



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Grantor        =  
Museum       =  
Transferor    =  
x               =  
y               =

Dear               :

This letter supersedes our letter ruling to you dated June 6, 2014 in response to your ruling request regarding the proper treatment of a transfer of part of the assets of another private foundation to you under §§ 507 and 4943, and whether certain activities are subject to unrelated business income tax under §§ 511, 512, and 513 of the Internal Revenue Code (I.R.C.).

Facts:

You are a nonprofit corporation described in § 501(c)(3) and classified as a private operating foundation under § 509(a) that you represent is described in § 4942(j)(3). Your purposes are charitable and educational. Your mission is to promote the appreciation of, and education about, Grantor's art medium specifically and public art generally, primarily through the creation, maintenance, and public placement of artwork created by Grantor ("Artwork").

Museum is a § 501(c)(3) organization and classified as a public charity under § 509(a)(2) that operates a museum and park with permanent and seasonal exhibits, concerts, dance and drama performances, film screenings, fairs and celebrations, community gatherings, arboretum, and shopping and dining. Works by well-known and emerging American and international artists (including Grantor) are accessibly exhibited and interpreted through publications, lecture, workshops, and other educational programs.

Transferor is a private operating foundation that will make two transfers of assets. It will first transfer about y%, which is more than 25%, of its assets to you and then the remainder to Museum. Transferor will then provide notice of termination to the Secretary at least one day after the transfer to Museum is completed and then terminate its private foundation status under § 507(a)(1). You represent that Transferor will exercise expenditure responsibility over its grants to

you until such time as it disposes of all of its assets, and it will satisfy the § 4945(h) reporting requirements for the taxable year in which the final transfers are made. You and Transferor have nearly identical governance structures with control of both currently vested in Grantor, Grantor's son, and Grantor's nephew.

After the transfers, you will own all of Grantor's incomplete Artworks, future Artworks, as well as the preparatory works, the copyrights to all of Grantor's Artworks, and a significant amount of Grantor's completed Artworks.

You will curate and sponsor traveling exhibitions of Artwork and conduct related on-site educational programming without charge to the public in most cases, and on occasion subject to a nominal fee. Exhibit sites will include blighted urban centers and rural areas with little or no arts budgets or programming. You will loan art pieces to museums, cultural institutions, other nonprofit organizations, and municipalities, and work with private individuals or organizations to display the art in public venues. You will charge exhibition fees to organizations hosting the art but will reduce or eliminate fees for organizations unable to pay the full amounts. You represent that when charged fees will be in amounts comparable to fees charged by other organizations for similar loans of art.

Your workshop and studio activity will provide creation, conservation, and maintenance services ("Production and Maintenance Services") for Artworks. You will provide these services to Museum and other tax-exempt organizations that publicly display art, and to non-exempt organizations that commit contractually to publicly display their art and/or use the art for educational purposes for a significant period of time. You state that fees for services will be fair market value or less but not in excess of your costs.

You represent that no more than x% of your Production and Maintenance Services will be for artwork created by individual artists and/or works owned and displayed privately by organizations and private collectors. Your interns will perform the work as part of the education. You will charge either fair market value or the amount necessary to cover your costs. Any excess fees will not greatly exceed the educational needs of the interns you train.

You represent that your educational activity will educate the public about the process of creating art, demonstrate the many ways art can be protected and finished for public display, train individuals in the techniques for making art, and educate the public about Artwork. You will conduct public demonstrations and lectures and invite Museum members and other groups to visit the studios and workshops. You are committed to providing such public demonstrations, lectures, and tours without regard to ability to pay. You state that admission to these educational events is generally free but in some instances, you will charge modest admission fees. In describing how you determine the admission fees, you state that the fees charged for public demonstrations and lectures are comparable to, or less than, the fees charged by other organizations and are intended to cover or defray your costs in providing these events. Similarly, the fees charged for visits and/or tours to your studios and workshops are intended to cover or defray the costs of any consumables provided to attendees and any other costs in connection with the visit or tour. School groups, which comprise tens of thousands of students annually, are charged no fees at all for these services. In addition, if an individual or group is unable to pay the full amount of any applicable fee, you will reduce or eliminate the fee.

