DAVIS POLK & WARDWELL

450 LEXINGTON AVENUE
NEW YORK, NY 10017
212 450 4000
FAX 212 450 3800

MENLO PARK
WASHINGTON, D.C.
LONDON
PARIS
FRANKFURT
MADRID
TOKYO
BEIJING
HONG KONG

MARIO J. VERDOLINI
212 450 4969
MARIO.VERDOLINI@DPW.COM

July 16, 2007

Re: **File No. SR-NASD-2007-023 – U.S. Federal Income Tax Considerations**

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Dear Ms. Morris:

On behalf of the National Association of Securities Dealers, Inc. ("**NASD**") and NASD Regulation, Inc. ("**NASDR**"), I am writing to describe generally the case law, statutory provisions and guidance published by the Internal Revenue Service (the "**IRS**" or the "**Service**") relevant to the disclosure in NASD's December 14, 2006, proxy statement (the "**Proxy Statement**") that it was not possible to increase the one-time $35,000 payment that would be made to NASD members (the "**Member Payment**") in connection with the proposed consolidation of NASD's member regulatory activities with those of NYSE Regulation, Inc. ("**NYSE Regulation**" and such transaction, the "**Proposed Transaction**").

By way of background, the tax law contains an absolute prohibition on a distribution of assets by tax-exempt organizations, including NASD, to their members. Although there are limited exceptions to that prohibition, none of them clearly applies here. Thus, there are no authorities directly on point that would allow NASD to make the contemplated Member Payment without jeopardizing its tax exemption. As a result, the only way that NASD could make the proposed Member Payment was by securing a private letter ruling from the IRS to the effect that the Proposed Transaction – including the Member Payment – would not affect its tax exemption. In order to maximize its chance of securing an IRS ruling in a timely manner that would not delay the closing of the Proposed

Transaction, NASD filed a ruling request with the IRS on October 26, 2006 and amended that request to state the amount of the proposed Member Payment on November 27, 2006. After NASD made additional submissions responding to questions raised by the IRS, the IRS issued the ruling.

Discussion

NASD's charter makes clear that NASD members have no claim to NASD's equity. NASD's tax-exempt status under federal law creates a similar prohibition on member claims to NASD's equity.

It is clearly and consistently articulated in numerous court decisions and IRS rulings over the course of decades that an entity such as NASD, which is recognized by the Service as exempt from U.S. federal income tax, may not pay any dividends or otherwise confer any part of its earnings to its members without losing its tax exemption. In fact, this prohibition against "private inurement" is so foundational to U.S. tax law that it originates in the Corporate Excise Tax of 1909, predating by four years the ratification of the Sixteenth Amendment that made a federal income tax constitutional. *See* Tariff Act of 1909, ch. 6, § 38, 36 Stat. 112. This prohibition today appears in several places in the Internal Revenue Code, including in Section 501(c)(6), which authorizes an exemption from tax for business leagues, chambers of commerce and similar organizations like NASD and NASDR that are "not organized for profit and *no part* of the net earnings of which inures to the benefit of any private shareholder or individual" (emphasis added). The Service and courts have repeatedly determined that this prohibition is an absolute: "There is no *de minimis* exception to the inurement prohibition." Gen. Couns. Mem. 39862 (1991); *Beth-El Ministries, Inv. v. United States*, 44 A.F.T.R. 2d 79-5190 (D.D.C. 1979) ("Even if the benefit inuring to the members is small, it is still impermissible"); *see also McGahen v. Commissioner*, 76 T.C. 468 (1981), *aff'd,* 720 F.2d 664 (3d Cir. 1983); *Unitary Mission Church v. Commissioner*, 74 T.C. 507 (1980), *aff'd,* 647 F.2d 163 (2d Cir. 1981); *Gookin v. United States*, 707 F. Supp. 1156 (N.D. Cal. 1988). Because the inurement of a single dollar of an exempt entity's net earnings to its shareholders or members invalidates its exemption, seemingly minor improprieties have been the basis for revocation. *See, e.g.*, *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151 (E.D. Wash. 1963) (tax exemption revoked for sponsoring the cost of refreshments provided to club members).

Notwithstanding the absolute prohibition against the private inurement of an exempt organization's net earnings, there are certain very narrowly drawn circumstances in which a payment can be made to members and will not actually constitute inurement. None of these exceptions clearly authorizes the proposed Member Payment.

Rebates of Dues or Fees. An organization exempt from tax under Section 501(c)(6) may rebate fees paid in by its members. *See* Rev. Rul. 81-60, 1981-1 C.B. 335 ("[I]t is well established that a business league or other organization

exempt under § 501(c)(6) may refund part of the dues or contributions previously paid to the organization for its activities. Such refunds are treated as reductions in dues."); *see also* Priv. Ltr. Rul. 8226013 (1981), Rev. Rul. 77-206, 1977-1 C.B. 149 (1977); *King County Ins. Assoc. v. Commissioner*, 37 B.T.A. 288 (1932).

