

## CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 406

June 22, 1977

### UNRELATED DEBT-FINANCED INCOME

#### Syllabus:

Under Revenue and Taxation Code Section 23701d, a trust was granted exemption from state income tax for the educational purpose of promoting the appreciation and preservation of historical and architecturally significant buildings. By gift, the organization acquired an historical commercial shopping complex upon the condition it make the remaining payments on a promissory note secured by an outstanding deed of trust. Approximately fifty tenants are established in the complex and remit lease payments to the exempt organization. The trust also owns three small lots of historical significance, subject to deeds of trust, which are in close proximity to the shopping complex, two of which produce rental income.

Under these facts, advice has been requested concerning the operation of the "unrelated debt-financed" property provisions of Revenue and Taxation Code Section 23735. As provided therein, income received by an exempt organization from property acquired by and encumbered with debt-financing may be taxable unless the exclusions available under the various definitions and rules of the law have application.

#### Questions:

- (1) Was rental income from a historical trust's debt-financed property intended to be taxed as unrelated business income?
- (2) Are the receipts from the commercial leasing of a historical shopping complex exempt from taxation as (a) an income producing activity substantially related to the organization's exempt purpose, or (b) income derived from property which was not acquired subject to acquisition indebtedness?
- (3) Are the rental receipts generated by the two smaller "debt-financed" lots taxable income to the trust?

#### Decision:

- (1) Yes
- (2) See discussion.

(3) No.

Discussion:

(1) As a general rule, rental receipts received by an exempt organization are not subject to the unrelated business income tax (Section 23731). Such income, however, is taxable if produced by debt-financed property as defined in Section 23735. Comparable federal law (Internal Revenue Code Section 514) has been held applicable to the unrelated debt-financed income of an exempt historical organization. (See Rev.Rul. 77-47, 1977\_\_\_\_Cum. Bull.\_\_\_\_). As conformity exists in the federal and state statutes, it is reasonable to conclude that Section 23735 was also intended to apply to income realized from debt-financed property of a state historical trust.

(2) An exempt organization's debt-financed property includes any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year.

An exception to the foregoing exists in Section 23735 (b)(1) (A)(i) which exempts:

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 such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 17631 or 23701 . . .

In determining whether there is a substantial relationship between the use of the property and the exempt purpose of the organization, the former must contribute importantly to the accomplishment of the latter. (See Rev.Rul. 77-47, 1977\_\_\_\_Cum.Bull.\_\_\_\_.)

The exempt purpose of an historical organization is generally the preservation, rehabilitation and restoration of historical sites and making such restored property available for public viewing. In this manner, an organization is carrying on activities similar to those of a museum and, thus, is educational within the meaning of Revenue and Taxation Code Section 23701d.

The leasing of space to commercial vendors in a historical structure (aside from the need of the organization for income) is difficult to characterize as contributing importantly to the achievement of an educational purpose similar to that of a museum. The preservation, rehabilitation and restoration of a historic site is not accomplished by such activity nor is the general public meaningfully educated as to such purposes by the availability of various specialty businesses.

As such, the relationship between the commercial leasing activity and the

accomplishment of the historical organization's exempt purpose is not of the substantial quality required by Section 23735. Rental receipts, therefore, are not excludable from taxable income under the "substantial relationship" exception to debt-financed property of Section 23735 (b) (1)(A)(i).

However, a ten-year exception to the taxability of receipts from debt-financed property is available under Revenue and Taxation Code Section 23735 (c) (2) (B) which provides:

. . . If an organization acquires property by gift subject to a mortgage which was placed on the property more than five years before the gift, which property was held by the donor more than five years before the gift, the indebtedness secured by such mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of such gift. This subparagraph shall not apply if the organization, in order to acquire the equity in the property by bequest, devise, or gift, assumes and agrees to pay the indebtedness secured by the mortgage, or if the organization makes any payment for the equity in the property owned by the decedent or the donor.

By a grant deed gift, the exempt trust obtained title to the historical shopping complex upon the condition it pay remaining installments on a note secured by a deed of trust. The grantor remained personally liable for the encumbrance. For breach of the condition, legal recourse was limited to regaining title to the property. In Wolfert v. Guadagno, 130 Cal.App. 661 (1933), the court held that where a party is liable on a mortgage or trust deed obligation and conveys to another subject to the encumbrance, the making by the other party of payments is only to protect his interest and not an assumption of legal responsibility. (See also Cal. Jur.2d, Mortgages, Sections 263 and 267.)

Accordingly, the conditional agreement to make payments on the promissory note can not be considered an assumption of the outstanding encumbrance. The trust, therefore, will not be treated as having acquired the historic shopping complex subject to acquisition indebtedness for ten years subsequent to the date of the gift. As a result, rental income received from such property will not be taxable to the trust under Section 23735 for the same period.

(3) In the vicinity of its other properties, the trust owns two small lots, subject to deeds of trust, which were purchased for the purpose of future restoration. As both are debt-financed and are presently leased to commercial enterprises, the taxability of the lease income must be considered in conjunction with Section 23735(b)(3)(A). As provided therein, if an organization acquires real property for the principal purpose of using the land in the exercise of its exempt purpose, commencing within 10 years from the time of acquisition, such property will not be treated as debt-financed for ten years so long as: (a) the property is in the neighborhood of other property owned by

the organization which is used in the furtherance of its exempt purpose and (b) the organization does not abandon its intent to use the land in such a manner within the ten-year period.

Prospective application of this rule is automatic for the first five years of the ten-year period provided the planned exempt use is not abandoned. After the initial five-year period, the rule applies prospectively only if the organization establishes to the satisfaction of the Franchise Tax Board that conversion to the exempt use will occur by the end of the ten-year period.

The statutory requirements of Section 23735 (b) (3) (A) have been satisfied by the trust for the first five years. The subject lots are located in close proximity to other property used by the organization in the performance of its exempt function and the intent to use the lots for historical purposes has remained constant.

Nevertheless, after the expiration of the first five years, the trust must establish that it is reasonably certain the lots will be used in the exempt manner prior to the conclusion of the ten-year grace period. This can be accomplished if the trust submits a definite plan detailing a specific improvement date and some affirmative action toward the fulfillment of such plan. In this fashion, rental receipts from the two lots, otherwise considered unrelated debt-financed income, will not be taxable for the entire ten-year period under the exception of Section 23735 (b) (3) (A).