You will catalogue and maintain the definitive list of Grantor created art, and make catalogues available to the public for research, educational, and authentication purposes. You will offer internships to post-secondary and post-graduate students in the Grantor's medium. Interns will study and practice methods and techniques of Grantor's medium, and can participate in archival, publication, and exhibition projects.

As part of your effort to enhance the public understanding and appreciation of the Grantor's medium, you will produce limited edition Artwork for sale at significant discount to museums, municipalities, and other tax-exempt entities for public display or educational purposes. You will sell to non-exempt entities who commit contractually to publicly display the art or use the art for educational purposes for a significant amount of time at fair market value, and sell a limited number of art pieces to private parties who ultimately commit to loaning or gifting the purchased art to exempt organizations or municipalities for public displays, and such sales will be at fair market value.

You may also from time to time sell original Artworks that were part of your permanent collection for fundraising purposes. Sales will be on the same terms with respect to public or private organizations, or individuals as described above for Artworks created as inventory for sale.

Finally, you will also license the sale of reproductions, using fee structures comparable to fees charged by other organizations for similar licensing activity not to exceed fair market value. You will not provide any services in connection with licensing agreements other than quality control.

#### Rulings Requested:

You have requested the following rulings:

1. You shall not be treated as a newly created organization following Transferor's transfer of assets to you pursuant to a reorganization as described in § 507(b)(2).
2. You will succeed to Transferor's aggregate tax benefit in proportion to the amount of the fair market value of the assets you receive from it.
3. Your applicable holding period in the transferred assets for purposes of § 4943(c)(4), (5) and (6) includes both the period during which Transferor held such assets and the period during which you hold such assets.
4. Transferor will not be transferring all of its net assets to a private foundation that is effectively controlled, directly or indirectly, by the same person or persons that effectively controlled the transferor private foundation. Therefore, you should not be treated as if you were Transferor for purposes of Chapter 42 and §§ 507 through 509.
5. Any person who is a substantial contributor within the meaning of § 507(d)(2) with respect to Transferor will be treated as a substantial contributor with respect to you, regardless of whether such person meets the \$5,000/two percent test with respect to you at any time.

6. You will receive the transferred assets subject to Transferor's prior excise tax liabilities under Chapter 42 (and any penalty resulting therefrom), if any, to the extent Transferor did not previously satisfy those liabilities.
7. Your Grantor medium Production Services and Maintenance Services for Museum, and for other tax-exempt organizations that publicly display art and/or use it for educational purposes, and non-exempt organizations that commit contractually to publicly display their art and/or use their art for educational purposes for a significant period of time, are substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), and revenue from such services does not result in unrelated business taxable income (UBTI) as defined in § 512(a)(1).
8. Your Grantor medium Production Services and Maintenance Services for art created by individual artists, or owned by organizations and private collectors and displayed privately are substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), and revenue from such Services does not result in unrelated business taxable income as defined in § 512(a)(1).
9. Sales of original Artwork held as inventory to tax-exempt and public entities for public display or other educational purposes, and to non-exempt entities that commit contractually to publicly display their Artwork and/or use their Artwork for educational purposes for a significant period of time, are substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), and revenue from such sales does not result in unrelated business taxable income as defined in § 512(a)(1).
10. Licensing of Artwork images is substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), falls under the modification for royalty income provided in § 512(b)(2), and does not result in unrelated business taxable income as defined in § 512(a)(1).

Law:

I.R.C. § 501(c)(3) provides an exemption from federal tax for organizations that are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

I.R.C. § 507(a)(1) states that a private foundation may voluntarily terminate its private foundation status by submitting to the Internal Revenue Service a statement of its intention to voluntarily terminate its private foundation status pursuant to § 507(a)(1) and by paying any termination tax under § 507(c).

I.R.C. § 507(b)(2) states that, in the case of a transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization, the transferee private foundation shall not be treated as a newly created organization.

