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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Identification Number:

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Legend:

M =
N =
O =
P =
R =
S =
T =

Dear :

This letter is in reference to the letter from the authorized representative of M, in which M requested rulings, as amended, with respect to whether a particular activity will be unrelated trade or business under section 513 of the Internal Revenue Code and whether M's income from N is will be considered to be unrelated business taxable income within the meaning of section 513.

M is an organization recognized by the Internal Revenue Service as exempt from federal income tax as an organization under section 501(c)(6) of the Code. M is a business league formed by, and to further the common business interests of, O system operators. M states that it identifies, plans, and funds the development of new technology for the benefit of the O industry and transfers such knowledge to the industry. The O industry includes O equipment manufacturers and other suppliers (who are not members of M), as well as O operators (who may or may not be M members).

M sets voluntary standards for the O industry as a whole, which standards are freely available to the interested public, including equipment manufacturers as well as O operators. However, M states that its activities are intended primarily to further the common business interests of O operators (who may or may not be M members), wherever they are located worldwide.

M states that it promotes the improvement of business conditions in the O industry by researching and identifying particular new technologies, developing specifications to enable and ensure among different O systems, testing and certifying that products meet the developed specifications, disseminating information gained through research, development, and product testing, and helping the O industry deploy innovative technologies. M states that its overall role with the O environment to provide dedicated research and development that helps the O industry maintain and sharpen its competitive edge, and to remove technological barriers to future services.

M states that although the vast majority of P in the United States and Canada are served by M members, not all of the O operators are members of M. Nevertheless, M states that it does not limit its benefits to its members. O operators that are not members of M, as well as equipment manufacturers and suppliers, benefit equally from M's research, development, and refinement of the industry standards and M's other related technology development activities, the results of all of which are freely available to the interested public worldwide.

M states that the ability of on a O system, as well as with on a different O system, promotes the interest of the O industry because it permits O operators and consumers to utilize equipment from various manufacturers without problems arising from a particular manufacturer's . Consistent with this purpose, M states that it develops and issues uniform technical specifications for the of specific technologies within the O marketplace.

R, a government agency, has recognized that M is effectively the "national standards organization" for the O industry. R has urged the O industry to voluntarily develop more extensive with respect to certain products. Pursuant to proposed rulemaking by R, M states that it will jointly develop test suites with other members of the O industry, select qualified secure interfaces, and make its testing facility available for appropriate testing of certain products under these standards. An R Order requires that testing be conducted at a "qualified testing facility," but does not explicitly give M a monopoly on this testing. M states that it is noteworthy, however, that the R Report specifically named only M as a "qualified testing facility." M states that it is the only "qualified testing facility" in existence at the present time, and that it is extremely unlikely that there will soon, if ever, be another “qualified testing facility,” in large part because no other party has the experience and expertise to effectively operate such a facility, and because of the capital investment that would be required (and the limited returns that investment would likely produce). The R Report also stated that M was a research and development consortium of O operators representing more than 85% of the O subscribers in the United States, 75% of the O subscribers in Canada, and 12% of the O subscribers in Mexico. Further, the Report stated that M acted as a clearinghouse to provide the O industry with information on current and prospective technological developments and worked with other industries to develop for proposals to national and international standards bodies.

M states that essential to its development and refinement of uniform technical specifications for the O industry is the participation by manufacturers (who are not members of M) in the product testing and certification process. An integral part of developing a commercially viable, is M’s ability to update a specification to incorporate findings from certification testing and feedback from participating manufacturers. M states that it regularly revises its specifications based on information gained from certification test results and comments from manufacturers. In particular, through the certification testing program, M has discovered many errors and ambiguities in a particular specification and changed the specification accordingly. M states that by refining its specifications based on certification test results and feedback, M advances the O industry as a whole.

M states that O operators (whether M members or not) benefit from M’s certification testing because it ensure that manufacturers’ products really are . Without interoperability, a O operator would be required to restrict its customers to using a single manufacturer’s equipment. As a result of M’s certification testing, O systems actually (as opposed to theoretically) use products from different manufacturers, inducing competition among manufacturers in terms of price, quality, features, etc. M states that this competition benefits O operators, and without this competition, the development of the O industry would be impeded.

M states that due to the inherent complexities in building to a , if manufacturers were left to test products on their own, it would take many years for every manufacturer’s interpretation of the to achieve true , which would severely retard the growth of the O industry. M states that, in fact, its certification testing has revealed on numerous occasions that different manufacturers do not interpret the standards consistently.

