PLR 9542045, 10/20/95 -- IRC Sec. 512

October 20, 1995

Code sec.512

Uil nos.0512.10-00; 0368.11-00

Headnote

The Service has ruled that an exempt educational organization's transfer of assets and the licensing of its trade name and membership list to a for-profit organization will not jeopardize its section 501(c)(3) exempt status.

Full Text

Date: July 28, 1995

CP:E:EO:T

EIN : * * *

Key District Office : * * *

LEGEND:

X = * * *

Y = * * *

Z = * * *

a = * * *

b = * * *

c = * * *

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f = * * *

g = * * *

h = * * *

i = * * *

j = * * *

x = * * *

Dear * * *

This responds to a letter dated December 22, 1994, as supplemented and modified by subsequent correspondence, containing a request for various letter rulings for X and its taxable subsidiaries, Z and Y.

Facts

1. Background

Founded by prominent educators, explorers and inventors, X is a nonprofit corporation recognized as an exempt organization described in section 501(c)(3) of the Internal Revenue Code of 1986 (hereinafter 'Code') and classified as other than a private foundation under section 509(a)(2). X has for many years engaged in educational and charitable activities in support of its exempt purposes. Such purposes include increasing within the United States and throughout the world a knowledge and knowledge of the b sciences.

Activities in support of these purposes include (i) the support of research and exploration in any branch of the b sciences, (ii) the conduct of seminars and lectures, (iii) the publication of books, magazines or other periodicals, (iv) the production of films for television and video, and (v) any and all other activities necessary or appropriate in

support of the above purposes and activities.

In the past decade, through its c and through grants, X has focused considerable manpower and financial resources on improving classroom teaching of a subjects.

X is a membership nonprofit corporation, with a large number of members from the public-at-large. X's official journal, d, is distributed to all members on a monthly basis. X is governed by a Board of Trustees ('Board') exceeding 20 persons, as provided in X's By-laws.

X's functions are carried out by divisions devoted to the various activities described above. For example, the e is responsible for researching, producing and distributing books, magazines and periodicals. The f is responsible for production of films for television and video. The total number of f employees is well over 100.

X annually files Form 990, reflecting gross revenues from its exempt functions. It reports on Form 990-T advertising income as unrelated trade or business income. The Form 990's balance sheet reflects assets, including (i) cash endowment, (ii) tangible personal property, (iii) intangible property, i.e., copyrights in the books, films, TV programs, etc., produced by the e and f, and (iv) real property. Another valuable asset of X is its name, logo, and related trademarks (collectively, 'Trade Name'). Given X's strong international recognition and reputation, its Trade Name signifies unsurpassed quality and may be unique in its field. Yet another valuable asset is its membership list.

For many years X, in furtherance of its exempt purposes, has produced programming for the Public Broadcasting Service ('PBS'). Known as g, the programming was funded in part by corporate sponsors. For the 1995 calendar year neither X nor PBS was able to obtain a corporate sponsor willing to underwrite the g production costs. As a result, X agreed to produce five hour-long g for a commercial network, h, which agreed to underwrite the g production costs. While h will also pay X a fee fixed according to a schedule for the g, X will not share in any related advertising revenues.

X's principal interest in the h series of g is to continue to produce high-quality educational programming consistent with its mission and exempt purposes. Nonetheless, X believes that broadcast on a commercial network of its g may be viewed by the Internal Revenue Service as an 'unrelated trade or business' within the meaning of section 513(a) of the Code. X wishes to ensure that such commercial broadcast activities do not jeopardize its exemption under section 501(c)(3).

2. PROPOSED TRANSACTION

To preclude any tax risk to its section 501(c)(3) exempt status, x proposes to engage in the following transactions, effective as of January 1, 1995, but subject to the receipt of the rulings herein requested:

(a) Transfer the f Assets and Liabilities (defined below) to a newly-created taxable corporation ('Y'), for Y stock and debt in the face amount of 7x represented by a promissory note ('Note') secured by f Assets. The Y stock will be shares of voting common, with all of the issued and outstanding shares to be held by X. The Note will have a nine year term with a single lump sum principal payment at the end of the term, with interest payable quarterly at an appropriate rate.

The f Assets to be transferred consist principally of the following items: (i) film library (including copyrights therein), (ii) a list of i subscribers (i.e., subscribers to the j

program), most of whose names were derived from X's membership list, (iii) furniture, fixtures and equipment, (iv) cash (working capital), (v) accounts receivable, (vi) contract rights attributable to the Trademark License (defined below), and (vii) going concern value. X has also agreed to contribute to Y on a staged basis cash aggregating 3x as Capital contributions.

