INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
November 7, 2000

Number: **200107020**
Release Date: 2/16/2001
Index (UIL) No.: 145.00-00, 7805.00-00
CASE MIS No.: TAM-113450-00/CC:TEGE:EOEG:TEB

Manager, TEB Outreach, Planning, and Review

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Issuer =

Organization =

Bonds =
Facilities =

Seller 1 =

Seller 2 =

Mr. A =

Corporation B =

Company C =

Lessee =

Space 1 =

Space 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =
Date 5 =

Date 6 =

Year 1 =

Year 2 =

a =

b =

c =

d =

e =

f =

ISSUE:

Whether the Issuer is eligible for relief under § 7805(b) of the Internal Revenue Code (the “Code”) from the retroactive revocation of the Organization's exempt status, the effect of which was analyzed in the previous technical advice memorandum in this case issued on October 22, 1999. The Issuer argues that it relied on the determination letter issued to the Organization, its conduit borrower.

CONCLUSION:

The Issuer’s request for relief under § 7805(b) is denied.

FACTS:

On or about Date 1, the Organization received a favorable determination letter as to its status as a tax exempt organization under § 501(c)(3). The Organization’s primary purpose was to further economic development through the development of job opportunities and the elimination of blighting or deteriorating physical conditions.

A few years later, the Organization contemplated the purchase of office space and a parking garage using the proceeds of tax-exempt bonds. It planned to lease all or most of the office space to its § 501(c)(6) subsidiary, an entity organized to facilitate international trade activity, which, in turn, would sublease the office space to businesses with potential for job growth and international trade. The employees and visitors of the tenants of the office space would use the parking garage, which would be run by a private operator.

On or about Date 3, the Organization received a favorable letter ruling that the proposed leasing activity by the Organization and its subsidiary would not affect adversely the Organization's § 501(c)(3) status, that the rental income from the office space and the revenues from the parking garage would not be unrelated trade or business income, and that the space would not be debt-financed property under § 514(b). The Organization's letter ruling did not address the terms of the purchase of the office space or the garage nor any aspect of the Bond transaction.

Seller 1 was a limited partnership of which Mr. A was the general partner and various trusts for his children were the limited partners. Seller 1 owned an a-story building (the "building"). The building was subject to two leases to the Lessee, a party unrelated to either the Organization or the A Group, described below. In combination, these two leases covered nearly all of the space within the building. The area covered by the first lease was Space 1. In the month prior to Date 4, the Lessee and Seller 1 entered into an agreement whereby the Lessee agreed to relinquish its interest in Space 1, with the exception of a reception area.

Seller 2 was a limited partnership of which Mr. A and Corporation B were general partners. Mr. A was president of Corporation B. Seller 2 owned a parking garage.

The Issuer issued the Bonds on Date 4, and loaned the proceeds to the Organization to purchase the first b floors of the building owned by Seller 1 (the "office space") and the parking garage owned by Seller 2 (together, the "Facilities"). The Bonds were zero-coupon revenue bonds secured by the Facilities and the revenues to be received by the Organization.

Seller 1 purchased $d of the Bonds and Seller 2 purchased the remaining $e of the Bonds. The Organization transferred $d of bond proceeds to Seller 1 for the office space and transferred $e of bond proceeds to Seller 2 for the parking garage. Seller 1 retained ownership of the c remaining upper floors (the "upper floors") of the building. Thus, the Sellers of the Facilities are the same parties as the Bondholders.

The purchase agreement for the Facilities was entered into by the Organization, its subsidiary, Mr. A individually, Seller 1, and Seller 2. The purchase agreement refers to Mr. A and the Sellers collectively (the "A Group").

In the purchase agreement, the A Group agreed to make renovations to the office space within one year. Failure to complete the renovations within the year would subject the A Group to a penalty of $f per day. Company C, another entity run by Mr. A, was located in the office space. The Organization permitted Company C to retain its office there to supervise the renovations. The renovations were delayed beyond the year, and Company C remained. It was not until mid-Year 1, approximately two and one-half years after the purchase of the Facilities, that the renovations were substantially completed. The Organization's books showed no record of payment from the A Group for the delay in renovations.

At the time of conveyance, the building was subject to a mortgage securing payments on a loan obtained by the A Group. Both the purchase agreement and the loan agreement between the Issuer and the Organization with respect to the Bond proceeds (the "loan agreement") required the A Group to obtain a release of the mortgage on the office space within six months of closing. In the event of a default under this condition, the Bonds were to be redeemed and the Facilities returned to the Sellers. The A Group was unable to negotiate a release without incurring a prepayment penalty, so the respective parties amended the purchase agreement and the loan agreement to extend the deadline by six months. The Issuer, the trustee for the Bonds, and the Bondholders approved the amendment to the loan agreement. One year after closing, the A Group still was unable to obtain a release of the mortgage without a prepayment penalty, and the trustee at the direction of the Bondholders waived the default for failure to remove the mortgage encumbrance.

