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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: MAY 31 2002

Contact Person:

Identification Number:

Significant Index No. 512.01-00

Telephone Number:

T:EO:B3

Employer Identification Number:

Legend:

Foundation =
Association =
Corporation =
State =
x =

Dear

This is in reference to your ruling request dated September 12, 2001, concerning the federal income tax consequences stemming from proposed grants from the Foundation to the Association, the proposed transfer of Corporation assets to the Association and the Foundation, and the Association's assumption of responsibility for conducting continuing legal education in State.

Facts:

Foundation is a nonprofit corporation established over 30 years ago, and has been found to be an organization exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Foundation has been classified as other than a private foundation under section 509(a)(2). Its purposes include advancing the science of jurisprudence, promoting and improving the administration of justice, and facilitating the understanding of and compliance with the law. In pursuing these objectives, Foundation publishes and distributes reports and other literary works on law-related subjects and the administration of justice.

Association is a nonprofit business league, and has been found to be an organization exempt from federal income tax under section 501(a) of the Code as an organization described in

section 501(c)(6). Association is an integrated bar association consisting of all attorneys licensed to practice law in State, and is governed by rules established by the State Supreme Court. Its purposes include improving the administration of justice, fostering and maintaining high standards of conduct, integrity, confidence, and public service of those persons engaged in the practice of law, safeguarding and promoting the professional interests of bar members, and encouraging continuing legal education of bar members.

Corporation is a nonprofit organization and public charity established over 20 years ago, and has been found to be an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3). It has for many years administered an educational program for the study, discussion, and dissemination of information related to local and State laws and the laws of the United States. Practicing attorneys in State are encouraged, but not required, to avail themselves of these educational opportunities in accordance with a State Supreme Court decision. Corporation receives the majority of its funding through grants from Foundation and gross receipts from its continuing legal education seminars and publications.

All persons who are admitted to practice law in State are members of Association. Membership in Foundation is limited to those attorneys, active members of Association, who have contributed money to Foundation. The members of Corporation are active members of Association who are elected, qualifying for, and serving on Association's executive council.

The proceeds from Corporation's seminars and publications have not kept up with expenses, resulting in the organization being operated at a loss. Association has made loans totaling x to Corporation, and also has provided Corporation with staff support and other administrative resources.

The solution proposed by Association and Corporation is to consolidate, inasmuch as many of their activities overlap. Corporation would be dissolved, and Association would organize and sponsor continuing legal education programs for attorneys in State. The number of programs would be reduced, and the seminars with broadest appeal would continue to be held.

Once Association has assumed the role of Corporation in organizing and sponsoring continuing legal education programs and activities in State, Foundation may make grants or contributions to Association to reimburse it for expenses and overhead incurred in conducting the programs and activities.

Since Article III of Foundation's Articles of Incorporation provides that Foundation will make grants only to exempt organizations qualified under section 501(c)(3) of the Code to further exempt educational purposes, Foundation has proposed amending its Articles of Incorporation to allow Foundation to make gifts, grants, or contributions to be used exclusively to facilitate understanding of and compliance with the law, to promote the study of law, legal research, and the diffusion of knowledge.

Foundation also has proposed implementing expenditure safeguards to ensure that Association uses the grant funds for educational purposes, including a grant restriction under

which Association would be required to deposit all Foundation grant funds in a separate account for continuing legal education programs and related activities. All funds deposited in this account would be restricted to expenses and overhead incurred by Association for continuing legal education programs. The separate account is intended to prevent the commingling of grants or contributions from Foundation with other funds received by Association for purposes not consistent with Foundation's purposes. In addition, Association would provide Foundation with annual reports detailing deposits and withdrawals from the account, which would be certified by an authorized Association official as true, correct, and complete.

In the event Association were to fail to comply with any material provision contained in the grant restriction agreement or ceases organizing, sponsoring, or conducting continuing legal education programs, any remaining unexpended gifts, grants, or contributions made under the agreement plus net income thereon would be returned to Foundation. The entire agreement and any gifts, grants, or contributions to Association for continuing legal education programming would be subject to approval by Foundation's board of directors.

Further, Corporation would obtain an independent appraisal of its assets, including its copyrighted written, audio, and audiovisual continuing legal education materials. Based on this appraisal, it would transfer assets to Association with a value equal to x, thus repaying the loans. Association would forgive amounts owed by Corporation to the extent the appraised value of the assets is less than the full amount of Corporation's liability.

Article XI of Corporation's Articles of Incorporation requires distribution of any assets upon winding-up and dissolution to an organization qualified as an exempt organization under section 501(c)(3) of the Code. Thus, any assets and continuing legal education materials in excess of the liability remaining upon Corporation's dissolution would be transferred to Foundation. These copyrighted materials would then be licensed to Association under a nonexclusive, perpetual, nontransferable, and royalty-free license.

