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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Uniform Issue List
4942.03-03
4942.05-02
4943.03-01
4943.04-03
4944.03-00

Date:

Contact Person:

Identification Number:

Telephone Number:

T:EO:B4

9/5/01

Employer Identification Number:

Legend:

M =
N =
O =
P =

x =

Dear Sir or Madam:

We have considered M's ruling request dated February 28, 2001. M has requested a ruling as to the tax implications of conducting certain activities through a controlled for-profit subsidiary.

Facts:

M is exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code and is now classified as a private foundation under section 509(a). M has been operating as a research center for clinical studies focusing primarily on perioperative N. M now believes that it must establish a for-profit subsidiary to facilitate interaction with pharmaceutical manufacturers.

N is a serious medical condition which is particularly susceptible to successful treatment by drugs. Pharmaceutical manufacturers can produce new and better drugs which are of great benefit to the medical community and patients. M has determined that it needs to share its data and experience with commercial drug companies in order to influence the development and testing of drugs and in fighting N and related disorders.

Pharmaceutical manufacturers are interested in utilizing the data and experience base of M, and are expected to pay fees for the intellectual property shared and services rendered. In order to preserve its tax exempt status, M proposes to conduct its activities with commercial

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drug companies through a for-profit subsidiary, O, as described below. M desires to structure O so that it will be considered a functionally related business and a program-related investment, so as to avoid the imposition of penalty taxes under sections 4942, 4943, and 4944 of the Code.

Since its founding, M has conducted extensive research on N and related disorders and disseminated the results of this research to the medical community and the interested public. M has conducted two major observational (epidemiological) studies on patients undergoing a certain type surgery and more than 20 clinical trials. Studies on patients undergoing other types of surgery have also been conducted. More recently, research conducted by M has expanded into other therapeutic areas, as identified in the ruling request.

Almost one-third of M's staff members hold doctoral level academic degrees. Principle functions of clinical research are performed in two clinical research groups that are supported by a full biometrics group with data management. There are also departments dealing with quality assurance, information technology, finance, and human resources.

M's research activities have resulted in the development of a large and important database concerning N patients and P patients in general. This database is extremely useful to pharmaceutical manufacturers because it provides quantitative information for use in the design of new clinical research protocols. In addition, the experience of the M staff and the knowledge base built up through M's research and clinical trials would also be extremely useful to pharmaceutical manufacturers in designing their own clinical research protocols.

M represents that the treatment of N and other P disease cannot advance without the cooperation of pharmaceutical manufacturers. M states that it can bring about new and better preventions and cures for these ailments only through the development of new and better drugs.

M proposes to establish O for the sole purpose of conducting research in the field of N and related disorders. Through O, M's database and experience could be used to assist pharmaceutical companies with the design and management of clinical trial programs to produce better drugs to treat N, P diseases and related disorders.

The commercial pharmaceutical manufacturers that participate in the clinical trials through O will be required to turn over the publication rights from the research to M. Consequently, research results will be available for M's staff to use in producing an academic paper for publication in a medical journal or similar venue. M states its intention to publish the results of each clinical trial program conducted through O.

M intends to initially fund O with its own capital contribution, but anticipates that outside capital may be needed in the future. As noted in the ruling request, "clinical trial programs are labor intensive, and require significant administrative and other staff." M plans to keep control of the Board of Directors of O by retaining appointment power over the majority of the voting Board members.

In a supplemental submission, M states that at the time of creation of O, it expects to make a $2,000x capital contribution in cash. M may also contribute some fixed assets such as office

furniture and computers. In O's second year, M anticipates making an additional $2,000x capital contribution. Thereafter, M represents that O should be able to sustain itself from its own profits, and it is expected to return dividends to M.

Concerning other potential investors, M may approach contract research organizations that do work similar to, but not exactly the same as, that of O. For example, a contract research organization which assists clinical trial programs with site monitoring might be interested in making an investment in O, because its area of expertise would be compatible, but not overlapping, with that of O.

Rulings Requested

M requests the following rulings:

(1) That the fair market value of O's stock held by M would be excluded from the aggregate fair market value of the assets of M under section 4942(e)(1)(A) of the Code for purposes of determining the minimum investment return for M.

(2) That the stock of O held by M will not be considered "excess business holdings" within the meaning of section 4943(c) of the Code.

(3) That neither the contribution of assets to O nor the holding of stock in O would constitute an investment which would jeopardize the carrying out of M's exempt purpose within the meaning of section 4944 of the Code.

Law:

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated "exclusively" for charitable, educational, scientific, or other specified exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which does not engage in proscribed legislative or political activities.

Section 1.501(c)(5)-1(d)(5) of the Income Tax Regulations defines the term "scientific" to include the carrying on of scientific research in the public interest. Subdivision (iii) states that scientific research will be regarded as carried on in the public interest-

"(c) If such research is directed toward benefiting the public. The following are examples of scientific research which will be considered as directed toward benefiting the public, and, therefore, which will be regarded as carried on in the public interest: ... (2) scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; (3) scientific research carried on for the purpose of discovering a cure for a disease; ..."

