IRS LETTER RULINGS

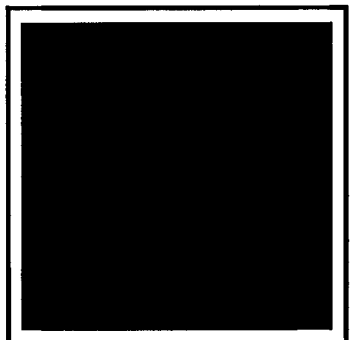
Letter Ruling Alert

by Lloyd H. Mayer,
Caplin & Drysdale

Round Income, Square Tax Code

Introduction

The creation of innovative income streams for private foundation can make it difficult for the Service to determine the proper tax treatment of such income streams under the existing tax rules. In a recent private letter ruling (PLR 200136025 (June 11, 2001)), a charitable trust that was classified as a private foundation sought the Service's blessing on its characterization of particular income as royalties for unrelated business income tax and section 4943 excess business holdings purposes. The trust had received a gift from a limited partnership of an income stream that equaled a fixed percentage of the partnership's "simulated taxable income." The trust did not receive any other rights or powers with respect to the partnership, nor did the trust have any control or influence over the partnership's activities, which involved operating a ski resort. (For PLR 200136025, see p. 247.)



Lloyd H. Mayer

The Service first concluded that the payment in fact qualified as "royalties" for purposes of section 512(b)(2) because the trust had a completely "passive" role with respect to the partnership. The Service then concluded that the trust's interest in that income was not a "business enterprise" for section 4943 purposes, apparently based on the fact that all of the income received by the trust as a result of owning that interest was section 512(b)(2) royalties. Finally, the Service concluded that since the trust's role was completely passive, the trust's purposes and activities were unchanged by the receipt of this income so the trust's section 501(c)(3) and section 509(a) status were unaffected. The Service's stated reasons for reaching these conclusions demonstrate the difficulty of applying the UBIT and excess business holdings provisions of the code to unanticipated forms of income.

Facts

The ruling involved a charitable trust that was classified as a tax-exempt private foundation under sections 501(c)(3) and 509(a). The trust owned significant assets and periodically distributed its income to various charitable organizations and for various charitable uses.

A limited partnership that owned and operated a ski resort offered to make a charitable contribution to the trust of a "royalty interest" equal to a fixed percentage of the partnership's "simulated taxable income." Virtually all of the interests in the limited partnership were owned by a single person, who had also made various donations to the trust but who did not apparently serve as one of the trust's trustees. The ruling does not state whether this person was a substantial contributor to the trust under section 507(d)(2) and therefore a disqualified person with respect to the trust under section 4946(a)(1)(A).

Simulated taxable income was defined as taxable income, determined as if the partnership were a corporation (without depreciation deductions or any carryforwards or carrybacks), with certain adjustments. These adjustments involved adding all cash receipts (excluding monies borrowed) not taken into account in computing taxable income, and deducting all amounts paid to reduce the partnership's indebtedness and all other amounts paid by the partnership that were not otherwise taken into account in computing taxable income.

If this income was negative, the "royalty" paid to the trust would be zero and there would be no effect on the amount of the royalty for any other year. This arrangement was to be evidenced by a written agreement, the "Perpetual Royalty Interest Agreement" (the "Agreement"). The Agreement also provided that the trust would not own any interest (general or limited) in the partnership or any part of the ski resort or the partnership's assets, and would have no right to control or direct the partnership's business activities, except for the right to review the royalty computations. The Agreement also protected the trust from any liabilities of the partnership, including providing that the partnership would indemnify the trust from any liability arising out of the Agreement or the partnership's actions (or inactions).

IRS Conclusions and Rationale

"Royalties"

The Service first addressed the issue of whether the payments from the partnership to the trust constituted "royalties" under section 512(b)(2) and therefore were exempt from UBIT. Noting the lack of any definition for the term royalties in the code or the regulations, except for a reference to "all the facts and circumstances of each case," the Service turned to Rev. Rul. 81-178, 1981-2 C.B. 135 (misidentified in the letter ruling as Rev. Rul. 81-78). In that ruling, the Service

differentiated between payments for the use of intellectual property, such as trademarks, trade names, service marks and copyrights, which qualified as section 512(b)(2) royalties, and payments for services such as personally endorsing products, making personal appearances, and participating in interviews. The ruling also stated that "[t]o be a royalty, a payment must relate to the use of a valuable right."