The f Liabilities to be transferred Consist of f current accounts payable. There is neither long-term indebtedness nor debt encumbering the f Assets being transferred.

X will sublease office space to Y. The transfer of the f Assets and Liabilities and cash will be effected pursuant to an Asset Transfer Agreement. There is no present plan to issue other shares of Y common stock or any other Y class of stock to third parties.

(b) X will license its Trade Name to Y for exclusive use by the latter in connection with (i) usage of the existing f film library and (ii) the future development, production and distribution of films, television and other audio-visual programming and ancillary materials. The license of X's Trade Name will be embodied in a Trademark License. In return for the license of the Trade Name, Y will pay an annual royalty to X in an amount commensurate with the income attributable to use of the Trade Name.

(c) X, contemporaneous with Y's formation, will also incorporate another taxable corporation ('Z'). As part of a pre-arranged plan, for bona fide business reasons X will contribute the Y stock to Z in return solely for voting common stock of Z. Accordingly, Y will become a wholly-owned subsidiary of Z, and hence a second-tier subsidiary of X.

There is no present plan to issue other shares of Z common stock or any other class of Z stock to third parties.

(d) The Z and Y directors and officers will consist in part of current X directors and officers, and in part of 'outsiders' (i.e., persons who will be neither X directors nor officers).

Prior to X identifying the outside directors, X's President and Executive Vice President will serve as the sole members of the Z and Y Boards of Directors for an interim period, not to exceed six (6) months, in order to undertake organizational activities.

RULINGS REQUESTED

Consistent with the above facts, X initially requested the issuance of the following rulings:

1. Neither X's transfer of the f Assets and Liabilities nor the license of its Trade Name and membership list to Y adversely affects X's continuing entitlement to section 501(c)(3) of the Code status as a section 509(a)(2) public charity.

2. X's transfer of the f Assets and Liabilities to Y will not cause the recognition under section 512(a)(1) of unrelated business taxable income to X.

3. Subsequent to the proposed transaction, the activities of Z and Y will not be attributed to X , i.e., X will not be deemed to be engaged in day-to-day management of either Z or Y by virtue of the (i) partial overlap of the Board and/or officers of X, Z and Y, (ii) provision of general and administrative services by X to Z and Y, or (iii) license of X's Trade Name and membership list to Y, or any combination of (i), (ii), and (iii).

4a. Interest on the Note will constitute interest within the meaning of section 512(b)(1);

4b. Amounts paid by Y to X under the license of the Trade Name will constitute royalties within the meaning of section 512(b)(2); and,

4c. Amounts paid by Y and Z to X for the lease of X's office space will constitute rent within the meaning of section 512(b)(3).

5a. Notwithstanding X's transitory direct control of x, subsequent to X's contribution of Y to Z, X will not be deemed to control Y within the meaning of section 512(b)(13), and hence the royalties, interest, and rents paid by Y will not be treated under section 512(b)(13) as items of gross income included in X's unrelated business taxable income under section 512(a)(1) and,

5b. Dividends that X may receive from Z will not constitute unrelated business taxable income under section 512(a)(1) by virtue of section 512(b)(1).

6. X will not be deemed in violation of the section 501(c)(3) inurement and private benefit tests with respect to amounts received from Y for interest on the Note, royalties for use of X's Trade Name, amounts paid for use of X's membership list, rents for the lease of X's office space, and compensation from Z and Y for general and administrative services, where all such amounts are determined in accordance with section 482 and the Income Tax Regulations (hereinafter 'regulations') thereunder, as follows:

6a. Interest on the Note: Section 1.482-2(a)(2)(i) of the regulations or section 1.482-2(a)(2)(iii);

6b. Rents under X's lease: Section 1.482-2(c)(2) of the regulations;

6c. Royalties for use of X's Trade Name and payments for use of X's membership list: Section 1.482-4(c) of the regulations; and,

6d. Compensation for general and administrative services: Section 1.482-2(b)(3) and (4) of the regulations.

7. For Federal income tax purposes, the formation of Y by X, the transfer by X of the f assets to Y in exchange for Y stock and the Note, followed by the immediate transfer by X of all the issued and outstanding stock of Y to Z in exchange solely for shares of Z stock, will be disregarded. Instead, these transactions will be treated as (i) a transfer by X of the f assets to Z in exchange for Z stock, the Note and the assumption by Z of the f liabilities (hereafter the 'z Exchange'), followed by (ii) a transfer by Z of the f assets to Y in exchange for Y stock and the assumption by Y of the f liabilities and the Note (the Y Exchange).