Subdivision (iv) of the above regulations states that, where one person is granted the exclusive right to use the patent resulting from the research, such research shall be considered as carried on in the public interest if the granting of the exclusive right is the only practicable manner in which the patent can be utilized to benefit the public. In such a case, however, the research from which the patent resulted will be regarded as carried on in the public interest only if it is scientific research described in subdivision (iii)(c) – in the present instance, scientific research carried on for the purpose of discovering a cure for a disease or which is published in a publicly available document.

Section 512(b)(13) of the Code subjects section 501(c) organizations to unrelated business income tax for certain amounts received from controlled entities.

Section 4941 of the Code imposes taxes on disqualified persons for acts of self-dealing.

Section 4942(e)(1) of the Code states that the minimum investment return for any private foundation for any taxable year is 5 percent of the excess of (A) the aggregate fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purpose, over (B) the acquisition indebtedness with respect to such assets (determined under section 514(c)(1) without regard to the taxable year in which the indebtedness was incurred).

Section 53.4942(a)- 2(c)(2)(v) of the Foundation and Similar Excise Taxes Regulations provides that any assets used (or held for use) directly in carrying out a private foundation's exempt purpose shall not be taken into account in determining the minimum investment return of the foundation. Section 53.4942(a)-3(i) provides that for purposes of subparagraph (2)(v), an asset is "used (or held for use) directly in carrying out the foundation's exempt purpose" only if the asset is actually used by the foundation in the carrying out of the charitable, educational, or other similar purpose which gives rise to the exempt status of the foundation. Whether an asset is held for the production of income or for investment rather than used (or held for use) directly by the foundation to carry out its exempt purpose is a question of fact. Where property is used both for charitable, educational, or other similar exempt purpose and for other purposes, if such exempt use represents 95 percent or more of the total use, such property shall be considered to be used exclusively for a charitable, educational, or other similar exempt purpose. If exempt use of such property represents less than 95 percent of the total use, reasonable allocation between such exempt and nonexempt use must be made for purposes of this paragraph.

Section 53.4942(a)-2(c)(3)(ii)(d) of the regulations excludes interests in a "functionally related business" and a "program related investment" from the minimum investment return of a private foundation.

A "functionally related business" is defined in section 4942(j)(4) of the Code and section 53.4942(a)-2(c)(3)(iii)(a)(2) of the regulations to include, "an activity which is carried on within a larger aggregate of similar services or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the charitable, educational, or similar exempt purpose of the organization."

The regulations include two examples. In the first example, the private foundation maintains a community of historic value which is open to the general public. For the convenience of the public, the private foundation, through a wholly-owned, separately incorporated, taxable entity, maintains a restaurant and hotel in the community. The restaurant and hotel facilities are deemed to be within the larger aggregate of activities which makes available for public enjoyment the various buildings of historic interest and which is related to the foundation's exempt purpose. The example states that the operation of the restaurant and hotel under such circumstances constitutes a functionally related business.

In the second example, a private foundation publishes a medical journal as part of its medical research program, which constitutes the basis for its tax exempt status under Code section 501(c)(3). Space in the journal is sold for commercial advertising. Even though the advertising activity may be subject to the unrelated business income tax imposed by section 511, such activity is within a larger complex of endeavors which makes available to the scientific community and the general public developments with respect to medical research. Accordingly, the publication of the journal is a functionally related business.

In the General Explanation of the Tax Reform Act of 1969, H.R. 13270, P.L. 91-172, prepared by the Staff of the Joint Committee on Internal Revenue Taxation, the following is stated on Page 43: "If a private foundation were exempt under the prior statutory provisions as a charitable scientific organization, then its tax-paying subsidiaries may continue to be wholly owned if they serve to translate the scientific achievements of the foundation into human progress by such means as demonstrating the feasibility of new scientific discoveries, or aiding in the economic or technical development of geographical areas by bringing to the public innovative products and processes which might not otherwise reach the public.

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 53.4943-10(a) of the regulations provides that under section 4943(d)(4) 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 4943(d)(3) of the Code and section 53.4943-10(a) of the regulations provides that the term "business enterprise" does not include a functionally related business, as defined in section 4942(j)(4) (see above).

Section 4944 of the Code imposes first and second level taxes on a private foundation which invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes. Taxes are also imposed upon any foundation manager who knowingly makes such investment, unless such participation is not willful and is due to reasonable cause. Section 4944(c), entitled "Exception for Program-Related Investments", provides that investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

Section 53.4944-3(a)(2)(i) of the regulations states that an investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities.

Section 53.4944-3(a)(2)(ii) of the regulations states that an investment in a "functionally related business" described in section 4942(j)(5)(B) of the Code (now section 4942(j)(4)(B)) and corresponding regulations shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B). Such an activity is also one which forms part of a functionally related business.

