that we could establish as a fact that renegotiation was such a "purpose" in this case since *** was found to haven excessive profits for the years in question and, furthermore, knew that it did not for years prior to 1950. Accordingly, there appears to be no factual basis for a denial of exemption because of the possibility that renegotiation advantages to *** were sought.

Perhaps, on the other hand, when Congressman *** used the word renegotiation, he meant to include also price redetermination. Price redetermination is different from renegotiation in that, among other differences, it is contractual rather than statutory; it is performed periodically throughout the life of the contract rather than once a year; it is considered on a contract by contract basis rather than on the aggregate of Government contracts in the contractor's possession; and it is performed by the particular agency granting the contract rather than the Renegotiation Board. Changes in amounts to be received by contractors due to price

redetermination are considered by the Renegotiation Board in determining whether excessive profits have been earned for purposes of renegotiation.

As mentioned above, the Government contracts transferred to *** were subject to price redetermination. Further, all Government contracts entered into directly with *** were subject to redetermination. To the extent that the rent paid by *** exceeded depreciation and amortization taken by *** on this property (approximately *** it is possible that the cost of the Government contracts was increased. For purposes of renegotiation, the Renegotiation Board, however, found that the rent differential was offset by the elimination from *** of that part of *** general overhead which had previously been allocated to *** (about *** when it was a division of *** . From our examination of the records, it appears that there was not a complete offset; e.g., while the rent paid by *** in 1956 was approximately *** the depreciation and amortization on the property amounted to approximately *** or a difference of *** Accordingly, since the difference of *** was offset by only *** supra, it would seem that contract costs were increased by *** for that year unless the increase was eliminated in price redetermination. In addition, part of the overhead which is no longer being allocated to *** possibly is being absorbed by the remaining *** price redeterminable business and, thus, would be increasing the cost of those contracts. Yet, on the other hand, in Supplemental Agreement No. 97 to contract AF 33 (038)-17618, dated December 9, 1955, it is indicated that the Air Force was aware of the rent differential factor and, thus, it is conceivable that the *** in negotiating the cost of its contracts with *** made some offsetting provision for the rent differential. Since all this is subject to conjecture, it is impossible to draw any definite conclusions with respect to this matter.

Whether the costs of price redeterminable Government contracts were really increased because of the rental factor is a matter within the province of the specific Government contracting agency and not one for determination by the Internal Revenue Service. From a tax standpoint, however, even if the contract costs were increased with some resulting benefit derived from price redetermination running to *** under the circumstances presented here we think that the Service would not be justified in revoking *** exemption. It would nevertheless remain a fact that the *** is organized and operated exclusively for section 501(c)(3) purposes, as has been shown above; the fact that the arrangements with *** and *** result in ***

enjoyment of rental income in excess of rental payments would not, in our judgment, afford a sound ground for denial to *** of the exempt status to which it is otherwise entitled under that section.

Although we have concluded that the *** exemption should not be revoked despite the possible benefits to it emanating from the difference between the rents that it receives and the rents that it pays, we think that under the provisions of section 482 of the 1954 Code it may be possible to allocate to *** the rental income received by *** from *** In other words, we believe we may be empowered to treat *** as if it receives the rents from *** and, in turn, contributes the net amount (after depreciation and amortization) each year to ***

Section 482 provides for the allocation of income and deductions among controlled taxpayers where there is a shifting or deflection of income from one controlled unit to another. See Grenada Industries, Inc., (1951) 17 T.C. 231. It appears that the requisite control required by section 482 is present here because *** owns all the stock of *** and is the sole trustee of *** in turn, is the sole stockholder of *** See section 1.482-1(a)(3) of the regulations for the definition of the term "control". It is immaterial that the organization which actually receives the income is exempt from tax. See section 1.482-1(a)(1) of the regulations. However, as indicated in Grenada Industries, Inc., supra, the existence of the requisite common ownership or control is not alone sufficient to justify the application of section 482; there also must be a shifting of income from one controlled unit to another.

