200905033

INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM

UIL: 501.0324

Area Manager, EO Examinations

Taxpayer's Name:

NOV 3 2008

Taxpayer's Address:

Taxpayer's ID No.:

Year(s) Involved:

LEGEND:

Charity	=
Sponsor	=
Corporation	=
A	=
B	=
C	=
Date a	=
Date b	=
Date c	=

ISSUES:

1. Do the activities performed by Charity for Sponsor constitute scientific research in the public interest and activities in furtherance of Charity's exempt purpose?

2. Does the agreement between Charity and Sponsor result in the inurement of any part of Charity's net earnings to private individuals?

3. Do the answers to issues 1 and 2 result in the conclusion that Charity is no longer exempt under section 501(c)(3) of the Internal Revenue Code or that Charity is subject to the tax on unrelated business income on its income from the agreement with Sponsor?

4. If Charity no longer qualifies for exemption, is Charity entitled to relief under section 7805(b) of the Code?

FACTS:

Charity was incorporated on Date a as a not-for-profit corporation. It submitted a timely Form 1023 and was granted tax exemption as an organization described in section 501(c)(3) on Date b. Charity is governed by a 3 person board of directors, consisting of A, B, and C. Charity was formed to investigate the basic science of and its use in the medical field.

uses a powerful magnetic field to align atoms in the body and then uses another field to alter this alignment, producing variations that can be detected and used to create an image. Different methods based on this general principle can be used to produce various image types and qualities.

Charity carries out a variety of activities designed to explore the use of in the medical field and has published its results. Charity has received funds for these activities from state and federal agencies for several years and has participated in joint research with a university medical school.

Corporation was formed several years before Charity and is a general business corporation. During the relevant time period, its shareholders were A, B, and two other persons. The board of directors of Corporation consisted of A, B, and C. Sponsor is also a business corporation. On Date c, Corporation granted Sponsor a non-exclusive license to use three of its patents. These patents related to one method of using

Charity and Sponsor entered into a research agreement whereby Charity would perform various activities for Sponsor, including collection of data gathered using the method covered by the patents licensed to Sponsor by Corporation. The agreement provided that any know-how, inventions (patentable or not) or copyrightable materials resulting from the research (the Results) would be the property of the party that created the Results. If the Results were produced jointly by the Charity and Sponsor, they would own the Results jointly. With respect to any part of the Results owned by Charity, the agreement required Charity to grant Sponsor (and its affiliated companies) a world-wide, non-exclusive, non-cancelable, royalty-free license to use the Results for any applications.

Charity designed the studies to be conducted under the agreement, though Sponsor's representatives were allowed to observe the studies without interfering in them. The following activities were to be conducted:

1. Collect clinical data on an experimental medical imaging method in the areas of trauma, stroke and vascular disease.
2. Demonstrate the viability of a modified version of the imaging method and its use in discriminating between clots and vessels.

The Results of the research will not constitute marketable products on their own. Charity's activities will not involve testing any commercial product to qualify it for sale, nor will Charity conduct market research or evaluate the commercial value of the method.

There were no restrictions on the publication of the results of Charity's studies, except that Charity was required to acknowledge Sponsor's support in any relevant publications. The results of Charity's studies were published in two separate papers in different scientific journals shortly after the studies were completed. The papers discussed the approach used in Charity's studies and the effectiveness of the new method compared to traditional methods.

Issue 1

Do the activities performed by Charity for Sponsor constitute scientific research in the public interest and do they qualify as activities in furtherance of Charity's exempt purpose?

Applicable Law

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, scientific, and other purposes, provided that no part of its net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it

engages primarily in activities that accomplish one or more of 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 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(5)(i) of the regulations provides that since an organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest, a "scientific" organization must be organized and operated in the public interest. The term "scientific" therefore includes the carrying on of scientific research in the public interest.

Section 1.501(c)(3)-1(d)(5)(ii) of the regulations provides that scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, such as ordinary testing.

Section 1.501(c)(3)-1(d)(5)(iii)(c) of the regulations states that scientific research will be regarded as carried on in the public interest if such research is directed toward benefiting the public. If the research is carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public, such research will be regarded as directed toward benefiting the public and therefore as research carried on in the public interest. Scientific research "will be regarded as carried on in the pubic interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research."

Section 1.501(c)(3)-1(d)(5)(iv) of the regulations states that an organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under section 501(c)(3) as a "scientific" organization if, among other things, it will perform research only for persons which are directly or indirectly its creators and which are not described in section 501(c)(3).

Revenue Ruling 68-373, 1968-2 C.B. 206 holds that an organization which performs clinical testing of drugs for commercial pharmaceutical companies according to specifications and procedures set out by the pharmaceutical companies is not engaged in scientific research, but is engaged in testing incident to normal commercial operations.