Applying the ruling to the income received by the trust, the Service concluded that the payments from the limited partnership to the trust would qualify as royalties under section 512(b)(2). The Service appears to have based this conclusion solely on the "completely passive role" of the trust with respect to the partnership. The Service did not address or explain how this income stream could constitute a royalty as defined in Rev. Rul. 81-178 given that it was not associated with the use of any valuable right by the partnership.

Excess Business Holdings

The Service then turned to the definition of a "business enterprise" under section 4943. The Service noted that for a partnership or joint venture, section 4943(c)(3) provides that the permitted holdings are calculated based on the profit interest and capital interest held by a private foundation and its disqualified persons. Citing section 4943(d)(3) and reg. section 53.4943-10(c)(1), the Service also noted that a business enterprise does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources, and that such income includes section 512(b)(2) royalties.

Relying on its conclusion that the income the trust would receive from the limited partnership constituted section 512(b)(2) royalties, the Service held that the income also constituted gross income from passive sources for purposes of section 4943. The Service then apparently concluded that this meant that the trust's "royalty interest" was not a business enterprise for section 4943 purposes, so the trust's royalty interest could not constitute an excess business holding. The Service did not provide an explanation for its apparent conclusion that the "business enterprise" in which the trust had an interest was the stream of income from the partnership and not the partnership itself.

Activities

Having determined that the income received by the trust from the partnership constituted non-taxable royalties for purposes of section 512(b)(2) and the royalty interest held by the trust did not constitute a business enterprise for section 4943 purposes, the Service ended the ruling by concluding that the trust's purposes and activities would remain unchanged by the receipt of this income. This conclusion allowed the Service to rule that the trust's tax-exempt, private foundation status under sections 501(c)(3) and 509(a) was unaffected by the receipt and continued ownership of this royalty interest.

Comment

This ruling demonstrates that private foundations continue to explore innovative means of receiving income without either running afoul of the chapter 42 restrictions on investments or being subject to UBIT. (See, e.g., PLR 199939046 (July 6, 1999) (involving an investment partnership of related foundations; discussed in this column in the November 1999 *EOTR*). It also highlights the difficulty of determining the tax consequences of such arrangements when they are subject to statutory and regulatory schemes designed for more traditional investments.

Royalties

The Service is correct that section 512(b)(2) does not provide a definition of the term "royalties," and that the applicable regulations only provide that the determination of whether a particular item of income falls within any of the modifications provided by section 512(b) "shall be determined by all of the facts and circumstances of each case." See reg. section 1.512(b)-1. The Service's conclusion that the income is royalties is difficult, however, to reconcile with the applicable law.

Section 512(b)(2) and the revenue ruling on which Service relies both strongly suggest that "royalties" are payments arising from the right to use intangible property. Section 512(b)(2) provides: "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 such income" (emphasis added). Reg. section 1.512(b)-1(b) applies this "from the property" language specifically to mineral royalties, but there is no indication that this language is limited only to such royalties. Rev. Rul. 81-178 provides that a tax-exempt organization receives section 512(b)(2) royalties when businesses pay the organization for permission to use the organization's trademarks, trade names, service marks, and copyrights, and members' names, photographs, likenesses, and facsimile signatures. It also states that "[t]o be a royalty, a payment must relate to the use of a valuable right," as opposed to a payment for personal services.

The definition of royalties as income relating to the right to use intangible property is also adopted by the courts applying section 512(b). For example, the U.S. Court of Appeals for the Ninth Circuit concluded "under section 512(b)(2) 'royalties' are payments for the right to use intangible property," relying in part on Rev. Rul. 81-178. *Sierra Club v. Commissioner*, 86 F.3d 1526, 1532 (9th Cir. 1996). The Tax Court has also defined royalties in this manner for section 512(b)(2) purposes, and the Service has agreed with this definition in recent litigation involving this issue. E.g., *Common Cause v. Commissioner*, 112 T.C. 332, 339-40 and n.3 (1999).

Finally, the Service has also agreed with this definition in internal documents discussing section 512(b)(2). Memorandum from Director, Exempt Organizations Division to Acting EO Area Managers dated Dec. 16, 1999 (*Doc 2000-6793 (000 original pages)*; *2000 TNT 46-19*). Given this consistent definition of the term "royalties" for purposes of section 512(b)(2), the better conclusion would have been that since the trust is not providing the limited partnership with the right to use any intangible property, the payments to the trust are not section 512(b)(2) royalties.

