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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: JUN 11 2001

Uniform Issue List
512.01-01
4943.03-01
4943.04-00
4943.04-03

Contact Person:

Identification Number:

Telephone Number:

T:EO:B4

Employer Identification Number:

Legend:

B =
M =
N =
O =
x =

Dear Sir or Madam:

We have considered M's ruling request dated February 14, 2001. M, a charitable trust, requests the following rulings: (1) that receipt and continued ownership of the x% perpetual royalty interest granted by N, a limited partnership, and the receipt of the related royalty payments will not result in unrelated business taxable income to M; (2) that receipt and continued ownership of the x% perpetual royalty interest granted by N will not result in excess business holdings to M; and (3) that receipt and continued ownership of the x% perpetual royalty interest granted by N and the receipt of the related royalty payments will not jeopardize the status of M as a tax exempt private foundation, under sections 501(c)(3) and 509(a) of the Internal Revenue Code, respectively.

M is controlled and operated by its trustees ("Trustees") in accordance with the governing instrument of M and policies and procedures adopted by the Trustees. M holds significant assets, some of which were donated to it by B. Periodically, the Trustees distribute income of M to various charitable organizations and for various charitable uses.

N is the owner and operator of O, a ski resort. N engages in no other line of business. Virtually all of N's interests are owned by B.

N wishes to make a charitable contribution to M of a royalty interest equal to x% of N's "simulated taxable income", which is equal to taxable income with certain adjustments. If this is a negative figure, the royalty shall be zero and shall have no effect on the amount of the royalty for any other year. The charitable contribution by N would be evidenced by a Perpetual Royalty

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Interest Agreement, of which you have enclosed a copy. The revenue to be derived by M from the Perpetual Royalty Interest Agreement will be used to further M's exempt purposes.

N's "simulated taxable income" is described in paragraph 2 of the Perpetual Royalty Interest Agreement as follows:

i) The first determination is of the amount that would be N's taxable income under the Code if N were a corporation (without depreciation deductions or any carry forwards or carry backs).

ii) After the computation in paragraph i) is completed, the following adjustments are made:

a) There is added to such taxable income all of N's cash receipts during the year (excluding monies borrowed) that were not taken into account in computing taxable income under paragraph (i).

b) There is deducted from such taxable income all amounts paid by N during the year to reduce N indebtedness and all other amounts paid out by N during the year that were not otherwise taken into account in computing taxable income under paragraph (i) (other than the royalty payable to M).

The net figure after the above adjustments is the "simulated taxable income", which will approximate N's net income.

Inasmuch as N is a partnership, its strict taxable income was not deemed to be an appropriate concept to be used in computing the royalty. Therefore, you have used the "simulated taxable income" concept in order to approximate N's taxable income if it were a corporation, with the above cash flow adjustments.

The Perpetual Royalty Interest Agreement specifically provides that M shall have no ownership of any partnership interest (either general or limited), no ownership of O or any of N's assets, and no power or right of any kind to control, direct, supervise, recommend or review N's business activities, operations or decisions, except for its right to review the royalty computations. In addition, the Perpetual Royalty Interest Agreement provides that M shall never be or become personally or otherwise liable for any cost, expense, payment or outlay incurred by N or due by N or for which N is liable or responsible, and N shall indemnify and hold M harmless from and against any liability arising out of the Perpetual Royalty Interest Agreement or arising out of any action or inaction by N.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated "exclusively" for charitable, educational, scientific, or other specified exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which does not engage in proscribed legislative or political activities.

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

Section 512(a) of the Code defines the term "unrelated business taxable income" to mean 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, both computed with the modifications provided in subsection (b).

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 512(b)(2) of the Code provides for the following modification to the term "unrelated business taxable income" (as defined in section 512(a)(1)): 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 that income.

The term "royalties" is not defined in either the Internal Revenue Code or the regulations. Section 1.512-1 of the regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) of the Code shall be determined by all the facts and circumstances of each case.

Rev. Rul. 81-78, 1981-2 C.B. 135, holds that payments which an exempt labor organization receives from various business enterprises (involving the organization's efforts to license its member professional athletes' names) for the use of the organization's trademark, trade name, service mark, or copyright, whether or not payments are based on the use made of such property, are classified as royalties for federal tax purposes. The revenue ruling states:

> To be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes.

The ruling also noted that, although excluded from unrelated business income tax as a royalty, the income from the licensing activity was income from unrelated trade or business because the licensing agreements did not directly promote the group's purposes.