Section 53.4944-3(b) of the regulations contains examples of program-related investments. In Example (5), Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorating urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. Even though X is large and established, the investment is program-related.

Analysis:

Section 1.501(c)(3)-1(d)(5) of the regulations, in defining the term "scientific", provides that scientific research will be regarded as carried on in the public interest if it is performed in order to discover a cure for a disease and for publishing the results of this research in publicly available resources. This is exactly what O, the for-profit subsidiary, will do. It will perform

research for the purpose of curing N and related disorders and publish papers discussing the research results in publicly available medical journals and similar venues.

The pharmaceutical manufacturers which will be provided services by O will have to retain any patents resulting from the research. They need to retain these rights to justify the large dollar investment in research necessary to bring new drugs to market. However, section 1.501(c)(3)- 1(d)(5) of the regulations provides that when a charity grants an exclusive right to research to a commercial company, and it is the only practicable manner in which such patent can be utilized to benefit the public, then the research may still qualify as "scientific" research within the meaning of Code section 501(c)(3) if it is research to cure a disease or the results are published. Both of these factors are present here.

M is not requesting a ruling that the activity described in Facts above constitutes a charitable or scientific activity within the meaning of Code section 501(c)(3). M has already determined that it will carry on the research within a for-profit subsidiary and pay federal income tax on any profit. The fact that the proposed research qualifies as "scientific" research, however, is relevant in determining its categorization as a functionally related business.

A functionally related business is an activity carried on within a larger aggregate of similar services or within a larger complex of other endeavors which is related to the exempt purpose of the organization. The exempt purpose of M is to carry on research for the purpose of discovering a cure for N and related disorders. Its activities have been solely directed to fulfilling this purpose. Similarly, the sole activities of O would consist of research carried on for the purpose of discovering a cure for N and related disorders. Thus, the facts herein appear to come within the definition of a functionally related business.

The fact that the research will be carried on by a for-profit subsidiary, O, will not preclude its qualification as a functionally related business. Section 53.4942(a)-2(c)(3)(iii)(b), Example 1, of the regulations describes a private foundation which operates a functionally related business through a separately incorporated taxable entity.

Example 2 of the above regulation speaks directly to medical research as it relates to a functionally related business. The private foundation in this example published the results of research in a medical journal, but also sold advertising space in the journal. The example states that the sale of advertising space is part of a larger complex of endeavors that makes medical research available to the scientific community and is therefore a functionally related business. Similarly, O, which will be controlled by M, will make the results of its research available to the scientific community, by granting M publication rights on each research project. This is similar to the situation described in Example 2. Advertising is not considered to promote an exempt purpose, but it was still determined to be a functionally related business because it was carried on within a larger complex of endeavors. The scientific research carried on by O will, itself, directly benefit the public when M publishes the results of this research. The research carried on by O would support, in an important way, the research which M itself would continue to carry on by making the database and experience of M available to the parties in the best position to produce practical cures for N and related disorders, that is, the pharmaceutical manufacturers. This is also similar to the example (see above) from the 1969 TRA Explanation.

Qualification of O's research as a functionally related business will mean that penalty taxes will not be imposed under sections 4942, 4943, and 4944 of the Code. Section 4944 specifically exempts program-related investments. Section 53.4944-3(a)(2)(ii) of the regulations provides that a functionally related business will qualify as a program-related investment. A program-related investment may be an investment in a for-profit company as long as the investment furthers the accomplishment of the private foundation's exempt activities. See section 53.4944-3(b), Example (5), discussed above. Similarly, section 4943(d)(3) and section 53.4943-10(b) of the regulations exclude a functionally related business and a program related investment from the term "business enterprise" for purposes of section 4943.

Rulings:

Based on the foregoing, we are able to rule as follows:

1. The fair market value of O's stock held by M will be excluded from the aggregate fair market value of the assets of M under section 4942(e)(1)(A) of the Code for purposes of determining the minimum investment return for M.

2. The stock of O held by M will not be considered "excess business holdings" within the meaning of section 4943(c) of the Code.

3. Neither the contribution of assets to O nor the holding of stock in O would constitute an investment which would jeopardize the carrying out of M's exempt purposes within the meaning of section 4944 of the Code.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon M's exempt status should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service Office. The mailing address is: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The telephone number there is 877-829-5500 (a toll free number).

This ruling does not purport to rule under any other Internal Revenue Code provisions, such as other provisions of Chapter 42 or sections 511 through 514.

Pursuant to a Power of Attorney on file in this office, we are sending a copy of this letter to your authorized representative.

We are also sending a copy of this ruling to the Ohio TE/GE Customer Service Office. Because this letter could help resolve any questions about M's exempt status, it should be kept with M's permanent records.

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.

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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.

Thank you for your cooperation.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4