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

**TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION**

Release Number: **200715015**
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Contact Person:

Identification Number:

UIL No.
501.03-00
512.00-00
4941.00-00
4943.00-00

Telephone Number:

Employer Identification Number:

Legend:
A =
B =
C =
D =
E =
Corporation =
LLC =
LP =
Date x =
y =
z =
aa =

Dear :

This letter is in response to your request seeking various rulings relating to the proposed transactions described below.

Facts

You were formed on Date x as a charitable trust under state law. You are controlled and operated by A, B, C and D, who serve as your Trustees. A and B are members of the E family. Your exempt purpose and sole activity is to make annual and periodical grants to such public charities as your Trustees determine from time to time to be appropriate. The Internal Revenue

Service has recognized you as a private foundation described in sections 501(c)(3) and 509(a) of the Internal Code.

Corporation is a large closely-held private company engaged in the commercial manufacturing business. Corporation is owned, directly and indirectly, by members of the E family through various entities they control.

LLC is a limited liability company under state law, the members of which are A and B.

LP is a limited partnership under state law. LLC owns a y percent general partnership interest in LP ("General Partner") and Corporation owns a aa percent limited partnership interest ("Limited Partner"). The two partners of LP will enter into an Agreement of Limited Partnership ("LP Agreement"). Under this agreement, LLC will contribute cash to LP and Corporation will contribute the exclusive ownership of certain trademarks, applications and registrations owned by Corporation ("Trademarks").

Pursuant to a proposed Trademark License Agreement ("License Agreement") between LP and Corporation, LP will grant to Corporation an exclusive right and license to use the Trademarks, on a worldwide basis, on or in association with the manufacture and sales of its manufactured products, and services relating to installation, maintenance, repair and servicing of the foregoing (the "Licensed Products"), as well as on related packaging and promotional and advertising material. For this exclusive right and license to use the Trademarks, Corporation will pay LP an annual royalty based on increasing percentages of "Net Sales" by Corporation of the Licensed Products. The percentages range from y percent to z percent of "Net Sales," which are defined as gross revenues less annual returns, discounts and freight losses.

The License Agreement provides that Corporation is permitted to review and approve or reject the proposed use of its trademarks and may inspect the facilities where the licensed products are produced, with prior notice, once per year. Under the LP Agreement, the General Partner is responsible for the management of the business and affairs of LP, and the Limited Partner has no right or power to take part in any way in the control of business of LP.

Corporation proposes to contribute to you its aa percent limited partnership interest in LP. As a result, you will become a Limited Partner in LP and will become a party to the Agreement of Limited Partnership with LLC. When LP receives royalty payments from Corporation pursuant to the License Agreement, LP will make distributions of these payments to its partners, including you. You will use these cash distributions to make grants to public charities.

Rulings Requested

1. Your receipt from Corporation of the limited partnership interest in LP will not result in unrelated business taxable income to you within the meaning of section 512 of the Code.
2. Your receipt from Corporation of royalties through LP will not result in unrelated business taxable income to you within the meaning of section 512 of the Code.

3. Your receipt from Corporation, and the continued ownership by you, of the limited partnership interest in LP, will not result in excess business holdings under section 4943 of the Code.

4. Your receipt from Corporation, and continued ownership by you, of the limited partnership interest in LP will not be an act of self-dealing to you under section 4941 of the Code.

5. Your receipt from Corporation of royalties through LP will not be an act of self-dealing to you under section 4941 of the Code.

6. Your receipt from Corporation, and continued ownership by you, of the limited partnership interest in LP will not jeopardize your tax-exempt status under section 501(c)(3) of the Code.

7. Your receipt from Corporation of royalties through LP will not jeopardize your tax-exempt status under section 501(c)(3) of the Code.

Law

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and other purposes, provided that no part of the net earnings inure to the benefit of any private shareholder or individual.

Section 511 of the Code provides that organizations recognized as exempt from federal income tax must pay tax on unrelated business income, as defined in section 512 of the Code.

Section 512 of the Code defines the term "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less the allowable deductions that are directly connected to such trade or business. However, section 512(b)(2) modifies the term unrelated business taxable income by excluding, among other things, all royalties whether measured by production or by gross or taxable income from the property and all deductions directly connected with that income.

Section 1.512(c)-1 of the Income Tax Regulations provides that if an exempt organization that is a member of a partnership that engages in an unrelated trade or business with respect to the organization, it must include, in computing its unrelated business taxable income, the distributive share of the partnership's gross income derived from the unrelated business and its share of applicable deductions.

Section 513(a) of the Code defines the term "unrelated trade or business" as a trade or business that is not substantially related to the exercise or performance by an organization of its charitable, educational or other purposes or functions constituting the basis for its exemption under section 501(c)(3), with exceptions not here relevant.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 of the Code, the term "trade or business" has the same meaning as it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(c) of the regulations provides that in determining whether a trade or business is “regularly carried on,” within the meaning of section 512 of the Code, the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued must be considered.