In Situation 2 of Rev. Rul. 81-78, the license agreement required the organization, through its member athletes, to endorse products or services in personal appearances and interviews. The ruling held that the royalty exception does not apply because of the element of personal services. This is consistent with the Service's position that provision of a relatively minimal degree of services by the exempt organization will preclude royalty treatment of the resulting income.

Under the Perpetual Royalty Interest Agreement, M will receive a royalty interest based on N's "simulated taxable income". The concept of "simulated taxable income" is intended to approximate taxable income as if N were a corporation, with certain cash flow adjustments, as discussed above. The royalty gives M no partnership interest in N nor any interest in the operations, assets or activities of N, and M is insulated from all liabilities of N. Accordingly, under the Agreement, M has a completely passive role. Inasmuch as the income which M receives is a true royalty, it is not taxable by virtue of the exclusion from unrelated business taxable income provided under section 512(b)(2) of the Code.

Section 4943(a) of the Code imposes a tax on the excess business holdings of any private foundation in a business enterprise during any taxable year.

Section 4943(c)(1) of the Code defines the term "excess business holdings" to mean, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

Section 4943(c)(2)(A) of the Code provides that the permitted holdings of any private foundation in an incorporated business enterprise are: (i) 20 percent of the voting stock, reduced by (ii) the percentage of the voting stock owned by all disqualified persons. This section also provides that where all disqualified persons together do not own more than 20 percent of the voting stock of an incorporated business enterprise, nonvoting stock held by the private foundation shall also be treated as permitted holdings.

Section 4943(c)(3) of the Code deals with permitted holdings of an unincorporated business enterprise. This section provides that in the case of a partnership or joint venture, "profit interest" shall be substituted for "voting stock" and "capital interest" shall be substituted for "nonvoting stock".

Section 4943(d)(3) of the Code provides that the term "business enterprise" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources. For purposes of subparagraph (B), gross income from passive sources includes the items excluded by section 512(b)(2).

Section 53.4943-10(a) of the Foundation and Similar Excise Taxes Regulations provides that under section 4943(d)(4) of the Code, the term "business enterprise" includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513.

Section 53.4943-10(c)(1) of the regulations states that for purposes of Code section 4943(d)(4), the term "business enterprise" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources. Thus, stock in a passive holding company is not to be considered a holding in a business enterprise even if the company

is controlled by the company. Instead, the foundation is treated as owning its proportionate share of any interests in a business enterprise held by such company under section 4943(d)(1).

Section 53.4943-10(c)(2) of the regulations provides that gross income from passive sources, for purposes of this paragraph, includes the items excluded by section 512(b)(2) (relating to royalties), among other exceptions listed under subparagraphs of section 512(b).

As discussed above, the income generated by the Perpetual Royalty Interest Agreement is passive royalty income under section 512(b)(2) of the Code. Therefore, the perpetual royalty interest is excluded from the definition of a "business enterprise" under section 4943(d)(3)(B). See sections 53.4943-10(a) and 53.4943-10(c)(2) of the regulations.

The purposes and activities which constitute the basis for the Service's recognition of the tax exempt status of M under section 501(c)(3) of the Code are not affected in any way by the Perpetual Royalty Interest Agreement. These purposes and activities remain the same; the Agreement in question only involves the passive receipt by M of royalty income. For the same reasons, the private foundation status of M under section 509(a) is unaffected by the Perpetual Interest Royalty Agreement.

Based on the foregoing, we are able to rule as follows:

1. M's receipt and continued ownership of the x percent perpetual royalty interest granted by N, and the receipt of the related royalty payments, will not result in unrelated business taxable income to M under section 512 of the Code.

2. M's receipt and continued ownership of the x percent perpetual royalty interest granted by N will not result in excess business holdings to M under section 4943 of the Code.

3. M's receipt and continued ownership of the x percent perpetual royalty interest granted by N and the receipt of the related royalty payments will not jeopardize the status of M as a tax exempt private foundation under sections 501(c)(3) and 509(a) of the Code, respectively.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon M's tax status should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service Office. The mailing address is: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The telephone number there is 877-829-5500 (a toll free number).

We are sending a copy of this ruling to the Ohio TE/GE Customer Service Office. Because this letter could help resolve any questions about M's tax status, it should kept with M's permanent records.

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

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 as precedent.

Thank you for your cooperation.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

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