



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Contact Person:

UIL: 512.02-00

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Identification Number:

Telephone Number:

Employer Identification Number:

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Dear :

This letter is in reference to the letter from the authorized representative of M, in which M requested rulings that its investment in N will not subject M to the tax on unrelated trade or business under section 511(a) of the Internal Revenue Code, and will not adversely affect M's tax exempt status under section 501(c)(6).

M is an organization recognized by the Internal Revenue Service as exempt from federal income tax as a business league organization under section 501(c)(6) of the Code. M is a nonprofit unincorporated voluntary member association under State law.

Membership in M is available to any person who is licensed to practice the profession's business in any jurisdiction of the United States as well as any person enrolled in a school accredited by O, and certain persons who are employed by a person who is a member of M. M's object is to advance the science of the profession, to promote improvement of the profession; to uphold integrity, honor, and courtesy in the profession and encourage and enforce adherence to high standards of professional conduct; to take positions on matters of public interest as deemed advisable; to encourage through education; to cultivate cordial relations among members; and to perpetuate the history of the profession and M.

In accordance with these purposes, M states that it conducts a number of activities that are intended to further the common interests of the members of the profession. M sponsors continuing education seminars, publishes continuing education materials and provides online continuing education programs that facilitate the development of areas of expertise of members of the profession and inform members of recent developments in the law. In addition, M publishes a weekly report of activities in the professional area and a monthly journal of relevant articles.

N is a for-profit joint venture, a limited liability company that is treated as a partnership for federal income tax purposes. N's business purpose is to provide an online library of a resources for M's members and members of other associations in the profession. The members of N are P, a for-profit holding company formed by M, and R, a for-profit corporation unrelated to M.

P is a for-profit limited liability company whose business purpose is to serve as a holding company which holds an equity interest in N on behalf of M. P is treated as a partnership for federal income tax purposes. The members of P are M and M's Executive Director. Based on M's initial contribution to P, M holds a 95% interest in profits and losses of P. M's Executive Director, based on his initial contribution to P, holds a 5% interest in profits and losses of P as a method of compensation. Prior to effectuating the compensation agreement, M received a study from an independent appraiser which concluded that M's Executive Director's total compensation, including the projected compensation from M and P, was reasonable in amount in view of compensation paid to senior executives of similar associations. M's large Board of Directors approved the compensation as reasonable, and the agreement was negotiated at arm's-length, both sides being represented by separate legal counsel. M's Executive Director has no vote on the Board and no family relationship with any Board member. Also, M requested a formal ruling from the Service on the matter and received a ruling that the issuance of the equity interest in P to the Executive Director does not affect M's status as an organization exempt under section 501(c)(6) of the Code. P is managed by a manager appointed by M, and M has the sole authority to remove the manager and to appoint any officers of P.

Prior to the formation of N, M licensed from R certain searchable computerized

databases that M made available to its members as the S service. The databases provided by R under the license agreement originally included State materials and certain federal materials. M provided access to these databases to its members through online internet access to the S service via M's website interface with R's computer system. No separately stated fee was charged to individual M members who utilized the online S service.

M states that the S service provided by M has been widely used by its members. In response to the increasing importance of an online library to its members and the profession, M determined to make an equity investment in its online library, rather than continue as a mere licensee of R for such services. By making an equity investment, M achieved two important objectives. First, an ownership interest provides M with greater control over the online library, allowing M to ensure the continued availability and quality of such services to M's members. As a licensee of R, M was subject to a continuing risk that R might cease to provide an online library, such as due to sale of the business or financial problems. As an equity owner, however, M is better able to control the continuing availability of an online library for its members. Second, M's equity investment allowed the expansion of the databases of S materials to provide a greater benefit to M's members and to provide the same benefit to members of the associations of other states. Thus forming N as a joint venture has allowed M to ensure the availability and quality of the S service and has facilitated expansion of the databases beyond the single State databases to include reference material from other States.

M states that it did not invest directly in N, instead investing indirectly through P. Pursuant to the Operating Agreement of N, R contributed business assets with a value of \$w and received an initial capital account credit of \$w and a 62.5% interest in profits and losses of N. P contributed \$x in cash and received an initial capital account of \$x and a 37.5% interest in profits and losses of N. The Operating Agreement provided P with the right to contribute an additional \$y in cash to the capital of N, thereby increasing P's percentage interest in profits and losses to 50%. P exercised this right, and R's percentage interest in profits and losses of N has been correspondingly reduced to 50%. In addition to the contributions described above, P and R have each contributed an additional \$z to the capital of N to provide funds for the expansion of S service databases.

N is managed by its members, P and R. Action by members generally requires the vote of members holding a majority percentage interest in N, although certain specified actions require the unanimous consent of the members (so long as P and R are the only members) or a two-thirds vote (if P and R are no longer the only members). Pursuant to the Operating Agreement of N, the members of N have appointed a Board of Representatives to oversee the operation of N, advise the members, and take such other actions for which authority is delegated by the members. The Board of Representatives consists of four representatives, two of whom are appointed by each member, and action by the Board requires a majority vote.

The Operating Agreement of N provides P with the right to purchase the State and federal databases from N in the event of any of the following:

(1) termination or expiration (other than by breach of the agreement by M) of the S

Services Agreement between M and N;

(2) withdrawal by P from N;

(3) assignment by P of its entire membership interest in N; or

(4) dissolution of N (by unanimous consent of its members or by judicial decree).

This right to purchase was negotiated by M to ensure, at a minimum, the continuing availability of the State and federal data bases to M's members.

