

Bond Case Briefs

Municipal Finance Law Since 1971

IRS LTR: Arrangement With For-Profit Won't Jeopardize Group's Exempt Status.

The IRS ruled that an agreement between a tax-exempt research organization and a for-profit company under which the company will pay the organization for the results of its research will not jeopardize the organization's exemption and will not constitute an unrelated trade or business.

Citations: LTR 201440023

Contact Person: * * *

Identification Number: * * *

Telephone Number: * * *

Uniform Issue List Numbers: 501.03-08, 513.00-00

Release Date: 10/3/2014

Date: July 8, 2014

Employer Identification Number: * * *

LEGEND:

b = * * *

c = * * *

d = * * *

M = * * *

O = * * *

P = * * *

Dear * * *:

This responds to your request for rulings on the effect of the Agreement (described below) on your status as an organization described in §§ 501(c)(3), 509(a)(1), and 170(b)(1)(A)(vi) of the Internal Revenue Code (the "I.R.C.") and on your liability for unrelated business income tax under §§ 511 through 513.

FACTS

You are exempt from federal income tax under § 501(c)(3) of the Internal Revenue Code. You are not a private foundation within the meaning of § 509(a) because you are described in §§ 509(a)(1) and 170(b)(1)(A)(vi). Your mission is to inform and educate the American public about b, to advocate for c, and conduct research on d. You attempt to disseminate the results of your research as broadly as possible. You distribute your research results primarily through your website, O, and through the media, including print, radio, television, and online media. You maintain an archive of d data known as your P product. The P product can be accessed over your website, O, for non-commercial purposes. You may allow commercial use of the P product for a fee.

You have entered into an agreement (the “Agreement”) with M, a for-profit, major media organization. The Agreement has an initial term of three years, subject to certain early termination and renewal rights. Under the Agreement, you agree to provide substantial portions of the results of your research (the “Information”) to M, and M agrees to pay a periodic fixed fee to you and to make the Information available to users of its electronic products and services.

The Agreement defines the Information as current data delivered on a monthly basis and a historical file of data going back several years. The Information shall consist of your entire P product.

Specifically, you agree to collect, code and process the Information, and to deliver the Information to M in a format and at the delivery frequency specified in the Agreement. You grant M a nonexclusive, worldwide right to use, store, reproduce, create derivative works from, display, and deliver the Information or any part thereof. In addition, M has the right to use the Information for internal business purposes, to market and sell its services, for research and reporting by its multimedia news operation, in its generic, “fair value”, composite or theoretical prices or ratings, or other similar pricing or rating models, and the development and distribution of its proprietary and descriptive databases, and for educational purposes. During the term of the Agreement, you agree not to deliver all or a substantial portion (i.e., 25 percent or more) of the Information to any of the twelve companies listed on a schedule of the Agreement. M acknowledges that substantial portions of the Information are in the public domain and that you do not purport to grant to M any intellectual property rights in such information that is in the public domain. M represents, warrants and covenants that it will use commercially reasonable efforts to incorporate the Information into its product so as to support your objective of broadly disseminating the Information.

If M exercises its right to terminate the Agreement (other than for cause) before the expiration of the initial term, it is obligated to pay you a fixed “termination fee.” In addition, upon termination of the Agreement, M has an option to purchase, for a separate fee, a perpetual license to use the information previously provided to it during the Agreement’s term.

RULINGS REQUESTED

You have requested the following rulings:

1. Your performance of the Agreement and receipt of fees thereunder will not jeopardize your status as an organization exempt from tax under § 501(c)(3) or as an organization that is not a private foundation.
2. Your performance of the Agreement is not an unrelated trade or business.
3. The periodic and termination fees that are or may be payable to you under the Agreement are not royalties.

LAW

I.R.C. § 501(a) exempts from federal income taxation organizations described in § 501(c).

I.R.C. § 501(c)(3) describes organizations organized and operated for charitable, educational, and other enumerated exempt purposes.

I.R.C. § 511 imposes a tax on the unrelated business taxable income of organizations described in § 501(c).

I.R.C. § 512(a)(1) defines the term “unrelated business taxable income” as the gross income derived

from any unrelated trade or business (as defined in § 513) regularly carried on, less certain allowable deductions that are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

I.R.C. § 512(b)(2) excludes all royalties from unrelated business taxable income.

I.R.C. § 513(a) 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 such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501.

Treas. Reg. § 1.501(c)(3)-1(a)(1) provides that, to be exempt as an organization described in § 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section.

Treas. Reg. § 1.501(c)(3)-1(c)(1) 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 § 501(c)(3).

Treas. Reg. § 1.501(c)(3)-1(d)(1)(i) includes “educational” among the list of purposes for which an organization described in § 501(c)(3) may be exclusively organized and operated.

Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized and operated exclusively for one or more of the purposes specified in subdivision (i), above, unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to 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.

Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) provides that the term “educational,” as used in § 501(c)(3) relates to: (a) the instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) the instruction of the public on subjects useful to the individual and beneficial to the community.

Treas. Reg. § 1.513-1(d)(1) provides, in general, that gross income derives from unrelated trade or business, within the meaning of § 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question — the activities, that is, of producing or distributing the goods or performing the services involved — and the accomplishment of the organization’s exempt purposes.

Treas. Reg. § 1.513-1(d)(2) provides that a trade or business is related to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is substantially related, for purposes of § 513, only if the causal relationship is a substantial one. Thus, for the conduct of 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. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the

accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rev. Rul. 70-186, 1970-1 C.B. 129, concerns an organization that was formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake to enhance its recreational features. It is financed by contributions from lake front property owners, from members of the community adjacent to the lake, and from municipalities bordering the lake. The organization's principal activity is to treat the water, to remove algae, and to otherwise improve the condition of the water for recreational purposes. These activities constitute charitable activities insofar as they insure the continued use of the lake for public recreational purposes. The benefits to be derived from the organization's activities flow principally to the general public through the maintenance and improvement of public recreational activities. Any private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations. In fact, it would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners. Accordingly, it is held that the organization is exempt from Federal income tax under § 501(c)(3).

Rev. Rul. 75-196, 1975-1 C.B. 155, concerns an organization, the principal activity of which is to maintain a law library that is located in the same building as the headquarters of the local bar association, an organization described in § 501(c)(6). The organization's support is derived primarily from contributions by the local bar association. The rules of the library provide that the facilities are available for use only by members of the local bar association. Membership in the bar association is open to all members of the legal profession in good standing with an office or residence in the municipality. The fact that access to and use of the library facilities are limited to a designated class of persons is not necessarily a bar to recognition of exemption under § 501(c)(3). What is of importance is that the class benefited be broad enough to warrant a conclusion that the educational facility or activity is serving a broad public interest rather than a private interest, and is therefore exclusively educational in nature. The library facilities are available to a significant number of people. The fact that attorneys who use the library may derive personal benefit in the practice of their profession from the information garnered thereby is incidental to this purpose and is, in most instances, a logical by-product of an educational process. Therefore, the limitation of the use of the facilities is reasonable and does not prejudice the exclusively educational nature and purpose of the facility. Accordingly, the organization qualifies for exemption under § 501(c)(3).

Rev. Rul. 80-295, 1980-2 C.B. 194, concerns an organization that was created as a national governing body for amateur athletics to promote systematic physical exercise and education, and foster interest in amateur sports among the public at large, and to encourage widespread public participation in athletics and recreational sports. The organization sponsors, supervises, and regulates programs in a number of different amateur sports. It also arranges for and coordinates open competition for amateur athletics at the local, state, regional, and national levels. The organization receives income each year from the sale of exclusive television and radio broadcasting rights to an independent producer, who contracts with a commercial network to broadcast many of the athletic events sponsored, supervised, and regulated by the organization. The broadcasting of the athletic events promotes the various amateur sports, fosters widespread public interest in the benefits of its nationwide amateur athletic program, and encourages public participation. Therefore, the organization's sale of broadcasting rights and the resultant broadcasting of its athletic events contributes importantly to the accomplishment of its exempt purposes, is substantially related to the purposes constituting the basis for the organization's exemption, and, therefore, is not unrelated

trade or business within the meaning of § 513.

Section 8.01 of Rev. Proc. 2014-4, 2014-1 I.R.B. 125, states that “[t]he Service may decline to issue a letter ruling or a determination letter when appropriate in the interest of sound tax administration or on other grounds whenever warranted by the facts or circumstances of a particular case.”

ANALYSIS

Issue 1A: Whether the performance of the Agreement and the receipt of fees thereunder would jeopardize your status as an organization exempt from tax under § 501(c)(3)

To be described in § 501(c)(3), an organization must be operated exclusively for an exempt purpose. Treas. Reg. § 1.501(c)(3)-1(a)(1). An organization is regarded as “operated exclusively” of exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes. Treas. Reg. 1.501(c)(3)-1(c)(1). Exempt purposes include “educational” purposes. Treas. Reg. § 1.501(c)(3)-1(d)(1)(f). The term “educational” relates to the instruction of the public on subjects useful to the individual and beneficial to the community. Treas. Reg. § 1.501(c)(3)-1(d)(3).

Your exempt educational purpose is to inform and educate the American public about b and to advocate for c. You achieve this purpose by tracking, assembling and disseminating unbiased information regarding d. Your performance of the Agreement serves to disseminate the Information more broadly and thus helps to accomplish your educational purposes.