8. The transfer by X of the section 351 f assets (see section 4.031-V of Rev. Proc. 83-59 Checklist) to Z in exchange for Z stock, the Note and the assumption by Z of the f liabilities will be an exchange within the meaning of section 351. (sections 351(a), 351(b), 357(a)).

9. Any gain realized by X on the transfer of the section 351 f assets in the Z Exchange will be recognized in the tax year that the exchange is consummated, but in an amount not in excess of the fair market value of the Note. (sections 351(a), 351(b)(1)). Any loss realized upon the exchange will not be recognized. (section 351(b)(2)).

10. No gain or loss will be recognized by Z upon the receipt of assets from X in exchange for shares of Z stock, the Note and the assumption by Z of the f liabilities. (section 1032(a)).

11. The basis of the section 351 f assets in the hands of Z will be the same as the basis of the section 351 f assets in the hands of X immediately prior to the Z Exchange, increased by the amount of gain recognized by X under section 351(b) on the Z Exchange. (section 362(a)).

12. The holding period of the section 351 f assets in the hands of Z will include, in each instance, the holding period during which X held the assets. (section 1223(2)).

13. The basis of the Z stock received by X in exchange for the section 351 f assets in the Z Exchange will be the same as the basis of the section 351 f assets immediately prior to the Z Exchange, decreased by (i) the fair market value of the Note and (ii) the amount of the f liabilities (except to the extent, if any, such liabilities are described in section 357(c)(3)) and increased by the gain recognized by X under section 351(b) on the exchange. (sections 358(a)(1), 358(d)(1), 358(d)(2)).

14. The basis of the Note received in exchange for the section 351 f assets in the hands of X will be its fair market value. (section 358(a)(2)).

15. The holding period of the Z stock received by X in exchange for the section 351 f assets in the Z Exchange will include the holding period of the section 351 f assets transferred by X to Z, provided the section 351 f assets were held by X as capital assets on the date of the Z Exchange. (section 1223(1)).

16. The transfer by Z of the section 351 f assets to Y in exchange for solely Y stock and the assumption by Z of the f liabilities and the Note will be an exchange within the meaning of section 351. (sections 351(a), 357(a)).

17. No gain or loss will be recognized by Z upon its transfer of the section 351 f assets to Y in exchange for solely Y stock and the assumption by Y of the f liabilities and the Note. (sections 351(a), 357(a)).

18. No gain or loss will be recognized by Y upon the receipt of assets from Z in exchange for shares of Y stock, the Note and assumption by Y of the f liabilities. (section 1032(a)).

19. The basis of the section 351 f assets in the hands of Y will be the same as the basis of the section 351 f assets in the hands of Z (as determined in accordance with ruling #11, above) immediately prior to the Y Exchange. (section 362(a)).

20. The holding period of the section 351 f assets in the hands of Y will include, in each instance, the holding period during which Z held the asset (as determined in accordance with ruling #12, above). (section 1223(2)).

21. The basis of the Y stock received by Z in exchange for the section 351 f assets in the Y Exchange will be the same as the basis of the section 351 f assets (as determined in accordance with ruling #11, above) immediately prior to the Y Exchange, decreased by (i) the amount of the Note and (ii) the amount of the f liabilities3 (except to the extent, if any, such liabilities are described in section 357(c)(3)). (sections 358(a)(1), 358(d)(1), 358(d)(2)).

22. The holding period of the Y stock received by Z in exchange for the section 351 f assets in the Y Exchange will include the holding period of the section 351 f assets (as determined in accordance with ruling #12, above) transferred by Z to Y, provided the section 351 f assets were held by Z as capital assets on the date of the Y Exchange. (section 1223(1)).

23. To the extent the basis in a transferred film in the hands of Z does not exceed the basis in the filing in the hands of X (determined under section 1011, adjusted as provided in section 1016(a)(3)(B)), such portion of the basis will not be subject to section 197 and will be amortizable under section 167. To the extent the basis in the transferred film in the hands of Z exceeds the basis in the film in the hands of X, such portion of the basis will be subject to section 197 and shall be amortized ratably over a 15-year period beginning with the month in which the Z exchange occurs. Pursuant to section 197(f)(2), for purposes of applying section 197, Y shall be treated as Z with respect to Y's entire basis in each transferred film. Accordingly, to the extent the basis in a transferred film in the hands of Y does not exceed the basis in the film in the hands of X, such portion of the basis will not be subject to section 197 and will be amortizable under section 167. To the extent the basis in the transferred film in the hands of Y exceeds the basis in the film in the hands of X, such portion of the basis will be subject to section 197 and shall be amortized ratably over a 15-year period beginning with the month in which the Y exchange occurs.

