Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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NO THIRD PARTY CONTACTS

Contact Person:

Telephone Number:

In Reference to: OP:E:EO:T:2

Date: JUN 28 1999

EIN:
Key District Office:

LEGEND:

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Ladies and Gentlemen:

This is in response to a letter dated June 16, 1999, from your authorized legal representatives, who have requested certain rulings on your behalf.

X is an organization exempt from federal income tax under section 501(a) of the Internal Revenue Code of 1986 ("Code") as an organization described in section 501(c)(4). X was organized for the purpose of promoting the interests of older persons and sponsors many programs which include educational, research, and social welfare activities. X makes its views known on programs and legislation that affect its members.

X has a large number of members who pay dues. Members of X receive a magazine, A, which has articles on such topics as

financial planning, travel, and health. X's members also receive a monthly newsletter, B, which keeps X's members informed on legislation affecting them and includes information on X's current activities.

Through contractual agreements with third party service providers, X offers various programs and services to its members. The members are free to decide whether or not to obtain such services or participate in such programs. On first joining X, members are advised of the availability of such programs and services through a new member packet. Members who renew their membership receive a renewing member packet of similar information. The availability of the programs and services is also made known through advertisements in A and B. Certain providers make separate mailings to X's members soliciting participation in a particular program.

The largest of these programs is a group health insurance program. By an Agreement and Declaration of Trust, X established Z, a trust. Z is administered by trustees selected by X's Board of Directors. Z, which holds, manages and administers the group health insurance policies, is a grantor trust under section 671 of the Code, and has regularly filed a Form 1041. Z, as the group policyholder, collects monies from X's members who elect to participate in the program, retains a specified percentage and pays the balance to the insurance company as the premium for the group health insurance coverage. Z holds such member payments for a limited time period until payable to the insurance company. Interest and gains or losses on the short-term investment of such amounts are earned by Z and then transferred to X, which is treated as the owner of Z pursuant to Code section 671.

From 1981 through December 31, 1997, X had agreements with C, under which C provided insurance to X's members. Beginning January 1, 1998, as a result of competitive bidding, X and Z have entered into agreements with D, E, F, and G to provide the services of the group health insurance program. These agreements provide for continuation of the group health insurance program in substantially the same form as the program existed prior to January 1, 1998. Certain of these agreements require the payment of a contract fee to X based upon receipts from X's members who participate in the program.

Beginning prior to 1998 other programs and services have also been provided to X's members through contractual agreements between X and H. These agreements specify that certain services will be provided to X's members, and that X will receive contract fee payments from the respective service provider based upon the amount the service provider receives from X's members. Pursuant to these agreements, the service providers are entitled to the

use of X's name and logo, and some of them are also given access to X's membership (mailing) list so they may contact X's members directly. In addition, X mails information concerning some of these programs in the new and renewing member packets sent to each new and renewing member. Service providers desiring to have material included in these new and renewing member packets provide such information to X and make a payment to X for such inclusion. X endorses these programs, advises its members of their availability and maintains a staff to oversee the operation of these programs and to act as coordinator to resolve any problems which its members may have with any of these programs. Pursuant to some of the agreements, X grants the service provider the exclusive right to provide a specific service to X's members.

Most of these agreements continue in effect after 1998. Under all these agreements, X has been authorized or required to perform certain monitoring, reviewing and auditing activities. It is contemplated that X will enter into similar agreements with other service providers in the future. Such similar agreements will be the subject of annual reports (see infra) to be provided by X and Y to the Chief, EP/EO Key District Office, identified on page 1, or his or her successors.

Y was created in December 1998, with business commencing on January 1, 1999, as a wholly owned taxable subsidiary of X. X has entered into (or will enter into) assignment agreements with Y, whereby X will assign to Y a portion of its right, title, and interest in its agreements with the service providers. Pursuant to these assignments, X will reserve for itself all of its right, title, and interest in its name, logos, symbol, mark, service marks, and acronym ("X's Marks"). The purpose of these assignments is to assign to Y all of X's other rights and obligations. In conjunction with these assignments, X has entered into (or will enter into) royalty agreements with the service providers that use X's Marks. The purpose of these royalty agreements is to set out the rights and obligations of the parties to the use of X's Marks.

