



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Release Number: **201123036**

Release Date: 6/10/2011

Date: March 15, 2011

Uniform Issue List:

501.03-28

509.01-01

512.00-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

LEGEND:

P =
b =
d =
e =
f =

Dear

This is in response to your ruling request dated November 6, 2007, which was subsequently revised and superseded by your letters dated September 21, 2009, August 11, 2010 and March 7, 2011, requesting rulings related to a proposed reorganization and transfer of assets, in the manner and for the purposes described below.

FACTS

You are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code ("Code") and are classified as other than a private foundation. Your primary activities consist of the development of d; e; and the dissemination of b information, all for the benefit of the general public. You conduct activities through a global network of controlled organizations. Though your principal business location is in the United States, you own or control several foreign subsidiaries, which have significant foreign operations.

In light of growing industry challenges to your manner of operation and the effect of such challenges on your ability to continue to serve your public b mission, you have decided to restructure by transferring e and other activities to for-profit subsidiaries. You will keep your core charitable and public educational activities and retain ownership and management of the shares of the e businesses and associated businesses.

You state the following reasons for the restructuring. The new structure will allow you to preserve and increase the value of the e activity, to the benefit of your remaining activities. Restructuring will enable you to use the stock of the for-profit subsidiaries as "acquisition currency," instead of cash or debt, to acquire other entities as part of a geographic and product

line expansion strategy. Restructuring will enable you to attract prospective partners by making it possible to offer a non-controlling equity investment in a for-profit corporation. Furthermore, by creating a for-profit subsidiary, you will be able to attract and retain key employees with an equity-based compensation system.

Under the plan of restructuring, you plan to form one or more domestic stock corporations (henceforth “DSub”). You will transfer assets to DSub in exchange for 100% of the stock of DSub and, possibly, debt issued by DSub. The assets to be transferred will include physical assets, contracts, and U.S. employees associated with the e activities (comprising f as well as research and certain other activities associated with f). You will then transfer 100% of the stock and debt of DSub to NewCo, a wholly-owned for-profit subsidiary, in exchange for Class A common stock of NewCo. None of the assets to be transferred by you would be subject to acquisition indebtedness as defined in section 514(c) of the Code.

In addition, you will form a new foreign corporation or use an existing foreign corporation (henceforth, “FSub”). You plan to transfer assets to FSub in exchange for 100% of the common and preferred stock (nonqualified preferred stock within the meaning of section 351(g) of the Code) of FSub. The transferred assets will include stock of foreign subsidiaries and intangibles such as trademarks, trade names, intellectual property, and goodwill. It is anticipated that FSub common stock will be issued in exchange for approximately 5% of the value of the assets transferred to FSub, and FSub nonqualified preferred stock will be issued in exchange for approximately 95% of the value of such assets. You will subsequently transfer 100% of the stock of FSub to NewCo in exchange for Class A common stock of NewCo. FSub will transfer some of the assets received from you to NewCo.

NewCo will authorize either one or two classes of common stock for issuance. If two classes are issued – Class A and Class B – Class A will be a high-vote stock whose majority shareholder will be you. Through majority ownership of NewCo’s Class A stock, you will have voting control over it and thus indirect control over DSub and FSub. If issued, Class B stock would be low-vote in nature. Potential shareholders of Class B stock may include you, employees, and external investors. You could own some of the Class B stock as part of the normal capitalization process between parent and subsidiary entities, while employees could own some of the Class B stock as part of an equity compensation plan. In addition, the Class B stock could be issued to certain investors in return for capital. Likely investors could include private placement, institutional investors, and strategic investors. Any capital raised in this process will serve as funds for future growth of NewCo. Future sales of the subsidiary stock to investors would be at fair market value as determined by a highly-qualified investment banking firm. Further, any future sales of NewCo stock will not affect your voting control over NewCo. If only one class of stock is issued, you will be the majority owner and will control the subsidiary. There are no plans to reduce your ownership of shares in NewCo, whether there are one or two classes of stock, to less than a majority interest.