The Service's difficulty with characterizing the income stream found here appears to have arisen from the fact that the income stream does not fit neatly into any typical category for income. It is not a dividend because it does not arise from the ownership of an equity interest in a corporation. It is not interest because there has not been any money lent. And it is not royalties because it is not a payment for use of intangible property.

The better approach for determining the tax treatment of this income, based on the facts stated in the ruling, would have been to turn to section 512(c)(1). That section provides that "[i]f 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 . . . 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."

The likely objection to this approach is that the trust's passive role with respect to the partnership means that it is not a "member" of the partnership for purposes of section 512(c)(1). The Service has not, however, let the passive role of a tax-exempt organization deter it from applying section 512(c)(1). The Service and the courts (at the urging of the Service) have both concluded that for purposes of this section a "member" includes general and limited partners, even though limited partners usually have little or no control over a limited partnership. See *Service Bolt & Nut Inc. v. Commissioner*, 724 F.2d 519 (6th Cir. 1983); Rev. Rul. 79-222, 1979-2 C.B. 236. In *Service Bolt & Nut Inc.*, the court specifically rejected the argument that the passive nature of limited partners required the conclusion that the term "member" did not included limited partners.

It is true that the Agreement provides that the trust did not own any interest (general or limited) in the partnership. The Service is not, however, generally bound by the parties' characterization of their relationship. At a minimum, the ruling would have been more helpful if the Service had reached the issue of whether section 512(c)(1) applies and provided a reasoned basis for concluding it did not apply, rather than attempting to force the income stream within the definition of "royalties."

Excess Business Holdings

The Service's section 4943 ruling also applies the tax rules in a puzzling way. Instead of determining whether the limited partnership constitutes a business enterprise, and then whether the trust's "royalty interest" in the partnership would be an excess business holding, the Service treats the stream of income represented by the royalty interest as if it is itself a separate trade or business. More specifically, the Service appears to base its section 4943 ruling on the fact that since 100 percent of that stream of income is gross income from passive sources (a conclusion that is itself suspect because the income is not in fact section 512(b)(2) royalties), that interest is not a "business enterprise" for section 4943 purposes and therefore the trust does not have an excess business holding by virtue of its receipt or ownership of that interest. The Service does not state why it did not make the business enterprise determination with respect to the partnership instead of with respect to the royalty interest.

The oddness of the above conclusion is illustrated by looking at the more common situation of owning a right to an income stream from a corporation. The right to such an income stream is generally held through the ownership of nonvoting stock, i.e., preferred stock that only confers a right to dividends but no voting or control rights over a corporation. In that case, it is well established that the determination of whether a foundation owns an interest in a "business enterprise" or an interest in an enterprise that receives 95 percent or more of its gross income from passive sources is not made at the nonvoting stock level but at the corporation level. See, e.g., Rev. Rul. 81-22, 1981-1 C.B. 510. The fact that the nonvoting stock itself only produces gross income from passive source, i.e., dividends, is irrelevant. The relevant question is whether the underlying corporation receives at least 95 percent or more of *its* gross income from passive sources.

The Service may have chosen to treat the royalty interest as a separate trade or business because it concluded that the royalty interest did not appear to be either a "profits interest" or a "capital interest" in the partnership. Section 4943 only applies to a foundation's interest in a partnership if that interest is either a "profits interest" or a "capital interest." Section 4943(c)(3). Here, the Agreement provides that the trust does not gain an interest in the partnership or any right to the assets of the partnership by virtue of receiving the "royalty interest," so the Service may have concluded that the trust would not have either a profits interest or a capital interest in the partnership. The ruling is unclear, however, regarding whether this was the Service's reasoning.

The determination of whether the trust's "royalty interest" is really a profits interest or a capital interest is critical to resolving the section 4943 question. The limited partnership is itself a business enterprise since the partnership's income is derived primarily from the ownership and operation of a ski resort and not from passive sources. Furthermore, if the contributor were a substantial contributor under section 507(d)(2) and therefore a disqualified person under section 4946(a)(1)(A) with respect to the trust, the trust would not have been able to own any profits interest or capital interest in the partnership. This is because section 4943 limits the percentage interest a private foundation, together with its disqualified persons, can own in the voting stock of a corporation, and further provides that if the disqualified persons own above the permitted threshold the foundation cannot even own nonvoting stock, although such stock may only provide a right to dividends and no other rights.[1] See section 4943(c)(2)(A) (permitting a private foundation to own an unlimited amount of nonvoting stock in a corporation, but only if all disqualified persons with respect to the foundation do not together own more than the excess business holdings threshold); reg. section 53.4943-3(b)(2)(i) (same). Section 4943(c)(3) applies these same restrictions to partnerships by substituting "profits interest" for "voting stock" and "capital interest" for "nonvoting stock." Therefore, assuming that the

contributor was in fact a substantial contributor, the ownership by the trust of either type of interest in the limited partnership would have been prohibited. Section 4943(c)(3).