I.R.C. § 507(c) imposes an excise tax equal to the lower of: (1) the aggregate tax benefits that have resulted from the private foundation's exempt status under § 501(c)(3), or (2) the value of the net assets of the private foundation on an organization that voluntarily terminates its private foundation status.

I.R.C. § 511(a)(1) imposes a tax on the unrelated business taxable income (as defined in § 512) of certain organizations including those described in § 501(c)(3).

I.R.C. § 512(a)(1) defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it, less certain deductions, and computational modifications.

I.R.C. § 513(a) provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the organization's need for income or funds or the use it makes of the profits derived) to the exercise or performance of an organization's purpose or function constituting the basis for its exemption under § 501.

I.R.C. § 513(c) provides that 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 purposes of the organization.

I.R.C. § 4943 imposes an excise tax on the excess business holdings of a private foundation in a business enterprise during any taxable year that ends in the taxable period. Excess business holdings are generally the amount of interests in the business enterprise greater than the permitted holdings. Where disqualified persons also have business holdings in the same business enterprise then the private foundation's otherwise permitted holdings are reduced by those amounts. A private foundation is allowed a five year period to dispose of certain large gifts and bequests without incurring the excise tax.

Treas. Reg. § 1.507-3(a)(1) states that in the case of a significant disposition of assets to one or more private foundations, within the meaning of paragraph (c) of this section which describes a § 507(b)(2) transfer, the transferee organization shall not be treated as a newly created organization, but shall succeed to those attributes and characteristics of the transferor organization described in Treas. Reg. § 1.507-3(a)(2), (3), and (4), which include its aggregate tax benefit, substantial contributors, and chapter 42 tax and penalty liabilities.

Treas. Reg. § 1.507-3(a)(2) states, in part, that a transferee organization to which this paragraph applies shall succeed to the aggregate tax benefit of the transferor organization.

Treas. Reg. § 1.507-3(a)(3) states that, for purposes of § 507(d)(2), in the event of a transfer of assets described in § 507(b)(2), any person who is a "substantial contributor" (within the meaning of § 507(d)(2)) with respect to the transferor foundation will be treated as a "substantial contributor" with respect to the transferee foundation, regardless of whether such person meets the \$5,000-two percent test with respect to the transferee organization at any time.

Treas. Reg. § 1.507-3(a)(4) states that if a private foundation incurs a liability for one or more of the taxes imposed under chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in § 507(b)(2) to one or more private foundations, in any case where transferee liability applies, each transferee foundation shall be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.

Treas. Reg. § 1.507-3(a)(6) provides that when a private foundation makes a § 507(b)(2) transfer of all or part of its net assets to another private foundation, the applicable period of time described in § 4943(c)(4), (5), or (6) shall include both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets.

Treas. Reg. § 1.507-3(a)(8)(ii) sets forth certain rules that apply to the transferee foundation with respect to the assets transferred in a § 507(b)(2) transfer to the same extent and in the same manner that they would have applied to the transferor foundation had the § 507(b)(2) transfer not been effected, mostly in the nature of transitional rules of limited scope for the Tax Reform Act of 1969.

Treas. Reg. § 1.507-3(a)(9)(i) provides that if a private foundation transfers all of its net assets to one or more private foundations which are effectively controlled (within the meaning of Treas. Reg. § 1.482-1(a)(3)), directly or indirectly, by the same person or persons which effectively controlled the transferor private foundation, for purposes of chapter 42 (§ 4940 et seq.) and part II of subchapter F of chapter 1 of the Code (§§ 507 through 509) such a transferee private foundation shall be treated as if it were the transferor.

Treas. Reg. § 1.507-3(c)(1) states that a transfer of assets is described in § 507(b)(2) if it is made by a private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization.

Treas. Reg. § 1.507-3(c)(2) defines the term "significant disposition of assets to one or more private foundations" as any disposition or series of dispositions where the cumulative total of dispositions is 25 percent or more of the fair market value of the net assets of the foundation at the beginning of the taxable year.

Treas. Reg. § 1.507-4(b) states that private foundations which make transfers described in § 507(b)(2) are not subject to the tax imposed under § 507(c) with respect to such transfers unless the provisions of § 507(a) become applicable.

