

Memorandum

District Director
Milwaukee, Wisconsin

DATE: MAY 24 1967

National Office
Internal Revenue Service

Wisconsin Alumni Research Foundation (WARF)
506 North Walnut Street
Madison, Wisconsin

This refers to your request for technical advice concerning the status of the subject organization for Federal income tax purposes.

In a ruling dated March 15, 1935, WARF was held to be exempt from Federal income tax under section 103(6) of the Revenue Act of 1932 (a predecessor to section 501(c)(3) of the Internal Revenue Code of 1954). This ruling was affirmed under the Revenue Act of 1936 by letter dated April 22, 1938. As the result of an examination of WARF for the years ended December 31, 1959, 1960, and 1961, you notified the organization by letter dated November 27, 1962, that you proposed to revoke its tax exempt status retroactively to January 1, 1959. Revocation of WARF's exempt status was recommended on the basis that the purpose of the organization's several income producing activities is to provide funds to the University of Wisconsin and further the acquisition of income producing properties, the size and extent of which is such that its conduct constitutes a primary purpose so as to bring it within the scope of section 502 of the Code as a feeder corporation notwithstanding the fact that profits are payable to a tax-exempt organization. Additionally, the June 19, 1944 charter amendment permitting WARF to contract with others not connected with the University with respect to the organization's patents program indicates it is organized for profit which precludes exemption under section 501(c)(3). However, in the event WARF's tax-exempt status should continue, the size and extent of its development and licensing operations would subject the income therefrom to the unrelated business income tax as imposed by section 511 of the Code.

Pretest of this proposed action was discussed at conferences held in your office with representatives of WARF on January 4, 24 and May 8, 1963. Submitted in connection with these conferences and approved by the conferee and the examining officer is an Agreed Statement of Facts, accompanied by Exhibit 1-A through Exhibit 31. Your transmittal of the case to this office for technical advice stated that WARF desired a conference in

Buy U.S. Savings Bonds Regularly on the Payroll Savings Plan

DD: Milwaukee, Wisconsin
 Re: Wisconsin Alumni Research Foundation (WARF)

the National Office. Accordingly, we held a formal conference on January 26, 1965, with certain directors and legal representatives of WARF. Certain information orally developed at the conference was further explained and documented in the form of a supplementary brief, with exhibits, on March 3, 1965. An informal conference was held on June 11, 1965, with one of the legal representatives of WARF, at which time he delivered a written reply dated June 6, 1965, to our development letter of May 7, 1965. In 1966 we were advised of the audit examination for the taxable years ended November 30, 1959, through November 30, 1964, of Dells Boat Co., Inc., Quadrant Corporation, Inc., and Buck Trails, Inc., including meetings and discussions had with representatives of WARF. These three corporations are taxable subsidiaries of WARF and are collectively known as the Wisconsin Dells properties. Most recently, 1967, we have been notified of protested tax issues stemming from this audit examination which are now pending in the Milwaukee Appellate Branch Office.

Based upon the facts disclosed in the documents and data submitted to this office, we conclude that the exempt status of WARF under section 501(c)(3) of the 1954 Code should not be disturbed. While WARF is an incorporated separate entity, the factors prompting its establishment, the tone of the language contained in its organizational documents, the close relationship between the officers and trustees of WARF and the administrators and faculty of the University of Wisconsin, as well as its operations being carried out in collaboration with the University, establishes that WARF is primarily organized and operated for the benefit of the University of Wisconsin and as such is carrying out charitable, educational and scientific purposes within the contemplation of section 501(c)(3). While the charter purposes of WARF are broadly stated as measured by section 1.501(c)(3)-1 of the Income Tax Regulations, subsection (a)(6) of this section does not require an organization to amend its organizational documents to conform to the requirement of the 1954 Code where its exempt status was determined before July 27, 1959.

The issues raised by you concerning the operations of WARF may be broadly categorized as (1) Concentrate Division activities, (2) Laboratory Division activities, (3) Licensing Division activities, (4) Investment Division activities, and (5) Involvement of WARF in the Wisconsin Dells properties. Technical advice or comments will be furnished in this order.

- 3 -

DD: Milwaukee, Wisconsin
 Re: Wisconsin Alumni Research Foundation (WARF)

