

## TRANSFER PRICING STRATEGIES FOR EXEMPT ORGANIZATIONS: A CASE STUDY

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### INTRODUCTION

Exempt organizations are generally permitted to engage in a trade or business to the extent that such trade or business is related to the organization's exempt purposes. In fact, engaging in a trade or business (1) enables an exempt organization to expand its exempt activities and programs and (2) offers a viable alternative to the traditional fundraising methods.

First, there are some constraints imposed by the Internal Revenue Service and the Internal Revenue Code.<sup>1</sup> The Service will impose income tax on an exempt organization under Section 511 if its trade or business activities are not related to the organization's exempt purposes (known as the "unrelated business income tax" or "UBIT").

Second, an exempt organization that engages in too much unrelated trade or business activities may jeopardize its exempt status.<sup>2</sup>

Therefore, exempt organizations have sought to minimize the amount of UBIT attributable to the exempt organization by engaging in unrelated trade or business activities through for-profit affiliates. While such corporate structures are generally permitted, the Service requires exempt organizations to deal with their for-profit affiliates on an arm's-length basis.

The arm's-length standard, as codified under Section 482, may provide an appropriate framework for income tax purposes in pricing transactions between an exempt organization and its related for-profit affiliates.<sup>3</sup> In addition to addressing the Service concerns, the authors submit the following economic proposition: a Section 482 analysis can be employed to determine the prices for transactions between (1) an exempt organization and (2) its for-profit affiliates. The Section 482 analysis should ensure that the exempt organization's limited resources are put to their best uses.<sup>4</sup>

In the absence of the arm's-length standard, it is not possible for exempt organizations to objectively evaluate (1) the costs (including taxes) and (2) the benefits of investing in different for-profit activities.

With this in mind, this article outlines some of the key provisions governing the UBIT provisions. This article also presents a case study. The case study introduces key tax personnel of an exempt organization to the process employed in analyzing transactions between an exempt organization and its for-profit affiliates. From a planning point of view, key lessons for exempt organizations are also presented.

*"The arm's-length standard, as codified under Section 482, may provide an appropriate framework for income tax purposes in pricing transactions between an exempt organization and its related for-profit affiliates."*

### SUMMARY OF RULES FOR TAX ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS

Exempt organizations routinely form taxable entities. Section 501(c)(3) hospitals, universities, labor unions, and health care organizations, among others, have for some time operated for-profits affiliated entities for mission-related and commercial purposes.

The tax on UBIT applies to most organizations exempt from tax under Section 501(a). These organizations include charitable, religious, scientific, and other organizations as described in Section 501(c).

Additionally, employees' trusts forming part of pension, profit-sharing, and stock bonus plans described in Section 401(a), are subject to the tax on UBIT.

*"Unrelated trade or business income arises from activities that are 'regularly carried on' by an exempt organization."*

### DEFINITION OF UNRELATED TRADE OR BUSINESS

A trade or business can be defined as any activity carried on for the production of income from (1) selling goods or (2) performing services. An activity does not lose its identity as a trade or business simply because it is carried on within a larger group of similar activities that may, or may not, be related to the exempt purposes of the organization.<sup>5</sup>

Unrelated trade or business income arises from activities that are "regularly carried on" by an exempt organization. However, these activities are not substantially related to the performance of the organization's exempt purpose or function, except that the organization uses the profits derived from

this activity. Business activities of an exempt organization ordinarily are considered regularly carried on if they:

1. show a frequency and continuity and
2. are pursued in a manner similar to comparable commercial activities of nonexempt organizations.

A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly, other than through the production of funds, to accomplishing its purpose. Whether activities contribute importantly to accomplishing the exempt organization's purpose is dependent upon the facts involved, such as the size and extent of the activities involved.

To determine whether activities contribute importantly to the accomplishment of an exempt purpose, there are a number of principles that should be considered.

Ordinarily, selling products that result from the performance of exempt functions is not an unrelated trade or business if the product is sold in substantially the same state it is in when the exempt functions are completed. However, if a completed product resulting from an exempt function is used or exploited in further business activity beyond what is reasonably appropriate or necessary to dispose of it, the activity is an unrelated trade or business.

