TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

200441038

Date: JUL 14 2004

Contact Person:

Identification Number:

Telephone Number:

T:EO:B2

UIL: 501.03-08; 513.00-00

X =
Y =
Z =

Dear

We have considered your ruling request dated July 8, 2003 for rulings related to the restructuring described below.

X is a very large organization described in sections 501(c)(3) and 509(a)(2) of the Internal Revenue Code. It has many thousands of members in many chapters around the world. The activities that X conducts to implement these purposes include the following:

Educating the public, and especially children, about X's area of interest;

Conducting research and discussion promoting public safety; including participation in government efforts at all levels;

Conducting membership programs regarding education and safety, providing responses to numerous inquiries per year, publishing newsletters containing technical updates and research developments; and

Organizing an annual exhibition.

Y is also an organization of long standing. It is described in Sections 501(c)(3) and 509(a)(2). Among its activities have been: promoting and providing education about X's area of interest, promoting public interest about X's area of interest, and operating a museum, library, and annual exhibition concerning X's area of interest. It has engaged in fundraising for itself and for X, and is governed by a joint executive committee with X.

The third related entity, Z, is a supporting organization recognized under Sections

501(c)(3) and 509(a)(3). It supports Y by managing endowment assets on its behalf. Its Board of Directors is appointed by Y, and includes a minority of those currently serving on the Board of Y.

Over the past year, X and Y have reviewed their structures and interactions. Recent events in the for-profit and exempt organization sectors prompted an examination of the way that assets should be held and governance conducted. The examination particularly focused on the inefficient current organizational structure and the potential impact on both organizations of an accident during the exhibition. The organizations propose to reorganize as described below.

X would become the primary operating corporation. It would continue its membership functions and programs and would assume other activities previously conducted by Y, such as operating the museum and educational and youth programs. X would become the sole sponsor of the annual exhibition, and would assume ownership of programs, and the assets used in these "risk-based" activities.

Y would become essentially a non-operating entity. It would hold title to certain assets: the headquarters, other buildings, and the museum collection. It would lease these to X for its lower-risk activities. Y would also take over the assets and function of Z. It would hold and manage the endowment assets. It is expected that the new Y will qualify under section 509(a)(1) and 170(b)(1)(A)(vi) of the Code through solicitation of gifts.

X would have the authority to nominate the directors of Y, and to remove them without cause, to approve the president of Y and his removal, and to approve amendments to the corporate documents. There would be two classes of directors, Independent and Overlapping. The Overlapping directors would consist of persons who concurrently serve on the board of X or who are ex officio directors. The Class O directors could not exceed 49%. Class I or Independent directors are persons not also serving on the board of X. Action by Y board would require a majority of the directors of each class who are present.

The reorganization will require a number of transactions, including: transfer of some land from X to Y, transfer of assets used in risk-based activity from Y to X, transfer of lines of business from Y to X (such as educational and youth programs, museum and library, sponsorship of the annual exhibition), and transfer of personnel, equipment, information systems from Y to X. After the reorganization, the working relationships will be governed by written contracts providing fair market value for the assets and services provided. For example, Y will lease to X the use of the headquarters, museum and library. X will provide support services to Y.

The organizations anticipate many benefits from the re-organization in addition to isolating the risk-based activities. The consolidation of activities should allow the organization to operate more efficiently and to make better use of the volunteer leaders who now serve in multiple roles for multiple organizations.

Implementation of the re-organization will require many steps over several years. The Board has already revised Y's articles of incorporation and by-laws, and has made transitional changes in X's corporate documents. After a thorough review of X's governance structure, some additional changes may be made in such procedural and governance matters as:

- Board size and composition (the proportion of directors elected by members, appointed by the board itself, ex officio members)
- Term lengths and limits
- Committee charters including such matters as composition, authority, accountability to the oversight and direction of X Board.
- Meeting procedures such as standard agenda formats, deadlines for submission of agenda items.

The leaders of the organizations are cognizant of pressures on both for-profit and exempt organizations to institute higher levels of accountability through redesigned corporate governance. As part of the corporate restructuring, the leaders will assess and amend the governance to assure that the directors will "exercise a higher degree of oversight, scrutiny and diligence in fulfilling their duties." The organizations do not anticipate "any substantive changes in the purposes or overall nature of X and/or its activities" to result from the revision of X's corporate documents. The membership will vote on the proposed changes to the organizing documents. This re-organization should be completed in time to implement it for the election of directors in July

Requested Rulings

1. The transfer of assets by X to Y and by Y to X, in anticipation of the restructuring will not adversely impact the tax-exempt status of X or Y under Section 501(c)(3) of the Code, nor result in unrelated business taxable income to either organization under Sections 511-514 of the Code.

