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IRS LTR: Exempt Organization's Stream Mitigation Activities Won't Result in UBTI.

Citations: LTR 201408031

The IRS ruled that an organization's stream mitigation activities in a watershed it protects are substantially related to its exempt purpose and don't constitute trade or business under section 513(a) and that income the organization receives from the sale of related mitigation credits isn't unrelated business taxable income.

UIL: 511.00-00, 512.00-00, 513.00-00

Release Date: 2/21/2014

Date: November 27, 2013

Dear * * *:

This is in response to your ruling request for a ruling as to whether certain activities conducted by you constitute an unrelated trade or business and whether the sale of proceeds derived from those certain activities are taxable as unrelated business taxable income under sections 511 through 514 of the Internal Revenue Code ("Code").

FACTS

You are a State non-profit corporation described in § 501(c)(3). You were organized for cultural and other educational purposes within the meaning of § 501(c)(3) and were specifically formed to educate individuals about the arts and natural sciences. You built and manage a nature center, as well as related facilities including nature trails to provide formal and participatory environmental education to students and the general public. In furtherance of your exempt purpose, you educate the public about the environment through museum exhibits, special programs, and interactive experiences in Preserve. You serve over 30,000 students from more than 35 school systems and an additional 25,000 visitors each year. You are supported by program fees, memberships, fundraising events, museum admissions, and donations from corporations and individuals.

You later amended your articles of incorporation to expand the description of your exempt purposes. Your purposes now include protecting the natural and scenic spaces of real property, protecting natural resources, and maintaining or enhancing water and air quality. In furtherance of these amended purposes, you protect the natural resources of Watershed, which includes Preserve. Preserve is owned by Commission and is leased to you.

You have represented that Commission was created as a public corporation by the State Legislature under an act of the general assembly of State, and Commission is considered a political subdivision of State. An act of State Legislature passed in 1980 reads, "There is hereby created a body corporate and politic to be known as [Commission under its former name], which shall be deemed to be a

political subdivision of [State] and a public corporation by that name . . .” An act of State Legislature passed in 1988 reads, “The body corporate and politic . . . known as [Commission under its former name], is hereby renamed as [Commission] . . . the general purposes of the commission are declared to be: acquiring, constructing, equipping, maintaining, and operating a recreational center and area or centers and areas . . . and doing any and all things deemed by the commission necessary, convenient, or desirable for and incident to the efficient and proper development and operation of such types of undertakings.” Further, nine of eleven members of Commission are appointed by County or City. The 1988 Act reads, “[Commission] shall consist of 11 members . . . Four of such members shall be appointed by the commissioners of [City] . . ., five members shall be appointed by the board of commissioners of [County] . . ., and two members shall be appointed by [Commission].”

In Year 1, Commission entered into an agreement whereby it leased to County the acreage necessary for constructing an environmental center on Preserve. Commission then subleased this land back from County and assumed “total responsibility” for the operation, regulation and maintenance of the center. Commission selected you as the sole managing agent and operator of the center and leased that portion of land to you for a substantial term. It also forbade you from making any capital improvements to the land (other than regular maintenance) without first notifying and seeking its approval. In Year 2, Commission leased additional acreage in the Watershed to you and extended the term of your lease. This amended contract clarified that during the lease period you may not “erect any currently unplanned substantial improvements, substantially alter the topography, nor substantially alter the vegetation growing upon said leased premises without the prior consent of Commission entered upon the Commission minutes.” Under a Declaration of Conservation Covenants and Restrictions, Commission covenants to maintain the majority of this additional land as stream buffers. Commission then executed a Deed of Conservation Easement to you in which the entire acreage is subject to your management for conservation purposes.

Thus, you hold a perpetual conservation easement over Preserve and some additional tracts in Watershed that contain streams. You indicate that this perpetual easement ensures that Preserve is kept undeveloped and its conservation values are preserved by maintaining the woodland and natural character of the property. Additionally, you are responsible for complying with Commission’s covenant regarding maintaining stream buffers.