However, the Agreement also benefits M by allowing it to use the Information to market and sell its services, for research and reporting by its news operations, and to develop and distribute its proprietary databases. Although an organization’s operations may be deemed to be beneficial to the public, if they also serve private interests other than incidentally, the organization is not entitled to exemption under § 501(c)(3). Treas. Reg. § 1.501(c)(3)-1(c)(1); Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). The word “incidental” in this context has both qualitative and quantitative connotations. To be “incidental” in the “qualitative” sense, the private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals. A benefit is quantitatively insubstantial only if it is insubstantial as measured in the context of the overall public benefit conferred by the activity. See Rev. Rul. 70-186.

Under the circumstances, we conclude that the benefit conferred on M under the Agreement is both qualitatively and quantitatively incidental. It is qualitatively incidental because the benefits under the Agreement flow primarily to the general public by enabling you to disseminate the Information to a wider audience, i.e., the subscribers to M’s services. M does not have an exclusive right to, or exclusive use of, the Information, which is otherwise available to the general public for free over your website. M is merely a means by which to broaden the dissemination of the Information and thereby to accomplish your exempt purposes more effectively. In addition, the benefit conferred on M is quantitatively incidental because the benefit derived by M in being able to include the Information in its package of services is insubstantial in comparison with the benefit obtained by the users of those services.

In addition, the Agreement does not confer an impermissible private benefit on M’s subscribers. By their nature, exempt educational activities serve public purposes by providing direct benefits to private parties. The public policy sought to be effected necessitates the dissemination of information and training to individuals, whose increased capabilities may generally serve to improve the public welfare. Further, in an educational context, an organization may be determined to be operating for public purposes even if the general public does not have the same direct access to the educational

program as does some smaller, restricted group. See Rev. Rul. 75-196. Although the Agreement will benefit only subscribers to M's services, the population served is broad enough to warrant a conclusion that the Agreement serves a broad public interest.

Therefore, your performance of the Agreement and your receipt of fees thereunder furthers your exempt purpose, serves a public and not a private interest, and, consequently, will not jeopardize your status as an organization described in § 501(c)(3).

Issue 1B: Whether the performance of the Agreement and the receipt of fees thereunder would jeopardize your status as an organization that is not a private foundation.

We decline to rule on whether the performance of the Agreement and the receipt of fees thereunder would jeopardize your status as an organization that is not a private foundation because of the factual nature of the issue. See Rev. Proc. 2014-4, 2014-1 I.R.B. 125, section 8.01.

Issue 2: Whether the performance of the Agreement is an unrelated trade or business

For purposes of the tax imposed under § 511 on an exempt organization's unrelated business taxable income (as defined in § 512), an "unrelated trade or business" is a trade or business the conduct of which is not substantially related to the organization's performance of its exempt functions. I.R.C. § 513(a). A trade or business is "substantially related" to exempt purposes if the production or distribution of the goods or the performance of the services from which the gross income is derived contributes importantly to the accomplishment of the organization's exempt purposes. Treas. Reg. § 1.513-1(d)(2).

Your exempt educational purpose is to inform and educate the American public about b and to advocate for c. You accomplish this purpose by disseminating unbiased information on the subject of d over your website and through various media outlets. M is a global news and media organization with a large subscriber base for its information services. The performance of the Agreement will enable you to disseminate the Information to M's subscribers, thus making the Information more widely available and contributing importantly to the accomplishment of your exempt purpose of informing and educating the American public about b and c. See Rev. Rul. 80-295. Consequently, the performance of the Agreement is substantially related to your exempt purpose and not an unrelated trade or business.

Issue 3: Whether the fees that are payable to you under the Agreement constitute royalties within the meaning of § 512(b)(2).

I.R.C. § 511 imposes a tax on the unrelated business taxable income of organizations described in § 501(c)(3). I.R.C. § 512(a)(1) defines "unrelated business taxable income" as gross income derived from an unrelated trade or business. I.R.C. § 512(b)(2) excludes all royalties from unrelated business taxable income. Thus, the issue of whether the fees payable to you under the Agreement constitute royalties would be relevant only if such fees were gross income derived from an unrelated trade or business. Since we have concluded that the performance of the Agreement is not an unrelated trade or business, the fees payable under the Agreement are not gross income derived from an unrelated trade or business. Consequently, there is no need to address this issue.

RULINGS

Accordingly, based on the information submitted, we rule as follows:

1A. Your performance of the Agreement and receipt of fees thereunder will not jeopardize your status as an organization exempt from tax under § 501(c)(3) of the Code.

1B. Because of the factual nature of the issue, we decline to rule on whether your performance of the Agreement and receipt of fees thereunder would jeopardize your status as an organization that is not a private foundation.

2. Your performance of the Agreement is not an unrelated trade or business within the meaning of § 513(a) of the Code.

3. Insofar as the periodic and termination fees payable to you under the Agreement are not gross income derived from an unrelated trade or business, there is no need to rule on whether such fees are royalties.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael Seto
Manager
Exempt Organizations, Technical

Enclosure
Notice 437