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January 12, 2011

VIA HAND DELIVERY

Ms. Lois Lerner
Director
Exempt Organizations Division
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: The National Hot Rod Association (EIN: 95-1686172)

Dear Ms. Lerner:

On behalf of a client, I am writing to bring your attention to certain information regarding the National Hot Rod Association (the "NHRA" or the "Association"), an organization exempt from tax under section 501(c)(6) of the Internal Revenue Code.¹ Based on the information described below, it appears that the NHRA may not be operating in compliance with the requirements of section 501(c)(6), and therefore I respectfully request that the Internal Revenue Service (the "IRS") initiate an examination of the organization.

Background Information Regarding the NHRA

The NHRA is classified as a business league exempt from tax under section 501(c)(6). According to the Association's website, it is "the world's largest and loudest auto racing organization."² The Association claims to have 80,000 members and more than 35,000 licensed competitors.³ It is affiliated with the National Hot Rod Association Motorsports Museum, an organization exempt from tax under section 501(c)(3). The Association reported \$122,564,365 of total revenue in 2008 on its return.⁴ During that same year, the NHRA expended

¹ All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury Regulations thereunder.

² <http://www.nhra.com/nhra101/about.aspx>

³ *Id.*

⁴ *See, e.g.*, NHRA 2008 Form 990 p. 1.

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\$120,688,938.⁵ For your convenience, we have attached a copy of the NHRA's 2006, 2007 and 2008 Forms 990 as Exhibits A, B and C, respectively, to this letter.

The NHRA regularly operates drag racing events and owns four racetracks (and a long-term lease with respect to a fifth) where some of these events are held.⁶ As the 2008 Form 990 discloses, nearly all of the revenue received by NHRA, \$121,925,685 of its \$122,564,365, is program services revenue, most of which apparently relates to spectator admissions, sponsorship and ads, and licenses and fees.⁷ Presumably, a significant percentage of this income is in the form of cash received at the racing events. These operations appear similar to those conducted by for-profit automobile entertainment companies, such as the National Association of Stock Car Auto Racing ("NASCAR") or the International Hot Rod Association ("IHRA"). Indeed, this portion of the NHRA operations is so profitable that, in 2007, the Association offered to sell certain assets to HD Partners Acquisition Corporation ("HD Partners"), a for-profit publically-traded company that, according to the Proxy Statement for the proposed acquisition, was "formed specifically as a vehicle to effect a merger, asset acquisition or similar business combination with one or more operating businesses in the media, entertainment or telecommunications industry."⁸ We have attached a copy of the prospectus offering the acquisition to the HD Partners' shareholders for your review.

In the Proxy Statement provided to the HD Partners shareholders, the assets that NHRA proposed to sell to HD Partners were described as the "Purchased Business."⁹ Specifically, these assets included:

The NHRA POWERade Drag Racing Series and substantially all professional NHRA drag racing assets and opportunities, which consist primarily of the following: (i) NHRA's existing television broadcast agreement with ESPN; (ii) an exclusive, worldwide, perpetual license to the NHRA brand for professional drag racing activities; (iii) broad and extensive rights to commercialize the NHRA brand and media assets, including exclusive rights to professional racing and "Official NHRA" sponsorship and licensing rights, exclusive and non-exclusive media exploitation rights in broadcast television, home entertainment and new media, and exclusive merchandising rights relating to both professional racing and the stand-alone NHRA brand; (iv) four NHRA-owned race tracks, an

⁵ *Id.*

⁶ See HD Partners Acquisition Corporation Proxy Statement, dated December 24, 2007 (the "Proxy Statement") at cover page.

⁷ NHRA 2008 Form 990, pp. 1 and 9.

⁸ See HD Partners Acquisition Corporation Proxy Statement, dated December 24, 2007 at p. 14.

⁹ See HD Partners Acquisition Corporation Proxy Statement, dated December 24, 2007 at p. 57.

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additional long-term track lease in Pomona, California and the NHRA headquarters building in Glendora, California; and (v) a video and photo archive chronicling the history of drag racing, which include more than 20,000 hours or video and film.¹⁰

The Proxy Statement further discloses that the consideration for the Purchased Business would have been between \$121,057,792 and \$123,457,792.¹¹ The shareholders of HD Partners ultimately voted against the acquisition.¹²

After the failed asset sale, the NHRA continued to operate its drag racing activities. In conjunction with these operations, the NHRA expended significant sums of money. For instance, in 2008, the Association awarded \$24,235,425 in prize and trophy money to the competitors of its events.¹³ It also expended \$10,946,985 to track operators in conjunction with these activities.¹⁴ In short, the drag racing operations appear to be the most significant activities undertaken by the Association.

