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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: JUN 20 2000

Employer Identification Number:

Contact Person:

U.I.L. Numbers:
501.03-30
512.01-00

Contact Number:
OP:E:EO:T2

Legend:

M =
N =
O =

Dear Applicant:

This letter is in reply to the letter from your authorized representative dated September 8, 1999, as amended by letter dated January 18, 2000, in which M requested rulings with respect to the tax consequences of the formation of a tax exempt entity as a holding company and the formation of a profit making subsidiary as described below.

M is an educational organization recognized by the Internal Revenue Service as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code. M is a publicly supported organization described in section 509(a)(1) of the Code. M's Articles of Incorporation state that M's purpose is to aid, promote, and encourage, by all appropriate means, including gifts of money or other property, schools, facilities, and other organizations that are exclusively educational. M currently has no members, but intends to amend its Certification of Incorporation to make N its sole member.

N is a recently incorporated organization that was organized and will be operated exclusively for the benefit of M. N has been recognized as exempt from federal income tax under section 501(c)(3) of the Code, and has been determined to be a supporting organization described in section 509(a)(3). N's initial Board of Trustees has five members, all of whom (except one) are also trustees of M. After M makes N its sole member, N will have the authority to appoint M's trustees. N states that it will amend its bylaws to state that at least a majority of its trustees also serve on M's Board of Trustees. N states that, initially, it will share all facilities, equipment, employees, and other assets in allocated portions with M which will be accurately recorded on each organization's books and records. N will reimburse M, at fair rental value, for the use of the facilities, equipment, and other assets owned by M.

297

O was recently incorporated as a for-profit corporation, and formed for *bona fide* business purposes: the establishment of partnerships with other for-profit organizations, capital development, cash management services, and the administration of individual retirement plans. O's Certificate of Incorporation provides that its initial Board of Directors shall have seven members. One of these seven members is also a trustee of M and N. O's bylaws restrict its shareholder's ability to appoint its directors by requiring that a majority of its directors shall not be trustees or officers of M or N. O states that its daily business operations will be managed by its officers, and that neither M nor N will participate in its business planning or day-to-day operations. M states that, initially, O will share certain functions, equipment, and other assets in allocated portions with M, which will be accurately recorded on each company's books and records. M states that all of its and N's relationships with O will be at arm's length, and that O will reimburse M, at fair rental value, for the use of the facilities, equipment, and other assets owned by M. M states that it is not anticipated that any employees of O will be shared with either M or N, but that if such sharing of employees is required, all shared employees will be compensated by each company in accordance with the amount of time such employees devote to each company. M states that O, at all times, will maintain separate bank accounts and have its own stationery and telephone lines. O intends to make dividend distributions to its parent company, N, which will use a portion of the funds to operate itself and contribute the remainder to M for its exempt purposes.

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

Section 509(a)(3) of the Code excludes from the definition of the term "private foundation" an organization which is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in sections 509(a)(1) or (2), and is operated, supervised, or controlled by or in connection with one or more organizations described in sections 509(a)(1) or (2).

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions and modifications.

Section 512(b)(1) of the Code provides that one of the modifications referred to in section 512(a)(1) is that all dividends shall be excluded from the term "unrelated business taxable income."

Section 513(a) of the Code defines the term "unrelated trade or business" as 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 organization of the function constituting the basis of its exemption.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes; and it is "substantially related" only if the causal relationship is a substantial one. The regulation continues that for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Rev. Rul. 67-390, 1967-2 C.B. 179, describes four cases where new applications for recognition of exemption would have to be filed. In each of the four cases described, a new legal entity has been created and each new entity must establish its exemption in accordance with section 1.501(a)-1(a)(2) of the regulations. Accordingly, each new entity must file an application for recognition of exemption to establish that it qualifies for exemption from federal income tax.

For federal income tax purposes, a parent corporation and its subsidiaries are separate taxable entities so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That is, where a corporation is organized with a *bona fide* intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. Britt, supra, at 234. However, where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1106 (5th Cir. 1973).

You have represented that O was formed for *bona fide* business purposes and will conduct various business activities. Since O is organized with a *bona fide* intention that it will have some real and substantial business function, its existence will not be disregarded for federal tax purposes. The only issue, therefore, is whether O should be deemed for tax purposes to be an instrumentality of M or N. As noted above, where a parent corporation so controls the affairs of the subsidiary that it is an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. In the absence of such control, the existence of the subsidiary will generally not be disregarded.

Based on the above facts and representations, the activities and income of O will not be attributed to M or N for purposes of (i) continued qualification for recognition of exemption as organizations described in section 501(c)(3) of the Code, and (ii) possible receipt of unrelated business taxable income with respect to O's activities. Accordingly, the creation of O will not adversely affect M's or N's continued qualification for recognition of exemption as organizations described in section 501(c)(3), or result in unrelated business taxable income under section 512(a)(1).

Subsequent to the formation of N and O, M will continue to operate exclusively for charitable purposes within the meaning of section 501(c)(3) of the Code. Although M will be amending its Articles of Incorporation to change its membership structure, it will not reincorporate or otherwise form itself into a new legal entity. The actions described above, in and of themselves, will have no adverse effect on a determination of exempt status or exception from private foundation status of either M or N. As provided in section 512(b)(1), dividends are specifically excluded from the definition of unrelated business taxable income.

Based on the facts and circumstances concerning the reorganization and related transactions as stated above, we rule as follows:

(1) N is exempt under section 501(c)(3) of the Code.

(2) N is determined to be other than a private foundation pursuant to section 509(a)(3).

(3) O's for-profit activities will not jeopardize the tax exempt status of either M or N.

(4) N's receipt of dividend distributions from O will not be treated as unrelated business taxable income under section 511(a) to either M or N.

(5) M's change from a non-member organization to a single member organization will not trigger the need for M to file a new application for recognition of exemption.

(6) The president of M and N, who is also on the Board of Trustees of both M and N and on the Board of Directors of O, may serve as an officer of O without jeopardizing the tax exempt status of either M or N.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Any such change should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records. A copy of this ruling is being forwarded to the Ohio TE/GE Customer Service office.

Except as we have specifically ruled herein, we express no opinion as to the consequences of these transactions under the cited provisions or under any other provisions of the Code. We have not been asked and we express no opinion on whether any amounts received by M from N or O in return for providing facilities, equipment, or other assets constitute unrelated business taxable income under section 512(a)(1) of the Code. Furthermore, we have not been asked and we express no opinion on whether payments of rent by N or O to M would be subject to tax by reason of section 512(b)(13).

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

(signed) Garland A. Carter

Manager, Exempt Organizations
Technical Group

300