The license agreement would restrict Association's use of the licensed continuing legal education materials solely for purposes in furtherance of Foundation's educational purposes. In addition, it would require Association to prepare and submit annual reports to Foundation regarding any continuing legal education activities organized, sponsored, and conducted by Association in connection with which the licensed materials were used. These reports would have to be certified by a duly authorized officer of Association as being true, correct, and complete.

Finally, the proposed license agreement provides that if at any time Association fails to substantially comply with any material provision in the agreement or ceases organizing or conducting continuing legal education activities, the authorization to use the copyrighted materials would be revoked, and that all such materials must be returned to Foundation. The license agreement is subject to approval by Foundation's board of directors.

Ruling Requests:

You have requested the following rulings:

(1) Neither the proposed grants from Foundation to Association solely to fund Association's continuing legal education programs and related educational activities, and associated overhead, nor the corresponding amendment to Foundation's Articles of Incorporation permitting such grants to be made from Foundation to Association, will adversely affect the tax-exempt status of Foundation.

(2) Prior to its winding-up and dissolution, Corporation may, in connection with a qualified independent valuation, transfer certain copyrighted written, audio and audiovisual materials and other assets used by Corporation for continuing legal education programs and related activities, to Association in full satisfaction of a bona fide liability payable by Corporation to Association without adversely affecting the tax-exempt status of either Corporation or Association, and without causing unrelated business taxable income for Corporation, and in the event the fair market value of such assets and continuing legal education materials exceeds the amount of such liability.

(3) Corporation may distribute the portion of the assets and the copyrighted written, audio, or audiovisual materials that exceeds such liability to Foundation pursuant to Corporation's winding-up and dissolution, with Foundation licensing the intangibles portion of such assets to Association under a nonexclusive, perpetual, nontransferable and royalty-free license, without adversely affecting the tax-exempt status of either Foundation or Association.

Law:

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

Section 501(c)(6) of the Code provides, in part, for the exemption from federal income tax of nonprofit business leagues, provided that no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 511 of the Code, in part, imposes a tax on the unrelated business income of organizations exempt from tax under section 501(c)(3).

Section 512(a)(1) of the Code defines "unrelated business taxable income" as gross income derived by any organization from any unrelated trade or business regularly carried on by such organization.

Section 512(b)(5) of the Code provides that all gains or losses from the sale, exchange, or other disposition of property, other than property which is (i) 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 (ii) property held primarily for sale to customers in the ordinary course of the trade or business are excluded from unrelated business taxable income.

Section 513(a) of the Code defines an unrelated trade or business to include 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 exempt purposes.

Section 1.501(a)-1(c) of the Income Tax Regulations defines the term "private shareholder or individual" to include persons having a personal and private interest in the activities of an organization.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that a tax-exempt organization operates exclusively for section 501(c)(3) purposes only if it engages primarily in activities that accomplish such purposes.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization will not be deemed to be 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 states that an organization that is not organized or operated exclusively for exempt purposes specified in section 501(c)(3) of the Code unless it serves a public rather than a private interest.

Rev. Rul. 68-489, 1968-2 C.B. 210, holds that an organization described in section 501(c)(3) of the Code will not jeopardize its exemption even though it distributes funds to organizations not themselves exempt under section 501(c)(3). The exempt organization ensured use of the funds for section 501(c)(3) purposes by limiting distributions to specific projects that are in furtherance of its own exempt purposes. The exempt organization also retained control and discretion as to the use of the funds and maintained records establishing that the funds were used for section 501(c)(3) purposes.

Analysis:

Under the proposed transaction, Foundation's Articles of Incorporation would be amended to allow Foundation to make distributions to Association solely to further Foundation's educational purposes. Foundation plans to enter into a grant restriction agreement to ensure that any gifts, grants, or contributions made to Association at Foundation's discretion will be used solely to further Foundation's educational purposes. This agreement was drafted using the expenditure responsibility rules found in section 4945 of the Code as guidelines

Section 4945(h) of the Code provides that private foundations must exert all reasonable efforts and establish reasonable procedures to (1) ensure that a grant to an organization such as a professional association is spent solely for the purposes for which it was made; (2) obtain full and complete reports from the recipient organization on how the grant funds will be or were spent; and (3) make full and detailed reports on such expenditures to the Internal Revenue

Service. Although Foundation is a public charity and not a private foundation, Foundation will adhere to the rules under section 4945 which are consistent with the holding of Rev. Rul. 68-489, *supra*.

Thus, in accordance with the agreement, Association would be required to deposit all grant funds from Foundation in a separate bank account established solely to receive funds for continuing legal education programs and activities, at a bank selected by Foundation. Association also would be required to submit annual reports to Foundation detailing the deposits and withdrawals from the account and the purposes of the withdrawals.