2. The merger of Z with and into Y will not adversely impact the tax-exempt status of Y (prospectively) or Z (retroactively) under Section 501(c)(3) of the Code, nor result in unrelated taxable business income to Y under Sections 511-514.

3. The expanded activities to be undertaken by X post-restructuring will not adversely impact the tax-exempt status of X under Section 501(c)(3) of the

Code.

4. The asset holding, asset management, investment and grantmaking functions to be undertaken by Y post-restructuring will not adversely impact the tax-exempt status of Y under Section 501(c)(3) of the Code

5. The provision of administrative or support services, as well as the transfer of personnel, funds, assets or resources, between X and Y post-restructuring will not result in unrelated business taxable income to either organization under Sections 511-514 of the Code.

Law

Section 501(c)(3) of the Code recognizes as exempt from federal income tax entities that are organized and operated exclusively for charitable purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations described in section 501(c).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived from any unrelated trade or business which it carries on regularly.

Section 512(b)(3) of the Code excludes from unrelated business taxable income rents from real property.

Section 513 of the Code defines the term "unrelated trade or business" as one that is not substantially related to the exercise or performance by an organization of its charitable purpose or function constituting the basis for its exemption.

Section 514(a)(1) of the Code requires that with respect to each debt-financed property, a proportion of the income derived from an unrelated trade or business be included in gross income.

Section 514(b)(1)(A)(i) of the Code excludes from the term "debt-financed property," the income from which must otherwise be included in gross income, property that is substantially related to the exercise or performance of the organization's charitable function.

Section 1.170A-9(e)(6)(ii) of the Income Tax Regulations permits the exclusion of "unusual grants" from the analysis of support to determine whether an organization is

publicly supported. No single factor is determinative, but the Service may consider factors similar to those listed in section 1.509(a)-3(c)(4). Among those listed as favorable factors are grants that are: in the form of assets which further the exempt purpose of the organization, whether the organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution, and whether the organization has a representative governing body.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized and operated exclusively for exempt purposes unless it serves a public rather than a private interest.

Section 1.501(c)(3)-1(e)(1) of the regulations states that an organization exempt under section 501(c)(3) of the Code may operate a trade or business as a substantial part of its activities if the operation of such trade or business is in furtherance of the organization's exempt purposes. Exemption will be denied to an organization that is organized or operated for the primary purpose of carrying on an unrelated trade or business.

Section 1.502-1(b) of the regulations provides that a subsidiary of a tax-exempt organization that performs a service for the exempt organization will not lose its exemption because, as a matter of accounting between the two, the subsidiary derives a profit. However, the subsidiary must not have a primary purpose of carrying on a trade or business that would be an unrelated business if regularly carried on by the parent. An example distinguishes between an organization that furnishes electric power for a parent university, and furnishing electric power for several unrelated organizations.

Section 1.513-1(d)(2) of the regulations state that a trade or business is related to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes, and it is substantially related for the purpose of section 513 only if the causal relationship is a substantial one. Thus, for the conduct of a 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.

Section 1.513-1(d)(4) provides that gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of an unrelated trade or business.

Rev. Rul. 77-72; 1977-1 C.B. 157 provides that the debt owed by a wholly owned tax exempt subsidiary of a labor union to the union is not “acquisition indebtedness” within the meaning of section 514(c) of the Code. The union had advanced funds, without any borrowing to the subsidiary owned to a third party. The Service found the transaction was not acquisition indebtedness incurred in acquiring or improving a property, but “merely a matter of accounting between the organizations.”

Rev. Rul. 78-41, 1978-1 C.B. 148, provides that a trust created by an exempt hospital to accumulate and hold funds to satisfy malpractice claims against the hospital may qualify for exempt status under section 501(c)(3) of the Code. The trust was determined to be an integral part of the hospital because it was controlled by the hospital and performed a function that the hospital could have performed directly.

Rev. Rul. 81-19, 1981-1 C.B. 353 concerns an organization formed to support and assist a particular university by receiving contributions, providing financial management to the academic departments, and managing vending machines. It carries out its activities in close consultation and cooperation with university officials. The university may operate vending facilities for the convenience of its students and faculty. Thus, operating the vending facilities is part of the educational program, and the organization was fulfilling its exempt purpose of furthering the university's educational program by performing for it various administrative functions including operating the vending machines. The Rev. Rul. pointed out that if the organization provided convenience items to another organization, income would be subject to unrelated business income tax. However, performing the tasks for an affiliated entity is “substantially related” to the organization's exempt purpose.

In *BSW Group v. Commissioner,* 70 TC 352 (1978), the Court found that a corporation formed to provide consulting services was not exempt under section 501(c)(3) of the Code because its activities constituted the conduct of a trade or business that is ordinarily carried on by commercial ventures organized for profit. Its primary purpose was not charitable, educational, nor scientific, but rather commercial.