In the protest brief mentioned earlier, it was indicated that the reason why *** did not lease the property directly to *** and then contribute annually the net rentals to *** was because, in the eyes of everyone sought to be attracted to *** the *** would have been left dependent upon the future generosity of *** and would not have had the assurance of a stable income on which it could effectively proceed to build a great medical research center. This may be a valid reason to be used in connection with our consideration of the merits of *** exemption; however, it does not disprove the probability that the real purpose for this arrangement (and, in any event, such was its net effect) may have been to deflect income from *** to *** possibly in order to avoid the 5% corporate limitation [3] on charitable contribution deductions, notwithstanding that a relatively small charitable contribution deduction was claimed in *** 1953 return for a part of

the value of the 10-1/2 year interest in the real property transferred. See the discussion supra. If that is the case, the Service would have a reasonably good chance of prevailing in a court of law should the taxpayer contest the Commissioner's allocation under section 482 since the burden of proof is on the taxpayer to show that the Commissioner was either unreasonable, arbitrary, or capricious. See Grenada Industries, Inc., supra.

Admittedly, there is little case authority to support our position, but we know of no case squarely in point that would deny the Commissioner power to utilize section 482 on the facts here presented. A case that might be considered as being contra (sic) to our view is Best Lock Corporation, (1959) 31 T.C. 1217 superseding (1957) 29 T.C. 389, where an individual, Mr. Best, gave an exclusive license for the use of certain inventions to a controlled foundation which, in turn, granted an exclusive sublicense to a controlled corporation in return for royalties. In its second opinion in the case, the Tax Court reversed its earlier position and held that the royalties were not constructive dividends to Mr. Best and, hence, not taxable to him. This was not, however, a case involving section 45 of the 1939 Code (now section 482), but one involving the possible application of the doctrine of "anticipatory assignment of income." Furthermore, unlike the instant case where the donor actually retained ownership of the property that was the subject of the gift (donating only a term interest), the Best Lock case involved an outright transfer of the exclusive right to make, use, and vend certain inventions for the full life term of certain letters patent, subject only to a fixed monthly royalty to the donor and usual conditions subsequent in the event of default by the donee. Moreover, some support for the possible application of section 482 is provided among our unpublished precedents. See in that regard G.C.M. 32053 (August 1, 1961) in re: *** I-122 holding that section 482 could be applied to tax as a wholly-owned subsidiary the amount of appreciation contained in appreciated stock transferred to its parent (an exempt organization) for cost and thereafter redeemed for an amount at least equivalent to the appreciated value of the stock when transferred.

Accordingly, consideration should be given to keeping open any unclosed years of *** However, notwithstanding that the Service might be able to allocate the rental income to *** it seems we now cannot disallow that part of *** 1953 charitable contribution deduction which is attributable to the gift of rentals because the year is closed. Furthermore, it is doubtful that the

mitigation of limitation provisions, sections 1311, et seq., would aid us because it would be difficult to sustain the position that it is *** and not the Service, that would be taking an inconsistent position with respect to the allowance of any charitable contribution deduction related to the rents. Compare Heer-Andres Investment Co., (1954) 22 T.C. 385, acq. in result only, C.B. 1955-2, 6.

**UNRELATED BUSINESS INCOME**

A third area of inquiry raised by you is whether the rents received by the *** can be taxed as unrelated business income. Alternative approaches are suggested - (1) It is arguable that the rents received under the sublease arrangement are derived from personalty rather than real property and thus are not excluded from the unrelated business income tax under section 512(b)(3); or (2) the various separate transactions could be viewed as one transaction and the lease to *** might thereby be found to be subject to a business lease indebtedness under the provisions of section 514 of the 1954 Code.

Section 512(b)(3) excludes from the definition of "unrelated business taxable income" all rents from real property (including personal property leased with real property). Nothing in this Code section, the legislative history, or the regulations indicates that the real property from which the rents are received must be owned by the exempt organization. In other words, the consideration received by the Foundation under the sublease may be considered rents from real property regardless of the fact that it did not itself own such property but merely leased it. We believe the legislative history can be read as supporting such an interpretation of section 512(b)(3).