In order to establish a structure whereby X will carry on its future activities in a manner that will not affect its tax-exempt status under section 501(c)(4) of the Code and minimize any possible liability for tax on unrelated business income under section 511, X proposes to have the following activities performed by Y:

(1) Receiving, reviewing, and recommending modifications to strategic and operating plans of the service providers;

(2) Auditing and inspecting management reports, complaints, finances, and statistical data of the service providers;

(3) Receiving, reviewing, approving, and recommending modifications of mailings of the service providers;

(4) Approving the nature and timing of communications of the service providers with X's members;

(5) Maintaining ombudsman services to help resolve claims, disputes, and other problems with the service providers;

(6) Monitoring the performance of the service providers and their compliance with the various agreements;

(7) Performing internal audit checks and reviews of the service providers;

(8) Reviewing product development, budgets, and pricing by the service providers;

(9) Responding to complaint correspondence regarding the service providers;

(10) Monitoring of promptness and quality of performance of the service providers;

(11) Engaging in ongoing research regarding new benefits and other changes that might be needed or desirable;

(12) Conducting quality control activities, including preparation and supervision of member services quality studies;

(13) Creating marketing services respecting X's membership list;

(14) Preparing, or supervising preparation of market analyses; and,

(15) All other activities as are necessary to promote the service providers.

Consistent with the proposed restructuring, the activities listed above will be carried out by Y, and X will not carry out such activities. Also consistent with the proposed restructuring, nothing will prevent X's counsel and officers from drafting, reviewing and monitoring agreements between X and Y that describe and provide for Y's conduct of such activities. X will retain the right to confirm that the service providers have made the proper amount of royalty payments to it; that the service providers have not defrauded X in any manner; that the service providers continue to have the ability to perform under

their respective contracts with X; and, that Y is complying with its contracts and retains the ability to carry out such contracts effectively. X and Y, respectively, may each name liaison staff to implement the various agreements among X, Y, and the service providers.

In accordance with the proposed restructuring, Y will be compensated by the service providers for the services specified above in an amount equal to the fair market value of the services rendered, generally cost plus I percent. In addition to the amounts paid by the service providers to Y, each service provider will pay X a royalty for the use of X's Marks, pursuant to a royalty agreement.

X and Y have entered into an agreement whereby Y has (and will continue to have) its own staff, whose members will be employees of Y. The most relevant terms of this agreement are as follows:

(1) A majority of the members of Y's Board of Directors will not be current or former officers or directors of X;

(2) Y's Board of Directors will be the sole governing and policy making body of Y;

(3) Y's officers and other employees will be in charge of all day-to-day activities of Y;

(4) Y's Board of Directors will be composed of at least five persons, one of whom will be X's Executive Director;

(5) Y's Board of Directors will hold regular meetings, at least three times per year;

(6) Officers and directors of Y will be elected or appointed in conformity with Y's Bylaws;

(7) Y's Board will maintain complete and accurate minutes of its meetings and decisions;

(8) Y will keep and maintain complete and accurate financial records;

(9) Shareholder meetings of Y will be held at least once a year;

(10) An Executive Committee of the Y Board is permitted by Y's Bylaws; if such a Committee is established, a majority of the Committee will not be current or former officers or directors of X. X's Executive Director would be a member of

the Executive Committee. The Executive Committee would have interim authority to make policy decisions and would meet as often as necessary;

(11) X has provided sufficient initial capitalization to enable Y to carry out the activities specified above. Y has issued its own capital stock and will keep accurate records of issuance, transfer, and cancellation of shares;

(12) Y will retain a certified public accounting firm to perform an audit of its financial statements once each year. Y will file timely and accurate federal and state income tax returns, reporting its expenses pursuant to IRS rules and (where applicable) generally accepted accounting principles;

(13) In conformity with financial accounting rules, Y may report its financial statements on a consolidated basis with those of X;

(14) Y may sue and will retain its own legal counsel and obtain liability and other insurance to cover its staff and operations;

(15) Y will maintain its own separate offices, separate telephone number(s), separate telephone listing(s), separate bank account(s), and separate stationery;

(16) Y will enter into separate contracts with each service provider, which will specify the services to be provided by Y and the amounts and methodology of the payments by the service providers directly to Y;

(17) Funds or assets of Y will not be combined or commingled with funds or assets of X;

(18) Although Y may declare dividends to its shareholder, Y will not declare excessive dividends that would deplete Y's necessary working capital;

(19) Y may purchase or lease assets necessary to carry out the activities specified above, and it will have its own employees. Substantially all of Y's employees will not also be employed by X. Some current employees of X will be transferred to Y, which will hire some employees on its own;

(20) Monitoring and reviewing with respect to the service providers will be performed by employees of Y;

(21) Y will have a separate payroll, bank account, and space (which may be a separate area in X's building);

