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

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Contact Person:

Identification Number:

Telephone Number:

T:EO:B4

Employer Identification Number.

Legend:

M=
N=
O=
P=
Q=

Dear Sir or Madam:

We have considered M's ruling request dated January 19, 2001. M has requested a ruling as to the effects of a merger of a taxable subsidiary, O, into M. O's tax exempt parent.

M is a nonprofit corporation formed under the laws of the State of N. It has been recognized by the Service as exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code. It has also been classified as other than a private foundation by the Service. 0, an N business corporation, was formed in 1991 as a taxable subsidiary of M. The Service, in a ruling letter dated December 21.1992, determined that the creation of the taxable subsidiary would not adversely affect the tax exempt status of M.

M owns 100% of the outstanding stock of 0. M is a scientific research and educational organization formed and operated in the public interest to carry on research and to make the results of such research known to the public through the publication of papers and treatises written in its own right and through the commercialization of its technology through 0 and other taxable subsidiaries. M is mainly concerned with scientific research relating to the development of certain technology.

O's business purpose was to pursue the commercialization of P technology so that M would be providing its patented P technology to the public. 0 has, in fact, licensed P technology to various licensees. 0 also manufactured Ps for sale to licensees of P technology, and to customers such as universities, research organizations, and research departments of business organizations. 0, on March 13, 2000. sold substantially all of its intellectual property and intangible assets, including all rights to P technology, to Q, a manufacturer. At the time of sale to Q, 0 still had the right to receive certain royalties from the licensing of P technology. The

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transaction with Q was structured such that 0 retained the right to receive a portion of the licensing royalties due to it from various licensees, as those royalties are received after the closing. You anticipated that the royalty payments will continue at least through calendar year 2003. In order to support the needs of the licensees of the P technology, 0 has, under a license agreement from Q, continued to manufacture Ps. However, after the merger, the only ongoing activity of 0 will be the passive active activity of receiving royalty payments on a quarterly basis.

In a supplemental submission dated May 22.2001, you have informed us that the governing boards of M and 0 have decided that M will not continue the manufacture and sale of Ps following the merger. Instead. you expect that within the next few weeks, 0 will sell the P manufacturing business (including the manufacturing facility and equipment) to a new corporation which will be owned and controlled by employees of 0 and M. The sale of those assets will be at fair market value. It will be a taxable transaction, with 0 recognizing gain on the sale. M will hold a minority interest in the new corporation. You further advise us that,

> Although there are a number of business reasons for selling the manufacturing assets to a new corporate entity, the principal objectives are to qualify the new corporation for certain research grants, and to incentivize the key employees who work in the P manufacturing business. The new corporation will be a taxable corporation, and net revenues from the P manufacturing business will continue to be taxable.

Inasmuch as 0 has sold most of its rights in P technology and is no longer in a position to commercialize the technology, you propose that 0 merge into its parent, M, under the terms of the business corporation and nonprofit statutes of the State of N.

You request the following two rulings:

1) The merger of 0 into M will not affect the tax exempt status of M.

2) The royalty payments to which 0 is entitled under the terms of the sale to Q and which will, afler the merger, be received by M. will not be taxable income or unrelated business taxable income to M -either accelerated at the time of merger or as the royalty payments are received.

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 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501 (c).

Section 512(a) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (defined in

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section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is 'related" to exempt purposes 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). Further, it is "substantially related", for purposes of section 513 of the Code, only if the causal relationship is a substantial one. For this relationship to exist, the production or the performance of the service from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income wntribute importantly to such purposes depends, in each case, upon the facts and circumstances involved.

Section 512(b)(2) of the Code provides for the following modification to the term "unrelated business taxable inwme" (as defined in section 512(a)(l)): There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with that income.

The term "royalties" is not defined in either the Internal Revenue Code or the regulations. Section 1.512-I (b) of the regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) of the Code shall be determined by all the facts and circumstances of each case.

Rev. Rul. 81-178, 1981-2 C.B. 135, holds that payments which an exempt labor organization receives from various business enterprises (involving the organization's efforts to license its member professional athletes' names) for the use of the organization's trademark, trade name, service mark, or copyright, whether or not payments are based on the use made of such property, are classified as royalties for federal tax purposes. The revenue ruling states:

> To be a royalty, a payment must relate 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.

The ruling also noted that, although excluded from unrelated business inwme tax as a royalty, the inwme from the licensing activity was income from unrelated trade or business because the licensing agreements did not directly promote the group's exempt purposes.

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In Situation 2 of Rev. Rul. 81-178, the license agreement required the organization, through its member athletes, to endorse products or services in personal appearances and interviews. The ruling held that the royalty exception does not apply because of the element of personal services. This is consistent with the Service's position that provision of services by the exempt organization will preclude royalty treatment of the resulting income.

After the merger of 0 into M, the only activity of 0 which will continue will be the passive receipt of royalty income. Therefore, M's exempt status under section 501(c)(3) of the Code will not be affected by this merger.

The income which M will receive directly as a result of the merger would still be excluded from unrelated business taxable income because of the exception for royalty income under section 512(b)(2). The evidence in the administrative file establishes that the income derived from the licensing of the P technology is royalty income.

Based on the foregoing, we rule as follows:

1) The merger of 0 into M will not adversely affect the tax exempt status of M under section 501(c)(3) of the Code.

2) The royalty payments to which 0 is entitled under the terms of the sale to Q and which will, after the merger, be received by M, will not be taxable income or unrelated business taxable inwme to M – either accelerated at the time of the merger or as the royalty payments are received.

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 your tax 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).

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's 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 tax status, a wpy should be kept in its 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.

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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