Revenue Ruling 76-296, 1976-2 C.B. 141, provides, in part, that otherwise qualifying scientific research will not constitute an unrelated trade or business by reason of its being undertaken pursuant to contracts with private industry and where the commercial sponsor retains the ownership rights to the research and any rights in patents resulting from the research. The ruling also provides that if patent rights are involved, publication of the research results may be delayed pending reasonable opportunity to establish those rights.

In IIT Research Institute v. United States, 9 Cl. Ct. 13 (Cl. Ct. 1985), a U.S. Claims Court reviewed the activities of an organization exempt under section 501(c)(3) of the Code. The organization contracted with a variety of industry members to perform research for them. The court defined the term "scientific" to include "the process by which knowledge is systematized or classified through the use of observation, experimentation, or reasoning." The court found that the organization was not involved in the commercialization of the products or process developed as a result of its research. IIT Research Institute only developed a project to the point where the research principles were established. At this point, the sponsors would make the principles available to different customers, usually in the form of newly developed products or equipment. The court found significance in the fact that IIT Research Institute did not engage in any consumer or market research or ordinary testing of the type which is carried on incident to commercial operations. The court therefore found that the organization's activities were research and not ordinary testing carried on as an incident to commercial or industrial operations.

In Midwest Research Institute v. United States, 554 F.Supp. 1379 (W.D. Mo. 1983), aff'd 744 F.2d 635 (8th Cir. 1984), the court held that the Midwest Research Institute did not jeopardize its tax exempt status by performing projects for private sponsors. The court stated that a project is scientific research "if professional skill is involved in the design and supervision of a project intended to solve a problem through a search for a demonstrable truth." The court stated that projects are "ordinary testing" if the work is generally repetitive and done by scientifically unsophisticated employees to determine if the item tested meets certain specifications, "as distinguished from testing done to validate a scientific hypothesis."

Analysis

An organization is operated exclusively for exempt purposes if it is operated for scientific purposes within the meaning of section 501(c)(3) of the Code. Section 1.501(c)(3)-1(d)(5) of the regulations defines the term "scientific" to include the carrying on of scientific research in the public interest. The regulation sets out a three-part test for determining whether an organization is operated for "scientific" purposes:

1. The organization's activities must be scientific.
2. The organization's activities must constitute research.
3. The organization's activities must be in the public interest.

An activity can be considered scientific even though it is "applied" or "practical" as contrasted with "fundamental" or "basic." Treas. Reg. 1.501(c)(3)-1(d)(5)(i). Courts have broadly defined the term scientific to include a process by which knowledge is systematized or classified through the use of observation, experimentation, or reasoning. IIT Research Institute v. United States. See also Midwest Research Institute v. United States, supra. Charity's activities involve gathering and analyzing data on complex medical imaging methods and its activities are conducted by physicians. Thus, Charity's activities involve systematizing knowledge through the use of experimentation and the activities are scientific within the meaning of section 1.501(c)(3)-1(d)(5) of the regulations.

Section 1.501(c)(3)-1(d)(5)(i) of the regulations states that the term research, when taken alone, is a word with various meanings; it is not synonymous with "scientific." The regulations go on to state that scientific research does not include activities that are ordinarily carried on as an incident to commercial operations, such as ordinary testing or inspection of materials. Treas. Reg. 1.501(c)(3)-1(d)(5)(ii); see also Rev. Rul 68-373. The court in IIT Research Institute identified several facts indicating IIT was engaged in research, not commercial testing: IIT did not develop the commercial potential of products, it did not conduct market research, and it did not perform any product testing. Its activities were focused on determining whether particular research principles were valid.

Charity's activities are similar to those conducted by IIT. Charity is engaged in evaluating whether the imaging method is able to identify a variety of medical conditions. Charity is not testing any commercial product to qualify it for sale, unlike the organization described in Rev. Rul. 68-373. Any Results generated by Charity's research could provide the basis for commercial products, but would not constitute marketable products on their own. Charity does not conduct any market research or evaluate the commercial practicality of the method.

Therefore, Charity's activities are scientific research within the meaning of section 1.501(c)(3)-1(d)(5) of the regulations.

Section 1.501(c)(3)-1(d)(5)(iii)(c) provides that scientific research is carried on in the public interest if the results of the research are made available to the public, such as through a treatise or trade publication. It also provides that scientific research may be carried on in the public interest even though a commercial sponsor retains the rights to any intellectual property produced by the research. See also Rev. Rul. 76-296, supra. Thus, although a private benefit may be conferred on the intellectual property holders or other private individuals, the regulations consider that benefit to be incidental to the public benefit of facilitating scientific research.