(22) In order to carry out the activities specified above, Y will have the authority to obtain administrative services from whatever sources it judges best, including computer services, human resources support, office rentals, accounting services, and legal services. Y may obtain administrative services from its own employees, from commercial providers, or from X. In the event administrative services are provided by X, Y will pay X for such services on a cost basis;

(23) Y will pay X its cost as rent for any space used in any building of X;

(24) Y will receive from X guidance, when necessary, to enable it to act in a manner which is consistent with the social welfare purposes of X. This guidance will relate to the social welfare purposes of X and not the business activities of Y. This guidance will not result in X's day-to-day control of Y, but will consist of advice to assure that Y's business activities are consistent with X's objectives, values, and mission; and,

(25) Y will have authority and discretion to conduct its day-to-day business pursuant to the judgment of its Board and officers.

After expiration of the terms of the current agreements between X and the service providers, the future royalty agreements between X and the service providers will not require them to use Y for monitoring and reviewing services. Future royalty agreements between X and the service providers may require the service providers to enter into contracts with third parties that will provide such monitoring and reviewing services. These services will not be performed by X.

In order to implement and substantiate the separate status of Y from X, X and Y will undertake the following:

(1) The time periods of the current binding agreements with the respective service providers will constitute respective transition periods. During this period, the parties recognize that only Y is capable of providing the monitoring and reviewing services required under the agreements between X and the service providers;

(2) With respect to new service provider agreements, X will establish a procedure to ensure that there will be full and fair competition for providing the monitoring and reviewing services presently performed by Y;

(3) X may negotiate and enter into separate agreements with one or several third parties to provide all or part of the monitoring and reviewing services required by the respective new agreements between X and the service providers;

(4) Among the methods that X may use to implement this full and fair competition are competitive bidding and canvassing competition for price and performance quotes; and,

(5) X will maintain records respecting activities undertaken to promote such full and fair competition.

X has provided its mailing list to Y by a no fee license of such list. Y has the right to sublicense the list to each service provider, whose contract with X authorizes use of that list, for the term of such contract. Y will not pay X for its license of the list in connection with the service providers' uses of the list. Each current service provider will pay Y for use of the list equal to J percent of total contract payments. In return for such fee, Y will perform all actions necessary for the management of its sublicenses of the list, including segmentation, transfer, security, audits of use and misuse, and collection of rentals. After expiration of such current contracts, Y and the service providers will negotiate fair market value amounts for use of the list.

Amounts paid to X and Y by the service providers will be determined in the following manner:

(1) With regard to current contracts, compensation to Y for services rendered and the J percent of the contract fee paid to Y for list rentals will be subtracted from the total contract fee. The net amount remaining will constitute the royalty fee paid to X for use of its Marks.

(2) With regard to new contracts, service fees payable to Y, royalties payable to X, and mailing list rental fees payable to Y will be negotiated by the parties to the contracts.

Y may enter into contracts with third parties to provide services to such third parties. Y will have the right to use X's mailing list in connection with business opportunities other than those included in the assignments, with the written consent of X. In carrying out the activities specified above, Y will not constitute or represent itself as an agent, joint venturer, partner, co-venturer of, or with, X, and will be an independent contractor acting as a consultant to X. Y can perform any activity permitted of corporations engaged in the trade or businesses permitted of Y by its Articles of Incorporation and Bylaws.

Activities involving soliciting, negotiating, procuring, and editing advertisements - whether or not from the service providers - may be performed by Y for fair market value fees, or by X. Y will receive reasonable fees for such advertising services, based on its costs plus a minimum markup of I percent. Each service provider will pay to X advertising charges for advertisements of the service provider appearing in X's publications and in the new and renewing membership mailings. Each service provider will be charged advertising rates by X that are comparable to market rates charged for similar advertisements. X will receive reasonable fees for such advertising. X will continue to report its gross advertising income on its Form 990-T as gross unrelated business income. X will compute its unrelated business income tax liability respecting such gross advertising income, less deductions, in conformity with section 512 of the Code and the regulations thereunder.

X will identify the service providers in its materials that describe member benefits. Y will attempt to provide marketing and other services to entities and individuals unrelated to X, for which it will contract on an arm's-length basis.