24. Royalties incurred by Y to X for use of X Trade Name pursuant to the Trademark License will be allowed as a deduction under section 162(a) in the tax year incurred.

Law AND ANALYSIS — EXEMPT ORGANIZATION ISSUES

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

Section 511 of the Code imposes a normal tax and a surtax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

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 provides that the term 'unrelated trade or business' means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 1.513-1(d)(2) of the regulations provides 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 (other than through the production of income). Further, it is 'substantially related,' for purposes of section 513 of the Code, only if the

causal relationship is a substantial one. For this relationship to exist, the production of goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends in each case upon the facts and circumstances involved.

Section 1.501(c)(3)-1(e) of the regulations provides that an organization may meet the requirements of section 501(c)(3) of the Code although it operates 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 purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.

An organization is not operated exclusively for an exempt purpose if more than an insubstantial part of its activities are in furtherance of a nonexempt purpose. Better Business Bureau v. United States, 326 U.S. 279 [34 AFTR 5], 283 (1945).

The central question in this case is whether the commercial activities of Y and Z can be considered the activities of X for purposes of determining X's qualification for exemption under section 501(c)(3) of the Code.

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 [30 AFTR 1291], 438 (1943); Britt v. United States, 431 F.2d 227 [25 AFTR 2d 70-1212], 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., 488 F.2d 1098, 1106 (5th Cir. 1973).

X has created two for-profit subsidiaries. Since each corporation is organized with a bona fide intention that it will have some real and substantial business function, its existence will not be disregarded. Accordingly, X's creation of two for-profit subsidiaries by means of the transfer of certain of its assets, as described above, will not adversely affect X's continuing entitlement to section 501(c)(3) status.

The law and analyses regarding the license of X's Trade Name is discussed hereafter under paragraph 4b. For purposes of this ruling we will assume without so ruling that rental of the membership list and the providing of general and administrative services will constitute an unrelated trade or business by X.

The rental of X's Trade Name results in the receipt of royalty income. The rental of X's membership list and the providing of general and administrative services, even assuming that such activities constitute an unrelated trade or business, are an insubstantial part of X's activities. X is not organized or operated for the primary purpose of carrying on an unrelated trade or business.

For the above reasons, the organization, capitalization with cash and f assets, and the ownership of Y in return for Y stock and the Note, and the contemporaneous contribution of the Y stock to Z for all of the latter's issued and outstanding stock will not jeopardize X's continuing entitlement to section 501(c)(3) status as a section 509(a)(2) public

charity.

2a. IN GENERAL. Section 512(b)(5) of the Code provides that, in computing unrelated business taxable income, an organization may modify its gross income by excluding 'all gains from the sale, exchange, or other disposition of property' other than (i) inventory and (ii) property held primarily for sale to customers in the ordinary course of a trade or business (collectively, 'inventory'). Section 1.512(b)-1(d) of the regulations restates the broad language of section 512(b)(5) of the Code.

Accordingly, any gain realized and otherwise recognizable by X on the transfer of the f Assets to Y is excluded from unrelated business taxable income pursuant to section 512(b)(5) of the Code.

2b. INVENTORY. Despite the exclusion of inventory from the computation modification of section 512(b)(5) of the Code as mentioned above, here the sale of such inventory will not result in unrelated business taxable income under section 512(a)(1), where the inventory's sale is 'substantially related' under section 513(a) to the exempt purposes of X.

A trade or business is 'related,' where it has a causal relationship to the achievement of an organization's exempt purposes, and it is 'substantially related' only if the causal relationship is a substantial one. Thus, for the trade or business from which a particular amount of gross income is derived to be substantially related to the purposes for which exemption is granted, the production and distribution of goods or the performance of services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Section 1.513-1(d)(2) of the regulations.

X's inventory consists of the i films of and about b sciences. Each i is intended to, and does in fact, increase and diffuse the public's knowledge of a matters and b sciences. That is, the is contribute importantly within the meaning of section 1.513-1(d)(2) of the regulations to the accomplishment of the purposes for which X was granted and maintains its exempt status under section 501(c)(3) of the Code.