While Charity's activities may confer a tangential benefit upon both Sponsor and Corporation, as long as the requirements in section 1.501(c)(3)-1(d)(5)(iii) of the regulations are satisfied, this benefit is incidental and does not result in a conclusion that the research is not in the public interest. Charity published two papers in publicly available journals discussing the results of the research for Sponsor. There is no indication that publication was unreasonably delayed after completion of the research. The fact that Sponsor retained exclusive rights to use any Results created from the research does not prevent the conclusion that the research itself was in the public interest. Similarly, the fact that Charity's research has the potential to increase the value of the patents held by Corporation does not prevent the research from qualifying as "scientific research in the public interest" because this potential benefit is incidental to Charity's activities. Therefore, Charity's activities are scientific research carried on in the public interest within the meaning of section 1.501(c)(3)-1(d)(5) of the regulations.

Section 1.501(c)(3)-1(d)(5)(iv)(a) of the regulations states that an organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest if it performs research only for persons that are directly or indirectly its creators and which are not described in section 501(c)(3). Regardless of whether the contract between Charity and Sponsor using Corporation's patents could be considered research performed for Charity's creators, Charity performs substantial research for other organizations as well. Charity has performed research activities for different state and federal agencies for many years. Therefore, section 1.501(c)(3)-1(d)(5)(iv)(a) does not prevent Charity from being regarded as organized and operated for the purpose of carrying on scientific research.

Issue 2

Does the agreement between Charity and Sponsor result in the inurement of any part of Charity's net earnings to private individuals?

Applicable Law:

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(a)-1(c) of the regulations defines private shareholder or individual as a person having a personal and private interest in the activities of the organization.

Rev. Rul 69-383, 1969-2 C.B. 113, provides an example of a possible inurement situation that did not jeopardize an organization's exempt status. In the revenue ruling a tax exempt hospital entered into a contract with a radiologist which provided that the radiologist would be compensated by receiving a percentage of the gross receipts of the radiology department. The contract was negotiated on an arm's-length basis, the radiologist did not control the hospital, the amount received under the contract was reasonable in terms of the responsibilities and duties assumed, and the amount received under the contract was not excessive when compared to the amounts received by other radiologists in comparable circumstances. For these reasons, the ruling concludes that the transaction between the hospital and the radiologist did not constitute inurement.

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), the court defined "net earnings" to include more than the difference between gross receipts and disbursements in dollars. The court held that earnings, in the form of gross receipts and other assets, may inure to an individual in ways other than the distribution of dividends.

In Gemological Institute of America v. Riddell, 149 F. Supp. 128 (S.D. Cal. 1957), the court found that net earnings inured to a private individual when the organization paid over substantial sums in compensation to its founder.

In People of God Community v. Commissioner of Internal Revenue, 75 T.C. 127 (1980), the court found that part of an organization's net earnings inured to the benefit of private individuals because their compensation was based on a percentage of the organization's gross receipts with no upper limit. The court held that the petitioner was not exempt as an organization described in section 501(c)(3) of the Internal Revenue Code of 1954.

In Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953), the court acknowledged that payment of reasonable compensation to officers is not inurement. The court went on to say, however, that if the salaries paid are excessive and unreasonable then inurement of corporate net income will result. Such inurement would not allow an organization to claim tax exemption.

In American Campaign Academy v. Commissioner of Internal Revenue, 92 T.C. 1053 (1989), the court used the term "insider" as an equivalent to "private shareholder or individual" and explained that the latter means individuals who are able to exercise control over the organization, such as founders, trustees, directors, and officers.

Analysis

Section 1.501(c)(3)-1(c)(2) of the regulations states that an organization is not operated exclusively for exempt purposes if any of its net earnings inure to the benefit of private individuals. Courts have interpreted "net earnings" to include large transfers of cash or assets to private individuals, regardless of whether those transfers are considered "gross" or "net." See, e.g., Harding Hospital, Inc. v. United States, supra; Gemological Institute of America v. Riddell, supra; People of God Community v. Commissioner of Internal Revenue, supra. However, the term is limited to the transfer of value from the organization to a private individual. Section 1.501(a)-1(c) of the regulations defines private shareholder or individual as a person having a personal and private interest in the activities of the organization. This includes directors, officers, and any other person who is able to exercise control over the organization.

A and B are private shareholders with respect to Charity within the meaning of section 1.501(a)-1(c) of the regulations because they are directors of Charity. However, the agreement between Charity and Sponsor does not provide for the transfer of net earnings or any money from Charity to A, B, or any other individual. Therefore, no net earnings inure to the benefit of A or B due to the agreement between Charity and Sponsor.