If an asset or facility necessary to the conduct of exempt functions is also used in commercial activities, its use for exempt functions does not, by itself, make the commercial activities a related trade or business. The test is whether the activities contribute importantly to the accomplishment of exempt purposes.

Exempt activities sometimes create goodwill or other intangibles that can be exploited in a commercial way. When an organization exploits such an intangible in commercial activities, the fact that the income depends in part upon an exempt function of the organization does not make the commercial activities a related trade or business.

Unless the commercial exploitation contributes importantly to the accomplishment of the exempt purpose, the commercial activities are an unrelated trade or business.

## EXAMPLES OF EXCLUDED TRADE OR BUSINESS ACTIVITIES<sup>6</sup>

The Service provides guidance on the activities that are explicitly excluded from the definition of unrelated trade or business:

1. Volunteer workforce—Any trade or business in which substantially all the work is performed for an organization without compensation is not an unrelated trade or business.
2. Convenience of members—A trade or business carried on (a) by a Section 501(c)(3) organization or (b) by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees is not an unrelated trade or business.
3. Qualified sponsorship activities—Soliciting and receiving qualified sponsorship payments is not an unrelated trade or business. And, the payments are not subject to unrelated business income tax.
4. Selling donated merchandise—A trade or business that consists of selling merchandise, substantially all of which the organization received as gifts or contributions, is not an unrelated trade or business.
5. Employee association sales—The sale of certain items by a local association of employees described in Section 501 (c)(4), organized before May 17, 1969, is not an unrelated trade or business if the items are sold for the convenience of the association's members at their usual place of employment.
6. Bingo games—Certain bingo games are not included in the term "unrelated trade or business." To qualify for the exclusion, the bingo game must meet the following criteria:
  - a. it meets the legal definition of bingo,
  - b. it is legal where it is played, and
  - c. it is played in a jurisdiction where bingo games are not regularly carried on by for-profit organizations.
7. Gambling activities other than bingo—Any game of chance conducted by an exempt organization in North Dakota is not an unrelated trade or business if conducting the game does not violate any state or local law.
8. Pole rentals—The term unrelated trade or business does not include qualified pole rentals by a mutual or cooperative telephone or electric company described in Section 501(c)(12).
9. Distribution of low cost articles—The term unrelated trade or business does not include activities relating to the distribution of low cost articles incidental to soliciting charitable contributions. This applies to organizations described in Section 501 that are eligible to receive charitable contributions.

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10. Exchange or rental of member lists—The exchange or rental of member or donor lists between organizations described in Section 501 that are eligible to receive charitable contributions is not included in the term unrelated trade or business.
11. Hospital services—The providing of certain services at or below cost by an exempt hospital to other exempt hospitals that have facilities for 100 or fewer inpatients is not an unrelated trade or business.
12. Public entertainment activity—An unrelated trade or business does not include a qualified public entertainment activity.

A public entertainment activity is one traditionally conducted at a fair or exposition promoting agriculture and education, including any activity whose purpose is designed (a) to attract the public to fairs or expositions or (b) to promote the breeding of animals or the development of products or equipment.
13. Convention or trade show activity—An unrelated trade or business does not include qualified convention or trade show activities conducted at a convention, annual meeting, or trade show.

As indicated above, unrelated trade or business income is generally the gross income derived from any unrelated trade or business regularly carried on by the exempt organization, less the deductions directly connected with carrying on the trade or business. Unrelated business income is taxable, but some exclusions and special rules exist that should be considered in determining the income.

Unrelated business income exclusions include the following:

1. Dividends, interest, annuities, and other investment income—All dividends, interest, annuities, payments with respect to securities loans, income from notional principal contracts, and other income from an exempt organization's ordinary and routine investments that the Service determines are substantially similar to these types of income are excluded in computing unrelated business taxable income.
2. Royalties—Royalties, including overriding royalties, are excluded in computing unrelated business taxable income. To be considered a royalty, a payment should relate to the use of a valuable right, such as payments for trademarks, trade names, or copyrights. Mineral royalties are excluded whether measured by production or by gross or taxable income from the mineral property.