Treas. Reg. § 1.513-1(d)(2) provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income); and that it is "substantially related", for purposes of § 513, only if the causal relationship is a substantial one. 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.

Treas. Reg. § 1.513-1(d)(3) directs that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.

In Example 1 of Treas. Reg. § 1.513-1(d), an organization described in § 501(c)(3) operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business.

Treas. Reg. § 53.4946-1(a)(8) states that, for purposes of § 4941 only, the term "disqualified person" shall not include any organization which is described in § 501(c)(3) (other than an organization described in § 509(a)(4)).

In Rev. Rul. 69-269, 1969-1 C.B. 160, a hospital was concerned with providing sufficient parking space for visitors because visitation is considered to be supportive therapy and part of patient treatment. Because of a serious lack of adequate parking space, the hospital constructed adjacent to its main building a parking lot for patients and visitors only. The lot is not for general public utilization. A fee is charged for the use of these facilities and all profits are placed in the hospital's general operating fund. The ruling holds that providing such facilities contributes importantly to the accomplishment of the hospital's exempt purpose. Accordingly, this activity is substantially related to the purpose constituting the basis for the hospital's exemption and does not constitute unrelated trade or business within the meaning of § 513.

In Rev. Rul. 73-104, 1973-1 C.B. 263, the museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of works of art. The sale of greeting cards displaying printed reproductions of art works in the museum's collection contributes importantly to the achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest, and appreciation of art. Moreover, a broader segment of the public may be encouraged to visit the museum itself to share in its educational functions and programs as a result of seeing the cards. The fact that the cards are promoted and sold in a clearly commercial manner at a profit and in competition with commercial greeting card publishers does not alter the fact of the activity's relatedness to the museum's exempt purpose.

In Rev. Rul. 80-295, 1980-2 C.B. 194, the broadcasting of the organization's sponsored, supervised, and regulated athletic events promotes the various amateur sports, fosters widespread public interest in the benefits of its nationwide amateur athletic program, and encourages public

participation. Therefore, the organization's sale of broadcasting rights and the resultant broadcasting of its athletic events contributes importantly to the accomplishment of its exempt purposes.

In Rev. Rul. 81-178, 1981-2 C.B. 135, payments an exempt labor organization receives from various business enterprises for the use of the organization's trademark and similar properties are royalties within the meaning of § 512(b)(2) and are not taken into account in determining unrelated taxable income. However, payments the organization receives for personal appearances and interviews by its members are not royalties but are compensation for personal services and must be taken into account in computing the organization's unrelated business taxable income.

#### Analysis:

##### Rulings 1:

Section 507(b)(2) provides that in the case of a transfer from one private foundation to another private foundation according to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization, the transferee organization shall not be treated as a newly created organization. Section 1.507-3(c)(1) describes the terms "other adjustment, organization, or reorganization" as including any partial liquidation or any other significant distribution of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. The term "significant disposition of assets to one or more private foundations" is defined by § 1.507-3(c)(2) as any disposition or series of dispositions where the aggregate value transferred is 25 percent or more of the fair market value of the net assets of the foundation at the beginning of the taxable year. Because the Transferor is transferring to you more than 25% of its assets, the proposed transfer is described in § 507(b)(2).

##### Ruling 2:

In the case of a significant disposition of assets to one or more private foundations within the meaning of § 507(b)(2), the transferee organization shall be treated as possessing those attributes and characteristics of the transferor organization which are described in subparagraphs (2), (3), and (4) of Treas. Reg. § 1.507-3(a). Accordingly, you will be treated as possessing the Transferor's attributes and characteristics as described in Treas. Reg. §§ 1.507-3(a)(2), (3), and (4) including that a transferee organization shall succeed to the aggregate tax benefit of the transferor organization in proportion to the amount of the fair market value of the assets the transferee receives from the transferor.

