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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200149043

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Date:

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Contact Person:

Identification Number:

Telephone Number:

T:EO:B4

Employer Identification Number:

LEGEND:

X =
Y =

Dear Sir or Madam:

This is in response to a letter dated March 9, 2001, from X's authorized representatives, who requested certain modifications to rulings issued to X in a previous private letter ruling (hereinafter the "Previous PLR") dated June 28, 1999 (PLR 1999-38-041).

As noted in the Previous PLR, X is an organization exempt from federal income tax under section 501(a) of the Internal Revenue Code of 1986 (hereinafter the "Code") as an organization described in section 501(c)(4). X was organized to promote the interests of older persons and sponsors many programs that include educational, research, and social welfare activities. X makes its views known on programs and legislation that affect its members.

X has a large number of dues-paying members, and X maintains a membership list of its members (hereinafter the "Mailing List"). X's members receive a magazine that has articles on such topics as financial planning, travel, and health. X's members also receive a monthly newsletter that keeps them informed on legislation affecting them and includes information on X's current activities. Through contractual agreements with third party service providers, X offers various programs and services to its members. The members are free to decide whether to obtain such services or participate in such programs.

As noted in the Previous PLR, X created Y, a wholly owned subsidiary, whose business commenced in xxxx. X entered into assignment agreements with Y, assigning to Y a portion of X's right, title, and interest in its agreements with third party service providers. Pursuant to these assignments, X reserved all right, title, and interest in its name, logos, symbols, marks, service marks, and acronyms (hereinafter "X's Marks"). These assignments assigned to Y all of X's other rights and obligations as set forth in the agreements. In conjunction with these

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assignments, X entered into royalty agreements with the service providers that use X's Marks. The purpose of these royalty agreements is to set out the rights and obligations of the parties to the use of X's Marks.

Pursuant to the assignments, Y engages in activities on behalf of X consisting of monitoring the use by the service providers of X's Marks. Y also receives a no fee license to X's Mailing List and licenses such Mailing List to the service providers for a fee. This fee (hereinafter the "List Access Fee") is the rental payments received from the use of X's Mailing List. In addition to providing a sublicense to the service providers for the Mailing List, Y also performs all actions necessary for managing the Mailing List by the service providers, including segmentation, transfer, security, audits of use and misuse, and collection of rentals (hereinafter the "List Services"). Furthermore, Y acts as a service provider to X's members, making available to them the X Legal Services Network.

The Previous PLR noted that X agreed to bifurcate the payments from the service providers into two parts. One part is a royalty payment to X for the X Marks, and the other part is a payment to Y for the List Access Fee, List Services, and other activities.

The Previous PLR listed the following 15 activities to be carried on by Y and not to be carried on by X:

1. Receiving, reviewing and recommending modifications to strategic and operating plans of the service providers;
2. Auditing and inspecting management reports, complaints, finances, and statistical data of the service providers;
3. Receiving, reviewing, approving and recommending modifications of mailings of the service providers;
4. Approving the nature and timing of communications of the service providers with X's members;
5. Maintaining ombudsmen services to help resolve claims, disputes and other problems with the service providers;
6. Monitoring the performance of the service providers and their compliance with the various agreements;
7. Performing internal audit checks and reviews of the service providers;
8. Reviewing product development, budgets and pricing by the service providers;
9. Responding to complaint correspondence regarding the service providers;
10. Monitoring the promptness and quality of performance of the service providers;
11. Engaging in ongoing research regarding new benefits and other changes that might be needed or desirable;
12. Conducting quality control activities, including preparation and supervision of member services quality studies;
13. Creating marketing services respecting X's membership list;
14. Preparing, or supervising preparation of market analyses; and,
15. All other activities as are necessary to promote the service providers.

Consistent with the Previous PLR, X has not carried on any of these 15 activities. With

respect to payment for these 15 activities carried on by Y, the Previous PLR specifically requires the service providers to compensate Y for all of these activities in an amount equal to fair market value. Thus, the service providers are required to pay Y for activities (other than nos. 11, 13, 14, and 15) that benefit X, and not the service provider.

X proposes to terminate the no fee license of its Mailing List to Y and license the use of such Mailing List directly to the service providers. For this license, X will be paid a royalty equal to the fair market rental value of the raw mailing list information. The List Services and the services performed by Y and set out in the Previous PLR will continue to be performed by Y, and Y will receive payment for such services in amounts equal to the fair market value of the services. The total fee paid by the service providers under their agreements with X and Y will not change; however, the agreements will be modified to reflect the proper parties to which the payment will be due. X will receive royalties for its Marks and its Mailing List, and Y will receive payments for services related to the List Services and other activities. X will perform no services for its payments.

In order to simplify payment by the service providers, X and Y propose to hire an unrelated financial institution as their agent to receive the total payment from the service providers. The agent will allocate this payment to the accounts of X and Y in accordance with the contracts of X and Y with the service providers. X and Y will make payments to the financial institution in amounts equal to the fair market value of the service rendered by the financial institution and allocated between the two entities based upon the respective dollars allocated to them.