Based on the information disclosed on its 2008 Form 990, the NHRA was, at that time, governed by a five-member Board of Directors, none of whom were "independent" Directors.¹⁵ One of these Directors, Mr. Thomas Compton, serves as the NHRA's President. According to the NHRA's Form 990, Mr. Compton spent approximately 40 hours per week working on behalf of the organization; he received, however, approximately \$771,632 in taxable and nontaxable compensation for these efforts.¹⁶ In 2007, NHRA compensated Mr. Compton similarly: he received \$744,224 in compensation and contributions to his employee benefit plan and/or a deferred compensation plan.¹⁷

Mr. Dallas Gardner is the Chairman of the NHRA Board. He is also the Association's past President, and, according to the 2008 NHRA Form 990, he devoted 10 hours per week to NHRA in this capacity.¹⁸ The Form 990 also discloses that he received compensation from

¹⁰ *Id.*

¹¹ *Id.*

¹² <http://www.fastmachines.com/nhra/hd-partners-acquisition-fails-in-shareholder-vote/>

¹³ NHRA 2008 Form 990, p. 10.

¹⁴ *Id.*

¹⁵ *See, e.g.*, NHRA 2008 Form 990. We understand that the NHRA added two board members in 2010 who are obviously not reflected on the 2008 Form 990.

¹⁶ *Id.*

¹⁷ NHRA 2007 Form 990, p. 5.

¹⁸ NHRA 2008 Form 990, p. 7 and Schedule J.

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NHRA as an independent contractor, but the publicly available version of the Form 990 does not further explain this relationship. The total amount of compensation that he received from the Association in 2008 was \$319,073.¹⁹ In 2007, according to the Association's Form 990, he received \$331,051 and worked approximately one hour per week in his capacity as Chairman of the Board.²⁰

The NHRA also handsomely compensates many of its other Officers and Directors. For your convenience, we have prepared a chart detailing the NHRA compensation arrangements with certain Officers and Directors for 2006, 2007 and 2008.²¹

Table 1: NHRA Compensation Arrangements with Certain Officers and Directors

Name of Officer or Director	Title	2008 Compensation	2007 Compensation	2006 Compensation
Mr. Thomas Compton	President/Director	\$771,632	\$744,224	\$712,317
Mr. Dallas Gardner	Chairman of the Board	\$319,073	\$331,051	\$318,243
Mr. Peter Clifford	Director/Vice-President and General Manager	\$427,274	\$417,224	\$400,318
Mr. Graham Light	Director/Senior Vice-President Racing Operations	\$353,782	\$335,221	\$284,463
Mr. Richard Wells ²²	Director ²³	\$104,500	\$110,500	\$91,000
Mr. Wally Parks	Vice-Chairman	None reported	\$300,000	\$417,500
Gary Darcy	Senior Vice President	\$393,774	None reported	\$365,287

¹⁹ *Id.*

²⁰ NHRA 2007 Form 990, p. 5.

²¹ The data in this chart is compiled from NHRA's 2008 Form 990 (p. 7 and Schedule J), 2007 Form 990 (p. 5) and 2006 Form 990 (p. 5).

²² Mr. Wells is now deceased.

²³ Schedule J to the NHRA 2008 Form 990 notes that the compensation paid to Mr. Wells was for his services as an independent contractor.

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The NHRA, on the 2008 Form 990, also discloses that the President's compensation is set by the Board of Directors.²⁴ The compensation for the Directors is apparently set by a "personnel committee."²⁵ However, it appears as if there are no "disinterested" Directors who appoint this "personnel committee." In other words, the members of the personnel committee are likely appointed by an individual or individuals paid by the Association and may even be compensated themselves.

Moreover, the NHRA is not accountable to its 80,000 members—these individuals have no voting rights with respect to the organization's Board of Directors or its governance structure. Further, the Association's Form 990 discloses that, while NHRA has a Conflicts of Interest Policy, it does not require its Officers or Directors to disclose annually whether any conflicts exist.²⁶

Law Applicable to Section 501(c)(6) Organizations

Section 501(c)(6) provides for the exempt status of "business leagues . . . not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual." A business league, according to section 1.501(c)(6)-1 of the Treasury Regulations, "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." "Whether an organization's primary purpose is to engage in a business is . . . a question of fact."²⁷ For instance, the tax court held that the American Automobile Association, an automobile association providing commercial towing for its members, was engaged in a business and thus not entitled to exemption under section 501(c)(6).²⁸

The Regulations further provide that a business league's activities should be "directed to the improvement of business conditions of one or more lines of business" and not to "the performance of particular services for individual persons."²⁹ In distinguishing between services for particular members and general improvement of business conditions, courts and the IRS have focused on whether the economic benefits of the organization's activities flow primarily to specific members rather to the industry as a whole. For instance, a court determined that an organization formed to operate a laundry and dry cleaning plant for its members, who were in the

²⁴ *Id.*

²⁵ *Id.*

²⁶ NHRA 2008 Form 990, p. 6 and Schedule O.

