

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Release Number: **200727020**

Release Date: 7/6/07

Date: April 12, 2007

UIL: 501.03-33, 501.32-00, 513.00-00

E.O. Exams Programs and Review
Internal Revenue Service
1100 Commerce Street
MC 4900 DAL
Dallas, TX 75242

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Years Involved:

Date of Conference:

Legend:

M =

P =

Q =

R1 =

R2 =

S =

T =

U =

A =

x =

Date 1 =

Date 2 =

City =

State =

ISSUES:

1. Whether M is engaged in an exempt activity in furtherance of its 501(c)(3) purposes in the operation of P.
2. Whether M's operations resulted in inurement or private benefit to persons related to foundation managers and substantial contributors to M.
3. Whether part of the income from the operations of P constituted income from an unrelated trade or business under section 513 of the Code.

FACTS:

M is a not-for-profit corporation formed under the laws of State in 1988 by Q, a private foundation described in section 509(a) of the Code. M is exempt from federal income tax as an organization described in section 501(c)(3). M is classified as a private operating foundation.

M's articles of incorporation provide that it is organized as follows:

1. To operate a botanical gardens and park in City, State on a racially nondiscriminatory basis;
2. To lessen the burdens of government;
3. To conduct educational programs and research regarding botanical subjects; and
4. To carry on other charitable, scientific, literary or educational activities within the meaning of section 501(c)(3) of the Code.

Operation of P

M operates P, a complex of educational, recreational, hotel and convention center facilities in City, State. The educational and recreational components include an aquarium, horticultural conservatories, and an IMAX theatre open to the public for admission fees, a hotel, and a convention center.

Q and City entered into a lease agreement ("Lease"), effective Date 1 whereby Q would lease the property from the City for the development of the proposed civic and tourist attraction, known as P. P is not a separate legal entity, but is instead the structures, activities and attractions located on the property. The Lease granted the use of the property to Q for 40 years. The purpose was for Q to make significant improvements to the property, e.g. botanical garden, water park, public beach, children's zoo, campground, nature trails, restaurant and meeting rooms. The property is in an economically depressed, blighted area of City.

In 1990, City through U, a City agency, entered into an agreement with M and Q governing the operation and management of P and providing that all assets comprising P, other than animals, are owned by U. Q assigned its lease in the underlying land to U, along with the facilities that were constructed on the property. At all times, the title to property is held in the name of U. Employees are considered employees of M and not U. M must receive prior approval from U before using its name or logo or that of City in its promotions.

M contracts for all operation and maintenance services (electric, gas, water, etc.). M underwrites the expenses of P and is responsible for any liabilities and expenses. U is not responsible for any expenses or liabilities. All profits generated by P are earmarked to remain with P to be used for its operation, maintenance and expansion. City does not subsidize any operating deficits, nor can it use any profits for outside projects. M receives almost 100% of its contributions from Q, which it uses to construct recreational, tourist and business facilities.

In 1994, M, Q and U jointly requested a private letter ruling before proceeding with the construction of the hotel and aquarium facilities at the Complex. At the time of the request, the improvements were meant to increase the number of public users of the facilities and to become the City's main convention center and tourist attraction. Construction of the hotel was intended for the convenience of the visitors to the convention center and the Complex. A majority of the guests of the hotel were expected to be participants at events held at the convention center or at the Complex. The ruling held that M's operation of the aquarium and hotel would not constitute excess business holdings under section 4943 of the Code.

The hotel at P is similar in appearance and amenities to any comparable for-profit hotel. The hotel generated a little less than half of the gross sales of P in FY 2000. The hotel also provides, for a fee, valet parking, room service, movies, and dry cleaning/laundry service. Similar to for-profit hotels, P offered complimentary rooms to various groups, including employees of business entities owned by A's family, groups with at least 50 guests, potential group businesses that are invited on-site for inspections prior to signing a contract, entertainers and performers for special events, guests that have had a poor experience at the hotel, and numerous employees.

P also operates a number of gift shops at the hotel and at the various attractions. The gift shops sell a variety of household items and arts and crafts.

In a private letter ruling to M, PLR 9551937 dated September 28, 1995, the Service held that the amounts that M received from admission receipts to the aquarium and as rental receipts from its operation of the hotel, that are paid by guests of the hotel visiting P, will not constitute unrelated business taxable income. This private letter ruling did not address all of the business activities conducted at P.

Dealings with Persons Related to Foundation Managers and Substantial Contributors

In 1996, City entered into a management contract with M for the management of P, which consists of the infrastructure and activities conducted on the leased land. In turn, M subcontracted the management contract to R1, a subsidiary of R2, a for-profit entity owned by Q, S and T. All of these entities were founded and effectively controlled by A and/or close members of his family. For each of the years in issue, A was granted the proxies for both Q and S to vote all of the stock of R1 owned by each.

R1 and R2 were both established companies at the time of their initial dealings with M (and still are). The contract with M is a small part of their business.

The contract provides among other things that primary legal and managerial responsibility is

retained by M. R1 runs the day-to-day operations of P on behalf of M. R1 is responsible for the employment, payment, training and supervision of all employees; however the employees are not employees of R1 but of M. R1 acts as agent for M to negotiate leases and licenses; to provide maintenance and upkeep; and to assist M in preparing reports for U.