X proposes that Y bill the proper party benefiting from the service provided. With respect to the 15 activities listed above (other than nos. 11, 13, 14 and 15) engaged in by Y, Y will bill X for such services at fair market value, and X will pay Y directly. The gross income to Y from these activities will not change, and all activity of Y benefiting X will be billed to X at fair market value as set forth in the Previous PLR.

X and Y are each required to file an annual report with the Mid-Atlantic Area Manager, EO Examinations. The date for filing the report is not set forth in the Previous PLR. X proposes that the Previous PLR be amended to require that the annual report be due on the due date for the respective entities' federal returns.

Section 501(c)(4) of the Code provides, in part, for the exemption from federal income tax for civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 511 of the Code provides, in part, for the imposition of tax on the unrelated business taxable income of organizations described in section 501(c), including those described in section 501(c)(4).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the allowable deductions that are directly connected with the carrying on of such trade or business.

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Section 512(b)(2) of the Code excludes from the computation of unrelated business taxable income all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

Section 1.512(b)-1 of the Income Tax Regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the modification for rents.

Rev. Rul. 81-178, 1981-2 C.B. 135, considers the application of section 512(b)(2) of the Code to two situations in which payments are received by an exempt organization. The holding in situation (1) is that payments for the use of the organization's trademarks, trade names, and service marks are royalties within section 512(b)(2). However, in situation (2), the holding is that payments for personal appearances and interviews are not royalties, but are compensation for personal services.

In Sierra Club, Inc. v. Commissioner, 86 F.3d 1526 (9th Cir. 1996), aff'g T.C. Memo. 1993-199 and rev'g on another issue 103 T.C. 307 (1994), the court stated that royalties in section 512(b)(2) of the Code are defined as payments received for the right to use intangible property rights, and that such definition does not include payments for services. With respect to income derived from the Sierra Club's rental of its mailing list, the court held that such income was royalty income under section 512(b)(2) and not payment for services.

In Common Cause v. Commissioner, 112 T.C. 332 (1999), the court found that, with the exception of the list brokerage activities, all the list rental transaction activities were royalty-related, and therefore, each rental payment constituted a royalty excluded from unrelated business taxable income under section 512(b)(2) of the Code. The court found that the parties involved in the transaction engaged in activities to exploit and protect the mailing list, and thus, the activities were royalty-related. The parties included the list manager, the list owner (petitioner), the company that stored the rental list, and the list brokers. Moreover, the court found that the list broker's activities were provided solely to the mailers and solely for their convenience, and that the list broker was not an agent of Common Cause. See also Planned Parenthood Federation of America, Inc. v. Commissioner, T.C. Memo 1999-206.

For federal income tax purposes, a parent corporation and its subsidiaries are separate taxable entities so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That is, when a corporation is organized with a bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. Britt, 431 F.2d at 234. However, when the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the

corporate entity of the subsidiary may be disregarded. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1106 (5th Cir. 1973).

By terminating the no fee license of its Mailing List and licensing the use of such list to the service providers in return for a fee, X will receive royalty income that will fall within section 512(b)(2) of the Code and will be excluded from the computation of unrelated business taxable income under section 512(a)(1). Under the circumstances described, the payments to X from the service providers for the use of X's mailing list are in accordance with situation (1) of Rev. Rul. 81-178, supra. This conclusion is also consistent with the decisions on mailing lists in Sierra Club, Inc., Common Cause, and Planned Parenthood Federation of America, Inc., supra.

The payment of royalty income by third parties to an agent for X and Y will not change the character of such income to X. X and Y's proposal to hire an unrelated financial institution as their agent to receive the total payment from the service providers will result in no change to the nature of the royalty payments under section 512(b)(2) of the Code. Such payments will continue to be royalty income when a financial institution acting as an agent of X and Y receives and distributes the funds.

X's payment to Y of fair market value for all services rendered by Y to X will not cause Y's separate existence to be disregarded for federal tax purposes. This change from the facts set forth in the Previous PLR will not adversely affect the character of Y's separate existence. Y will still engage in the business activities listed in the Previous PLR, and its gross income will remain the same. Y will still charge for services rendered; however, it now will charge X instead of the service providers. Thus, it still will be organized with a bona fide intention that it will have some real and substantial business function in accordance with Moline Properties, Inc., Britt, and Krivo Industrial Supply Co., supra.

The report called for in the Previous PLR will be due on the due date, with extensions, for the federal returns required by X and Y.

Based on the above facts, we rule as follows:

1. The List Access Fee received by X from third parties will result in the receipt by X of royalty income within the meaning of section 512(b)(2) of the Code, and the payment of such royalty income by third parties to an agent for X will not change the character of such royalty income to X.

2. The payment by X to Y of fair market value for all services rendered by Y to X will not cause Y's separate existence to be disregarded for federal tax purposes.

3. The report called for in the Previous PLR will be due on the due date, with extensions, for the federal returns required by X and Y.

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

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to X's authorized representatives. A copy of this letter should also be kept in X's permanent records.

This letter 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 by others 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.

This letter modifies our Previous PLR dated June 28, 1999 (PLR 1999-38-041).

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4