INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-103652-98 January 22, 1999

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Years Involved: ;
Date of Conference:

LEGEND:
Taxpayer =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

Year 3 =

ISSUE

Whether a membership corporation must recognize gross income with regard to nonrefundable credits that were granted to its members for use in offsetting their liabilities to the corporation for fees unrelated to membership.

FACTS

In Year 1, Taxpayer was incorporated as a nonprofit, membership corporation without shares, and subsequently was determined to qualify for tax exempt status under § 501(c)(6) of the Internal Revenue Code. Taxpayer was formed to conduct research in the field of computer applications and to implement the research findings. It may be noted that if an exemption application from Taxpayer were under consideration today, it is possible that an adverse position on exemption would be adopted.

Taxpayer was comprised of various categories of members, including those designated as "Sponsors" who were the sole voting members of Taxpayer. Sponsors were required to make an initial contribution of no less than $1,000,000, and the Board of Directors had the authority to fix the amounts of the initial and future contributions. The By-laws of Taxpayer provided that each Sponsor remained a Sponsor "for so long as it made its required contributions to the corporation when due and otherwise remain[ed] a member in good standing of the corporation."

Sponsors entered into "Formation and Funding Agreements" which detailed their funding obligations to Taxpayer and referred to the prospect that Sponsors might receive the future benefit of "credits" which could be applied against their liabilities to Taxpayer for licensing fees (the "credit plan"). The agreements stated that "no Sponsor shall earn any direct return on, or refund or restoration of, any contributions made hereunder, provided that the Corporation may, if authorized to do so by its Board of Directors, ... treat a portion of the amounts contributed hereunder as a prepaid credit against cash royalties [licensing fees] which may in the future become due." In addition, the By-laws provided that, in the event of the default or suspension of a Sponsor, the defaulting Sponsor did not lose its "right to receive any credit for its contribution against existing or future licensing fees to which the Sponsor is entitled on the date of such action."

As a tax exempt organization, Taxpayer annually reported membership fees, including the contributions from nine initial Sponsors, on information returns, Forms 990. No tax was paid on these amounts. On Date 2 in Year 3, Taxpayer completed a nontaxable type F reorganization as defined in § 368(a)(1)(F) of the Code. Consequently, Taxpayer notified the Internal Revenue Service that, as of Date 3 in Year 3, Taxpayer no longer qualified as a tax exempt organization.

Also in Year 3, Taxpayer admitted nine new Sponsors. Recognizing that the new Sponsors might unfairly reap the benefits of the contributions previously made by the nine initial Sponsors, Taxpayer intended to put the initial Sponsors on equal footing with the new Sponsors. Taxpayer accomplished this by implementing the credit plan whereby credits, equal to the amount of membership fees previously contributed by an initial Sponsor, could be offset against a Sponsor's liabilities to Taxpayer for licensing fees. A "Credit Exercise Agreement" between Taxpayer and one of the initial Sponsors read: "the Board of Directors has authorized the grant of certain credits against royalty and licensing fees otherwise due to the Corporation by the Credit Recipient."

Section 61 of the Code provides that, except as otherwise provided, gross income includes all income from whatever source derived.

Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income realized in any form.

In Rev. Rul. 91-36, 1991-2 C.B. 17, nonrefundable credits granted to customers of an electric utility company were not includible in the gross income of the customers. The credits represented a reduction in the purchase price of electricity.

ANALYSIS

The credit plan was implemented in order to put the initial Sponsors on equal footing with the new Sponsors. Each initial Sponsor has been granted credits in an amount equal to its total contribution in membership fees prior to Date 3 in Year 3. The Sponsors may offset the credits against their liabilities to Taxpayer for licensing fees, thereby reducing the amount due from the Sponsors in satisfaction of the liabilities. The credits are not refundable, and can only be used to offset licensing fees. Under these facts, Taxpayer is not required to recognize gross income as a result of the grant of the credits, nor as a result of the Sponsors' use of the credits. Rather, the credits represent a reduction in the licensing fee charged a Sponsor. Cf. Rev. Rul. 91-36, 1991-2 C.B. 17. Upon a Sponsor's use of the credits, Taxpayer need report no more in gross income than the amount collected in satisfaction of the reduced fee. We recognize this amount as the actual licensing fee charged the Sponsors. Cf. Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), acq., 1982-2 C.B. 2 (net selling price agreed upon between the parties must be given recognition for tax purposes).

CONCLUSION

Taxpayer, a membership corporation, does not recognize gross income with regard to nonrefundable credits that were granted to Sponsors for use in offsetting their liabilities to Taxpayer for licensing fees. Specifically, Taxpayer is not required to recognize gross income as a result of the grant of the credits, nor as a result of the Sponsors' use of the credits.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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