The research performed by Charity for Sponsor may result in some benefit to the shareholders of Corporation, including A and B. Even so, none of Charity's net earnings have inured to the benefit of the Corporation, including A and B, for purposes of section 1.501(c)(3)-1(c)(2) of the regulations. The private benefit involved in these activities is incidental to the benefit that Charity receives, in the form of payment by Sponsor, and to the benefit to the public from the results of Charity's research. It is well established that scientific research is an exempt purpose, even if commercial entities benefit by reserving the right to ownership of

any knowledge or patentable developments that arise from the research. See Rev. Rul. 76-296, supra.

Charity does pay A a salary, however the payment of a salary to a private individual does not automatically constitute inurement. Mabee Petroleum Corp. v. United States, supra. From the facts presented, the compensation paid to A is independent of the agreement between Charity and Sponsor and is therefore not addressed in this ruling.

Issue 3

Do the answers to issues 1 and 2 result in the conclusion that Charity is no longer exempt under section 501(c)(3) of the Code or that Charity is subject to the tax on unrelated business income on its income from the agreement with Sponsor?

Applicable Law

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, scientific, and other purposes, provided that no part of its net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of 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 1.501(c)(3)-1(e)(1) of the regulations provides that an organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purposes of carrying on an unrelated trade or business.

Section 511(a)(1) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3). Under section 512(a)(1) the term "unrelated business taxable income" is defined 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 certain deductions.

Section 512(a)(1) of the Code defines the term "unrelated business income" as "the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business."

Section 513(a)(1) of the Code provides, in relevant part, 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 (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organizations of its charitable, educational, or other purpose or function constituting the basis of its exemption, except that such term does not include any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes in the relevant sense, only where the conduct of business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income) and it is "substantially related", for the purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to the purposes for which exemption is granted, the production or distribution of goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of goods or the performance of services does not derive from the conduct of related trade or business. Whether the activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Section 1.513-1(d)(4)(i) of the regulations provides that income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of an unrelated trade or business.

Revenue Ruling 76-296, 1976-2 C.B. 141, provides, in part, that otherwise qualifying scientific research will not constitute an unrelated trade or business by reason of its being undertaken pursuant to contracts with private industry and where the commercial sponsor retains the ownership rights to the research and any rights in patents resulting from the research. The ruling also provides that, if patent rights are involved, publication of the research results may be delayed pending reasonable opportunity to establish those rights.

Analysis

An organization must be organized and operated exclusively for one or more exempt purposes in order to qualify for tax exemption under section 501(c)(3) of the Code. Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will not be regarded as operated exclusively for exempt purposes if more than an insubstantial amount of its activities are not in furtherance of an exempt purpose. In the discussion of Issue 1, supra, we concluded that Charity's activities pursuant to the contract with Sponsor are scientific research in the public interest. Therefore they do further scientific purposes within the meaning of section 501(c)(3) of the Code. Charity is organized and operated for the scientific purpose of researching new methods in medical imaging. In addition, we ruled that the contract between Charity and Sponsor does not result in inurement of Charity's net earnings to private individuals. Thus, Charity's activities pursuant to the contract with Sponsor further Charity's exempt purpose and do not jeopardize Charity's tax exempt status.

Section 511 of the Code imposes a tax on the unrelated business income of an organization exempt from tax under Section 501(c)(3) of the Code. Section 1.513-1(d)(4)(i) of the regulations provides that income derived from charges for the performance of exempt functions does not constitute income from the conduct of an unrelated trade or business. As discussed in Issue 1, supra, the research performed by Charity for Sponsor is the performance of an exempt function. Therefore, even though Charity is paid by a commercial sponsor, Sponsor, for its research, the payments do not constitute unrelated business income. See also Rev. Rul. 76-296, supra.

Issue 4

If Charity no longer qualifies for exemption, is Charity entitled to relief under section 7805(b) of the Code?

Analysis

We have determined that Charity continues to qualify for exemption under section 501(c)(3) of the Code. Therefore, we do not reach the question of whether Charity is entitled to relief under section 7805(b) of the Code.

Conclusions

1. The activities performed by Charity for Sponsor constitute scientific research in the public interest and therefore qualify as activities in furtherance of Charity's exempt purpose.

2. The agreement between Charity and Sponsor does not result in the inurement of any part of Charity's net earnings to private individuals.

3. The answers to issues 1 and 2 result in the conclusion that Charity continues to qualify for exemption under section 501(c)(3) of the Code and that Charity is not subject to the tax on unrelated business income.

4. We conclude that Charity continues to qualify for exemption and is not subject to the income tax on unrelated business income under section 511, therefore we do not reach the question as to whether Charity is entitled to relief under section 7805(b) of the Code.