The Senate report on section 422(a) of the 1939 Code (the predecessor of section 512) contains the following paragraph regarding the exclusions from the base of the tax on unrelated business income:

> Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because your committee believes that

> they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income". S. Rept. 2375, 81st Cong., 2nd Sess. (1950) C.B. 1950-2, 483, 506.

From this it can be gleaned that the intent behind this legislation was to eliminate the competitive advantages which exempt organizations enjoyed while competing with taxable organizations in the conduct of an active business. The sublease of real property is hardly more of a threat of carrying on an active business than the original lease of the real property. Accordingly, if it were necessary to come to a definite answer to this possible approach, we believe the consideration received from the subleasing of real property on such facts as are here presented could quite plausibly be regarded as rent from real property within the meaning of section 512(b)(3) of the 1954 Code.

However, it is not altogether certain that rent derived from subleases of real property can never represent rent from personal property rather than from real property. The Service might also have a plausible case for contending that an exempt organization which makes a business of purchasing advantageous leases from tenants in apartment houses and office buildings with a view to profiting from subleases should be considered to derive income from the rental of personal property so as to be taxable apart from the business lease provisions. If such a case should ever arise, an activity of that kind could well involve the type of competition with taxable business enterprises that Congress sought to reach in the unrelated business income tax provisions as they affect rent from personal property. On the facts in the instant case, however, it appears we would have little or no chance to convince a court that an exempt organization which leased rental properties solely for the purpose of subleasing them to its wholly-owned subsidiary is engaging in the kind of competition with taxable business enterprises that Congress sought to discourage in the unrelated business income tax provisions.

While the Code specifically excludes rents from real property in determining unrelated business

taxable income, there is an important exception to this rule in the case of certain "business leases". Section 514 provides generally that if an exempt organization described in section 511 of the Code receives income from a long-term lease (defined as "business lease") upon property which is directly or indirectly encumbered by a loan (defined as "business lease indebtedness") then only that portion of the net rental income which is attributable to the organization's equity in the property may be received tax-free.

Section 514(c) defines "business lease indebtedness" and provides, in part:

> (1) General Rule. - The term "business lease indebtedness" means, with respect to any real property leased for a term of more than 5 years, the unpaid amount of -
>
> (A) the indebtedness incurred by the lessor in acquiring or improving such property.

In a letter dated December 13, 1962, Congressman *** contends that a "business lease" is involved because indebtedness of *** was incurred by the *** in the three transactions by which it acquired assets of the *** along with the lease of the real property and plant equipment of the *** It is our opinion that it would be a tenuous argument to contend that the *** incurred indebtedness in acquiring the lease, [4] by treating the separate transactions as one and apportioning part of the indebtedness incurred on the purchase of the non-fixed assets to the acquisition of the lease. The facts in the file clearly indicate that the fair market value of the assets sold to *** on which the indebtedness was incurred, either was equal to or exceeded the cost to *** Hence, it would be difficult for us to attempt to apportion some of the cost of these assets to the acquisition of the lease. Accordingly, section 514 does not appear to be applicable as no indebtedness was incurred in acquiring the lease.

The administrative file is returned herewith.

By:

Crane C. Hauser

Chief Counsel

Internal Revenue Service

Enclosure:

Adm. file

Date: November 6, 1963

CC:I:I-740

Br3:RBT/HH

Mortimer M. Caplin

Commissioner of Internal Revenue

Attorney Advisor to the Commissioner

At a conference held on October 18, 1963 with representatives of the Commissioner's office, it was suggested that this office should (1) consider the advisability of rewriting the first paragraph on page 12 of G.C.M. 32594, this case, to make it clearer that we are not suggesting that the lease of the property from *** to *** be disregarded under a "substance versus form" argument, but, on the contrary, that we are recognizing the existence of a valid lease from *** to *** and a valid sublease from *** to *** although we are allocating part of the rental income received by *** to *** under the provisions of section 482 of the Code, and (2) as an alternative to our section 482 argument, should *** contest in a court of law any allocation made by the Commissioner under section 482, consider the possibility of disallowing part of the depreciation deduction claimed by *** on the property leased to *** since, to the extent that the fair rental value of the property leased by *** exceeds the rents charged to *** , the undivided portion of the property attributable to such rent differential should not be considered either (a) used in the trade or business, or (b) held for the production of income, as required by section 167.