Accordingly, the transfer of is to Y does not result in unrelated business taxable income to X under section 512(a)(1) of the Code.

3. As noted above, Y and Z will be formed for bona fide business purposes and in fact will conduct business activities. That is, Y will conduct the mission activities of X formerly conducted by f, and Z will constitute a holding company providing strategic planning with respect to other taxable activities in support of X's historical and continuing exempt functions. The only issue, therefore, is whether Y or Z should be deemed for tax purposes to be an instrumentality or an agent of X.

Under paragraph one of the LAW AND ANALYSIS, supra, we cited authority for the principle that 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.

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For an interim period of time represented to be no longer than six months from the date of capitalization of Z and Y by virtue of the asset transfers described above, the officers of X will also serve as officers of Z and Y. A majority of the Board of Directors of Y and Z will be independent of X, i.e., will not be X Board members, officers or staff persons. While the Secretary and Treasurer of Z and the Secretary of Y will also be X officers, the President and Chief Executive Officer ('CEO') of Y and Z will be independent of X, i.e., will not then be an officer or director (following the 'interim period' described in the first sentence above).

The management of X has represented that there is no understanding or agreement, written or unwritten, that X will direct or actively participate in the day-to-day management of Y or Z. X intends to exercise only the normal rights of a shareholder.

To the extent that Y and Z sublease office space from X and use the latter's office equipment and staff, detailed records will be maintained reflecting actual usage, and Y and Z will reimburse X for such usage. Similarly, where X provides general and administrative services to Y and Z pursuant to the Administrative Services Agreement, X will receive appropriate reimbursement from them.

Based on the above facts and representations, the activities and income of Y and Z should not be attributed to X for purposes of (i) X's continuing entitlement to tax-exempt status under section 501(c)(3) of the Code, and (ii) x being deemed in receipt of unrelated trade or business income with respect to Y's and Z's activities.

4a. 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 under section 512(a)(1). Section 512(b) provides that there shall be excluded all dividends, interest, payments with respect to securities loans ... and annuities. Assuming that the Note issued by Y to X is representative of valid debt and assuming that payments with respect thereto are, accordingly, respected as payments of interest, such payments will constitute interest under section 512(b)(1).

4b. Section 512(b)(2) of the Code 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, 1981-2 C.B. 135, considered the application of section 512(b)(2) of the Code to two situations in which payments were received by an exempt organization from third party licensees for use of the organization's trademarks, tradenames and service marks. Holding in Situation (1) that the licensing payments constituted royalties, the Service found that the retention and exercise of quality control rights by the licensor did not change this result, citing Lemp Brewing Co. v. Comm., 18 T.C. 586 (1952), acq. 1952-2 C.B. 2.

Accordingly, the payments made by Y to X for use of its Trade Name under the Trademark License will be deemed royalties within the meaning of section 512(b)(2) of the Code.

4c. Section 512(b)(3) provides that all rents from real property shall generally be excluded from unrelated business taxable income, provided that rental payments are (i) not based on the income or profits of any person from the property leased (other than an amount based on a fixed percentage(s) of receipts or sales) and (ii) attributable to real property, or personal property leased with real property, where such rents for personal property are an incidental amount of the total rents. Section 1.512(b)-1(c)(2)(ii)(b) of the regulations provides that rents attributable to personal property are not an incidental amount of the total rents received or accrued under the lease, determined at the time the lessee first places the personal property in service, if the personal property rents exceed ten percent (10%) of the total rents.

X either owns in fee simple real property used in the conduct of its exempt functions or leases such real property from unrelated third parties, with no outstanding 'acquisition indebtedness' within the meaning of section 514(c) of the Code. X intends to lease certain office space to Z and Y. X owns the office building in fee simple. As to such space, the rental will be fixed, i.e., not based on the income or profits of Z, Y or any third party, and the amount determined on an arm's-length basis. Any rental attributable to personal property located at such property will be incidental in amount within the meaning of section 512(b)(3) of the Code and section 1.512(b)-1(c)(2)(ii)(b) of the regulations.

Prior to the relocation of its headquarters in mid-1995, X will sublease from X the current headquarters office space. As to these and any other subleased premises, X will charge appropriate rents to Y and Z.

Accordingly, amounts paid by Y and Z to X for the lease or sublease of the above X office space will constitute rent from real property within the meaning of section 512(b)(3) of the Code.