Concentrate Division activities. Formation of WARF was prompted by the discovery of Professor Harry Steenbock of the University of Wisconsin of a process for producing vitamin B by ultra violet light irradiation. The discovery was of broad scope and had application to a wide variety of food, pharmaceutical and food products for humans, poultry and animals. It was determined by the Regents of the University, Professor Steenbock and certain alumni of the University to entrust the patent on this process to a non-profit corporation which could administer this and other patents growing out of research at the University for the ultimate benefit of University research. The concentrate operations evolved from efforts to find an alternative to the original Steenbock process. In 1946 Mopco Chemical Company purchased from WARF its operations in vitamin D concentrate for the fortification of fluid milk. This left the Concentrate Division in a position simply to continue its technical services as a processor of vitamin concentrates without being involved with the commercial sale of the product to individual dairies. You view this operation as a business activity, of not insubstantial proportion, and not in furtherance of an exempt purpose even though the manufacturing aspect is included as a corporate power in WARF's charter. Accordingly, we explored this matter further at the January 1965 conference, referred to above. It was there represented by WARF (later substantiated by a written statement, identified as Exhibit 103) that in October 1963, a wholly-owned general business corporation, Warf Vitamin Concentrates, Inc., was incorporated and that all properties and activities of the Concentrate Division were transferred to this independent business enterprise. Our review of this situation establishes that a complete spin-off of the Concentrate Division activities was made to the new corporation and that for the periods prior to this spin-off the income from the Concentrate Division was consistently reported as unrelated business income on Forms 990-T filed by WARF. In view of these circumstances we conclude that any questions relating to the commercial nature of this operation are now moot.

Laboratory Division activities. The laboratory was initially established in 1930 to assure the maintenance of standards in products produced by licensees under the Steenbock Vitamin D patents. Such quality control was subsequently applied to other licensed products under patents owned by WARF. At approximately the same time, additional laboratory business from outside clients was being developed. In 1937 the laboratory was established as a division in WARF's operations. After the

COV. LET. 7/31/67, TO
 ROSS LETTER REPORT

DD: Milwaukee, Wisconsin
 Re: Wisconsin Alumni Research Foundation (WARF)

expiration of the Steenbock patents and the end of World War II, the expansion of the laboratory activities was aggressively undertaken with the primary motive of establishing a self-supporting and profitable operation in addition to being of service to WARF's licensing operations and the University. A 1960 Special Trustees' Report (No. 383), which also contains a review of a 1953 Trustees' Report, together with a Special Trustees Report No. 392, further attest to the continuing expansion over the years of a commercial testing and development laboratory as well as future potential growth. In addition to these reports and other data furnished in connection with the Laboratory Division activities, an on the premise check was made (including examination of several hundred invoices) by an Internal Revenue Agent to evaluate the classification of work, using the Classification Chart identified as Exhibit 14-A as a yardstick, and there was much evidence of misclassification of projects as well as work results serving private interests rather than being made available to the interested public. Based upon all the available information, we conclude that while the work projects covered a broad spectrum, this Division is being conducted primarily as a testing and consulting laboratory which is industry oriented. In performing such work for profit, the Division is competing with regular commercial laboratories rather than conducting scientific research coming within the ambit of section 1.501(c)(3)-1(d)(5) of the Income Tax Regulations. Thus, revenue produced by the Laboratory Division is unrelated business as defined in section 512 and subject to the tax imposed by section 511 of the Code. The burden of proof rests upon WARF to clearly show that specific projects which this Division undertakes come within the contemplation of section 512(b)(9) of the Code which excepts "fundamental research", or specific projects are clearly "scientific research" as defined in the Regulations at section 1.501(c)(3)-1(d)(5)(iii)(a), (b), or (c).

Licensing Division activities. As previously stated, WARF was created to administer the Steenbock vitamin D patents with their concomitant licensing agreements. As the Licensing Division has evolved over the years, it still does not solicit inventions but accepts voluntarily assigned inventions by staff members, students and friends (in isolated instances) of the University. It carries out whatever developing processes are necessary, takes all steps required to obtain patents, and actively pursues the obtaining of licensing agreements with industry on a royalty basis together with servicing those

- 5 -

DD: Milwaukee, Wisconsin
Re: Wisconsin Alumni Research Foundation (WARF)

agreements to the extent of undertaking educational activities of a promotional type normally associated with commercial advertising. Approximately twenty patents were under license during the three-year period here under consideration. The criteria for accepting the assignment of an invention (as set forth in Exhibits 10C and 10D) is that the invention must be patentable or potentially patentable and must be an invention which can be developed into a marketable product or process. Nevertheless, this does not preclude the accepting of an invention if such action would be in the public interest even though not financially profitable, or where such action is considered advisable from the standpoint of maintaining favorable relationship with the inventor (particularly where an inventor had previously been productive in assigning other inventions which had been commercially successful), or such action is considered essential for defensive purposes in an area where WARF has a licensing position. The underlying tone of these collective factors points to the obtaining of income from the commercial exploitation of inventions rather than the passive collection of royalties from licensing agreements such as contemplated by section 512(b)(2) of the Code. However, technical advice may not be furnished on the issues presented by the Licensing Division activities since patent processing and licensing activities by university oriented organizations and by scientific research organizations constitute the subject of a study being conducted by the Service, the study has not been concluded, and the resolution of these issues should await the results of the study and the establishment of a Service position.