M states that its certification does not attest to the quality of a product or to any features of the product. M tests and certifies only for compliance with a particular M technical specification which ensures . M does not test for quality control, product functionality, or performance of a product in other respects, which are solely the responsibility of the manufacturer. Further, M states that its certification testing does not replace or supplement the ordinary testing or inspection procedures used by a manufacturer in the manufacture of its products.

M states that the costs of developing and refining the specifications, equipping laboratory space, writing test plans and test scripts, interacting with equipment manufacturers, hosting the and dry runs, and performing the certification tests have far exceeded the amount of fees charged to manufacturers. M states that fees are generally set at a level designed to cover the direct cost of the testing, not to recoup the expenses incurred in creating the specifications and in developing the testing procedures. M also states that it, and its members, absorbs the majority of the costs of developing the technical specifications and conducting the certification testing for compliance with those specifications. M charges equipment manufacturers a fee that only partially defrays these costs. Overall, M states that it does not make a profit in connection with these activities, and, in fact, has incurred considerable losses in connection with these activities.

S is a working group convened under joint supervision to develop standards for a certain technology. M states that acceptance of the developed standard opens a clear path to worldwide , and that a single, universal standard puts the technology within economic reach of O operators. Before the standard coalesced, M states that it was well underway in reviewing available technology for the system, and that its activities culminated in the issuance of a request for proposal of the system. As an outgrowth of the request, M

became an active participant in S and was a central figure in the definition and evaluation of the standard.

M states that during the final stages of the standard-setting process, some of the key participating companies, including M, realized that patent rights clearances would become an important issue since S dealt with technical standards and did not directly deal with intellectual property rights. They knew that while a highly cooperative and collaborative effort would yield a superior technical standard, it would also include a large and diverse group of patent holders. It was ultimately determined that if the standards were to become implemented on a global basis, the underlying patents would have to be packaged in a manner that provided easy, reasonable, fair, and nondiscriminatory access. M stated that it recognized that without such a coalition, the future of the O industry would be in jeopardy. A working group was commissioned to search for viable options for the patents necessary for the standard to become a reality. Ultimately, N, a limited liability corporation, was formed to operate as an independent patent administrator. M states that it was one of the initial investors in the partnership. The primary goal of N is to make the technology available to manufacturers in an efficient and equitable manner.

M states that N does not legally own the patents that it administers. N receives its income from a set administrative fee that is charged to the patent holders for handling the licensing agreements, collecting royalties, and remitting royalties to the patent owners. M receives a share of this fee.

M states that the purpose of N is to facilitate the adoption of the proposed standard, T, structures its licensing arrangements in a manner that forces both patent holders and users to share technology in a fair and nondiscriminatory fashion. As no one company holds all the patents necessary for the implementation of T, N effectively forces the sharing of intellectual property. A licensee cannot obtain the patent rights needed to implement T without allowing its own intellectual property rights to be entered into a pool. M states that its participation in N is an efficient and effective way for it to carry out its exempt purposes of developing the distributing technology to the O industry. N is treated as a partnership for federal tax purposes.

M states that in the beginning, N administered only T. Currently, N also administers several other similar technological standards, including variations of T. M states that more than 96% of N's income is from fees associated with T, and only a *de minimis* amount of N's income is from fees associated with the other standards.

M has requested rulings that:

(1) Certification revenue generated by M is not considered unrelated business taxable income under section 513 of the Code because certification is directly related to M's exempt purpose and M does not conduct certification with a profit motive.

(2) M's allocable share of the income and expenses of N that are attributable to N's administration of the intellectual property rights associated with any version of the proposed standard used by the United States O industry is not unrelated business taxable income under section 513.

Section 501(c)(6) of the Code provides for the exemption from federal income tax of business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(6)-1 of the Income Tax Regulations provides that a business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for a profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league.

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

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions and modifications.

Section 512(b) of the Code provides that the modifications referred to in section 512(a)(1) include, in part, (1) the exclusion of all dividends, interest, and annuities, and all deductions directly connected with such income, and (2) the exclusion of all royalties (including overriding royalties) and all deductions directly connected with such income.

Section 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in section 512(b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(a) of the Code 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 the function constituting the basis of its exemption.

Section 1.513-1(d)(2) of the regulations provides that 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; and it is "substantially related" only if the causal relationship is a substantial one. The regulation continues that 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.