Section 4941 of the Code imposes excise taxes on any act of self-dealing between a private foundation and a disqualified person, as defined in section 4946(a)(1).

Section 4941(d) of the Code states that the term “self-dealing” means certain direct and indirect transactions between a private foundation and a disqualified person: the sale or exchange, or leasing, of property; the lending of money or other extension of credit; describes the furnishing of goods, services, or facilities; describes the payment of compensation or the payment or reimbursement of expenses; the transfer to, or use by or for the benefit of, the income or assets of a private foundation; and agreement to make any payment to a government official. These transactions are also described in section 53.4941(d)-2 of the Foundation and Similar Excise Taxes Regulations.

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, which 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)(3) 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 section 4943(d)(3) of the Code, 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 royalties excluded by section 512(b)(2) of the Code.

Section 4946 of the Code defines the term "disqualified person" with respect to a private foundation. Section 4946(a)(1)(E) provides that a disqualified person includes a corporation of which "foundation managers" own, directly and indirectly, more than 35 percent of the total combined voting power. Section 4946(b) defines the term "foundation manager" with respect to a private foundation to include an officer, director or trustee of the private foundation.

Rev. Rul. 81-178, 1981-2 C.B. 135, distinguished royalty income that is not subject to the tax on unrelated business income from compensation for services that is subject to the tax on unrelated business income. One organization was paid solely for the use of trademarks, trade names, copyrights, photographs, and facsimile signatures. The agreements setting the fees gave the organization the right to approve the quality and style of the licensed products, which did not change the character of the income as royalties. A second organization was compensated for active endorsement of products and services, including personal appearances and interviews by members of the organization. Such payment is compensation for services, and thus not within the royalty exception of section 512(b)(2) of the Code.

The court in Sierra Club v. Commissioner, 86 F.3d 1526 (9th Cir. 1996), aff'g T.C. Memo 1993-199, rev'g on another issue, 103 T.C. 307 (1994), thoroughly considered the definition of the term "royalties" as used in section 512(b) of the Code. It held that, in the context of section 512(b), royalties are defined as payments received for the right to use intangible property; and that a royalty is passive and cannot include payments for services rendered by the owner of the property.

In Oregon State University Alumni Association v. Commissioner, 193 F.3d 1098 (9th Cir. 1999), the issue was whether the bank was paying the alumni associations for the good will associated with the schools' names, seals, colors, and logos or whether it was paying them for mailing list management and promotional services. The court concluded that the payments were royalties because they were made for the use of the property rights, not for the minimal services.

Analysis

Ruling 1

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by an exempt organization from any unrelated trade or business, as defined in section 513, regularly carried on by it.

Section 513(a)(1) of the Code defines the term "unrelated trade or business" as a trade or business that is not substantially related to the exercise or performance by an organization of its exempt purposes of functions.

Section 1.513-1(b) of the regulations provides that the term "trade or business" has the same meaning as it has in section 162 of the Code, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(c) of the regulations provides that in determining whether a trade or business is "regularly carried on," within the meaning of section 512 of the Code, the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued must be considered.

Corporation proposes to contribute to you its aa percent limited partnership interest in LP. Thus, you will become a Limited Partner in LP and will become a party to the Agreement of Limited Partnership with LLC. Under the LP Agreement, the General Partner, LLC, has management authority over the operations of LP. Under the LP Agreement, as a Limited Partner, you will have no authority to manage and operate LP, but will hold the LP interest as a passive investor. Consequently, since your receipt of the limited partnership interest as a contribution from Corporation is not a trade or business that is regularly carried on, the receipt of this contribution will not result in income from an unrelated trade or business within the meaning of section 513 of the Code, and thus will not result in unrelated business taxable income to you within the meaning of section 512(a)(1).

Ruling 2

Section 512(b)(2) of the Code provides that the term "unrelated business taxable income" does not include royalties. In Situation 1 in Rev. Rul. 81-178, supra, the organization received payments solely for the use of certain of its intangible property. Although under the arrangement, the organization had the right to approve the quality and style of the licensed products or services, that did not change the character of the income as royalties under section 512(b)(2). In Situation 2, the organization received compensation for the active management of products and services, including personal appearances and interviews. These payments were not royalties but payments for services. In Sierra Club, supra, the court defined royalties as payments received for the right to use intangible property, and cannot include payments for services rendered by the owner of the property. See also, Oregon State University Alumni Association, supra.

Under the License Agreement, LP will grant to Corporation an exclusive right and license to use the Trademarks in connection with the Licensed Products. In return, Corporation will pay LP an annual royalty based on the net sales of the Licensed Products by Corporation. Under the License Agreement, Corporation is permitted to review and approve or reject the proposed use of the Trademarks and may inspect the facilities where the licensed products are produced, with prior notice, once per year.