##### Ruling 3:

Section 4943 imposes an excise tax on the excess business holdings of a private foundation during any taxable year that ends in the taxable period. Excess business holdings are generally the amount of interests in the business enterprise greater than the permitted holdings. Where disqualified persons also have business holdings in the same business enterprise then the private foundation's otherwise permitted holdings are reduced by those amounts. A private foundation is allowed a five year period to dispose of certain large gifts and bequests without incurring the excise tax. Treas. Reg. § 1.507-3(a)(6) provides that whenever a private foundation makes a § 507(b)(2)



transfer of all or part of its net assets to another private foundation, the applicable period of time described in § 4943(c)(4), (5) or (6) shall include both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets. As described above, Transferor intends to transfer a significant portion of its assets, but not all of its assets, to you which will constitute a transfer of assets pursuant to a reorganization plan as described in § 507(b)(2). Therefore, your applicable period of time in the transferred assets described in § 4943(c)(4), (5) and (6) will include both the period during which Transferor held such assets and the period during which you holds such assets.

Ruling 4:

Under Treas. Reg. § 1.507-3(a)(9)(i), if a private foundation transfers all of its net assets to another private foundation which is effectively controlled by the same person or persons which effectively controlled the transferor private foundation, the transferee private foundation is treated as if it were the transferor. Here, Transferor is transferring less than all of its net assets to a private foundation, so you are not treated as Transferor for all private foundation purposes. Instead, you will be treated as possessing its attributes and characteristics which are described in Treas. Reg. §§ 1.507-3(a)(2), (3), (4), and, to the extent applicable, (6) and (8)(ii).

Ruling 5:

Treas. Reg. § 1.507-3(a)(3) provides that for purposes of § 507(d)(2), in the event of a transfer of assets described in § 507(b)(2), any person who is a substantial contributor (within the meaning of § 507(d)(2)) with respect to the transferor foundation shall be treated as a substantial contributor with respect to the transferee foundation, regardless of whether such person meets the \$5,000—two percent test with respect to the transferee organization at any time. If a private foundation makes a transfer described in § 507(b)(2) to two or more transferee private foundations, any person who is a substantial contributor with respect to the transferor foundation prior to such transfer shall be considered a substantial contributor with respect to each transferee private foundation.

As discussed above, Transferor's transfers to you are § 507(b)(2) transfers. Grantor is a substantial contributor to Transferor. In addition, Grantor and any other persons who are substantial contributors to Transferor are also substantial contributors to you without regard to whether each person meets the \$5,000—two percent test with respect to you.

Ruling 6:

Transferor intends to transfer a significant portion of its assets, but not all of its assets, to you pursuant to a reorganization plan under § 507(b)(2). Treas. Reg. 1.507-3(a)(1) provides that, in a § 507(b)(2) transfer, a transferee organization will not be treated as a newly created organization. The transferee organization is treated as possessing those attributes and characteristics of the transferor organization which are described in Treas. Reg. § 1.507-3(a)(2), (3) and (4). Treas. Reg. § 1.507-3(a)(4) provides that if a private foundation incurs liability for one or more of the taxes imposed under Chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in § 507(b)(2) to one or more private foundations, in any case where transferee liability applies, each transferee foundation shall be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such

liability. Therefore, you will receive the transferred assets subject to Transferor's prior excise tax liabilities under Chapter 42 (and any penalty resulting therefrom), if any, to the extent Transferor did not previously satisfy those liabilities.

Ruling 7:

Section 511 imposes a tax on the unrelated business taxable income of § 501(c)(3) organizations. Unrelated business taxable income is generally gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it. See I.R.C. § 512(a)(1). Section 513 defines 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 its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501." To determine that an activity is substantially related to an exempt purpose, Treas. Reg. § 1.513-1(d) requires the activity have a causal relationship to the exempt purpose that is substantial and that the size and scope of the activity not be on a larger scale than reasonably necessary for performance of such exempt functions.

