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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Date: APR 17 2003

Contact Person:

ID Number:

Telephone Number:

0512.00-00

In reply refer to:
T:E:O:RA:T:1

E.I.N.

**LEGEND**

A=
B=
C=
D=
E=
X=

Dear Sir/Madam:

This is in response to a letter from your authorized representative requesting rulings on your behalf regarding the federal income tax consequences of the transfer from B to C of certain assets, and the subsequent sale or exchange of those assets, under section 511 of the Internal Revenue Code.

**FACTS**

A is a nonprofit organization organized under the laws of the state of D. A is exempt from federal income tax under section 501(c)(6) of the Internal Revenue Code. A is a trade association comprised of most of the new car and truck dealers in the state of D. A provides its members with opportunities to advance mutual interests within the industry and operates to advance the general interests of the new retail automotive and truck industry in the state of D.

In 1947, A formed a group insurance trust, B, which provided insurance coverage

(health, life, short-term disability, vision, and dental insurance) to A's member-employers and their employees. B has not been recognized as exempt from federal income tax under section 501(a) of the Internal Revenue Code.

E is a mutual insurance company which provided insurance products through B. E notified B that it intends to demutualize the company. Consequently, B will receive X shares of E stock. As a result of the demutualization, B's net worth and reserve balance will increase substantially. A has decided to transfer all of B's surplus reserves, including the demutualization proceeds, to C to be used for charitable and educational purposes relating to the automotive industry in the state of D.

C is an organization exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and is not a private foundation within the meaning of section 509(a) because it is an organization described in section 509(a)(3). C was organized to conduct educational activities and programs related to the industry in which A's members are engaged.

## RULINGS REQUESTED

The following are the requested rulings:

1. The termination of B and the transfer of the surplus assets to C will not cause A, B or its subscribers to be subject to the excise tax of section 4976 of the Code since such transfer is not a reversion to the benefit of an employer for purposes of section 4976 of the Code.

2. The transfer of the surplus assets, including the demutualization proceeds, from B to C will not result in taxable income or unrelated business taxable income to A, B, C or B's subscribers.

3. The receipt of the demutualization proceeds in the form of E stock will not result in taxable income for B.

4. The sale or exchange of some or all of the E stock by C after the transfer from B will not result in unrelated business taxable income for C.

## LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations that are organized and operated exclusively for charitable, religious, or educational purposes, no part of whose net earnings inures to any private individual.

Section 501(c)(6) of the Code provides for the exemption from federal income tax of trade associations not organized for profit, provided that no part of their net earnings inures to the benefit of any private shareholder or individual.

Section 511 of the Code imposes a tax on the unrelated business taxable income of exempt organizations, including those described in sections 501(c)(3) and 501(c)(6).

Section 512(a)(l) of the Code 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, both computed with the modifications listed in section 512(b).

Section 512(b)(5)(B) of the Code excludes from the computation of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property other than property held primarily for sale to customers in the ordinary course of the trade or business.

Section 4976 of the Code imposes an excise tax on an employer equal to 100 percent of any disqualified benefit provided by an employer-maintained welfare benefit fund.

Section 4976(b)(1)(C) of the Code defines "disqualified benefit" to include any portion of a welfare benefit fund reverting to the benefit of the employer.

In Malat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), the Supreme Court defined the standard to be applied in determining whether property is held "primarily" for sale to customers in the ordinary course of business for purposes of section 1221 of the Code. The Court interpreted the word "primarily" to mean "of first importance" or "principally." By this standard, ordinary income would not result unless a sales purpose is of first importance.

Factors that have been considered in determining whether the sale of property has been carried out in the regular course of the taxpayer's business are:

(1) the purpose for which the property was acquired;
(2) the frequency, continuity and size of sales;
(3) the extent of improvements to the property;
(4) the activities of the owner in improving and disposing of the property;
(5) the purposes for which the property is held; and
(6) the proximity of purchase and sale.

## RATIONALE

The information submitted states that the B will be terminated and the surplus assets will be transferred to C, an organization exempt under section 501(c)(3), to carry out C's educational purposes. The surplus assets will not revert to A or A's members.

C is not an employer with respect to A, nor is it an organization that is an alter ego of A's member-employers. It is a charitable organization, the assets of which are dedicated to charitable purposes and cannot be used for the private benefit of A's member-employers. Therefore, the transfer of B's surplus assets to C is not a reversion "to the benefit of the employer" as defined in section 4976(b)(1)(C) of the Code.

As organizations described in section 501(a) of the Code, A and C are subject to section 511 regarding the imposition of tax on their unrelated business income. B will transfer the surplus reserves, including E stock, to C, and the questions presented are whether the transfer of the surplus reserves and C's subsequent sale of the E stock may be excluded from the computation of unrelated business taxable income as gain from the sale of property under section 512(b)(5). In determining whether this modification is applicable in this case, the surrounding circumstances must be considered.

The information submitted indicates that A created the insurance trust many years ago for the benefit of its member employers and their employees. Once the insurance trust is terminated, the surplus assets, including the demutualization proceeds, will be transferred to an organization qualified under section 501(c)(3) of the Code, the purpose of which is to carry on exempt activities for the benefit of the employees and those affiliated with the automotive industry in the state of D. The surplus assets will be transferred to C only upon B's termination and E's demutualization. Since C will receive the assets based on the one-time, unforeseen occurrence of demutualization, A or C could not have had a business purpose in mind when the property was acquired. Therefore, the transfer of the property is not indicative of an intention to use the property in the regular course of a trade or business.

Furthermore, because C does not hold the E stock either as stock in trade, inventory or for sale in the ordinary course of business, the gain on the subsequent sale of E stock will be excluded from the computation of unrelated business taxable income by reason of section 512(b)(5) of the Code.

## CONCLUSION

Based on the facts and information submitted and the representations made, we conclude that:

1. The termination of B and the transfer of the surplus assets to C will not cause A, B or its subscribers to be subject to the excise tax of section 4976 of the

Code since such transfer is not a reversion to the benefit of an employer for purposes of section 4976 of the Code.

2. The transfer of the surplus assets, including the demutualization proceeds, from B to C will not result in unrelated business taxable income to A or C.

3. The sale or exchange of some or all of the E stock by C after the transfer from B will not result in unrelated business taxable income for C.

We have referred the other matters contained in your ruling request to appropriate offices within Chief Counsel since these matters are not within our jurisdiction. Those offices will communicate directly with you.

These rulings do not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

These rulings are directed only to the organizations that requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited as precedent.

This ruling is based on the understanding that there will be no material change in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service. Please keep this ruling letter in your permanent records.

Sincerely yours,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1