5a. Sections 512(b)(1), (2), and (3) of the Code generally provide that interest, royalties, and rent from real property, respectively, are excluded from the computation of unrelated business taxable income.

Section 512(b)(13) of the Code provides, in part, that notwithstanding the exclusion for interest, royalties, and rents described above, such payments made by a controlled organization can be taxable to the controlling organization in proportion to what would be the unrelated business income of the controlled organization if operated by its parent. The definition of 'control' is contained in section 368(c).

Section 1.512(b)-1(l)(4)(i)(a) of the regulations and section 368(c) of the Code indicate that, in the case of a controlled stock corporation, the term 'control' means ownership by an exempt organization of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation. No indirect ownership rules are provided.

In this case, the interest, royalties, and rents are paid to the parent x by X's second tier subsidiary, Y. Under the definition of control under section 368(c) of the Code, X does not own at least 80 percent of the stock of Y following the transfer of Y's stock to Z. Therefore, because there is no direct control of X by X, as required by section 368(c), the interest, royalty, and rent payments made by Y to X are not taxable as unrelated business taxable income under section 512(b)(13). (Such analysis obviously does not apply to any rent payments made by Z to X).

5b. Z will constitute the common parent of an affiliated group of taxable corporations (initially including only Y) which will file a consolidated federal income tax return. Any after-tax earnings and profits of the affiliated group may be remitted by Z as dividends to X for use by X in the performance of its tax-exempt functions.

Section 512(b)(1) of the Code provides that dividends will be excluded from the computation of unrelated business taxable income under section 512(a)(1).

Accordingly, dividends X may receive from Z will not constitute unrelated business taxable income under section 512(a)(1) by virtue of section 512(b)(1).

6. IN GENERAL. Section 501(c)(3) of the Code provides that an organization will be exempt, in relevant part, if it is organized and operated exclusively for exempt purposes, and no part of its net earnings inures to the benefit of any private shareholder or individual. This statutory requirement subsumes what is commonly referred to as the (i) *inurement test and (ii) the private benefit test.*

Section 1.501(c)(3)-1(c)(2) of the regulations restates and elaborates upon the inurement test by providing that an organization will not be deemed operated exclusively for exempt purposes if its net earnings inure in whole or in part to the benefit of 'private shareholders' or 'individuals.'

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations elaborates upon the private benefit test by providing that an organization is not organized or operated for exempt purposes unless it serves a public rather than a private interest. To meet this requirement, it is necessary that the organization establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests.

The Service's long-standing position is that an organization described in section 501(c)(3) of the Code can organize, capitalize and own, provide services and assets (real and personal, tangible and intangible) to a taxable entity without violating either the inurement or private benefit tests, regardless of whether the taxable entity is wholly or partially owned. The common condition, however, to Service approval of such cash/asset transfers and provision of services has been that the section 501(c)(3) organization receive fair market/rental value for the assets transferred and arm's-length compensation for the services provided.

For purposes of the inurement and private benefit restrictions under section 501(c)(3) of the Code, the appropriate amounts paid by Y and Z to X for interest, rents, royalties, use of the membership list, and general and administrative services will be determined in accordance with section 482.

Representations — CORPORATE ISSUES

The following representations have been made in connection with the transfer of the f assets from Transferor to Transferee 1. The Transferor is X, the Transferee 1 is X, and Transferee 2 is Z for purposes of the Corporate 'REPRESENTATIONS' and for purposes of the 'Corporate Rulings' set forth later in this letter.

(a) (i) No stock or securities will be issued for services rendered to or for the benefit of Transferee 1 (Y) in connection with the proposed transaction, and (ii) no stock or securities will be issued for indebtedness of Transferee 1 (Y) that is not evidenced by a

security or for interest on indebtedness of Transferee 1 (Y) which accrued on or after the beginning of the holding period of Transferor (X) for the debt.

(b) Transferor (X) will not retain any rights in the property transferred to Transferee 1 (Y), other than a security interest in the f assets as collateral under the Note.

(c) All rights, title, and interests for each copyright, in each method of exploitation, are being transferred to Transferee 1 (Y).

(d) Transferor (X) will license its trade name to Transferee 1 (Y) for its exclusive use in connection with (i) usage of its existing f film library and (ii) future development, production and distribution of films, television and other audiovisual programming and ancillary materials. Transferor (X)'s license of the trade name does not constitute a transfer of property within the meaning of section 351(a). Transferor (X) will retain significant power, right and continuing interest in the trade name to be licensed to Transferee 1 (Y).