Unrelated business income does not include royalty income received from licensees by an exempt organization that is the legal and beneficial owner of patents assigned to it from inventors for specified percentages of future royalties.

3. Rents—Rents from real property, including elevators and escalators, are excluded in computing unrelated business taxable income. Rents from personal property are not excluded. However, special rules apply to mixed leases of both real and personal property.
4. Income from research—A tax-exempt organization may exclude income from research grants or contracts from unrelated business taxable income. However, the extent of the exclusion depends on the nature of the organization and the type of research.
5. Gains and losses from disposition of property—Exclusions from unrelated business taxable income include gains and losses from the sale, exchange, or other disposition of property other than:
  - a. stock in trade or other property of a kind that would properly be includable in inventory if on hand at the close of the tax year;
  - b. property held primarily for sale to customers in the ordinary course of a trade or business; or
  - c. cutting of timber that an organization has elected to consider as a sale or exchange of the timber.
6. Income from services provided under federal license—Exclusions of unrelated business taxable income from a trade or business carried on by a religious order or by an educational organization maintained by the order apply only if certain requirements are met.

## CASE STUDY: XYZ ASSOCIATION

This discussion presents the case of XYZ Association ("XYZ") to introduce tax personnel in exempt organizations to key elements of a transfer pricing analysis. It also presents the analysis of an excluded source of UBIT, namely royalties, in arriving at the transfer price between an exempt organization and its related for-profit affiliate.

XYZ was founded by prominent scholars and educators. It is a nonprofit organization recognized as an exempt organization under Section 501(c)(3). It has for many years engaged in the educational and charitable activities in support of its exempt purposes. Such purposes include increasing—within the United States—elementary school children knowledge of the XYZ sciences.

The activities in support of the XYZ exempt purposes include (1) research and exploration and (2) publication of children books and journals. XYZ created LMN as a for-profit company, in 2002, to publish and market books and journals. In 2002, the XYZ leadership had proposed a 5 percent royalty between XYZ and LMN. However, the management of LMN believed that this royalty would unduly burden LMN and extract much needed capital for operations.

The XYZ leadership needed (1) a review of the proposed royalty between XYZ and LMN for its use of all relevant trade-

marks and trade names and (2) an understanding of the arm’s-length profits for the LMN sales of the XYZ *Children Journal* (the *Journal*), as well as other books and periodicals to the XYZ membership and the general public.

Initial conversations with XYZ and LMN personnel established that LMN (1) undertakes all production and publication activities and (2) assumes certain risks relating to the publication and marketing of journals and periodicals. XYZ is the beneficial owner of all trade names and trademarks associated with its name including the *Journal* and the LMN books and publications.

LMN management profit projections suggested that LMN could realize, on average, preroyalty operating profits of 5 to 7 percent per year from 2002 to 2007. The XYZ membership purchases about 90 percent of all LMN production.

Although the leadership of both organizations heatedly debated the merits of the projections, it was clear that they needed an independent assessment of the royalty based on the profit potential of LMN on a going forward basis. Section 1.482 provides for a stepwise analysis framework to arrive at an arm’s-length range of consideration for intercompany transactions.

The following discussion presents (1) a description of the procedures involved in the analysis of the XYZ/LMN transactions and (2) a summary of results.

**PROCEDURE 1: OVERVIEW OF THE LMN BUSINESS**

LMN engages in the business of compiling, publishing, and distributing information materials, in printed or in electronic form, relating to the field of the XYZ sciences. The company generates income from both subscription and book sales to the XYZ membership and the general public.

LMN is a wholly owned subsidiary of XYZ. It began its periodical operations in April 2002 and incorporated book operations in July 2002. Previously, both the periodicals and book business segments were part of XYZ.