The portion of your Production and Maintenance services you provide to Museum and other tax-exempt organizations that publicly display Artwork and/or use it for educational purpose, and non-exempt organizations that commit contractually to publicly display their Artwork and/or use their Artwork for educational purposes for a significant period of time is substantially related to the achievement of your exempt purposes (other than through the production of income) within the meaning of Treas. Reg. § 1.513-1(d)(2) because (i) publicly accessible displays are necessary to educate the public, (ii) you do not own or control any exhibition space and therefore must work with governments or other organizations to publicly display the art, and (iii) creation and maintenance of displayed Artwork pieces requires highly specialized skill and knowledge most cooperating organizations lack. Necessity makes the causal relationship between the production, public display, and maintenance of Artworks and achieving your exempt purposes a substantial one. Necessity also means your Production and Maintenance services to such organizations contribute importantly to the accomplishment of your exempt purposes. See Rev. Ruls. 69-269 and 80-295, *supra*. Accordingly, the relationship test in Treas. Reg. § 1.513-1(d)(2) is met.

The fact that you charge the displaying organizations fees comparable to similar transactions does not diminish the important contribution Production and Maintenance of publicly exhibited pieces of Artwork makes to achieving your exempt purposes. Your Production and Maintenance services are less commercial because you reduce or eliminate fees for organizations unable to pay the full amounts. Moreover, you represent that you limit substantially all of these services to Artwork pieces. Accordingly, your Production and Maintenance services to exempt organizations displaying Artworks is substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), and revenue from such services does not result in "unrelated business taxable income" as defined in § 512(a)(1).

Ruling 8:

Based on your representations, you also provide an insubstantial amount of Production and Maintenance services for art created by individual artists, or owned by organizations and private

collectors and displayed privately. Section 1.513-1(d)(1) and (2) require that there be a causal relationship between the activity and an exempt purpose, and that the causal relationship be a substantial one. Section 1.513-1(d)(3) requires that where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. In Example 1 of Treas. Reg. § 1.513-1(d), an organization described in § 501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business.

Because the work will be performed by interns as part of their education, the services have a causal relationship to your exempt purposes of educating about the medium, that is substantial within Treas. Reg. § 1.513-1(d)(2). Moreover, the fees charged are commensurate with the interns' educational needs thus showing the size and scope of the services are not on a larger scale than is reasonably necessary for the performance of your educational function, as required by Treas. Reg. § 1.513-1(d)(3). Accordingly, such services are like the organization in example 1 of Treas. Reg. § 1.513-1(d) and are substantially related to the achievement of your exempt purposes (other than through the production of income) within the meaning of Treas. Reg. § 1.513-1(d)(2). The revenue from such services does not result in "unrelated business taxable income" as defined in § 512(a)(1).

#### Ruling 9:

The sale of goods held for inventory is a trade or business subject to unrelated business income tax unless the conduct of which is substantially related (aside from the organization's need for income or funds or the use it makes of the profits derived) to the exercise or performance of an organization's purpose or function constituting the basis for its exemption. See I.R.C. § 513(a). Treas. Reg. § 1.513-1(d)(2) provides that a trade or business is "substantially related" to purposes for which exemption is granted only if the production or distribution of the goods from which the gross income is derived 'contributes importantly' to the accomplishment of those purposes.

One of your exempt purposes is stimulating and enhancing public awareness, interest, and appreciation of art. You sell original Artwork held as inventory to tax-exempt and public entities for public display or other educational purposes, and to non-exempt entities that commit contractually to publicly display Artwork and/or use their Artwork for educational purposes for a significant period of time.

Like the museum in Rev. Rul. 73-104, *supra*, part of your basis for exemption is the ownership, maintenance, and exhibition for public viewing of works of art. In the ruling, the museum's mass sale of print reproductions of art held in the museum's collection contributes importantly to the achievement of its exempt educational purposes because although the sold reproductions were not publicly displayed they reaches a broader segment of the public who thereby may be encouraged

to visit the museum itself to share in its educational functions and programs as a result of seeing the cards.

In your case, you too are selling goods held for inventory. Unlike a museum that sells reproductions for private use, you are selling original Artwork subject to an obligation for the purchaser to publicly display the artwork and use it to educate the public for a significant amount of time. Your conditional sales of original art similar to a museum's mass sale of reproductions, encourage the public sharing in your educational functions and programs, because of your purchasers' obligations to publicly exhibit the original art and use it to educate the public for a significant period of time similarly reaches a broader segment of public. Such sales contribute importantly to the achievement of your exempt purposes by stimulating and enhancing public awareness, interest, and appreciation of art and is substantially related to your exempt purposes under Treas. Reg. § 1.513-1(d), and therefore is not subject to unrelated business income tax.