(e) The transfer is not the result of the solicitation by a promoter, broker, or investment house.

(f) The value of the stock received in exchange for accounts receivable will be equal to the net value of the accounts transferred, i.e. the face amount of the accounts receivable previously included in income less the amount of the reserve for bad debts.

(g) The adjusted basis and the fair market value of the assets transferred by Transferor (X) to Transferee 1 (Y) will, in each instance, equal or exceed the sum of the liabilities to be assumed by Transferee 1 (Y) plus any liabilities to which the transferred assets are subject.

(h) The liabilities of Transferor (X) to be assumed by Transferee 1 (Y) were incurred in the ordinary course of business and are associated with the assets to be transferred.

(i) There is no indebtedness between Transferee 1 (Y) and Transferor (X) and there will be no indebtedness created in favor of Transferor (X) as a result of the transaction, other than the Note which Transferee 1 (Y) will issue to Transferor (X).

(j) The transfers and exchanges will occur under a plan agreed upon before the transaction in which the rights of the parties are defined.

(k) All exchanges will occur on approximately the same date.

(l) There is no plan or intention on the part of Transferee 1 (Y) to redeem or otherwise reacquire any stock to be issued in the proposed transaction.

(m) Taking into account any issuance of additional shares of Transferee 1 (Y) stock; any issuance of stock for services; the exercise of any Transferee 1 (Y) stock rights, warrants, or subscriptions; a public offering of Transferee 1 (Y) stock; and the sale, exchange, transfer by gift, or other disposition of any Transferee 1 (Y) stock to be received in the exchange (other than the transfer of Transferee 1 (X) stock by Transferor (X) to Transferee 2 (Z)), Transferor (Y) will be in control of Transferee 1 (Y) within the meaning of section 368(c).

(n) Transferor (X) will receive stock, securities or other property approximately equal to the fair market value of the property transferred to Transferee 1 (Y).

(o) Transferee 1 (Y) will remain in existence and retain and use the property transferred to it in a trade or business.

(p) There is no plan or intention by Transferee 1 (Y) to dispose of the transferred property other than in the normal course of business operations.

(q) Transferor (X) will pay the expenses, if any, incurred by itself and Transferee 1 (Y) in connection with the proposed transaction.

(r) Transferee 1 (Y) will not be an investment company within the meaning of section 351(e)(1) and section 1.351- 1(c)(1)(ii) of the regulations.

(s) Transferor (X) is not under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) of the Code and the stock received in the exchange will not be used to satisfy the indebtedness of such debtor.

(t) Transferee 1 (Y) will not be a 'personal service corporation' within the meaning of section 269A.

Rulings

Based on the above facts, we rule as follows:

I. Exempt Organizations Rulings --

1. Neither X's transfer of the f Assets and Liabilities nor the license of its Trade Name and membership list to Y adversely affects X's continuing entitlement to Code section 501(c)(3) status as a section 509(a)(2) public charity.

2. X's transfer of the f Assets and Liabilities to Y will not cause the recognition under section 512(a)(1) of the Code of unrelated business taxable income to X.

3. Subsequent to the proposed transaction, the activities of Z and Y will not be attributed to X, i.e., X will not be deemed to be engaged in day-to-day management of either Z or Y by virtue of the (i) partial overlap of the Board and/or officers of X, Z and Y (ii) provision of general and administrative services by X to Z and Y, or (iii) license of X's Trade Name and membership list to Y, or any combination of (i), (ii), and (iii).

4a. Interest on the Note will constitute interest within the meaning of section 512(b)(1) of the Code.

4b. Amounts paid by Y to X under the license of the Trade Name will constitute royalties within the meaning of section 512(b)(2) of the Code.

4c. Amounts paid by Y and Z to X for the lease of X's office space will constitute rent within the meaning of section 512(b)(3) of the Code.

5a. Notwithstanding X's momentary control of Y, subsequent to X's contribution of Y stock to Z, X will not be deemed to control Y within the meaning of section 512(b)(13) of the Code, and hence the royalties, interest, and rents paid by Y will not be treated under section 512(b)(13) as items of gross income included in X's unrelated business taxable income under section 512(a)(1).

5b. Dividends that X may receive from Z will not constitute unrelated business taxable income under section 512(a)(1) of the Code by virtue of section 512(b)(1).