Your Board of Trustees will continue to serve three-year terms and consist of three classes whose terms expire in succeeding years. All or a majority of the initial members of NewCo’s Board of Directors will consist of all the Trustees of your Board of Trustees for at least one year to assure continuity. Thereafter NewCo’s Board of Directors will consist of directors elected

annually by your Board, selected from its own ranks or elsewhere as it determines to be appropriate, except that the Chair of your Board and your Chief Executive Officer will automatically be members of NewCo's Board.

After the restructuring, NewCo will conduct the e activities in a manner not materially different than the manner in which those activities were conducted by you. You will continue to educate the public on b and engage in education and outreach programs, conduct research, make grants to outside organizations and programs that support your exempt purposes, and act as a b resource. In addition, you will continue to set international, independent d and be the coordinating body to bring together the expertise and interested parties required to develop new d.

Currently, d and d-related products and services are distributed to the public by an unrelated party, P, under a services agreement with you. Under that agreement, P collects purchase fees from customers and remits the entire amounts collected to you. In return, you pay P a distribution fee. The agreement provides that you and P intend for P to serve as an independent contractor, and that nothing in the agreement shall give P any right, ownership, or interest in any d or d-related products. After the restructuring, you will enter into a distribution arrangement with NewCo that is similar to your arrangement with P. Specifically, you will contract with NewCo to distribute d and d-related products and services to customers of NewCo's e activities. NewCo will collect the fees from its customers for distributing the d and transfer those amounts, without offset or compensation, to you.

RULINGS REQUESTED

You have requested the following rulings:

1. Your transfer of the assets and liabilities related to the e activities ultimately to NewCo in the manner described above (the "restructuring") will not jeopardize your tax-exempt status as an organization described in section 501(c)(3) of the Code.
2. After the restructuring, you will continue to be an organization described in section 501(c)(3) of the Code.
3. Your proposed transfer of assets and liabilities ultimately to NewCo will not result in any unrelated business taxable income within the meaning of sections 511-514 of the Code. Notwithstanding the foregoing, you are not requesting a ruling on the question of whether ordinary income recognized by virtue of sections 1245 and 1250, if any, as a result of the transfer of assets and liabilities is unrelated business income under sections 511 through 514.
4. The income derived by you from the P agreement and from NewCo from the distribution of d to the public constitutes substantially related income and is treated as if derived directly from the individual purchaser of the educational materials, i.e. the d, for purposes of section 509(a)(2) of the Code.
5. After the restructuring, you will be recognized as a public charity within the meaning of section 509(a)(2) of the Code.

LAW

Section 501(a) of the Code exempts from federal income tax organizations described in section 501(c).

Section 501(c)(3) of the Code describes organizations organized and operated exclusively for charitable, scientific, testing for public safety, literary, educational, and other specified exempt purposes.

Section 509(a) of the Code defines the term “private foundation” as a domestic or foreign organization described in section 501(c)(3) other than an organizations described in section 509(a)(1), (2), (3), or (4).

Section 509(a)(2) of the Code, in pertinent part, describes an organization which (A) normally receives more than one-third of its support in each taxable year from any combination of (i) gifts, grants, contributions or membership fees, and (ii) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business (within the meaning of section 513), not including such receipts from any person, or from any bureau or similar agency of a governmental unit, in any taxable year to the extent such receipts exceed the greater of \$5,000 or 1 percent of the organization’s support in such taxable year, and (B) normally receive not more than one-third of its support in each taxable year from gross investment income.

Section 511 of the Code imposes a tax on the unrelated business taxable income of every organization described in section 501(c)(3).

Section 512(a)(1) of the Code defines “unrelated business taxable income” as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions directly attributable to such business activity, with certain modifications.

Section 512(b)(2) of the Code excludes from unrelated business taxable income all 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 excludes from unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or; (B) property held primarily for sale to customers in the ordinary course of the trade or business.

Section 512(b)(13)(A) of the Code provides, in pertinent part, that if an organization (the “controlling organization”) receives or accrues (directly or indirectly) any royalty from another entity which it controls (the “controlled organization”), notwithstanding section 512(b)(2), the controlling organization shall include such royalty as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the

controlled entity (or increases any net unrelated loss of the controlled entity). In the case of a corporation, section 512(b)(13)(D) defines "control" as ownership (by vote or value) of more than 50 percent of the stock in such corporation.