The publications that LMN markets to the XYZ members are the *Journal*, as well as books and publications with a smaller distribution. XYZ counts about 15,000 children members in the United States and 200 educational institutions. About 90 percent of all journal and book sales are to XYZ members.

XYZ itself purchases a certain amount of publications from LMN. the XYZ direct purchases amount to less than 1 percent of total LMN production. And, the prices per unit are based market wholesale prices.

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*“The functional analysis is a key component of a transfer pricing study. The analysis examines the functions, intangible assets, and risks of related parties participating in relevant intercompany transactions.”*

**PROCEDURE 2: INDUSTRY AND MARKET SEGMENT OVERVIEW**

The revenue stream of most similar publishers of magazines and journals is a mixture of advertising and circulation revenue. Despite a large number of competitors, no clear leader exists in the segment. This is the result of the continuing fragmentation and competitive challenges in this part of the industry.

Magazine publishing, in general, is a highly fragmented industry with approximately 11,000 periodicals in the United States. Although there are thousands of magazines in the United States, the industry is dominated by a handful of journal and magazine publishing companies. Consequently, this segment displays a significant degree of diversity in the size and organizational type of its members. Participants range from smaller not-for-profit organizations and privately held for-profit publishers, to larger publicly held companies with revenues in excess of \$2.5 billion.

The LMN segment is highly fragmented, however, with no player displaying any significant degree of dominance over the others. Although traditionally economies of scale in printing used to be a key for success, the increasing use of digital technology applications have changed the fundamental economics of the publishing industry. This allows smaller publishers to profitably participate in niche markets.

In short, the industry structure indicates that the LMN management expectation of low profits on a post-royalty basis may be well founded.

**PROCEDURE 3: FUNCTIONAL ANALYSIS**

The functional analysis is a key component of a transfer pricing study. The analysis examines the functions, intangible assets, and risks of related parties participating in relevant intercompany transactions.

The results of the functional analysis allow (1) for a characterization of the entities involved in the intercompany transactions and (2) for a determination of the comparability between related and unrelated entities.

The functional analysis is organized in two parts. The first part examines, respectively, the LMN and XYZ operations, assets employed, and risks assumed. The second part describes the characterization of LMN and XYZ for the purposes of comparable selection and the application of the transfer pricing method.

A summary of the results of the functional analysis is provided below.

1. **Managerial Functions:** LMN organized its managerial functions in departments that follow a traditional publishing industry organizational structure. These functions are: advertising sales, marketing, magazine editorial, research, design, magazine production, circulation, audit, new media, and legal.

XYZ conducts and sponsors all activities related to research and exploration as well as educational activities of the XYZ sciences.

2. **Production and Technical Support:** LMN is responsible for coordinating all key production with third parties and technical support functions. Some of the functions include: study and survey design for special projects; physical production coordination and management; product technical support; internal MIS functions; and publication design and development.

LMN assumes all responsibilities for these functions. XYZ does not have production and technical support functions in relation to publishing activities.

3. **Marketing:** LMN undertakes all marketing functions (promotion, advertisement, etc.) relating to periodicals and books with guidance and approval from XYZ regarding the use of its trademark and trade name.
4. **Product Management:** LMN assumes all responsibilities for the management function relating to its line of journals and magazines. This includes:
  - a. general product management such as data licensing monitoring, product enhancements, and pricing and
  - b. product planning such as product characteristics evaluations, product specification definition, and product performance assessments.

XYZ does not perform these functions, but it provides guidance and strategic plan approval on critical areas.

5. **Sales and Service:** LMN conducts customer and competitive research, development of market communications and promotion plans, sales and product support and distribution. XYZ does not perform these functions. However, it owns the lists of XYZ members and *Journal* subscribers.
6. **Distribution:** The LMN distribution function involves the process of delivering publications and providing services to customers.

A variety of tactics exist for implementing this function. These functions range from intensive distribution systems such as exclusive dealerships to extensive distribution systems such as the use of mass marketers.

LMN assumes full responsibility for the operations of this function. XYZ bears the costs associated with the LMN mailing of publications to XYZ members.