In accordance with your first suggestion, we have reconsidered the language used in the aforementioned paragraph and think it would be better to change it, as follows:

> Although we have concluded that the ***
> exemption should not be revoked despite the
> possible benefits to it emanating from the

difference between the rents that it receives and the rents that it pays, we think that under the provisions of section

482 of the 1954 Code it may be possible to allocate to *** most, if not all, of that portion of the rental income received by *** from *** which exceeds the rental paid by *** to *** In other words, in order to clearly reflect *** income, we believe that most, if not all, of such excess rental income received by Institute should be allocated to *** because such amount allocated would have inured originally to the benefit of *** had it dealt at arm's length in negotiating the lease with *** Under the facts peculiar to this case, it may be possible to allocate to *** the entire amount of such excess rental income because, as mentioned on page 4 of this memorandum, *** was paying to *** no more than a reasonable rental for this property. In other words, since this is a case where *** could have received a commensurate rental directly from *** without using *** as an intermediary, it seems that a fair rental to be received by *** from the property should be an amount equivalent to the rental paid by *** to *** See the case of Advance Machinery Exchange, Inc., v. Commissioner, 196 F.2d 1006 (2d Cir. 1952), where the court sustained the Commissioner's allocation of all the net income from four business entities to one of the four, when it was determined that there was, in reality, but one taxable entity to which all the income was attributable. Then, in turn, *** should be treated as contributing to *** each year such amount allocated to it under section 482.

In connection with your second suggestion, should a court determine that any allocation made by the Commissioner under Section 482 was invalid, we think that a plausible argument could be made that *** is not entitled to take as a depreciation deduction with respect to the property leased to *** an amount greater than that portion of the depreciation that would have been allowable to *** on the property had it not entered into the lease with *** which the rental received by *** bears to the fair rental value of the property.

Section 167(a) of the Code provides that a depreciation deduction will be allowed for the exhaustion, wear, and tear of property either used in the trade or business, or held for the production of income. The phrase "used in the trade or business" is generally construed to mean "devoted to the trade or business". Thus, depreciation is allowable on assets which are idle or the use of which is temporarily suspended due to lack of market for the product or other causes. Mere discontinuance of the active use of the property does not change its character previously established as business property. Such assets are, for income tax purposes, still regarded as being used in the trade or business. 4 Mertens, Law of Federal Income Taxation, section 23.11a (1960 Revision); Alfred Kruse, 29 T.C. 463 (1957). Property once used in the business remains in such use until it is shown to have been withdrawn from business purposes. Benjamin R. Kittredge v. Commissioner 88 F.2d 632 (2d Cir. 1937). Once property is removed from business purposes, however, a deduction for depreciation is no longer allowed.

In the case of Lorraine Corporation (Dissolved) v. Commissioner, 17 T.C.M. 719 (1958), the taxpayer was organized to engage in the business of renting, leasing, holding, and dealing in real estate. Certain property acquired by the taxpayer as part of its business holdings was eventually leased to a private nonprofit foundation for $1 per year. In holding that the taxpayer could no longer claim a depreciation deduction on the property after entering into the lease, the Tax Court stated the following, at page 722 -

> It seems obvious that at the time of entering into the lease the petitioner abandoned any profit motive insofar as this property was concerned. No rental profit in the usual business sense would be realized under this

> lease, and clearly such a lease would be a deterrent to a sale of the property. The conclusion is inescapable that at that time the property was withdrawn from business purposes of the petitioner and that it was thereafter devoted to the purposes of the nonprofit Foundation in which the petitioner's president was interested.

Cf. Lester E. Yeager, Executor v. U.S., 58-1 U.S.T.C. par. 9174 (W.D. Ky. 1957).