However, there are three significant limitations on the payment of rebates by exempt organizations that made reliance on this exception by NASD impossible. First, the refunds can only be paid from dues paid by the members receiving the refund. *See* Rev. Rul. 81-60, 1981-1 C.B. 335 ("Refunds ... must be made out of funds paid by those receiving the refunds."). Second, a rebate, by definition, must not exceed the amount of dues previously paid by members. *See Michigan Mobile Home & Recreational Vehicle Inst. v. Commissioner*, 66 T.C. 770, 777 (1976) (revoking exemption where entity paid "rebates" that "were far in excess of the maximum annual dues"); Rev. Rul. 77-206 ("Rebates ... may not exceed the amount of the deposits."). The Service has further required that only current-year dues can be rebated. *See, e.g.*, Rev. Rul. 81-60, *supra*. Third, the rebate must be made pro rata with respect to the dues previously paid, and must not reflect a preference for members. *Compare* Rev. Rul. 81-60, *supra* (pro-rata rebate permitted) *with Michigan Mobile Home*, *supra* (exemption revoked where fees for trade show were rebated to members but not to non-members).

Although the aggregate amount of the proposed Member Payments fits within the amount of allowable rebates, the rebate exception does not squarely apply here because a $35,000 payment would far exceed the $1,200 of current-year paid-in dues of those NASD members subject to the lowest annual assessments. Under the published rulings, a payment of $35,000 could not be made to those small members without risking the loss of NASD's tax exemption. It would be possible to structure the aggregate payment to the members so that it would fit within the rebate exception – but only if (i) the payments were made to members in proportion to total assessments, rather than in proportion to their base assessment, and (ii) the amount received by each member were limited to paid-in dues for the current year. If the Member Payments had been structured in that manner, members likely would have found the allocation unfair because small-firm members would receive a rebate in the range of $1,200, but large-firm members would receive a much larger rebate.

Distributions upon Liquidation. Courts have allowed organizations exempt from tax under Section 501(c)(6) to make distributions to members on the event of the entity's liquidation. *See, e.g., Washington State Apples v. Commissioner*, 46 B.T.A. 64, 70 (1942). NASD is not liquidating, and we have found no case or ruling that applied the liquidation exception to a transaction in which operations were to continue. In any event, it is likely that even upon liquidation, amounts distributed to members would be limited to previously paid-in dues, and that the entity's exemption for the year of distribution would be revoked if members were to share in the earnings of the organization. *See Washington State Apples*, *supra*. While one Tax Court case has allowed

distribution of more than the previously paid-in dues (*Mill Lane Club v. Commissioner*, 23 T.C. 433 (1954)), the Seventh Circuit has also ruled that the mere fact that an exempt entity's charter allowed for distribution of assets to members upon liquidation was sufficient to invalidate its exemption where some of the assets had been purchased out of earnings, rather than dues (*Uniform Printing & Supply Co. v. Commissioner*, 33 F.2d 445 (7th Cir. 1929)).

Reasonable and Appropriate Expenses. The Tax Court has suggested on one occasion that the existence of inurement to members should be reviewed in light of "the reasonableness and appropriateness of the expenses" to the exempt purpose of the entity and that "control of financial decisions by individuals who appear to benefit personally from certain expenditures does not necessarily indicate inurement." *Unitary Mission Church*, 74 T.C. at 515. Although the Tax Court ultimately revoked the church's tax exemption, that dictum is consistent with the general proposition that an exempt organization can enter into arm's-length transactions with members. *See* Rev. Rul. 97-21, 1997-1 C.B. 121 (recruiting incentives negotiated at arm's length by tax-exempt hospital do not constitute private inurement); Rev. Rul. 80-106, 1980-1 C.B. 113 (consignment sales negotiated at arm's length by tax-exempt thrift shop do not constitute inurement); Priv. Ltr. Rul. 9643036 (arm's-length sale of substantially all the assets of tax-exempt hospital to a for-profit hospital did not result in private inurement).

Given the large size of the aggregate amount of the proposed Member Payment ($170 million to $180 million, depending on the number of members) in relation to the balance sheet of NASD, the IRS was unlikely to rule that the payment qualified as a reasonable and appropriate expense, even if it was necessary to the Proposed Transaction.

Determination of Amount of Member Payment. On an aggregate basis, the proposed Member Payment is within the amount that could be rebated in a manner consistent with the rebate exception. Moreover, given its size, the proposed Member Payment was supported economically by the present value of the expected incremental future cash flows attributable to the Proposed Transaction after taking into account transaction costs, including future rebates and other reductions in fees that were described in the Proxy Statement. Thus, it can be said that the proposed Member Payment would not reduce the value of NASD's equity.

IRS Ruling. The IRS has issued rulings (one each to NASD and NASDR) that the Proposed Transaction, which includes the proposed Member Payment, would not affect the tax-exempt status of NASD or NASDR. In the rulings, the IRS found that the Proposed Transaction would further the exempt purpose of NASD by producing benefits for the securities industry, and, by extension, for the public that relies on NASD and NASDR to ensure fairness in the industry. Because of (i) the importance of the payment to the Proposed Transaction as a

whole; (ii) the financial data presented by NASD explaining that the amount of the Member Payment is expected to be paid out of the value of expected incremental future cash flows, rather than the value of NASD's equity; and (iii) the unique facts and circumstances of the Proposed Transaction, the IRS approved the Proposed Transaction, including the payment.

Under these circumstances, and based on the authorities and guidance described above, if NASD had increased the amount of the proposed Member Payment, there would have been a serious risk that the IRS would not have issued the rulings and that NASD could be found to violate the prohibition against private inurement if it went forward with the proposed Member Payment without the benefit of a ruling.

If you have any questions or if I can be of any further assistance, please do not hesitate to call me at (212) 450-4969.

Very truly yours,

Mario J. Verdolini, Jr.