Thus, Corporation is licensing intangible property to LP and is providing only minimal services to LP. Consistent with Situation 1 in Rev. Rul. 81-178 and the decisions in Sierra Club and Oregon State University Alumni Association, the arrangement under the License Agreement is that of a license of intangible property, and the corresponding payments made by Corporation to LP constitute royalties to LP within the meaning of section 512(b)(2) of the Code.

Consequently, under the principles of section 1.512(c)-1 of the regulations, these royalties, whether or not distributed by LP to you, will also constitute royalties to you within the meaning of section 512(b)(2) of the Code.

Ruling 3

As a result of Corporation's contribution of its aa percent limited partnership interest in LP to you, you will become the owner of this limited partnership interest. Therefore, as a Limited Partner in LP, you will receive distributions from LP of its share of royalties Corporation will pay LP pursuant to the License Agreement. LP will derive virtually all of its income from these royalty payments. As concluded in Ruling 2, these payments constitute royalties within the meaning of section 512(b)(2) of the Code. Section 4943(d)(3) and section 53.4943-10(c)(2) of the regulations provides that the term "business royalties" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources, including royalties under section 512(b)(2) of the code. Thus, LP does not constitute a business enterprise and under section 4943(a), your ownership of the limited partnership interest in LP does not constitute a business holding. Accordingly, your ownership of the limited partnership interest in LP does not result in an excess business holding to you under section 4943.

Rulings 4 and 5

Section 4941 of the Code imposes excise taxes on any act of self-dealing, whether direct or indirect, between a private foundation and a disqualified person. Section 4941(d) lists the types of transactions that constitute acts of self-dealing.

Corporation is owned, directly and indirectly, by members of the E family through various entities they control. Several members of the E family serve as your Trustees. Thus, under section 4946 of the Code, because the E family constitute foundation managers with respect to you and the E family controls Corporation, Corporation is a disqualified person with respect to you.

As a result of Corporation's contribution of its aa percent limited partnership interest in LP to you, you will become the owner of this interest. Therefore, as a Limited Partner in LP, you will receive distributions from LP of its share of royalties Corporation will pay LP pursuant to the License Agreement. Although Corporation is a disqualified person with respect to you, neither your receipt of the contribution of the limited partnership interest from Corporation nor your receipt of your share of royalties from LP as a Limited Partner in LP are transactions described in section 4941(d) of the Code or section 53.4941(d)-2 of the regulations. Thus, neither transaction constitutes a direct or indirect act of self-dealing between you and Corporation under section 4941 of the Code.

Rulings 6 and 7

The Internal Revenue Service has recognized you as a private foundation described in sections 501(c)(3) and 509(a) of the Code. Your exempt purpose and sole activity is to make annual and periodical grants to such public charities as your Trustees determine from time to time to be appropriate.

As a result of Corporation's contribution of its aa percent limited partnership interest in

LP to you, you will become the owner of this interest. Therefore, as a Limited Partner in LP, you will receive distributions from LP of its share of royalties Corporation will pay LP pursuant to the License Agreement. You will continue to use these distributions to make grants to public charities. Neither your receipt from Corporation of the contribution of its limited partnership interest in LP, nor your continued ownership of this interest, nor your receipt of its share of royalties from LP as a Limited Partner in LP, will have an adverse impact on your exempt activities or purposes. As a result, neither of these transactions will jeopardize your tax-exempt status under section 501(c)(3) of the Code.

Rulings

1. Your receipt from Corporation of the limited partnership interest in LP will not result in unrelated business taxable income to you within the meaning of section 512 of the Code.
2. Your receipt from Corporation of royalties through LP will not result in unrelated business taxable income to you within the meaning of section 512 of the Code.
3. Your receipt from Corporation, and the continued ownership by you, of the limited partnership interest in LP, will not result in excess business holdings under section 4943 of the Code.
4. Your receipt from Corporation, and continued ownership by you, of the limited partnership interest in LP will not be an act of self-dealing to you under section 4941 of the Code.
5. Your receipt from Corporation of royalties through LP will not be an act of self-dealing to you under section 4941 of the Code.
6. Your receipt from Corporation, and continued ownership by you, of the limited partnership interest in LP will not jeopardize your tax-exempt status under section 501(c)(3) of the Code.
7. Your receipt from Corporation of royalties through LP will not jeopardize your tax-exempt status under section 501(c)(3) of the Code.

This ruling is based on the understanding there will be no material changes in the facts upon which it is based.

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.

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

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.

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,

Steven B. Grodnitzky
Manager
Exempt Organizations
Technical Group 1

Enclosure
Notice 437