²⁷ IRS CONTINUING PROFESSIONAL EDUCATION TEXT, *IRC 501(c)(6) Organizations*, John Frances Reilly, Carter C. Hull, and Barbara A. Braig Allen, 2003.

²⁸ *American Automobile Association v. Commissioner*, 19 T.C. 1146 (1946).

²⁹ Treas. Reg. § 1.501(c)(6)-1.

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laundry business, was formed to perform a particular service for individual persons.³⁰ Likewise, a court held that an organization that was designed to promote the publication of its members' writings was promoting the interests of particular individuals, rather than that of the industry as a whole.³¹

Finally, in order to maintain its tax-exempt status under section 501(c)(6), a corporation must ensure that no part of its net earnings inure to the benefit of any private shareholder or individual.³² This prohibition is absolute; even a small amount of inurement to an officer, director, or other insider will result in a denial or revocation of the organization's exemption as a business league.³³

The Regulations under section 501(a) define a "private shareholder or individual" as a person with "a personal and private interest in the activities of the organization."³⁴ Chief executives, corporate officers, and other "insiders" in a position to control or influence an organization's activities are generally considered "private shareholders or individuals" for purposes of the inurement prohibition.³⁵ For example, in evaluating whether any inurement occurred, the Officers and Directors of the NHRA, including Messrs. Compton and Gardner, are considered "private shareholders" of the NHRA.

There is very limited authority under section 501(c)(6) addressing the inurement proscription in the statute. Considerable authority exists, however, regarding the scope and application of the inurement proscription provided for by section 501(c)(3). Moreover, at least one court has looked to the authority under section 501(c)(3) for guidance in resolving an inurement controversy involving a section 501(c)(6) organization.³⁶ This analysis is logical—the inurement language of section 501(c)(3) and section 501(c)(6) is identical and both sections describe categories of organizations that are exempt from tax under section 501(a). Thus, the inurement authorities interpreting the prohibition of section 501(c)(3) should be applicable to the analysis of a question involving a section 501(c)(6) organization.

³⁰ *A-1 Cleaners and Dyers Co. v. Commissioner*, 14 B.T.A. 1314 (1929).

³¹ Rev. Rul. 57-453, 1957-2 C.B. 310.

³² IRC § 501(c)(6).

³³ See Rev. Rul. 67-251, 1967-2 C.B. 196 ("The net earnings of the league are inuring to the benefit of private individuals Therefore, the league is not exempt from Federal income tax under section 501(c)(6) of the Code, even though [the amount involved] is minor in relation to its other activities which are directed to improvement of business conditions in a line of business.").

³⁴ Treas. Reg. § 1.501(a)-1(c).

³⁵ See *United Cancer Council v. Comm'r*, 165 F.3d 1173 (7th Cir. 1999).

³⁶ See *Michigan Mobile Home and Recreational Vehicle Institute v. Commissioner*, 66 T.C. 770 (1976) citing *Founding Church of Scientology v. Commissioner*, 412 F.2d 1197 (9th Cir. 1987)

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Certain types of payments clearly constitute inurement. For instance, as the IRS has stated, “[i]nurement takes many forms [including] excessive compensation paid to insiders.”³⁷ In accordance with this truism, courts and the IRS have long interpreted the prohibition of inurement as requiring those in charge of an organization to be paid no more than “reasonable” compensation by the organization.³⁸ Guidance for the “reasonableness” determination has been drawn from a standard established under section 162, which defines “reasonable compensation” as the amount that “would ordinarily be paid for like services by like enterprises for like services under like circumstances.”³⁹

The NHRA May be Operating a For-Profit Business and Providing Particular Services to its Members

As the NHRA Form 990s and the Proxy Statement demonstrate, the Association’s racing business is quite profitable. Indeed, it is so profitable that these assets, which are responsible for the bulk of the organization’s revenue, were the target of an asset acquisition by HD Partners and are strikingly similar to the operations of NASCAR and IHRA. As noted above, the IRS determines whether a section 501(c)(6) organization is operating a “business” as a for-profit would based on all the facts and circumstances. The commercial successes of organizations like NASCAR and IHRA provide striking proof that the NHRA operates a business as a for-profit would. Moreover, the fact that the bulk of the NHRA revenue comes from assets that a for-profit organization contemplated buying to incorporate into its commercial endeavors provides additional compelling evidence that those assets constitute a business the type of which is normally carried on by a for-profit organization. Just as AAA’s towing activities were not entitled to exemption because they operated as a commercial business—by providing a service that for-profit businesses provided⁴⁰—the NHRA drag racing business operates in a similar commercial fashion—and indeed, a for-profit organization sought to buy those very assets to provide the same service.