## RISKS ASSUMED

Risks are those factors that expose a company to the possibility of loss or damage. The most salient risks in the XYZ/LMN transaction are:

1. **Product Risk:** Product and service risk include the financial effect of publications, both in paper and electronic form, that are defective. These risks are borne (1) directly by LMN and (2) indirectly by XYZ through the effect on the level of subscription-based royalty revenue.
2. **Market Risks:** Market risks include the financial effect of fluctuations in cost, demand, pricing, inventory, and events such as (1) market entry by competitors or (2) development of substitute products or services, changes in the bargaining power of suppliers, and significant increases in the bargaining power of customers.

LMN will bear all market risks. This is because it is responsible for maintaining and developing the level of demand for its information products and services. XYZ also bears market risks through the effect on the level of subscription-based royalty revenue.

3. **Customer Credit Risk:** Customer credit risk is fundamentally the risk of default on credit purchases. Customer credit risks generally increase (1) the volatility of a firm's cash flows and (2) the expected levels of operating assets.

In terms of the LMN sales of publications to the XYZ membership, customer credit risk is low based on the history of subscription revenue and the rules governing the XYZ membership.

*“Risks are those factors that expose a company to the possibility of loss or damage.”*

## PROCEDURE 4: CHARACTERIZATION OF LMN

For purposes of determining distribution of profits between the related parties and the comparability of uncontrolled companies to LMN, it is helpful to summarize, in the form of a characterization, the LMN and XYZ functions and risks.

LMN is characterized as a contract publisher/marketer of academic journals and other publications. It undertakes—under the guidance of XYZ—all sales, distribution, and editorial functions. And, XYZ bears certain risks associated with these activities. XYZ can be best characterized as the owner of the trademarks and trade names as they relate to the LMN publications. XYZ provide strategic direction on the management and marketing of the LMN publications.

## PROCEDURE 5: BEST METHOD REVIEW

The functional analysis organizes the “facts and circumstances” that influence the allocation of profits between relat-

ed parties. It also determines the criteria that influence the selection of the best transfer pricing method.<sup>7</sup>

Section 1.482-4(a) prescribes four methodologies for determining an arm’s-length consideration for transfers of intangibles property:

1. the comparable uncontrolled transactions method (CUT),
2. the comparable profits method (CPM),
3. the profit split method, and
4. unspecified methods.

Each method should be applied in accordance with the general rules regarding comparability, as outlined in Section 1.482-1, and the “best method” rule of Section 1.482-1(c).

*“Section 1.482-4(a) prescribes four methodologies for determining an arm’s-length consideration for transfers of intangibles property. . . .”*

#### ASSESSMENT OF PRESCRIBED METHODS

Each of the methods specified in the regulations should be assessed to determine (1) which of them has a greater degree of comparability between the controlled and uncontrolled transaction and (2) which is more reliable. The method which combines the greatest degree of comparability and reliability will be the primary transfer pricing method.

1. **Comparable Uncontrolled Transaction Method**—Research was conducted to identify uncontrolled transactions comparable to the XYZ license of its marketing intangibles to LMN. The search for CUT comparables focused on finding both (a) licenses between unrelated third parties and (b) licenses of the same of similar assets from XYZ to unrelated third parties or by LMN of similar intangibles from unrelated parties.

Since, XYZ only licenses to LMN and third-party licenses of similar marketing intangibles were not publicly available, the CUT method was rejected.

2. **Comparable Profits Method**—The CPM applies the arm’s-length standard to controlled property transfers by reference to the profitability of uncontrolled taxpayers engaged in similar activities.

Under the CPM, transfer prices are set to generate a level of profitability for the tested party, in this case LMN, that falls within a specified range of profitability of uncontrolled tax payers with comparable functions and risks.

A number of companies similar to LMN were identified to apply the CPM.

*“Each method should be applied in accordance with the general rules regarding comparability as outlined in Section 1.482-1, and the ‘best method’ rule of Section 1.482-1(c).”*

3. **Profit Split Method**—The profit split method determines arm’s-length transfer pricing on the basis of the relative value of each controlled taxpayer’s contribution to the combined profit or loss in a particular controlled transaction or set of controlled transactions.