In 1998, City approved an extension of M's management contract with R1. The amendment extended its primary term for 15 years ending on Date 1, and provided for two optional 5-year extensions that are exercisable only by M at its sole discretion. These options have not been exercised by M at this time.

For the years in issue, the management fee paid to R1 was set at a flat figure of \$x per year. The management contract has never been put out to public bid, or contracted for in any similar competitive process. M has furnished an appraisal attesting to the reasonableness of the compensation of R1.

In addition to management services, M also contracted with entities affiliated with A or family members of A for banking and insurance services. M represents that the contractual terms and fees were reasonable.

LAW:

Section 501(a) of the Internal Revenue Code provides that an organization shall be exempt from taxation if it is an organization described in subsection (c) or (d) of the same section. Subsection (c) of section 501 includes in its list of organizations qualifying for tax-exempt status under section 501(a) organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(c)(2) of the Income Tax Regulations provide that, in order for an organization to qualify for exemption under IRC 501(c)(3), no part of the organization's net earning may inure to the benefit of any private shareholder or individual. A "private shareholder or individual" is defined as any person having a personal and private interest in the activities of the organization. Section 1.501(a)-1(c) of the regulations. An organization is not organized or operated for one or more of the exempt purposes enumerated in section 1.501(c)(3)-a(d)(1)(i), and thus is not described in 501(c)(3) of the Code, if it is organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or person controlled, directly or indirectly by such interests. Section 501(c)(3); Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations.

Revenue Ruling 85-1, 1985-2 C.B. 177 provides that the determination of whether an organization is lessening the burdens of government requires consideration of whether the organization's activities are activities that a governmental unit considers to be its burden, and whether such activities actually lessen such governmental burden. An activity is a burden of the government if there is objective manifestation by the government unit that it considers the activities of the organization to be its burden. Such consideration may be evidenced by the interrelationship between the governmental unit and the organization. In this context, the lessening of the burdens of government is determined by considering all relevant facts and circumstances; however, a favorable working relationship between the government and the

organization is strong evidence that the organization is actually "lessening" the burdens of government.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(a). Unrelated business taxable income is defined in section 512 of the Code as the gross income derived by any organization carried on by it, less the deductions allowed by the same chapter, which are directly connected with the carrying on of such trade or business

Section 513 of the Code provides that unrelated trade or business is any trade or business, the conduct of which is not substantially related (aside from the need for income) to the exercise or performance of the organization's exempt purpose or function that constitutes the basis for its exemption under section 501.

Section 513(c) of the Code provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities, or within a larger complex of other endeavors which may, or may not, be related to the exempt purpose of the organization.

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 substantial causal relationship to the achievement of exempt purposes. 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.

Section 53.4942(a)-2(c)(3)(iii) of the Foundation and Similar Excise Tax Regulations provides in example 1 that X, a private foundation that maintains a community of historic value which is open to the general public. For the convenience of the public, X through wholly owned, separately incorporated, taxable entity, maintains a restaurant and hotel in the community. Such facilities are within the larger aggregate of activities which makes available for public enjoyment the various buildings of historic interest and which is related to X's exempt purpose. Under such circumstances, the operation of the restaurant and hotel constitutes a functionally related business.

RATIONALE:

1. Exempt Activity

Whether the operation of P is an exempt activity requires an analysis of the facts and

circumstances. M's purpose is to develop, operate and maintain the property leased to it by U. M was created for the specific purpose of undertaking the joint development and operation of P. City through U considers the operation of P to be its burden, as set out in Rev. Proc. 85-1, *supra*. Through U, it oversees the operations of P. The land and buildings are owned by City or U, while the lease on the land is owned by Q. In addition, City has credited the dollars spent against the rent for improvements. Such ownership by U as well as the joint undertaking of the activities shows that the activities and operations of P are considered by the government to be its burdens. Because operation of P itself is one of M's exempt purposes on behalf of City government under the specific facts presented, we conclude that M is operated for exempt purposes as described in section 501(c)(3) of the Code.

2. Inurement and Private Benefit

While insiders of M benefit from the management and other contracts with M, we find the benefit to be incidental under the facts and circumstances. The contracts, while not competitively bid, generally appear reasonable, other than a lengthy management term, and the fees not excessive. The amounts involved are but a small portion of M's total expenses. The businesses at issue are well-established businesses dealing with the general public and not operating primarily to do business with M.

3. Unrelated Business

In the instant case, there is no dispute that M is engaged in businesses, that they are regularly carried on, and that they do not fall within the modifications described in section 512(b) of the Code. The sole issue is whether one or more of such businesses are not substantially related to the exempt purposes of M.

With a typical charitable organization, many of the individual income-producing activities carried on by M in the operation of P would likely be unrelated. However, based on the facts and circumstances, including the scope and motivation for the activities, the income-generating activities, from hotel services to eating establishments, are substantially related to the accomplishment of M's exempt purpose of lessening the burdens of government.

CONCLUSION:

1. M is engaged in an exempt activity in furtherance of its 501(c)(3) purposes in the operation of P.
2. M's operations did not result in inurement or private benefit to persons related to foundation managers and substantial contributors to M.
3. The income from the operations of P constituted income from related trades or businesses under section 513 of the Code.

A copy of this memorandum is to be given to M. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.