³⁷ IRS Chief Counsel Advice 200936027 (Sept. 4, 2009).

³⁸ See, e.g., *Mabee Petrol. Corp. v. United States*, 203 F.2d 872 (5th Cir. 1953) (“The familiar principle that corporate net earnings may not be channeled to officers in the form of excessive and unreasonable salaries is too well settled to require citation of authority.”); *World Family Corp. v. Comm’r*, 81 T.C. 958 (1983) (“It is well established that an exempt organization is entitled to pay reasonable compensation for services without endangering its exemption.”) (citations omitted); *Church of Scientology v. Comm’r*, 823 F.2d 1310 (9th Cir. 1987) (“payment of excessive salaries will result in a finding of inurement”) (footnote and citations omitted); Gen. Couns. Mem. 39498 (Apr. 24, 1986).

³⁹ Treas. Reg. § 1.162-7(b)(3).

⁴⁰ *American Automobile Association*, *supra*, 19 T.C. 1146.

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Furthermore, given the extraordinarily high percentage of the NHRA budget that is expended on the racing activities and that benefit particular individuals—be they prize winners, race track operators or other private parties profiting from the racing events—it certainly appears as though the Association may be operated to benefit specific commercial interests, rather than the industry as a whole. The NHRA's circumstances are no different than the organizations designed to promote the writings or provide a laundry service to its members—in each of these situations, the organization's primary purpose is to further the interests of its particular members, rather than the industry as a whole.

The NHRA Compensation Arrangements May be Excessive

As Officers and Directors of the organization, Mr. Compton, Mr. Gardner and the other individuals discussed above are entitled to reasonable compensation. However, based on the standard described above, we believe that the NHRA compensation arrangements detailed in the organization's Form 990 may well be excessive, especially in light of the scope of responsibilities described for some of the individuals in question.

To this end, we evaluated the comparable compensation data detailed in the American Society of Association Executives compensation report. While the report does not contain data for officials with either the title President or Chairman of the Board, it does contain data for Chief Executive Officers. According to this study, average total compensation paid to CEOs at the ten largest trade associations in the United States, measured by number of staff, was \$642,447 in 2006.⁴¹ The 75th percentile for compensation paid to CEOs at the 24 largest trade associations, measured by annual budget, was even less—\$621,750.⁴² The compensation that Mr. Compton received in 2006, 2007 and 2008 was in excess of both these numbers.

Moreover, it appears that the organization has little—or no—procedural controls in place to ensure that compensation decisions are evaluated on an independent basis. Not only does the organization not require its Officers and Directors to disclose any conflicts, but, at least through 2008, the NHRA also appeared to lack *any* independent Directors who were capable of approving compensation or other issues involving its Officers and Directors. Likewise, the fact that two Directors are both compensated—handsomely—for services provided to the NHRA as independent contractors may be problematic. In light of these defects, the abnormal circumstances surrounding these arrangements, and the value of the various compensation packages, we have no choice but to question the overall structure.

Conclusion

⁴¹ See ASAE, *Association Compensation & Benefits Study* (2006) at 27, T.20. Each of these organizations had more than 100 employees.

⁴² See *id.* at 25, T.16.

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As you can see, the information regarding the NHRA's business activities, financial benefits provided to private parties, and compensation arrangements is troubling, at best. Moreover, the IRS Exempt Organizations Division recently noted its interest in ensuring that section 501(c)(6) organizations are, in fact, operating in compliance with the Code.⁴³ Accordingly, I respectfully request that the IRS initiate an examination to determine whether the NHRA's activities and compensation arrangements described above do, indeed, violate the rules provided under section 501(c)(6).

If you have any questions or require any additional information, please do not hesitate to contact me at (202) 862-5020.

Sincerely,



Marcus S. Owens

Enclosures

cc: Director, EO Examinations

⁴³⁴³ See, EO Implementing Guidelines and Workplan for the 2010 Fiscal Year at p. 28.