X has requested the following rulings:

(1) The activities of Y will not be attributed to X, for purposes of determining X's continued qualification for recognition of exemption as an organization described in section 501(c)(4) of the Code, or with respect to X's possible liability for tax on unrelated business income under section 511;

(2) Neither X's creation and initial capitalization of Y, nor the license of its Marks and contribution of a no fee license of its mailing list to Y will adversely affect X's continued qualification for recognition of exemption as an organization described in section 501(c)(4) of the Code;

(3) Neither X's creation and initial capitalization of Y, nor its contribution of a no fee license of its mailing list will result in unrelated business taxable income under section 512(a)(1) of the Code;

(4) Interest reportable by X in connection with Z's operations will constitute interest within the meaning of section 512(b)(1) of the Code, and, thus, such amounts will be excluded from the computation of unrelated business taxable income under section 512(a)(1);

(5) Gains or losses from the sale, exchange, or other disposition of property recognizable by X in connection with Z's operations will constitute gains or losses within the meaning of section 512(b)(5) of the Code, and, thus, such amounts will be excluded from the computation of unrelated business taxable income under section 512(a)(1).

(6) Amounts paid by service providers to X under the license of X's Marks will constitute royalties within the meaning of section 512(b)(2) of the Code, and, thus, such amounts will be excluded from the computation of unrelated business taxable income under section 512(a)(1); and,

(7) Dividends that X may receive from Y will be excluded under section 512(b)(1) of the Code from the computation of unrelated business taxable income under section 512(a)(1).

Section 501(c)(4) of the Code provides, in part, for the exemption from federal income tax for civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements.

Section 1.501(c)(4)-1(a)(2)(ii) of the regulations provides that an organization is not operated primarily for the promotion of social welfare if its primary activity is carrying on a business with the general public in a manner similar to organizations which are operated for profit.

Section 511 of the Code provides, in part, for the imposition of tax on the unrelated business taxable income of organizations described in section 501(c), including those described in section 501(c)(4).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business.

Section 513(a) of the Code 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 an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of the purpose or function that constitutes the basis for its exemption under section 501.

Section 513(c) of the Code 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 512(b)(1) of the Code, in part, excludes from the computation of unrelated business taxable income all dividends and interest.

Section 512(b)(2) of the Code excludes from the computation of unrelated business taxable income all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

Section 512(b)(5) of the Code, in part, excludes from the computation of unrelated business taxable income 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 1.512(b)-1 of the regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the exempt organization or is a share of the profits retained by such organization as a partner or joint venturer, such payment is not within the modification for rents.

Section 1.513-1(a) of the regulations, in part, provides that unless one of the specific exceptions of section 512 or 513 applies, the gross income of an exempt organization subject to the section 511 tax is includable 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.

Rev. Rul. 81-178, 1981-2 C.B. 135, considers the application of section 512(b)(2) of the Code to two situations in which payments are received by an exempt organization. The holding in Situation (1) is that payments for the use of the organization's trademarks, trade names and service marks are royalties under section 512(b)(2) of the Code; the holding in Situation (2) is that payments for personal appearances and interviews are not royalties, but are compensation for personal services.

For federal income tax purposes, a parent corporation and its subsidiaries are separate taxable entities so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That is, where a corporation is organized with a bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. Britt, 431 F.2d at 234. However, where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1106 (5th Cir. 1973).

The central question in this case is whether the nonexempt commercial activities of Y should be attributed to, and be considered the activities of, X for purposes of determining X's continued qualification for recognition of exemption as an organization described in section 501(c)(4) of the Code, or with respect to its possible liability for tax on unrelated business income under section 511.

An organization described in section 501(c) of the Code can organize, capitalize and own, provide services and assets (real and personal, tangible and intangible) to a taxable entity without violating the requirements for exemption, regardless of whether the taxable entity is wholly or partially owned.

In this instance, X has created a taxable subsidiary, Y. X has represented that Y will be formed for bona fide business purposes and, in fact, will conduct various business activities in connection with X and third parties. Y will conduct activities formerly conducted by X. Since this corporation is organized with a bona fide intention that it will have some real and substantial business function, its existence will not be disregarded for federal tax purposes. The only issue, therefore, is whether Y should be deemed for tax purposes to be an instrumentality of X.

As noted above, where a parent corporation so controls the affairs of the subsidiary that it is an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. In the absence of such control, the existence of the subsidiary will generally not be disregarded.

A majority of the Board of Directors of Y will be independent of X, i.e., will not be current or former X Board members or officers. X has represented that it will not direct or actively participate in the day-to-day management of Y. X intends to exercise only the normal rights of a shareholder. To the extent that Y may lease office space from X, detailed records will be maintained reflecting actual usage, and Y will reimburse X for such usage. Similarly, if X were to provide administrative services to Y, X will receive appropriate reimbursement for such services.