A few years ago, you hired a consultant to perform an environmental assessment of Watershed. The assessment pointed out significant problems with the stream quality in Watershed and determined the steps necessary to remediate Watershed’s waterways. You received a Clean Water Act Section 319 grant to address certain storm water detention and stream restoration, and could possibly obtain other such grants in the future. A national program to address nonpoint sources of water pollution provides funds for the grants that originate from the Federal government, and are then allocated to state nonpoint source agencies. The state agencies may award the grants to awardees such as you. The state agencies must ensure that awardees comply with Federal laws and that their projects are designed in compliance with those laws. However, since grant funding may be sporadic, in order to complete the remediation activities, you plan to form a stream mitigation bank with support of Commission.

By conducting stream mitigation activities to restore deeply eroded, degraded streams to a functional form, as part of operating the stream mitigation bank, you will generate mitigation credits that can be sold within an environmental conservation program created and managed by various state and Federal agencies. More specifically, as inducement to invest in the significant costs associated with stream restoration, the U.S. Army Corps of Engineers (“Corps”), with the cooperation and participation of other Federal and state agencies, oversees a program, pursuant to

authority under Section 404 of the Clean Water Act or Section 10 of the Rivers and Harbors Act of 1899, that allows the owner of impaired streams to create value by restoring and preserving the streams and receive "credits" from the restoration and preservation activities. A stream mitigation bank is the legal structure that provides the mitigation credits. The creation of credits occurs under a mitigation banking instrument that must be approved by the Corps, and the number of credits to be awarded for completed work is established in the mitigation banking instrument. Releases of credits in the mitigation bank occur when the work has been satisfactorily performed under the requirements of the mitigation banking instrument. Once all of the mitigation credits are sold, as discussed below, there are no additional proceeds from the mitigation bank. However, the owner/sponsor of the mitigation bank is responsible for the monitoring and maintenance of the restored stream reaches for seven years after completion of the final phase. In your case, after this seven year period, you, as Trustee for the Preserve, are charged with management of the water resources in perpetuity.

The mitigation credits generated by your stream mitigation activities can be sold to private developers or governmental units who have projects which may cause any stream disturbance or impact on a stream somewhere else in the primary service watershed. Such projects include the construction of bridges or piped road crossings. The Corps is responsible for providing permits to developers as pertinent to stream effects, and for public review and comment of permits. In order to receive construction permits, the Corps requires developers to mitigate the environmental impacts of their projects as feasible. The intent of the Corps in its mitigation programs is to ensure that there is "no net loss" to the stream or wetland environments. Mitigation credits serve as a preferred option for meeting the requirements. If the developer proposes this option, the amount of credits a developer must buy is dependent on the length and severity of the impact on the given streams within a developer's project, and is determined by the Corps. The pricing of mitigation credits is market-driven. The Corps does not regulate the pricing of the mitigation credits. However, the Corps is the entity that issues the mitigation credits when the mitigation work is completed in accordance with the terms of the mitigation banking instrument. Sale of mitigation credits is restricted to developers of projects in the primary service area watershed or, after certain penalties are applied, in secondary zones.

Commission entered into a contractual agreement with you authorizing you to form a stream mitigation bank (Bank). Commission appointed you as the manager of Bank and delegated to you the authority to negotiate the banking instrument with the Corps and other state and Federal agencies. You and Commission submitted the mitigation banking instrument to the Corps, the U.S. Environmental Protection Agency, the U.S. Fish and Wildlife Service, and the State Department of Natural Resources. The banking instrument was approved and is administered by the Corps on behalf of itself and the other agencies. Under the terms of the banking instrument, Commission is the sponsor of Bank. The banking instrument makes clear that as the sponsor, Commission is solely responsible for "planning, funding, developing, managing and monitoring Bank in accordance with the Mitigation Banking Instrument." As noted above, in addition to signing the banking instrument, Commission also executed the Deed of Conservation Easement and restrictive covenant related to Watershed to you. As manager of the Bank and under the Deed and contractual agreement with Commission, you provide the financing, supervision and future monitoring of preservation construction requirements, and conduct and fund the mitigation activities. Commission authorized you to sell all the mitigation credits generated from Bank.