Since (a) XYZ owns all relevant intangible assets and (b) LMN does not own any nonroutine intangible property, the application of the residual profit split method would result in the results as provided in the application of the CPM.<sup>8</sup>

4. **Unspecified Method**—Section 1.482-3(e)(2) provides that the use of an “other” method is appropriate if none of the above specified methods provide a reasonable estimate of an arm’s-length consideration.

Since the CPM was deemed appropriate for testing the XYZ/LMN transactions, unspecified methods were not selected.

#### PROCEDURE 6: APPLICATION OF SELECTED METHOD

The CPM is based on the economic principle that similar companies in similar circumstances will earn similar returns. Section 1.482-5(a) explains that the CPM “evaluates whether the amount charged” to or by the tested party “in a controlled transaction is arm’s-length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. . . .”

A range of arm’s-length consideration is calculated by determining a profit level indicator for a set of uncontrolled comparables.

#### Tested Party

According to Section 1.482-5(b)(2), the tested party of a controlled transaction in most cases, “will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.”

XYZ is the owner of all marketing intangible property. Therefore, XYZ is the most complex entity. Suitable comparables, however, were available for LMN given the simpler operations it undertakes.

#### Profit Level Indicator

As previously mentioned, profit level indicators are ratios that measure the relationship between sales or profits and costs or

resources. Any number of profit level indicators may be used depending on the circumstances.

There are three profit level indicators specifically mentioned in the Section 1.482 regulations:

1. rate of return on capital employed,
2. ratio of gross profit to operating expenses, and
3. ratio of operating profit to net sales (operating margin).<sup>9</sup>

We did not select the ratio of gross profit to operating expenses (i.e., the Berry ratio) as the appropriate profit level indicator. The Berry ratio (1) stresses the importance of similar management and operational cost structures and (2) is used primarily for simple distribution operations.

Additionally, the return on capital employed, or net sales divided by operating assets, was not chosen since LMN outsources all production to third parties and operating assets do not have a great role in generating LMN's operating revenue.

The ratio of operating profit to net sales (operating margin) was chosen as an appropriate profit level indicator to measure LMN performance as a licensor of XYZ intangible property.

**PROCEDURE 7: COMPARABLE COMPANY SEARCH**

This procedure involves the research to identify companies that operate as publishers/marketers of educational and/or scientific information in the United States. In this case, the research process concentrated on identifying unrelated companies operating in a similar manner to LMN.

We used publicly available databases to identify public companies with operations, risks, and assets employed that are similar to those of LMN.

We searched the following U.S. standard industrial classification (SIC) codes:

SIC Code Number	SIC Code Description
2721	Periodicals: Publishing, or Publishing and Printing
2731	Books: Publishing, or Publishing and Printing
2741	Miscellaneous Publishing

*“There are three profit level indicators specifically mentioned in the Section 1.482 regulations. . . .”*

*“The Berry ratio (1) stresses the importance of similar management and operational cost structures and (2) is used primarily for simple distribution operations.”*

The review of over 300 publishers yielded a portfolio of six comparable companies to LMN.

**Development of an Operating Margin Range**

Determining an arm's-length level of consideration for LMN's sales to the XYZ members on the results of a single comparable company would be inappropriate. This is due to the diverse activities of the comparable companies selected.

Therefore, to provide a spectrum of comparability that should cover the LMN functions, risks, and assets, a range of arm's-length operating margins were calculated using all of the selected comparable companies.

**Adjustments**

In Section 1.482-1(e)(2)(ii), the regulations require that “[I]f material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction(s) if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.” The regulations go on to suggest that elements of (1) working capital—such as accounts receivable, accounts payable, and inventory—and (2) fixed asset levels, may all be items affecting the differences between the tested party and the comparables.

Additionally, Section 1.482-1(e)(2)(iii)(B) states that the reliability of the analysis should be increased, where possible, “by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables. . . . The reliability of the analysis is increased when statistical methods are used to establish a range of results in which

the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range.”