Rev. Rul. 68-264, 1968-1 C.B. 264, defines a particular service for the purposes of section 501(c)(6) of the Code as an activity that serves as a convenience or economy to the members of the organization in the operation of their own businesses.

Rev. Rul. 70-187, 1970-1 C.B. 131, holds that a nonprofit organization formed by manufacturers of a particular product to conduct a program of testing and certification of the product to establish acceptable standards within the industry as a whole qualifies for exemption under section 501(c)(6) of the Code. The revenue ruling states that the organization furnishes interested manufacturers with specifications setting forth minimum quality and performance standards. Approximately 90 percent of the manufacturers in the industry participate in the program of testing and certification and the organization fixes its charges at amounts sufficient to defray only the cost of the program. The revenue ruling also states that the organization's product testing and certification to enforce its product standards is a self-regulatory measure to prevent trade abuses in the industry. The revenue ruling concludes that the program does not constitute the performance of particular services for individual persons because the organization is engaged in activities directed to the improvement of business conditions within the industry as a whole.

ISSUE ONE

From the information that has been presented, it is clear that M's primary activities are to promote the O industry.

(1) M sets uniform technical standards for equipment used in the O industry and makes these standards freely available to the interested public, manufacturers, and O operators, whether or not they are members of M; (2) M conducts testing to assure that equipment purporting to meet those specifications does, in fact, meet the specifications as advertised, thereby preventing inaccurate representations by equipment manufacturers that their equipment is when, in fact, it is not; (3) M offers its testing and certification program to any interested manufacturer without requiring the manufacturer to become a member; (4) virtually all of the manufacturers of the relevant O equipment in the United States market participate in M's certification testing program; (5) M's fees for certification testing are insufficient to recoup all of its direct costs (without taking into account indirect costs); (6) M's certification testing does not replace or supplement ordinary testing and inspection procedures used by individual manufacturers; and, (7) M serves a self-regulatory function for the O industry. In this manner, M is similar to the organization described in Rev. Rul. 70-187, <u>supra</u>.

M's certification testing is not considered to be a particular service, as defined in Rev. Rul. 68-264, <u>supra</u>, because M has not established a vehicle that merely relieves manufacturers of the problems encountered in testing a program or a piece of hardware for quality control, product functionality, or performance in other respects. M's purpose is not to provide ordinary testing of products and it does not replace or supplement the ordinary testing or inspection procedures used by a manufacturer of its product, but rather to ensure with other products among different O systems. In this respect, M is providing a service that benefits the entire industry rather than providing a particular service for individual manufacturers.

ISSUE TWO

In order to determine whether M's distributive share of the ordinary income from N constitutes unrelated business income, it is necessary to "look through" the partnership and determine whether N's trade or business is substantially related to M's exempt purposes. N's purpose is to facilitate the adoption of T by licensing arrangements in a manner that forces both patent holders and users to share technology in a fair and nondiscriminatory manner. M states that the licensing of technology and the dissemination of information to manufacturers for incorporation with products manufactured and sold to O companies is one of the key exempt purposes of M. This purpose, in consideration of all the facts and circumstances, is not considered to be a particular service because it is offered to the entire industry on a nondiscriminatory basis. Such purpose is therefore considered to be an exempt purpose within the meaning of section 501(c)(6) of the Code, and N's activity in this regard is substantially related to M's exempt purposes within the meaning of sections 1.513-1(d)(1) and (2) of the regulations.

Accordingly, based on the facts and circumstances concerning the proposed transaction as stated above, we rule as follows:

(1) Certification revenue generated by M is not considered unrelated business taxable income under section 513 of the Code because certification is directly related to M's exempt purpose.

(2) M's allocable share of the income and expenses of N that are attributable to N's administration of the intellectual property rights associated with any version of T used by the United States O industry is not unrelated business taxable income under section 513.

These rulings are based on the facts as they were presented and on the understanding that there will be no material changes in these facts. Any such change should be reported to the Ohio Tax exempt and Government Entities (TE/GE) Customer Service Office. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records. A copy of this ruling is being forwarded to the Ohio TE/GE Customer Service Office.

Except as we have specifically ruled herein, we express no opinion as to the consequences of this transaction under the cited provisions or under any other provision of the Code. No position is taken as to the unrelated business tax treatment of M's allocable share of the income and expenses of N that are not attributable to T used by the United States O industry.

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.

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.

Sincerely yours,

Jane Baniewicz
Manager, Exempt Organizations
Technical Group 2