You state that your activity of protecting Watershed lessens the governmental burdens of Commission, "to care for [Preserve] and [Watershed]." You state that the effect of the Deed of Conservation Easement is to require you to perform the obligations of Commission, as owner of the Preserve, including those requiring affirmative action under the Declaration of Conservation

Covenants and Restrictions and those arising under the Bank instrument. You represent that this arrangement with Commission was in accordance with all laws of State, including contracting provisions. You expect to spend several million dollars in performing your obligations to Commission. In addition, a commitment has been made by you, County, and City to address storm water management issues in the developed areas surrounding Preserve.

RULINGS REQUESTED

1. That your stream mitigation activities are substantially related to your exempt purpose under § 501(c)(3) of the Code and do not constitute an unrelated trade or business within the meaning of § 513(a).

2. That the income you receive from the sale of credits by Bank is not unrelated business taxable income under § 512(a)(1).

LAW

Section 501(c)(3) of the Code provides in part for the exemption from federal income tax of organizations organized and operated exclusively for religious, charitable, or educational purposes.

Section 511(a) imposes a tax on the unrelated business taxable income of organizations described in § 501(c).

Section 512(a)(1) defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions and modifications.

Section 513(a) defines the term "unrelated trade or business" as 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 the functions constituting the basis for its exemption.

Section 513(c) provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.501(c)(3)-1(d)(1)(i) of the Income Tax Regulations ("Treas. Reg.") provides that an organization may be recognized as an organization described in § 501(c)(3) of the Code if it is operated exclusively for one or more of the following purposes: religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals.

Section 1.501(c)(3)-1(d)(2) of the Treas. Reg. provides a definition of the term "charitable" as it is used in § 501(c)(3) of the Code. The term "charitable" is used in its generally accepted legal sense and includes lessening of the burdens of government.

Section 1.513-1(a) of the Treas. Reg. provides that gross income of an exempt organization subject to the tax imposed by § 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(c)(1) of the Treas. Reg. provides that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of §

512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of non-exempt organizations.

Section 1.513-1(d)(1) of the Treas. Reg. provides that gross income derives from "unrelated trade or business" within the meaning of § 513(a) of the Code if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

Section 1.513-1(d)(2) of the Treas. Reg. provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes, and it is "substantially related" only if the causal relationship is a substantial one. For the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Rev. Rul. 85-1, 1985-1 C.B. 177 and Rev. Rul. 85-2, 1985-1 C.B. 178, recognize as charitable certain organizations that assist state and local governments in carrying out their functions. The criteria for determining whether an organization's activities lessen the burdens of government are first, whether the governmental unit considers the organization's activities to be its burden; and second, whether these activities actually lessen the burden of the governmental unit. An activity is a burden of the government if there is an objective manifestation by the governmental unit that it considers the activities of the organization to be its burden. The interrelationship between the governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden. Whether the organization is actually lessening the burdens of government is determined by considering all of the relevant facts and circumstances. A favorable working relationship between the government and the organization is strong evidence that the organization is actually "lessening" the burdens of the government. However, the fact that the government or an official of the government expresses approval of an organization and its activities is not sufficient to establish that the organization is lessening the burdens of government. See Rev. Rul. 85-2, supra (concluding that the organization's activity of training guardians ad litem actually lessens the burdens of the juvenile court, in part because the court uses the volunteers trained by the organization). Thus, the functions that constitute the burdens of government must be identified and the organization's activities must actually lessen those burdens.