Based on the above facts and representations, the activities and income of Y will not be attributed to X for purposes of (i) X's continued qualification for recognition of exemption as an organization described in section 501(c)(4) of the Code, and (ii) X's possible receipt of unrelated business taxable income with respect to Y's activities.

Accordingly, neither X's creation and initial capitalization of Y, nor X's contribution of a no fee license of its mailing list to Y, as described above, will adversely affect X's continued qualification for recognition of exemption as an organization described in section 501(c)(4). For the above reasons, neither the creation and initial capitalization of Y, nor its contribution of a no fee license of its mailing list will result in unrelated business taxable income under section 512(a)(1) of the Code.

Section 512(b) of the Code sets forth modifications for various kinds of income excluded from the computation of unrelated business taxable income as defined in section 512(a)(1). Section 512(b), in part, provides that there shall be excluded all dividends, interest, and gains or losses from the sale, exchange, or other disposition of property. X's grantor trust, Z, invests on a short-term basis payments received from X's members, who obtain group health insurance. Such investments produce interest income and gains or losses to Z from the sale, exchange, or other disposition of property. X has represented that such gains or losses are not from property held primarily for sale to customers in the ordinary course of the trade or business. Under these circumstances, such amounts will constitute interest under section 512(b)(1) and gains or losses under section 512(b)(5). Any payment of dividends by Y to X will fall within the modification under section 512(b)(1).

Payments to X by the service providers will be for the use of X's Marks, as described above. The question is whether such payments result in the receipt of royalty income under section 512(b)(2) of the Code. Section 512(b)(2) provides that there shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income. Rev. Rul. 81-178, supra, states that such payment must relate to the use of a valuable right, such as for the use of trademarks, trade names, service marks, or copyrights. In this instance, the payments made to X for use of its Marks under the royalty agreements will be treated as royalties within the meaning of section 512(b)(2).

Based on the above facts and representations, we rule as follows:

(1) The activities of Y will not be attributed to X, for purposes of determining X's continued qualification for recognition of exemption as an organization described in section 501(c)(4) of the Code, or with respect to X's possible liability for tax on unrelated business income under section 511;

(2) Neither X's creation and initial capitalization of Y, nor the license of its Marks and contribution of a no fee license of its mailing list to Y will adversely affect X's continued qualification for recognition of exemption as an organization described in section 501(c)(4) of the Code;

(3) Neither X's creation and initial capitalization of Y, nor its contribution of a no fee license of its mailing list will result in unrelated business taxable income under section 512(a)(1) of the Code;

(4) Interest reportable by X in connection with Z's operations will constitute interest within the meaning of section 512(b)(1) of the Code, and, thus, such amounts will be excluded from the computation of unrelated business taxable income under section 512(a)(1);

(5) Gains or losses from the sale, exchange, or other disposition of property recognizable by X in connection with Z's operations will constitute gains or losses within the meaning of section 512(b)(5) of the Code, and, thus, such amounts will be excluded from the computation of unrelated business taxable income under section 512(a)(1).

(6) Amounts paid by service providers to X under the license of X's Marks will constitute royalties within the meaning of section 512(b)(2) of the Code, and, thus, such amounts will be excluded from the computation of unrelated business taxable income under section 512(a)(1); and,

(7) Dividends that X may receive from Y will be excluded from the computation of unrelated business taxable income under section 512(b)(1) of the Code.

We have not been asked and we express no opinion on whether amounts received by X from Y in return for providing any administrative services constitute unrelated business taxable income under section 512(a)(1) of the Code. Furthermore, we have not been asked and we express no opinion on whether payments of interest or rent by Y to X, which would otherwise be excluded from the computation of unrelated business taxable income pursuant to sections 512(b)(1) and (3), respectively, would be subject to tax by reason of section 512(b)(13).

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

X and Y will file with the Chief, EP/EO Key District Office, identified on page 1, or his or her successors, an annual report containing, at a minimum, the following information as to the preceding calendar year:

(1) A copy of all royalty agreements entered into by X;

(2) A confirmation that X's and Y's operations were consistent with the proposed restructuring described above; and,

(3) Such other information that X believes is relevant for consideration by the Internal Revenue Service to confirm that X's and Y's operations were consistent with the proposed restructuring described above.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to X's authorized representatives.

We are providing your Key District Office with a copy of this ruling. You should keep a copy of this letter in your permanent records.

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This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited by others as precedent.

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

Sincerely yours,

Garland A. Carter

Garland A. Carter
Chief, Exempt Organizations
Technical Branch 2