In the purchase agreement, the A Group agreed to convey the office space to the Organization free of the Lessee's interest unless the Organization otherwise agreed in writing. As stated above, the Lessee already had agreed in the previous month to release its interest in Space 1, an area entirely within the office space and the subject of the first lease. The area covered by the second lease was Space 2, comprising over half of the office space, plus the upper floors to be retained by Seller 1. Contemporaneously with the purchase agreement, Seller 1, the Organization, and the Lessee entered into a written agreement with respect to the second lease (the "lease restructuring agreement").

Pursuant to the lease restructuring agreement, the Lessee agreed to vacate Space 2. It would continue to lease the upper floors from Seller 1. In return for vacating Space 2, Seller 1 agreed to pay the Lessee a certain amount per year per square foot of Space 2 ("Seller 1's payment"). Nevertheless, the lease restructuring agreement also provided that the Lessee was permitted at any time during the nearly four years remaining on the lease to use some or all of Space 2 without payment to the Organization, upon 45-days' written notice to the Organization and to Seller 1. In the latter situation, Seller 1's payment would be reduced proportionately for any space so used. If Seller 1 failed to make its payment, the lease restructuring agreement allowed the Lessee to offset its rent payments under the lease. The Lessee's rent payments were assigned to the holder of the mortgage on the building; therefore, the lease restructuring agreement was contingent on either the A Group paying the mortgage in full or obtaining the mortgage holder's permission to the offset arrangement. As noted above, the A Group did not pay off the mortgage; however, the mortgage holder did consent informally to the offset arrangement.

In the latter half of Year 1, about three years after the Bonds were issued, the Internal Revenue Service (the "IRS") commenced an audit of the Organization. At that time, both the Lessee and Company C continued to occupy portions of the office space. Another company used a portion of the office space as a subtenant of the Lessee. Neither the Organization nor the A Group received any rent from this subtenant. During Years 1 and 2, the Lessee and its subtenant occupied from half to three-quarters of the office space. The Organization's subsidiary was using a small amount of the office space. Neither the Organization nor its subsidiary had leased out any of the office space to international businesses as intended or to any other organizations. Company C never relinquished its space. The audit resulted in findings related to private benefit and inurement to the A Group.

On Date 5, nearly four years after issuance, the Bonds were canceled and the Facilities returned to the Sellers. The Organization did not pursue its administrative remedies in connection with the adverse findings of the audit. Several months later, the Organization ceased its corporate existence. On Date 6, approximately 14 months after the Bonds were canceled, the IRS issued a determination letter revoking the Organization's tax exempt status effective Date 2, the beginning date of the Organization's taxable year in which the purchase of the Facilities occurred, for the following reasons:

> You are not a charitable organization within the meaning of Treasury Regulation 1.501(c)(3)-1(d)(2). You have not operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code. You are operated for private benefit and your earnings inure to the benefit of private individuals.

The IRS also began an audit of the Bonds, during which a request for technical advice was submitted. The technical advice memorandum dated October 22, 1999, provided that absent an effective remedial action, the revocation of the Organization's § 501(c)(3) status would cause interest on the Bonds to be includable in the gross income of the Bondholders retroactive to the date of issuance of the Bonds. It also provided that there was no effective remedial action because the time for remedial action started on the date the acts occurred that caused the revocation and those acts occurred more than 90 days before the Bonds were canceled. Under the technical advice memorandum, the date that the revocation letter was issued was not a factor in determining whether the remedial action was effective.

LAW AND ANALYSIS:

Section 7805(b) provides that the Secretary may prescribe the extent, if any, to which any ruling shall be applied without retroactive effect.

Section 601.201(l)(5) of the Statement of Procedural Rules provides:

> Except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability was directly involved in such ruling if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling was originally issued with respect to a prospective or proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment. To illustrate, the tax liability of each employee covered by a ruling related to a pension plan of an employer is directly involved in such ruling. Also, the tax liability of each shareholder is directly involved in a ruling related to the reorganization of a corporation.

Thus, relief under § 7805(b) is available where there has been a change in the position of the IRS unrelated to a change in the relevant statute, and the taxpayer relied to its detriment on the IRS' statement of its previous position. Eligibility for the relief necessarily requires, first, a ruling stating the IRS' position on which the taxpayer may rely and, second, a modification or revocation of that position.

Generally, relief under § 7805(b) entitles the taxpayer to prospective application of the revocation or modification from the date of that modification or revocation. The effect is that the acts taken by the taxpayer consistent with, and in reliance on, the earlier ruling and before the date of the modification or revocation, are deemed to be in compliance with the IRS' then interpretation of the Code. Acts taken by the taxpayer after the date of the modification or revocation, however, are evaluated in light of the IRS' revised interpretation and are not protected by the earlier ruling.

There are no rulings or other statements of an IRS' position concerning tax exempt bond rules relevant to this case that have been modified or revoked. Thus, the Issuer can not exhibit reliance on any such rulings in order to limit the retroactive effect of the technical advice memorandum. The ruling on which the Issuer relies is the Organization's determination letter. That ruling was revoked. The only possible focus, then, of the Issuer's request for relief is on the effective date of the revocation of that determination letter.