As mentioned in G.C.M. 32594, this case, the taxpayer leased certain property to *** for 10-1/2 years, which it had up to that time utilized in its electronic and aircraft businesses. The renting of this property, alone, would not remove it from business purposes of the taxpayer, since the Service, as well as the Tax Court, follows the rule that the mere renting of a residence or other rental property constitutes trade or business. See, for example, Leland Hazard, 7 T.C. 372 (1946); Anders I. Lagreide, 23 T.C. 508 (1954); and Reiner v. United States, 222 F.2d 770 (6th Cir. 1955). Applying the principles established by the authorities which we have hereinabove cited to the facts of the instant case, however, we think the taxpayer withdrew a proportionate part of such rented property from business purposes - that proportionate part of the property which is attributable to the differential between the rental received by *** from *** and the fair rental value (which we believe is the rental received by *** from *** of the property. *** itself admitted that the differential in rents was a gift by listing such excess rental value as a charitable contribution on its 1953 income tax return. Accordingly, we believe that *** is not entitled to claim as a depreciation deduction an allowance greater than that previously mentioned for exhaustion, wear, and tear on the property leased to ***

This case, of course, is somewhat distinguishable from Lorraine Corporation, supra, where the rental charged was a nominal amount of $1. There the court merely had to hold that the entire property was removed from business purposes. In the instant case, where *** is receiving a rental equivalent to its depreciation and amortization of the property (e.g., 2.1 million

in 1956), a court might be reluctant to hold that an undivided portion of the property leased was removed from business purposes. It is true, though, that property is not always completely used in trade or business, but also may be used for other purposes. Thus, if (1) only a part of the property is used for business purposes (Lenn K. Buchwash, 9 T.C.M. 835 (1950) - free use of one of the two rental apartments), (2) the entire property is used only partially for business purposes (J. Lustman, 19 T.C.M. 617 (1960) - car used partly for personal services and partly in taxpayer's employer's business), or (3) a portion of the property is used only part time for business purposes (Rev. Rul. 62-180, C.B. 1962-2, 52), there must be an apportionment so that depreciation will be limited to the proportion of business use to total use. We have found no case on all fours, however, covering the facts in the instant case.

In conclusion, it is our opinion that (1) the Service should primarily rely on the section 482 argument, in preference to the argument concerning partial disallowance of the depreciation deduction, in dealing with *** since we think it is the stronger of the two alternatives and, furthermore, would yield, as indicated at the above-mentioned conference, a greater amount of tax, and (2) should the case ultimately proceed to litigation, the alternative argument should also be presented to the court.

The administrative file is returned herewith.

By:

R. P. Hertzog

Acting Chief Counsel

Internal Revenue Service

Enclosure:

Adm. file

[1]

*** determined that the then fair rental value of the property exceeded the rents charged to *** under the lease by the amount of *** determined on a discounted basis *** if not discounted). Accordingly, it listed on its 1953 return charitable contributions of *** excess rental value plus

the *** value of the donated intangible assets mentioned above). However, the deduction was limited to *** because of the 5% corporate limitation on charitable deductions and, furthermore, *** was precluded from carrying over the excess under the provisions of the 1939 Code. In a protest brief, referred to later on, it is contended that the value of the gift, presumably including the gift of the excess rental value as well as the intangible property, was a minimum of ***

2

This will be more fully explained subsequently.

3

For example: For *** taxable year 1953 prior to the split-off of its aircraft business, it was limited to a charitable contribution deduction of *** As shown above, the rent differential (which would have been *** contribution to *** had subleased the property directly to *** ) for the year 1956 was *** This amount would have exceeded *** maximum allowable contribution deduction for the year 1953 by over *** Furthermore, all things remaining the same, presumably the excess of the rent differential over the amount allowable as a charitable contribution deduction would be much greater now because *** income would no longer be included in computing *** 5% limitation. Accordingly, to the extent that the contribution deduction exceeds the 5% corporate limitation, *** would be taxable on the rental income. Confirmation of these possibilities should be made by checking *** returns for years after 1953.

4

The contractual arrangement to pay rents under a lease is not in itself a debt until the rent is due. See William Filene's Sono Company v. Wood at el., (1918) 245 U.S. 597.