The Court explained that the corporation had failed to demonstrate that its services were not in competition with commercial businesses. Also, the organization's financing did not resemble that of the typical organization described in section 501(c)(3) of the Code. It had not solicited, nor had it received, voluntary contributions from the public. Its only source of income was from fees from services, and those fees were set high enough to recoup all projected costs, and to produce a profit. Moreover, it did not appear that the corporation ever planned to charge a fee less than "cost." And finally, the corporation had failed to limit its clientele to organizations that were recognized as exempt under section 501(c)(3).

Analysis

1. The transfer of assets and the new distribution of assets are consistent with the continued tax-exempt status of both organizations. A one-time transfer will not convert exempt organizations to commercial entities. See, section 1.170A-9(e)(6)(ii) of the regulations, *supra* concerning the impact on foundation status of such large, but unique donations. The organizations will transfer physical assets that are used in the conduct of the exempt functions of both organizations. There is ample evidence that the organizations will continue to attract substantial public support, and the governing bodies of both of the organizations are representative of a wide membership. Furthermore, the transfers will not result in unrelated business income subject to tax; the transfers are unique events rather than a trade "regularly carried on." See section 512(a)(1) of the Code, *supra*.

2. The merger of Z into Y will not affect the tax-exempt status of either organization. The purposes and activities of both organizations have previously been held to qualify as tax-exempt. Nor will it cause unrelated taxable business income to Y for the reasons discussed in (1.) above. Y will manage the assets of just one, related organization. This situation is like that in Rev. Rul. 81-19, *supra*, rather than the one in *BSW Group v. Commissioner, supra* where a consulting firm performed services for a number of unrelated entities.

3. The expanded activities that X plans to undertake will not adversely impact its tax-exempt status. The new activities, including operating a museum and educational programs, and sole sponsorship of the annual exhibition, all are educational activities. We cannot rule, however, on the particulars of the anticipated bylaw changes (eg, board size and composition) because we have not been provided with sufficiently detailed information.

4. The asset holding, asset management, investment and grant-making functions that Y will undertake after the restructuring will not adversely impact its tax-exempt status. All of the activities support the exempt purposes carried out by X.

This situation is like the one in Rev. Rul. 78-41, *supra,* where the Service held that a corporation may base its exempt status on provision of such essential administrative services to affiliated organizations.

5. The provision of administrative and support services and the transfer of personnel, assets and resources between X and Y after the re-structuring will not result in taxable, unrelated business income to either organization. Some of the payments fall into categories exempted from unrelated business taxable income such as leases for real property. See section 512 of the Code, *supra.*

Neither organization is providing services to the general public or to other organizations. This situation is different than *BSW Group v. Commissioner, supra.* It is like the organization formed to assist a specific university in Rev. Rul. 81-19, supra. The purpose of Y to support X is memorialized in its Articles of Incorporation, and the overlapping boards assure close coordination. The relationship is like the parent-subsidiary described in section 1.502-1(b) of the regulations.

Each entity will provide services or assets important to the exercise of the exempt purpose of both itself and the recipient organization. Thus, the activity will not be "unrelated" as defined by section 513 of the Code, *supra.* Providing necessary services to affiliated organizations does not constitute an unrelated trade or business, and will not result in taxable unrelated business income.

Ruling

Therefore we rule that:

1. The transfer of assets by X to Y and by Y to X, in anticipation of the restructuring will not adversely impact the tax-exempt status of either X or Y under Section 501(c)(3) of the Code, nor result in unrelated business taxable income to either organization under Sections 511-514 of the Code.

2. The merger of Z with and into Y will not adversely impact the tax-exempt status of Y (prospectively) or Z (retroactively) under Section 501(c)(3) of the Code, nor result in unrelated taxable business income to Y under Sections 511-514.

3. The expanded activities to be undertaken by X post-restructuring will not adversely impact the tax-exempt status of X under Section 501(c)(3) of the Code.

4. The asset holding, asset management, investment and grant-making functions to be undertaken by Y post-restructuring will not adversely impact the tax-exempt status of Y under Section 501(c)(3) of the Code

5. The provision of administrative or support services, as well as the transfer of personnel, funds, assets or resources, between X and Y post-restructuring will not result in unrelated business taxable income to either organization under Sections 511-514 of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which it is based. Any such change should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office.

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code. This ruling is directed only to the organizations that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Because this letter could help resolve future tax questions, you should keep a copy of this ruling in your permanent records. A copy of this ruling is being forwarded to the Ohio TE/GE Customer Service office.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Joseph Chasin, Manager,
Exempt Organizations
Technical Group 2