In the case of an controlled entity which is not exempt from tax under section 501(a), section 512(b)(13)(B)(ii) of the Code defines the term "net unrelated income" as the portion of such entity's taxable income which would be unrelated business taxable income if such entity were exempt under section 501(a) and had the same exempt purposes as the controlling entity.

Section 513(a) of the Code defines unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of the organization for funds or the use it makes of the profits derived) to the exercise of the organization's exempt purposes or functions.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations ("regulations") provides that in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in that section.

Section 1.501(c)(3)-1(c) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes specified in section 501(c)(3).

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Section 1.501(a)-1(c) of the regulations defines the term "private shareholder or individual" as a person having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(3) of the regulations defines the term "educational" as including the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.513-1(d)(1) of the regulations states that the determination of whether a trade or business is substantially related to an organization's exempt purpose necessitates an examination of the relationship between the business activities that generate the particular income in question and the accomplishment of the organization's exempt purposes.

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 activity has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Rev. Rul. 75-387, 1975-2 C.B. 216, concerns a blood bank that is recognized as exempt from federal income tax under section 501(c)(3) of the Code. The blood bank's principal source of support is receipts from the sale of blood. The blood bank enters into agreements with the hospitals it supplies with blood whereby the hospitals are responsible for collecting charges from the patients and reimbursing the blood bank. Under the agreements, all blood furnished to the hospitals remains the property of the blood bank until used. The receipts collected by the blood bank for blood furnished to any patient do not exceed \$5,000 or one percent of the blood bank's support for any taxable year. The blood sales receipts remitted from each participating hospital greatly exceed \$5,000 or one percent of the blood bank's support. The blood bank's blood sales receipts exceed one third of the blood bank's support, and it receives not more than one-third of its support in any taxable year from gross investment income. The ruling states that, since the blood bank retains both legal title to the blood and control over the hospitals regarding its return or redirection at any time prior to use, an agency relationship is created between the hospitals and the blood bank. Therefore, amounts paid to the hospitals are treated as though they have been paid to the blood bank directly, and each patient is considered a separate payor for purposes of the \$5,000 or one percent of support limitation provide for in section 509(a)(2)(A)(ii).

ANALYSIS

Issue 1: Whether your transfer of assets and liabilities related to the e activities ultimately to NewCo in the manner described above would jeopardize your tax-exempt status as an organization described in section 501(c)(3) of the Code.

The facts presented do not reveal that the proposed transfer of assets and liabilities would inure to the benefit of any member, trustee, or officer of you or to any private individual in violation of section 1.501(c)(3)-1(c)(2) of the regulations. Your restructuring transactions appear reasonable and in furtherance of legitimate purposes. In return for transferring assets to DSub, you will receive 100 percent of the stock and debt of DSub. In return for transferring assets to FSub, you will receive 100 percent of the common and preferred stock of FSub. In return for the transfer of its DSub stock and debt and FSub stock to NewCo, you will receive and retain a majority interest in NewCo. Furthermore, NewCo, will be carrying on the same e activities, in substantially the same manner as previously carried on by you, activities that correspond to an exempt purpose under section 501(c)(3) of the Code. Your intended use of NewCo stock as part of an equity-based compensation system for your employees will not necessarily result in inurement of your net earnings within the meaning of section 1.501(c)(3)-1(c)(2). An exempt organization may cause shares of its taxable subsidiary to be issued as part of a reasonable compensation package. Therefore, the transfer of the assets and liabilities related to the e activities to NewCo would not jeopardize your exempt status as an organization described in section 501(c)(3).

Issue 2: Whether you will continue to be an organization described in section 501(c)(3) of the Code after the restructuring.

Following the restructuring, your activities will consist of developing d and promoting b through public educational activities. Organizations formed to establish and promote b through the

development of d are entitled to exemption as educational organizations within the meaning of section 501(c)(3) of the Code and section 1.501(c)(3)-1(d)(3) of the regulations. Furthermore, you will not only continue to conduct public educational activities, but likely will expand those activities dedicated to educating the general public on international b issues. Therefore, after the restructuring, you will continue to meet the operational test of section 1.501(c)(3)-1(c) by engaging primarily in activities which accomplish one or more exempt purposes.