The Issuer's request for relief under § 7805(b) from the revocation of the Organization's § 501(c)(3) status, if granted, would mean that for the Issuer the revocation of the Organization's determination letter would be effective only as of date of the revocation. The essence of the Issuer's argument in favor of this request for relief is that its lack of knowledge about the legal effect of the Organization's actions entitle it to have the Organization's actions before the revocation actually occurred deemed consistent with the Organization's charitable purposes. (The Issuer has not asked us for relief based on a lack of knowledge about the actions of the Organization.) Thus, as to the Issuer the deliberate acts causing the revocation would not have occurred until after the date of the actual revocation. The consequence for purposes of the Bonds would be that, for the Issuer, the Organization's acts prior to the revocation date would not trigger the beginning of the time period for taking remedial action; rather, the Organization's acts taken after that effective date would be the deliberate actions.

Section 601.201(l)(5) sets forth the procedural rules that apply when a taxpayer has relied upon a ruling that is revoked or modified. These rules generally apply to (1) the taxpayer to whom the ruling was originally issued and (2) a taxpayer whose tax liability was directly involved in such ruling. The Issuer is not the taxpayer to whom the determination letter was addressed. While the Issuer has some interest with respect to the Bonds, it does not have a tax liability. It is the Bondholders that bear any tax liability. Nevertheless, the Issuer has argued that it is a taxpayer directly involved in the ruling.

We need not decide, however, in this case whether, for purposes of § 7805(b), it is appropriate to consider the Issuer as directly involved in the determination letter addressed to its conduit borrower. Under § 601.201(l)(5), a taxpayer cannot rely on a ruling letter unless the taxpayer acted in good faith in relying on the letter. Here, the Issuer cannot claim good faith reliance on the Organization's determination letter. The Issuer knew of, and moreover participated in, some or all of the acts that resulted in the revocation of the Organization's tax exempt status.

Good faith includes honesty of intention and freedom from knowledge of circumstances which ought to put the holder upon inquiry. BLACK'S LAW DICTIONARY (6th ed. 1990). As stated in the previous technical advice memorandum, the tax exempt status of an organization as the owner and user of a bond-financed facility must be maintained subsequent to the issuance of the bonds. Accordingly, the relevant time of inquiry is not only at the time of issuance of the bonds, but continues subsequent to that date.

The Organization's tax exempt status was revoked because the Organization was not operated exclusively for charitable purposes; it operated for private benefit and inurement. *See generally* § 1.501(c)(3)-1, Income Tax Regs. The audit of the Organization determined that the A Group was the recipient of that prohibited private benefit and inurement. For example, the A Group benefitted from the delays in and waiver of lifting the mortgage encumbrance, the one and one-half year delay in the renovations without payment of the delay penalty, and the continued occupancy of office space by Company C and the Lessee nearly four years after the Organization's purchase of the Facilities.

The Issuer, as evidenced by the purchase agreement and the loan agreement, was aware of the mortgage on the building, the leasehold interest, and the A Group's obligation to make renovations. The Issuer extended the deadline on lifting the mortgage encumbrance, and thereafter, the bond trustee waived the requirement.

The Issuer argues that these actions were taken in good faith, were aimed at going forward with the Organization's ownership of the Facilities and the leasing of the office space, and were not to the detriment of the Organization. For example, had the default not been waived, the purchase agreement provided that the Organization redeem the Bonds and return the Facilities to the Sellers. The Issuer states that it had no knowledge or intent that the actions would be factors in the revocation.

This, however, does not alter the fact that the Issuer had knowledge of the actions themselves. Also, it knew, or should have known, that these actions benefitted the A Group, private persons, and were inconsistent with the requirements for § 501(c)(3) status. Thus, the Issuer cannot demonstrate good faith reliance on the Organization's determination letter.

The Issuer also has pointed to the Organization's letter ruling as further evidence that the Organization was acting in accordance with the facts in its application for exemption. The facts set forth in the Organization's letter ruling about the leasing activity never came to fruition, however, and thus, the letter ruling does not help the Issuer.

We note also that it is the Bondholders that ultimately would be the primary beneficiaries of any relief to be granted in this case. The Bondholders are the same parties as the Sellers and the recipients of the private benefit. They were aware of and participated in the actions leading to the revocation. The Bondholders, therefore, are unable to claim good faith reliance on the Organization's determination letter.

Because the Issuer has failed to establish it acted in good faith in relying on the Organization's determination letter, we need not address whether the Issuer meets the remaining factors set forth in § 601.201(l)(5). No implication should be drawn from this conclusion as to the circumstances, if any, under which an issuer justifiably could rely on a § 501(c)(3) determination letter issued to its conduit borrower.

Accordingly, based on the facts as presented above, we deny the Issuer's request for relief under § 7805(b).

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.