In Virginia Professional Standards Review Foundation v. Blumenthal, 466 F. Supp. 1164 (D.D.C. 1979) ("Virginia PSRO"), two organizations were formed pursuant to a federal law that provided for the establishment of professional standards review organizations ("PSROs") to ensure the effective, efficient and economic delivery of health care services to Medicare and Medicaid beneficiaries. The Department of Health, Education, and Welfare was charged with implementation of the PSRO program. The district court stated that "[t]he legislative history of the statute indicates that the PSRO programs were created essentially to act in the government's place in ensuring the 'effective, efficient and economic' delivery of health care services to Medicare and Medicaid beneficiaries." Id. at 1166. The court also stated that "[i]t is well established that a corporation which provides a community benefit . . . or lessens the burdens of government . . . may be regarded as engaged in charitable activities." Id. at 1170. The court concluded that these organizations operated exclusively for charitable purposes under § 501(c)(3) of the Code.

In Professional Standards Review Organization of Queens County, Inc. v. Commissioner, 74 T.C. 240

(1980), acq., 1980-2 C.B. 2 (“Queens County PSRO”), the Tax Court held that an organization created pursuant to a federal statute that reviewed the appropriateness and quality of healthcare services provided to Medicare and Medicaid recipients was exempt under § 501(c)(3) of the Code because it lessened the burdens of government. The Tax Court held that the PSRO’s activities of lessening the burdens of the Federal Government and promoting public health far outweighed any incidental benefit that individual physicians, or even the profession as a whole, would derive from petitioner’s purposes and activities.

In Columbia Park and Recreation Assoc. v. Commissioner, 88 T.C. 1 (1987), aff’d without published opinion, 838 F.2d 465 (4th Cir. 1998), the court of appeals upheld the decision of the Tax Court that the organization did not lessen any burden of government and thus, was not exempt under § 501(c)(3) of the Code. The organization provided a wide range of services and facilities to the residents of Columbia, Maryland. The organization contended that if it did not provide these services and facilities the local or state government would have to provide them. The Tax Court stated that this assertion does not mean that the organization’s activities are, in fact, a burden of government. Instead, the organization must demonstrate that the State of Maryland and/or the county accept the organization’s activities as their responsibility and recognize the organization as acting on their behalf. In addition, the organization must further establish that its activities actually lessen the burden of the state or local government.

In Indiana Crop Improvement Association, Inc. v. Commissioner, 76 T.C. 394 (1981), acq. 1981-2 C.B. 1, the Tax Court found that the organization was described in § 501(c)(3) of the Code because, among other purposes, it was lessening the burdens of government. The organization’s primary activity was the certification of crop seed within the State of Indiana; a substantial amount of time was also spent conducting scientific research in seed technology and providing instruction in modern seed technology in conjunction with Purdue University. The State of Indiana did not have a department of agriculture to regulate agricultural products within the State and delegated by law agricultural regulatory functions to Purdue University and the director of the Purdue University Agricultural Experiment Station; the function of seed certification was in turn delegated by Purdue University to Indiana Crop Improvement Association, Inc. The Tax Court found that as the official seed certifying agency for the State of Indiana, the organization was directly assisting the U.S. Department of Agriculture in enforcing the standards and procedures established under federal statute rather than primarily promoting the economic interests of commercial seed producers and commercial farmers.

In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283, 66 S. Ct. 112, 90 L. Ed. 67, 1945 C.B. 375 (1945), the Court stated that “the presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes.”

ANALYSIS

You have requested a ruling that your stream mitigation activities in Watershed are substantially related to your exempt purposes and do not constitute an unrelated trade or business within the meaning of § 513(a) of the Code.

“Unrelated business taxable income” is gross income derived from any unrelated trade or business that is regularly carried on by the organization. Section 512(a)(1). Gross income of an exempt organization is taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization’s performance of its exempt functions. Section 1.512-1(a) of the Treas. Reg.

A trade or business is an activity carried on for the production of income from the sale of goods or the performance of services. Section 513(c) of the Code. You will sell credits from Bank to a variety of entities and intend to receive income from that activity. Therefore, it meets the definition of a trade or business under § 513(c).