N enters into contracts with certain associations to provide an online library of a resources for each association. M states that to date, all contracting associations are state associations, although N has and may continue to pursue contracts with local associations as well. Pursuant to each current contract, the state association has the exclusive right to market the entire database of a resources of N to its members and others within the state. Each state association is entitled to impose conditions on access to the database, potentially involving limitation of access to the association's members or the charging of a fee to individual users. However, even if an association chooses to impose fees for access to the S service, it would not be possible to vary the fee based on the amount of usage of the online a library because N does not have the ability to track an individual's use of the S service.

N's contracts with certain associations other than M provide that if N ceases to operate as a going concern and there is no successor-in-interest obligated to perform N's duties under the contract, N will provide to that association an electronic copy of the respective state databases. In that event, the association would be provided with a non-exclusive, royalty-free, perpetual license to distribute or otherwise make available the database of the state materials (but not the databases of federal materials or materials from other states) to its members.

N's contracts with certain associations other than M also provide that such associations may be entitled to a payment in the event of a sale or change in control of N. Thus, upon (i) the sale or transfer to an unrelated third party of substantially all of the assets of or membership interests in N or (ii) a merger or similar transaction in which the surviving entity is an unrelated third party, N will pay to the participating association a percentage of the excess, if any, of the amount received upon the sale or change in control over the sum of a base amount plus the total amount contributed to the capital of N by its members after the date of the contract plus the expenses incurred in connection with the sale or change of control. The base amount is subject to periodic adjustment.

M states that the activities of N in creating and maintaining online databases of a

resources provide significant educational benefits for M's members and the members of contracting state associations, as well as benefits to the general public in the form of improved a services. A user of S has complete access to the entire contents of the S service, including federal materials and materials from every state whose association has entered into a contract with N.

M has requested rulings that:

- (1) M's investment in N will not result in the receipt of unrelated business taxable income by M.
- (2) M's indirect investment in N will not adversely affect the tax exempt status of M.

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(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. 67-182, 1967-1 C.B. 141, holds that an organization whose only activity is providing a reference library of "electric logs," maps, and information services used solely by its members in their oil exploration businesses is not exempt as an organization described in section 501(c)(6) of the Code. The revenue ruling states that the organization is making specialized information available to its members on a cooperative basis which serves as a convenience and economy in the conduct of their businesses; operating a library as described is an activity which constitutes the performance of particular services for individual persons. Also, since membership is limited and the facilities of the organization are made available only to participating members, the organization's activities are not aimed at the improvement of business conditions in the industry as a whole.

Rev. Rul. 67-296, 1967-2 C.B. 212, holds that income from the conduct of classes by a professional association exempt under section 501(c)(6) of the Code in order to qualify persons for a specific status within the particular profession does not constitute gross income from unrelated trade or business subject to the tax imposed by section 511. The revenue ruling states that improvement of business conditions in one or more lines of business as a whole is a purpose for which exemption is recognized under section 501(c)(6), and the conduct of classes in the manner described to develop and improve the skills of those in a given profession is an activity substantially related to an accomplishment of such purpose.

Rev. Rul. 2004-51, 2004-22 I.R.B. describes (1) whether an organization continues to qualify for exemption from federal income tax as an organization described in section 501(c)(3) of the Code when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company (LLC) formed with a for-profit corporation, and (2) whether the organization is subject to unrelated business income tax under section 511 on its distributive share of the LLC's income. The revenue ruling holds that when the facts establish that the activities conducted through the LLC are substantially related to the exercise and performance of the exempt organization, the

exempt organization continues to qualify for exemption under section 501(c)(3) and is not subject to unrelated business income tax under section 511 on its distributive share of the LLC's income.

From the information that has been presented, it is clear that M's primary activities are to promote improvement within its profession, and that education of members to develop and improve their skills within the profession is substantially related to the accomplishment of exempt purposes within the meaning of section 501(c)(6) of the Code. See Rev. Rul. 67-296, supra.

P is a partnership for federal tax purposes, and therefore P's activities are attributed to M for purposes of determining both whether M continues to operate as a business league within the meaning of section 501(c)(6) of the Code, and whether M has engaged in unrelated trade or business and therefore may be subject to the unrelated business income tax on its distributable share of P's income. Rev. Rul. 2004-51, supra, is applicable to this situation although the issue being decided there involves an organization recognized as exempt under section 501(c)(3). N is also a partnership for federal tax purposes, and since P is a partner of N, in the same manner as the relationship between M and P, N's activities may be attributed to P for purposes of determining whether N's activities are substantially related to the accomplishment of exempt purposes within the meaning of section 501(c)(6) of the Code.

The activities being carried out by N, the provision of an online library of a resources for M's members and members of other associations in the profession, are not the same as the activities of the organization described in Rev. Rul. 67-182, supra. In that revenue ruling, denying recognition of exemption under section 501(c)(6) of the Code, the specialized information was being provided only to participating members of an organization with a limited membership. The facts show that, unlike N, the organization's activities are not aimed at the improvement of business conditions in the industry as a whole, but rather serve as a convenience and economy to the individual members in the conduct of their businesses.

Although not exempt itself under section 501(c)(6) of the Code itself, N is nonetheless providing services that would be considered to be educational within the meaning of section 501(c)(6) to M's members, as well as to persons within the profession who are not members of M. Because such activity is substantially related to M's exempt purpose, M would not be subject to unrelated business income tax under section 511 on its distributive share of N's income through P.

Accordingly, based on the facts and circumstances concerning the proposed transaction as stated above, including the facts that M's Executive Director does not control M, that his compensation agreement was negotiated at arm's-length, that the agreement was determined to be reasonable by independent appraisal, and assuming that in the future M's Executive Director's compensation will continue to be reasonable,

we rule as follows:

- (1) M's investment in N will not result in the receipt of unrelated business taxable income by M.
- (2) M's indirect investment in N will not adversely affect the tax exempt status of M.

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.

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