Internal Revenue Service

Department of the Treasury

Washington, DC 20224

No Third Party Contact
501.03-00
511.00-00
513.00-00

Contact Person: 199915061

Telephone Number:

In Reference to: OP:E:EO:T:4

Date: JAN 20 1999

EIN:
Key District:

Legend:

M -
N -

Dear Sir:

This is in response to your request, dated November 12, 1998, for a ruling on whether the proposed merger between you and M would adversely affect your tax-exempt status under section 501(c)(3) of the Internal Revenue Code and the rulings previously issued concerning specific activities.

You and M are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and classified as a non-private foundations within the meaning of section 509(a)(2). You both share the same mission to provide visionary leadership to state school boards and to support, through risk management services, their mutual pursuit of enhancing public school education. After the merger, you will be the surviving corporation and M's status as an entity would disappear.

You were formed for the purpose of administering the various risk management programs created for the state public schools. You achieve cost savings by pooling together resources and avoiding duplication of efforts in the areas of risk management and loss control respecting public school resources, utilizing workshops, newsletters, consulting, contract supervision, financial management services, etc. You are governed by the same board as M. M is considered the mechanism whereby governance of members is formulated and policy is articulated, while you are the mechanism for actually delivering the services and programs to the members.

You are compensated for providing administrative services to N. You also offer programs and workshops, largely attendant to your role as administrator of N, designed to teach school

Refers to Written Determ. 9404004 954100

district employees cost containment methods and ways to reduce financial losses associated with risks attendant to the various programs you administer. In 1995, the Service ruled that your activities of administering the 4 self-funding programs were in furtherance of your exempt purpose of lessening the burdens of government. The Service held the management activities were not unrelated trade or business because they reduced a governmental burden.

M is a voluntary, unincorporated nonprofit organziaton established to serve the public school districts in your state. M's membership is composed of public school districts, county school boards, junior colleges, appraisal boards, cooperatives, and education service centers through the state. All of M's active members are instrumentalities or political subdivisions of the state. M has a 42 member Board of Trustees representing every geographical area of the state.

M's activities include attainment of adequate and equitable financial support of the state public schools; sponsorship of seminars, conferences, research and other projects in the various aspects of public education; promotion of efficient and effective managements and governance of the public schools; providing a forum for solutions to problems in public education; providing current information regarding public education, including changes in schools law and developments in educational programs; and the provision of services to enhance sound management and fiscal responsibility for the school districts.

M licenses its name and logo to N. In 1993, the Service ruled that four comparable licensees, created in accordance with state law to discharge necessary governmental functions for or on behalf of participating local governments, to use M's name and logo, did not contribute importantly to M's exempt function; thus earnings from such licenses constituted unrelated business income. The Service further determined the amounts received under the agreements were attributable to royalties, as described in section 512(b)(2). The Service also held that because M controlled the licensee entities, section 512(b)(13) was applicable. In 1997 three of the entities merged into a fourth and are now known as N.

N is an administrative agency of cooperating state local governments created in accordance with state law to discharge necessary governmental functions for or on behalf of participating local governments. N acts to discharge governmental functions and expend public funds in providing a number of similar services. It identifies risk exposures for school districts in the areas of workers' compensation, employee benefits, unemployment benefits, and property casualty

and liability, develops plans for reducing and/or minimizing those exposures, provides for efficient and effective claims administration for losses which have occurred, develops a plan for financing and funding of those losses and/or exposures, invests those funds for the most effective return to meet their intended purpose, secures appropriate financial protection for catastrophic or higher or more frequent than expected losses, educates school districts on methods to prevent future claims and/or losses, and negotiates with various vendors for preferred services and pricing to its members.

Section 501(c)(3) of the Code provides for the exemption from federal income tax under section 501(a) of organizations that are organized and operated exclusively ... for educational and charitable purposes.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 501(m)(1) of the Code provides that an organization described in sections 501(c)(3) or 501(c)(4) will be exempt from tax under section 501(a) "only if no substantial part of its activities consists of providing commercial-type insurance."

Section 501(m)(3) of the Code provides several exceptions to the definition of commercial-type insurance. Under section 501(m)(3)(A), commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients.

Section 511 of the Code imposes for each taxable year a tax on the unrelated business taxable income (as defined in section 512) of every organization described in section 501(c).

Section 512 of the Code defines unrelated business taxable income as the gross income derived by an organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions which are directly connected with the carrying on the trade or business, with certain modifications.