Following the regulations, the range of arm's-length operating margins was made more reliable by calculating the interquartile range as described in the regulations.

**PROCEDURE 8: SUMMARY OF FINDINGS**

Our analysis established a 1999-2002 comparable company range of operating margins with (1) an upper quartile of 6 per-

cent, (2) a median of 3 percent, and (3) a lower quartile of 1 percent. For sales of magazines and journals to the XYZ memberships from 2002 to 2007, the LMN management projected a range 5 to 7 percent of yearly preroyalty operating margins.

Applying the 6 percent royalty suggested by the XYZ leadership would provide LMN with a 0 to 2 percent post-royalty average operating margin during the period. These margins fall below the median of the arm's-length range of consideration provided by companies comparable to LMN.

Although any result within the range is to be considered to be at arm's length, given the highly competitive and fragmented nature of LMN's industry, the risks of arriving at post-royalty results that fall under the arm's-length range with a 5 percent royalty are high.

Therefore, a prudent approach would be to set a royalty of about 3 percent to arrive at results closer to the median of the comparable companies.

## LESSONS FOR EXEMPT ORGANIZATIONS

The case study of XYZ indicates that exempt organizations can efficiently determine the "prices" for transactions with their related for-profit affiliates by applying the principles set forth in the Section 1.482 regulations.

The benefits for following such an approach include:

1. increased transparency to all the stakeholders on how the prices were developed,
2. buy-in from all stakeholders that prices are consistent with market standards of performance,
3. development of appropriate incentives for the management of the for-profit venture,
4. assurance that the prices set will provide for the most efficient allocation of scarce financial resources, and
5. proactive development of documentation and ability to maximize UBIT safe harbor in the event the proposed amendments to Section 512(b)(13) are passed.

Therefore, we recommend (from both operational and income tax perspectives) that exempt organizations use the Section 1.482 principles in structuring transactions with for-profit affiliates.

### Notes:

1. All Code and Section references shall be to the Internal Revenue Code of 1986, as amended (the "Code").

2. Publication 598, (revised March 2000), *Tax on Unrelated Business Income of Exempt Organizations* (hereafter "Publication 598"). This article follows the IRS publication in presenting the relevant unrelated business income tax.
3. These issues were discussed by Barry J. Hart in "What Exempt Organizations Need to Know About The Transfer Pricing Rules," *Journal of Taxation of Exempt Organizations*, March/April 2000, and "Recordkeeping Is the Key to Transfer Pricing Compliance," *Journal of Taxation of Exempt Organizations*, May/June 2000. Those articles discuss, in detail, the application of the Section 1.482 regulations to tax-exempt organizations.
4. For an analysis of the IRS regulatory compliance benefits of employing transfer pricing principles, see Barry Hart's articles, *supra* note 3.
5. Publication 598, p. 3.
6. Publication 598, p. 6.
7. Section 1.482-4 specifically addresses methods of determining an arm's-length charge for the license or transfer of intangible property to a controlled party. The principles and methods in this section have antecedents in the Tax Reform Act of 1986, which adopted the "commensurate with income" approach to transfers of intangible property (commonly referred to as the "super royalty" provision).

The commensurate with income approach is reflected in Section 1.482-4(f)(2)(i) through the comparability standards and the requirement that the "consideration charged [for the intangible] in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible."

8. Section 1.482-6(c)(2)(i) describes a comparable-based profit split, whereby uncontrolled taxpayers' proportions of the combined operating profit or loss in situations similar to the controlled transaction are used to allocate the related parties' combined operating profit or loss.

Since a portfolio of uncontrolled taxpayers in similar circumstances was not found, this method was rejected.

9. The regulations define operating profit as all income derived from the business activity being evaluated. Operating profit excludes interest and dividends, income derived from activities not being tested by this method, or extraordinary gains and losses that do not relate to the continuing operations of the tested party.

Operating expenses are defined as all expenses not included in cost of goods sold, except for interest expense, and any other expenses not related to the operation of the relevant business activity.

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