**Ruling 10:**

You plan to license images of Artwork to unrelated persons that do not require identifying the artist, the title or subject matter of the work, the date or period of its creation, if known, or information as to where viewers can see the original Artwork. You may require licensed images bear your copyright. The licenses use a fee structure that is comparable to fees charged by other organizations for similar licensing activity, and in no case will such fees exceed fair market value. You own the copyrights to all licensed images. You state that you will not provide any services in connection with the licensing agreements other than quality control. You also state that all licensees are unrelated organizations.

Licensing images of Artwork in your collection without more is not substantially related to your exempt purposes and constitutes a trade or business as defined in § 513(a). Computation of unrelated taxable business income under § 512(a)(1) is modified to generally exclude royalty income and directly related deductions. See I.R.C. § 512(b)(2). A royalty is a payment that relates 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. Similarly, payments for the use of a professional athlete's name, photograph, likeness, or facsimile signature are ordinarily characterized as royalties. Royalties do not include payments for personal services. See Rev. Rul. 81-178, 1981-2 C.B. 135. You own the copyrights to all images licensed. The only services you will provide are quality control. Requiring licensed images bear your copyright is more a prudent step to protect your intellectual property than a personal service. Accordingly, although your licensing of Artwork images is not substantially related to your exempt purposes as defined in Treas. Reg. § 1.513-1(d)(2), it falls under the modification for royalty income provided in § 512(b)(2), and does not result in unrelated business taxable income as defined in § 512(a)(1).

Conclusion:

Based on the foregoing, we rule as follows:

1. You shall not be treated as a newly created organization following Transferor's transfer of assets to you pursuant to a reorganization as described in § 507(b)(2).
2. You will succeed to Transferor's aggregate tax benefit in proportion to the amount of the fair market value of the assets you receive from it.
3. Your applicable holding period in the transferred assets for purposes of § 4943(c)(4), (5) and (6) includes both the period during which Transferor held such assets and the period during which you hold such assets.
4. Transferor will not be transferring all of its net assets to a private foundation that is effectively controlled, directly or indirectly, by the same person or persons that effectively controlled the transferor private foundation. Therefore, you will not be treated as if you were Transferor for purposes of Chapter 42 and §§ 507 through 509.
5. Any person who is a substantial contributor within the meaning of § 507(d)(2) with respect to Transferor will be treated as a substantial contributor with respect to you, regardless of whether such person meets the \$5,000/two percent test with respect to you at any time.
6. You will receive the transferred assets subject to Transferor's prior excise tax liabilities under Chapter 42 (and any penalty resulting therefrom), if any, to the extent Transferor did not previously satisfy those liabilities.
7. Your Grantor medium Production Services and Maintenance Services for Museum, and for other tax-exempt organizations that publicly display art and/or use it for educational purposes, and non-exempt organizations that commit contractually to publicly display their art and/or use their art for educational purposes for a significant period of time, are substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), and revenue from such Services does not result in UBTI as defined in § 512(a)(1).
8. Your Grantor medium Production Services and Maintenance Services for art created by individual artists, or owned by organizations and private collectors and displayed privately are substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), and revenue from such Services does not result in UBTI as defined in § 512(a)(1).
9. Sales of original Artwork held as inventory to tax-exempt and public entities for public display or other educational purposes, and to non-exempt entities that commit contractually to publicly display their Artwork and/or use their Artwork for educational purposes for a significant period of time, are substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), and revenue from such sales does not result in UBTI as defined in § 512(a)(1).

10. Licensing of Artwork images is not substantially related to your exempt purposes, as defined in Treas. Reg. § 1.513-1(d)(2), but falls under the modification for royalty income provided in § 512(b)(2) and does not result in UBTI as defined in § 512(a)(1).

This ruling will be made available for public inspection under § 6110 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.

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

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. 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. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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,

Michael C. Seto  
Manager, Exempt Organizations  
Technical

Enclosure  
Notice 437