Section 512(b)(2) of the Code provides that royalties and all deductions directly connected with such income shall be excluded from unrelated business income tax.

Section 513 of the Code defines "unrelated trade or business," for any organization subject to tax under section 511, as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it made of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the regulations states that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one.

Rev. Rul. 81-178, 1981-2 C.B. 135, held that income derived from an agreement for the use of an organization's trademarks, trade names, service marks, copyrights, and members' names in connection with the promotion of merchandise and services provided by the businesses, where the organization maintained quality control rights, constituted tax free royalties within the definition of section 512(b)(2) of the Code.

Rev. Rul. 85-1, 1985-1 C.B. 178 and Rev. Rul. 85-2, 1985-1 C.B. 178, set forth the criteria for determining whether an organization's activities lessen the burdens of government. The relevant inquiry is whether the governmental unit considers the organization's activities to be its burden and whether the activities actually lessen the burden of the governmental unit. An activity is a burden of government if there is an objective manifestation by the governmental unit that it considers the activities of the organization to be its burden. The interrelationship between the governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden.

In National Water Well Association v. Commissioner, 92 T.C. 75 (1989) the Tax Court held that where an organization provided a licensee, an insurance company with membership lists, wrote articles on safety and its effect on insurance, provided exhibit space at conventions and meetings, employed someone to answer inquiries regarding the insurance, and place advertisements for the insurance in its journals to contact the organization directly, income derived from such activity on behalf of the licensee lost its character as passive royalty income, and was taxable.

In our Memorandum dated September 30, 1993, we held that amounts received from M's agreement with the predecessors of N" is royalty income under section 512(b)(2) of the Code and must be included in its unrelated business taxable income because it is derived from controlled entities, and the taxability of such income is determined in accordance with section 512(b)(13). The extent of M's activities were a one-page advertisement in its membership directory, containing a statement that the program is supported by M, and various administrative duties that the organization performs in relation to the royalties.

The law has not changed since our Memorandum was issued, and you have stated the licensing agreement will essentially remain the same, with only one change - that being your substitution for M after completion of the merger. The fact that you are now the licensor is not a "material fact" justifying any modification of the ruling or its precedential value.

In our Memorandum dated June 19, 1995, we stated that the administrative services provided by you to the predecessors of N lessened the burdens of government according to the criteria set forth in Rev. Ruls. 85-1 and 85-1, supra. We also ruled that the administrative services are related to your exempt function and are a related trade or business within the meaning of section 1.513-1(d)(2) of the regulations. Your state statute authorizing political subdivisions to enter into interlocal contracts for the provision of governmental services to increase efficiency and effectiveness of local governments provided an objective manifestation that the state considered risk management and the associated administrative and management services to be part of its burden and an obligation to be borne by all school districts. We found that your administrative services enabled the school districts to perform their essential governmental functions in a more cost-efficient manner and held that merely providing administrative services on behalf of governmental units would not be providing insurance within the meaning of section 501(m).

You stated that you will continue to operate in the same manner, with respect to the provision of administrative services and educational programs, as you did when our Memorandum dated June 19, 1995, was issued. Therefore, there is no modification to the ruling.

Based upon the information provided, after the merger you will continue to carry forward your programs and those of M. M is an organization recognized as tax-exempt under section 501(c)(3) and classified as a section 509(a)(2) organization. M will no longer be in existence after the merger. As there has been no change in facts previously provided for exemption and for the previous rulings, the merger of you and M will not adversely

affect your tax-exempt status under section 501(c)(3) and your status under section 509(a)(2).

Based on the information furnished, we rule that:

1. The proposed merger will not adversely affect your tax-exempt status under section 501(c)(3) of the Code or your foundation status under section 509(a)(2).

2. Upon effectuation of the proposed merger, you may treat the revenues derived as successor licensor, with respect to the royalty payments received from N, as amounts described in section 512(b)(2) of the Code, consistent with our Memorandum dated September 30, 1993. The provisions of section 512(b)(13) are still applicable.

3. Upon effectuation of the proposed merger, the performance of claims services by you on behalf of N will be considered in furtherance of a charitable purpose and not contrary to section 501(m), consistent with our Memorandum dated June 19, 1995.

We are informing your Key District Director of this ruling. If you have any questions please contact the person whose name and telephone number are shown in the heading of this letter. Please keep a copy of the ruling in your permanent records.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Chief, Exempt Organizations
Technical Branch 4