6. X will not be deemed in violation of Code section 501(c)(3) inurement and private benefit tests with respect to amounts received from Y for interest on the Note, royalties for use of X's Trade Name, amounts paid for use of X's membership list, rents for the lease of X's office space, and compensation from Z and Y for general and administrative services, where all such amounts are determined in accordance with section 482 and the regulations thereunder.

We express no opinion as to whether the Note issued by Y to X is representative of debt or equity for federal income tax purposes or whether payments made with respect to the Note constitute payments of interest. If the payments do constitute interest, such amounts will be excluded under section 512(b)(1) of the Code; see Ruling 4a., supra. No ruling is requested and none is issued as to whether payments made by Y or Z to X, relating to the rental of the membership list or the provision of general and administrative services, constitute unrelated business taxable income under section 512(a)(1). Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transfers and transactions described above under any other provision of the Code.

II. Corporate Rulings --

Based solely on the information submitted and the representations set forth above, and provided that the Note is debt for federal income tax purposes, we rule as follows:

1. The transfer by Transferor (X) of the f assets to Transferee 1 (Y) in exchange for Transferee 1 (Y) stock, the Note, and the assumption by Transferee 1 (Y) of the f liabilities will be an exchange described in section 351(a) and (b). The subsequent transfer by Transferor ('X') of the Transferee 1 (Y) stock to Transferee 2 (Z) will not cause the transfer of the f assets to Transferee 1 (Y) to fail to qualify under section 351(a) and (b).

2. Transferor (X) will recognize gain, if any, on its transfer of the f assets to Transferee 1 (Y) in exchange for Transferee 1 (Y) stock, the Note, and the assumption of the f liabilities, but not in excess of the fair market value of the Note received by Transferor (X) (sections 351(b)(1) and 357(a)). No loss will be recognized (section 351(b)(2)).

3. Transferee 1 (Y) will recognize no gain or loss on its receipt of the f assets from Transferor (X) in exchange for Transferee 1 (Y) stock (section 1032).

4. The basis of each f asset transferred by Transferor (X) to Transferee 1 (Y) in the hands of Transferee 1 (Y) will be the same as the basis of the asset in the hands of Transferor (X) immediately before the transaction, increased by the amount of gain recognized by Transferor (X) under section 351(b) on the transfer (section 362(a)).

5. The holding period of each f asset transferred to Transferee 1 (Y) in the hands of Transferee 1 (Y) will include the holding period of the asset in the hands of Transferor (X) (section 1223(2)).

6. The basis of the Transferee 1 (Y) stock received by Transferor (X) in the hands of Transferor (X) will be the same as the basis of the transferred f assets immediately prior to the exchange, decreased by the fair market value of the Note and the amount of the f liabilities (except to the extent those liabilities are described in section 357(c)(3)), and increased by the gain recognized by Transferor (X) under section 351(b) on the exchange

(sections 358(a)(1), 358(d)(1) and 358(d)(2)).

7. The basis of the Note received by Transferor (X) in the hands of Transferor (X) will be its fair market value (section 358(a)(2)).

8. The holding period of the Transferee 1 (Y) stock received by Transferor (X) in the hands of Transferor (X) will include the holding period of the f assets transferred to Transferee 1 (Y), provided that the f assets were capital assets or property described in section 1231 at the time of the exchange (section 1223(1)).

We express no opinion on the application of section 351 and related Code sections to Transferor (X)'s transfer of Transferee 1 (Y) stock to Transferee 2 (Z) because the transaction (an exchange of stock for stock in the formation of a holding company) is a no-ruling area. Section 3.01(22) of Rev. Proc. 95-3, 1995-1 I.R.B. 85, 87.

We also express no opinion concerning the federal tax consequences of the proposed transactions under any other provision of the Code or Income Tax Regulations, or any tax effects of any condition existing at the time of, or effects resulting from, the proposed transaction not specifically covered by the above rulings. In particular, no opinion is expressed concerning whether the Note is debt or equity for federal income tax purposes, or the tax consequences of the payment by Transferor (X) of Transferee 1 (Y)'s expenses in connection with the transfer of the f assets from Transferor ('X') to Transferee 1 (Y).

III. Royalty Deduction Ruling --

Royalties incurred by Y to X for the use of X's trade name pursuant to the trademark license will be allowed as a deduction under section 162 of the Code in the year incurred.

Your ruling request number 23, above, dealing primarily with section 197 of the Code will be the subject of a separate communication.

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

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.

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

Sincerely yours,

Edward K. Karcher

Chief, Exempt Organizations

Technical Branch 3