Under § 1.513-1(c)(1) of the Treas. Reg., we examine the frequency and continuity of the activities and the manner in which they are conducted to determine whether a trade or business is "regularly carried on." While the ultimate number of credits that you can sell is finite, you will be selling the credits regularly to various parties over a period of several years. Therefore, this activity is regularly carried on within the meaning of the Code and Regulations. See § 1.513-1(c)(1).

The remaining issue is whether the sale of these credits is substantially related to your exempt purposes. A trade or business is substantially related to exempt purposes if the business activities have a substantial causal relationship or contribute importantly to the achievement of exempt purposes. Section 1.513-1(d)(2).

Under the terms of the conservation easement, you are required to protect the conservation values of Watershed and Preserve on behalf of Commission. Through the arrangements discussed above, this responsibility was bestowed upon you by Commission, a political subdivision of State. By conducting stream mitigation activities, you are undertaking activities that lessen the burdens of government. Lessening the burdens of government is regarded as an exempt purpose. Rev. Rul. 85-1, supra; Rev. Rul. 85-2, supra; Virginia Professional Standards Review Foundation v. Blumenthal, supra; and Professional Standards Review Organization of Queens County, Inc. v. Commissioner, supra. The issue is whether your activities in creating a mitigation bank and selling the resulting mitigation credits is related to this purpose.

Commission was created as a public corporation by the State Legislature under an act of the general assembly of State to oversee all activities within Preserve. As a political subdivision, Commission is a governmental unit.

You are lessening the burdens of Commission because (1) there is an objective manifestation that Commission considers the activity of operating Bank, including the water remediation activities conducted through Bank in Watershed, to be its burden; and (2) you are actually lessening Commission's burden by operating Bank on behalf of Commission. See Rev. Rul. 85-2, and Columbia Park and Recreation Assoc. v. Commissioner, supra.

Under a Declaration of Conservation Covenants and Restrictions, Commission agreed to maintain a significant part of the Preserve land as stream buffers. Furthermore, as a signatory to the banking instrument and the listed sponsor of Bank, Commission is legally obligated to plan, fund, develop, manage, and monitor the Bank. By assuming this specific obligation in addition to its general conservation obligations, Commission demonstrated that it considers the activity of operating Bank, including the stream remediation activities in Watershed performed as a part of Bank, to be its burden.

In addition, Commission assigned its conservation obligations contained in the conservation easement to you, requiring you to maintain the land in essentially pristine condition and seek Commission's approval before making any capital improvements. Commission authorized you to negotiate the mitigation banking instrument and remediate these waterways. Furthermore, Commission delegated the operation of Bank, its legal obligation as sponsor of Bank, to you through a contractual agreement. In meeting minutes, Commission specified that it wanted you to be responsible for all "financing, supervision and future monitoring of preservation and construction requirements" associated with Bank. Commission also provided that you were authorized to sell all

credits generated by Bank. You have assumed all responsibilities for the planning, funding, developing, and monitoring of Bank as well as the authority to sell credits generated by Bank. By carrying out these activities, you are fulfilling Commission's conservation and legal obligations and lessening Commission's burden. Rev. Rul. 85-1, supra; Rev. Rul. 85-2, supra.

In order for the income derived from the sale of the credits to be taxable to you as unrelated business income under § 512(a)(1) of the Code, the income must be derived from an unrelated trade or business that is regularly carried on by you. Because the sale is not an unrelated trade or business as defined by § 513, any mitigation credit income you receive would not be taxable. Here, the activity is substantially related to your exempt purposes within the meaning of § 513(a) because it lessens the burdens of government.

RULING

1. Your stream mitigation activities are substantially related to your exempt purpose under § 501(c)(3) of the Code and do not constitute an unrelated trade or business within the meaning of § 513(a).

2. The income you receive from the sale of mitigation credits created by Bank is not unrelated business taxable income under § 512(a)(1).

This ruling will be made available for public inspection under § 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) provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. In particular, this ruling does not address whether the sale of any other form of credits would be considered unrelated business income and be taxable as such.

Because it could help resolved questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Ronald J. Shoemaker

Manager, Exempt Organizations

Technical Group 2

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