Investment Division activities. The original sources of funds which have built WARF's investment portfolio are principally from patent licensing and business operations, however, other sources have contributed substantial amounts. In December 1953, the Board of Trustees approved a plan to accept gifts subject to the reservation of income for not more than two named beneficiaries. This is designated the "Investment-Philanthropy Program". Pursuant to this plan the Foundation has received 56 gifts aggregating \$673,718 as of December 31, 1960. (Exhibit 31.) WARF has issued three types of life income plans: General Participation Form (Exhibit 105-D) and Segregated Form (Exhibit 105-E)---which were the subject of Internal Revenue Service letter dated March 26, 1954, which in substance ruled that the remainder interest provided for in the plans is deductible by the donor in his income tax return and that payments made by WARF to the donor constitute taxable income to such donor -- and Irrevocable Trust Form (Exhibit 105-F) -- which was the subject of Service letter dated February 18, 1960, which designated this "plan 1" and in substance ruled that the remainder interest provided for in this plan is

- 6 -

DD: Milwaukee, Wisconsin
 Re: Wisconsin Alumni Research Foundation (WARF)

deductible to the donor, that payments made by WARF to the donor of income from tax-exempt securities is nontaxable to the donor, and ruled on certain gift and estate tax matters. The issue raised here is whether the gifts subject to General Participation result in any part of the net earnings of WARF inuring to the benefit of any individual since the participation by a life income donor in the investment profits of the total fund on a pro rata basis, as opposed to a fixed return, indicates that some of the earnings do go to one or more individuals. For sometime now the Service has had under study the question of whether a fund created by an educational or charitable organization to which donors transfer property and receive life income based on earnings of the fund with remainder to the institution is an association taxable as a corporation for Federal tax purposes. Until such time as this study is completed and a position established, technical advice on the similar issue raised here is being reserved.

Involvement of WARF in the Wisconsin Dells properties. Acquisition of the several properties referred to as Wisconsin Dells commenced in 1954. These acquisitions are not considered as part of the investment portfolio of WARF, ownership and operations having been transferred to taxable business corporations. The following is a brief historical resume'. In 1954, the Upper Dells were given to WARF by the Connors and the Nussens in exchange for individual lifetime annuities. Operations were leased to Fred Harvey, a Chicago management firm, from January 1954, through October 1958. Thereafter, operations were carried out directly through two wholly owned subsidiary corporations of WARF, Dells Boat Co., Inc., and Quadrant Corporation, Inc. In 1956, Lower Dells was acquired from a Mrs. Raab, also under an individual lifetime annuity arrangement. Trails and lands essential to the amphibian vehicle operations were leased to Wisconsin Ducks, Inc., and in November 1960, a subsidiary corporation, Duck Trails, Inc., was organized to which all of this property was transferred. As a joint enterprise with other Dells interests, Fort Dells, Inc., was organized in 1959 to construct and operate an historical and amusement development, with WARF's interests holding three members on a board of five directors. WARF's holdings are represented by common stock in Dells Boat Co., Quadrant and Wisconsin Ducks, Inc., and bonds of Dells Boat Co., Quadrant, and Fort Dells (plus Quadrant also holding stock and bonds of Fort Dells). The financing of these various corporations represents a two to one ratio of debt to capital. Subsequently, properties identified as the Snider and Potter transactions were purchased by Dells Boat Company, which involved some

COV. LET. 7/31/67, TO
 ROSS LETTER REPORT

FIN. RPT. 2nd

DD: Milwaukee, Wisconsin
 Re: Wisconsin Alumni Research Foundation (WARF)

borrowing of funds from WARF. (Exhibit 21.) Items appearing in schedules attached to Form 990-A filed by WARF for 1960 and 1961, show Directors Fees and Management Service Fees received from the various Wisconsin Dells subsidiaries and offset against expenses of WARF. In explanation, it has been stated by WARF that these items represent payments for services rendered by officers and directors in their normal responsibilities. These individuals rendered specialized services for which the Wisconsin Dells corporations paid as they would pay for any consultant or other qualified persons. The amounts were received by WARF because the individuals were on WARF's payroll or otherwise affiliated with the Foundation. In lieu of having such individuals on payrolls of several entities, WARF carried these individuals and the Wisconsin Dells corporations made payments which served to reimburse WARF. (Exhibit 106.) Based upon an evaluation of the entire record, we are of the opinion that the sums received by WARF, identified as Directors Fees and Management Service Fees, represent reimbursements to WARF for time spent by certain of its employees in rendering services to other organizations, rather than WARF being compensated for directly furnishing management assistance. Further, these sums appear to constitute reasonable recoupment. Accordingly, we conclude that these sums are not unrelated business income subject to the tax imposed by section 511.

You did not request technical advice on whether WARF's income had accumulated unreasonably either in amount or duration so as to bring into operation the provisions of section 504 of the Code (section 3814 of the 1939 Code). However, there were indications in the administrative file that WARF's investment portfolio was built up from income realized from royalties and licensing activities, but the financial information was not in sufficient detail to make a determination. Therefore, the matter was discussed at the January 1965 conference (referred to above), additional information was subsequently furnished by WARF (identified as Exhibit 101), and the complete record was re-evaluated. We conclude that information of record establishes that there has been no unreasonable accumulation of income within the meaning of section 504(a)(1) of the Code.

- END -