Because Association will take steps to ensure that grants, gifts, and contribution amounts transferred to it by Foundation will be used solely for Foundation's educational purposes, Foundation may amend its Articles of Incorporation to permit the grants, gifts, and contributions to be made to Association where such amounts are sufficiently restricted to be used solely to facilitate understanding of and compliance with the law, to promote study of law, legal research, and diffusion of legal knowledge. Accordingly, the funds may be distributed directly from Foundation, an organization exempt under section 501(c)(3) of the Code, to Association, a business league exempt under section 501(c)(6), without affecting Foundation's exempt status under section 501(c)(3).

All nonexclusive, nontransferable, and royalty-free licenses of copyrighted continuing legal education materials made by Foundation to Association will be treated similarly to the gifts, grants and contributions, and should not affect Foundation's exempt status under section 501(c)(3) of the Code. Foundation and Association plan to enter into a licensing agreement that would restrict Association's use of the licensed continuing legal education materials to purposes in furtherance of Foundation's educational purposes. Thus, as Foundation plans to take steps to ensure that any licensed continuing legal education materials are used solely in furtherance of its educational purposes, any nonexclusive, nontransferable license between Foundation and Association will not adversely affect Foundation's exempt status under section 501(c)(3).

Under its Articles of Incorporation, Corporation's purposes are to conduct continuing legal education programs in various forms for Association members and other interested parties, and to publish information relating to the practice of law. It seeks to foster and improve the study of jurisprudence and law reform as well as to provide for the continuing legal education of Association's members, the attorneys licensed to practice in State. As noted previously, Corporation's liability to Association is a bona fide debt based on the advances made by Association to Corporation to fund the continuing losses incurred by Corporation in connection with its continuing legal education activities. Since Association is assuming Corporation's role in organizing, sponsoring, and conducting continuing legal education activities in State, and since Corporation has little cash or other available funds to repay the debt, it is beneficial to both Corporation and Association that Corporation repay the debt with in-kind assets.

Corporation plans to hire a qualified independent appraiser to evaluate its continuing legal education publications and other materials and determine the accurate fair market value of this property. Once this independent valuation has been obtained, only assets with a fair market value not greater than the amount of the debt will be transferred from Corporation to Association

in full satisfaction of liability. Since a qualified independent valuation will be obtained, and care will be taken to ensure that arm's-length and reasonableness standards will be observed, the prohibitions against inurement and private benefit will not be violated by the transfer of in-kind assets in full satisfaction of the debt owed by Corporation to Association. See sections 1.501(c)(3)-1(c)(2) and 1.501(c)(3)-1(d)(1)(ii) of the regulations.

Corporation's transfer to Association of copyrighted materials and other assets related to its continuing legal education activities in full satisfaction of its debt to Association would be substantially related to the furtherance of Corporation's exempt purposes. Therefore, any gain on such transfer will not create unrelated business taxable income for Corporation. Further, section 512(b)(5) of the Code provides that all gains or losses from the sale, exchange, or other disposition of property, other than property which is (i) 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 (ii) property held primarily for sale to customers in the ordinary course of the trade or business, are excluded from unrelated business taxable income. Any office equipment and supplies or furniture transferred by Corporation to Association in satisfaction of the debt would fall within this category. Accordingly, if the appraised value of any furniture or office equipment or supplies exceeds Corporation's basis in such assets, the resulting gain upon transfer of the assets to Association in satisfaction of Corporation's debt to Association will not constitute unrelated business taxable income.

Rulings:

Therefore, we rule that:

(1) Neither the proposed grants from Foundation to Association solely to fund Association's continuing legal education programs and related educational activities, and associated overhead, nor the corresponding amendment to Foundation's Articles of Incorporation permitting such grants to be made from Foundation to Association, will adversely affect the tax-exempt status of Foundation.

(2) Prior to its winding-up and dissolution, Corporation may, in connection with a qualified independent valuation, transfer certain copyrighted written, audio, and audiovisual materials and other assets used by Corporation for continuing legal education programs and related activities, to Association in full satisfaction of a bona fide liability payable by Corporation to Association without affecting the tax-exempt status of either Corporation or Association, and without causing unrelated business taxable income for Corporation, in the event the fair market value of such assets and continuing legal education materials exceeds the amount of such liability.

(3) Corporation may distribute the portion of the assets and the copyrighted written, audio, and audiovisual materials that exceeds such liability to Foundation pursuant to Corporation's winding-up and dissolution, with Foundation licensing the intangibles portion of such assets to Association under a nonexclusive, perpetual, nontransferable, and royalty-free license, without adversely affecting the tax-exempt status of either Foundation or Association.

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

This ruling is limited to the applicability of the provisions of the sections of the Code as noted above. This ruling is based on the understanding that there will be no material changes in the facts on which it is based.

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.

Sincerely,

Robert C. Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3