CRSO v. Commissioner, 128 T. C. 153 (U. S. Tax Court 2007)

The U. S. Tax Court ruled in CRSO v. Commissioner that a nonprofit organization's rental income from debt-financed commercial real estate disqualified it from tax-exempt status under Section 501(c)(3). The court clarified that such income constitutes a trade or business, making CRSO a feeder organization under Section 502, ineligible for exemption. This decision upholds the IRS's stance on limiting tax exemptions for entities primarily engaged in profit-making activities, even if proceeds are distributed to charitable causes.

Parties

CRSO, the petitioner, was a nonprofit corporation seeking tax-exempt status under Section 501(c)(3). The Commissioner of Internal Revenue, the respondent, denied this exemption, leading CRSO to appeal the decision to the U. S. Tax Court.

Facts

CRSO was incorporated in Washington in December 2000 as a nonprofit organization. Its sole activity involved renting two parcels of debt-financed commercial real estate in Wenatchee, Washington, and distributing the net profits to Chi Rho Corp. , a Section 501(c)(3) organization. The real estate was purchased by Hudson and Cynthia Staffield in 1997 and transferred to CRSO in 2000, with the Staffields remaining personally liable on the mortgage. The property was subject to long-term triple net leases with tenants operating a sporting goods business and a cellular telephone business. CRSO employed a management company to handle leasing and management for a monthly fee and a percentage of new lease revenues.

Procedural History

CRSO applied for tax-exempt status under Section 501(c)(3) in October 2001. The IRS proposed to deny this request in November 2002, concluding that CRSO was a feeder organization under Section 502. After a hearing with the IRS Appeals Office, a final adverse determination was issued on November 4, 2003, but it was initially sent to an incorrect address. CRSO did not receive this determination until it was resent to its counsel on June 14, 2005. CRSO filed a petition for declaratory relief under Section 7428 on June 27, 2005, which the Tax Court deemed timely since the initial notice was ineffective due to misdelivery.

Issue(s)

Whether CRSO's petition for declaratory relief was timely filed under Section 7428(b)(3)?

Whether CRSO's rental activity from debt-financed commercial real estate qualifies as a "trade or business" under Section 502(a), thus precluding tax-exempt status under Section 501(c)(3)?

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Rule(s) of Law

Section 7428(b)(3) requires a petition for declaratory relief to be filed within 90 days of the Secretary's mailing of a final adverse determination by certified or registered mail.

Section 502(a) denies tax-exempt status under Section 501 to an organization operated primarily for carrying on a trade or business for profit, even if all profits are payable to one or more exempt organizations.

Section 502(b)(1) excludes from the definition of "trade or business" the deriving of rents that would be excluded from unrelated business taxable income (UBTI) under Section 512(b)(3) if Section 512 applied to the organization.

Section 512(b)(3) excludes "all rents from real property" from UBTI, subject to exceptions including income from debt-financed property under Section 512(b)(4).

Holding

The court held that CRSO's petition was timely filed under Section 7428(b)(3) because the initial adverse determination letter sent to an incorrect address was ineffective. Additionally, the court held that CRSO's rental activity from debt-financed commercial real estate constituted a "trade or business" under Section 502(a), making CRSO a feeder organization ineligible for tax-exempt status under Section 501(c)(3).

Reasoning

The court reasoned that the initial adverse determination letter was ineffective for triggering the 90-day filing period under Section 7428(b)(3) because it was not sent to CRSO's last known address. The court cited precedent that misaddressed notices are nullities, thus the petition filed within 90 days of the correct notice was timely.

Regarding the tax-exempt status, the court analyzed the interplay between Sections 502 and 512. It determined that CRSO's rental income from debt-financed property was not excluded from UBTI under Section 512(b)(3) due to the operation of Section 512(b)(4), which includes debt-financed income as UBTI. Consequently, under Section 502(b)(1), which cross-references Section 512(b)(3), CRSO's rental activity was considered a "trade or business. " The court emphasized the legislative intent behind the 1969 amendments to maintain consistency between the feeder organization rules and the UBTI rules. It rejected CRSO's argument that its rental activity was merely an investment, not a business, as irrelevant under the statutory framework.

The court also dismissed CRSO's contention that the Section 502(b)(1) exclusion applied, noting that the operation of Section 512(b)(4) precluded the exclusion of debt-financed rental income from UBTI, thus disqualifying CRSO from the exclusion.

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Disposition

The court entered a decision for the respondent, denying CRSO's request for tax-exempt status under Section 501(c)(3).

Significance/Impact

This decision reinforces the IRS's position on limiting tax exemptions for organizations primarily engaged in profit-making activities, even if the profits are distributed to charitable causes. It clarifies the application of the feeder organization rules under Section 502, particularly in relation to rental income from debt-financed property. The case highlights the importance of proper notification procedures in tax disputes and underscores the need for organizations to carefully consider the tax implications of their income sources when seeking exempt status. Subsequent courts have referenced this decision when addressing similar issues of tax exemption and the classification of income as UBTI.

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