Reg. section 53.4943-3(c)(2) provides that "[t]he interest in profits . . . shall be determined in the same manner as [the] distributive share of partnership taxable income" and "[i]n the absence of a provision in the partnership agreement, the capital interest . . . in a partnership shall be determined on the basis of [the] interests in the assets of the partnership . . . upon . . . withdrawal from the partnership, or upon liquidation of the partnership, whichever is greater." It is evident that the royalty interest is not a capital interest, since the royalty interest explicitly did not grant the trust any right to any of the partnership's assets upon the trust's withdrawal from the partnership or upon liquidation of the partnership. It is more difficult to determine whether the royalty interest is in fact a profits interest.

The Agreement states that the trust does not have any interest in the partnership, but the parties' characterization of the arrangement is not binding on the Service. The Service has ruled previously that an interest in the profits of partnership is a "profits interest" for purposes of section 4943 regardless of whether the owner of that interest is a limited partner with no authority to exercise control over the partnership business. See, e.g., PLR 8407095 (Nov. 17, 1983). The Service has also previously ruled that an arrangement that effectively creates a profit interest in partnership, even if not labeled as such, is subject to the percentage ownership limitations of section 4943. See PLR 9715031 (Jan. 13, 1997) (involving a private foundation agreeing to have a private manager operate a hospital in exchange for a share of the resulting earnings).

If it is assumed that the Service reached the correct result, for whatever reasons, there are some interesting ramifications. For example, assume that instead of a partnership the business enterprise here was a corporation. There does not appear to be any reason, based on the Service's ruling, why the corporation could not have also given the trust a "royalty interest" that paid the trust a percentage of the corporation's taxable income, but did not give the trust any other rights of ownership or control. If such an interest did not qualify as either a profits interest or a capital interest for a partnership under section 4943, consistency would appear to require that it also not qualify as either voting stock or nonvoting stock under section 4943. If this is the case, then a disqualified person could own a corporation, have the corporation give to that person's private foundation a "royalty interest" representing up to 100 percent of the foundation's taxable income, and not have run afoul of the section 4943 restriction on excess business holdings. Such a result would appear to run counter to Congress's intent in enacting section 4943, specifically its concern that allowing a business enterprise controlled by disqualified persons to shift the income stream of the enterprise to their private foundation "might effectively remove from outsiders any practical opportunity to gain control." This was the reasoning beyond the prohibition on a private foundation owning nonvoting stock if its disqualified persons owned voting stock in excess of the section 4943 limits on voting stock. Staff of the Joint Comm. on Taxation, 91st Cong., 2d Sess., General Explanation of the Tax Reform Act of 1969, at 41 (Comm. Print 1970).

Activities

The Service's conclusion that the limited partnership's activities should not be attributed to the trust relies on the passive role of the trust. The difficulty with this conclusion is that it ignores section 512(c)(1) and the Service's general position that the activities of a partnership are attributable to its exempt organization members. See Rev. Rul. 98-15, 1998-1 C.B. 718. The Service has, however, only applied this general position when the exempt organization has exercised significant control over the partnership. It therefore would not be inconsistent for the Service to conclude that the fact that the limited partnership's activities are attributable to the trust for UBIT purposes does not require that they be attributed to it for section 501(c)(3) and section 509(a) purposes given the trust's passive role. The Service's conclusion may very well be correct, but it would be stronger if the Service had addressed why section 512(c)(1) would not compel a different result.

Conclusion

The permutations that contributors and private foundations can create for securing income streams for foundations is virtually unlimited. It is not surprising therefore that the rules designed to guide private foundations and the Service in how such income streams should be treated for tax purposes do not apply perfectly to every situation. This ruling reflects one such situation, where the Service's need to classify an income stream to fit the categories provided by the code has confused both the definition of "royalties" for purposes of section 512(b)(2) and the application of section 4943 to partnerships. The result unfortunately creates more and not less uncertainty in this area and makes it more difficult for foundations to proceed with new types of investments or to receive new types of income streams without first seeking their own ruling from the Service.

Endnotes

[1]Except for a *de minimis* amount of stock that represents 2 percent or less of the voting power and value of the corporation's stock. Section 4943(c)(2)(C)).