Issue 3: Whether the transfer of assets and liabilities related to the e activities ultimately to NewCo would result in any unrelated business taxable income within the meaning of section 512 of the Code.

The assets and liabilities related to the e activities that are to be transferred to NewCo are neither stock in trade or other property of a kind which would be properly includible in inventory if on hand at the close of the taxable year, nor property held primarily for sale to customers in the ordinary course of a trade or business. The property is not debt-financed property under section 514 of the Code. Consequently, if the transactions with DSub, FSub, and NewCo were recognition events, all gains or losses from transfer of the e assets and liabilities to NewCo would be excluded from unrelated business taxable income by reason of section 512(b)(5). With respect to any royalties you were to receive from NewCo – an entity that you control within the meaning of section 512(b)(13)(D) – such royalties would be excludible from your unrelated business taxable income by section 512(b)(2) except to the extent they would be subject to tax by reason of section 512(b)(13).

Issue 4: Whether amounts received by you under service agreements with P and NewCo for the sale, fulfillment, and distribution services for d and d-related products and services will be treated as gross receipts received directly from the purchaser of the d or d-related product or service rather than from P or NewCo for purposes of the \$5,000 or one percent limitation under section 509(a)(2)(A)(ii) of the Code.

Under the services agreement between you and P, P provides sales, fulfillment, and distribution services for d and d-related products and services. P pays you the gross sales of d and d-related products and services minus a fee for services. After the restructuring, NewCo will distribute d to customers of its e activities under an arrangement that is substantially similar to that between P and you. The agreement provides that P and you intend to create an independent contractor relationship, and that nothing in the agreement shall give P any right, ownership, or interest in any d or d-related products. The arrangement is similar to that between the blood bank and hospitals described in Rev. Rul. 75-387, 1975-2 C.B. 216. P and NewCo are acting as agents of you. Therefore, amounts paid to P and NewCo for d and d-related products and services will be treated as though paid directly to you, and each purchaser of d or d-related products and services will be considered a separate payor for purposes of the \$5,000 or one percent support limitation under section 509(a)(2)(A)(ii) of the Code.

Issue 5: Whether after the restructuring, you will be recognized as a public charity within the meaning of section 509(a)(2) of the Code.

Under Rev. Procs. 2011-4 and 2011-10, the EO Determinations Office issues determination letters on reclassification of public charity status. After your restructuring occurs, you may request a determination letter regarding your current public charity status from EO Determinations, based on your support over the five most recently completed tax years. Therefore we decline to rule on this issue.

RULINGS

Based on the information submitted, we rule as follows:

1. The transfer of assets and liabilities related to the e activities from you to NewCo in the course of restructuring will not jeopardize your tax-exempt status as an organization described in section 501(c)(3) of the code.
2. After the restructuring, you will continue to be an organization described in section 501(c)(3) of the Code.
3. Any gains or losses from the transfer of assets and liabilities from you to NewCo in the course of restructuring will be excluded from unrelated business taxable income under section 512 of the Code. In the event you receive or accrue any royalties from NewCo, such royalties would be excludable from unrelated business taxable income except to the extent they would be subject to tax by reason of section 512(b)(13). We are not ruling on the question of whether ordinary income recognized by virtue of sections 1245 and 1250 of the code, if any, as a result of the transfer of assets and liabilities is unrelated business income under sections 511 through 514.
4. Amounts received by you under service agreements with P and NewCo for the sale, fulfillment, and distribution services for d and d-related products and services will be treated as gross receipts received directly from the purchaser of the d or d-related product or service rather than from P or NewCo for purposes of the \$5,000 or one percent limitation under section 509(a)(2)(A)(ii) of the Code.

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 understanding there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon your tax status should be reported to the Service. 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 this letter could help resolve any future questions about tax consequences of your activities, you should keep a copy of this ruling 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 and Declaration of Representative currently on file with the Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Ronald J. Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure:
Notice 437