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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

UIL # 501.03-08
512.00-00
513.00-00

NO THIRD PARTY CONTACTS

Contact Person:

Telephone Number:

In Reference to: OP:E:EO:T:1

Date: JUL 20 1999

EIN:
Key District:

Legend:

A =
B =
C =
D =

Dear Taxpayer:

This is in response to a letter dated March 31, 1999, which supplemented and modified earlier correspondence, submitted on your behalf by your authorized representative, who requested a number of rulings as to whether the proposed transaction described below will jeopardize your tax-exempt status under section 501(c)(3) of the Internal Revenue Code, adversely affect your classification as other than a private foundation under section 509(a), or result in unrelated business income tax under sections 511 - 513.

A is a university described in section 501(c)(3) of the Code and classified as an educational organization within the meaning of sections 509(a)(1) and 170(b)(1)(A)(ii).

B is an organization described in section 501(c)(3) of the Code and classified as a supporting organization under section 509(a)(3). B, which operates solely for the benefit of A, functions principally to hold and manage certain endowments and long-term properties and programs for the benefit of A.

C is an organization described in section 501(c)(3) of the Code and classified as a supporting organization under section 509(a)(3). C, which operates solely for the benefit of A and B, functions principally to receive contributed properties which will be held temporarily, and to manage these short-term contributed properties.

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A owns, manages and rents acquired and donated property on or in the immediate vicinity of its campus. Upon receipt of the requested rulings, A may continue to hold and manage all or some of its properties, or it may transfer to B and/or C some of its properties.

A, B, and C will be collectively referred to as "Interested Parties."

A may capitalize B and C with initial transfers of cash, other assets and/or personnel. Upon receipt of the requested rulings, A may contribute to B and/or C additional cash or assets, certain furnishings and equipment, provide guaranty of line(s) of credit which B and/or C intend to obtain, and secure line(s) of credit as necessary. Subject to the determination of A's Board of Trustees, capitalization of B and C may include equity, debt, and possibly guaranty(ies) when preferable to an outright loan.

A may agree to make available to B and/or C clerical and professional employees, for which B and/or C will reimburse A on a reasonable basis representing cost for each day that the employee works for B and/or C. A may agree to provide B and/or C with access to A's office space, office equipment, computer terminal and other equipment, facilities, supplies and resources. In all cases, amounts charged by and paid to A for its services or for the use of its facilities, personnel and other resources shall reflect an arm's length charge which shall be an amount which was charged or would have been charged for the same or similar services or use of property in independent transactions between unrelated parties under similar circumstances considering all relevant facts. B and/or C will not be obligated to obtain goods and services from A, but, instead, will maintain complete discretion to utilize resources of third parties as well.

C proposes to form D, as a general, for-profit, business corporation, primarily to provide real estate management and other services to or for the benefit of the Interested Parties. Initially, all of D's capital stock will be owned by C. As sole shareholder, C will elect D's Board of Directors. Of D's board members, a majority may consist of persons who are trustees, officers, or employees of A, B, or C.

Activities of D will be limited to renting and managing real and personal property owned by A, B, or C. D's rental agreement will be at fair market value on a "net-net" basis so that the lessor will simply receive rental payments therefor from D for the use of the lessor's real property. The amount of rent received by an Interested Party will not depend in whole or in part on the income or profits derived by any person from the property leased. Rent, if any, received by an Interested Party for use of personal property will be incidental to rent received

for use of real property. D will assume all management services and responsibilities and will incur all expenses in connection with the use of the rental property, including payment of reasonable, fair market amounts of rent to the Interested Parties. D will manage these properties, sublet the properties to various entities or organizations, and provide management and consultation services to the sublessees. D intends to maximize its management fees and earnings with respect to the foregoing activities. In addition to the rental payments to A, B, or C, D will pay dividends to C.

Upon receipt of the requested rulings, one or more of the Interested Parties may capitalize D with transfers of cash, other assets and personnel, provide guaranty line(s) of credit which D intends to obtain, and secure the lines of credit as may be necessary. Subject to the determination of the Interested Party's Board of Trustees, capitalization of D may include equity, debt and possibly guaranty(ies) when preferable to an outright loan.

Any one or more of the Interested Parties may agree to make available to D clerical and professional employees, for which D will reimburse the respective Interested Party on a reasonable basis representing cost, plus benefits, for each day that the employee works for D. In accordance with the terms to be set forth in written agreements, any one or more of the Interested Parties may agree to provide D with access to the respective Interested Party's office space, office equipment, computer terminals and other equipment, facilities and resources. In all cases, amounts charged by and paid to an Interested Party for its services or for use of its facilities, personnel and other resources shall reflect an arm's length charge which shall be an amount which was charged or would have been charged for the same or similar services or use of property in independent transactions between unrelated parties under similar circumstances considering all relevant facts. D will not be obligated to obtain goods and services from any one or more of the Interested Parties, but, instead, will maintain complete discretion to utilize the resources of third parties as well.

Interested parties and D shall at all times operate as separate, independent and autonomous organizations. None of the Interested Parties will be involved in the management of D, and D will have its own employees, officers and directors. The day-to-day management of D will be placed in an individual who is exclusively employed by D and who will devote 100% of his/her time to D. The individual serving as the chief operating officer of D will not be a director, officer, or employee of any of the Interested Parties. D, which will have a business purpose that is separate and distinct from the purposes of the Interested Parties, intends to develop and carry out marketing strategies of its own, independent of the Interested Parties, and generally to

make its goods and services available to the general public and to entities unaffiliated with any one or more of the Interested Parties.

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

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as gross income derived by an organization from an unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with such trade or business.

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 the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of the purpose or function constituting the basis for its exemption.

Section 513(c) of the Code provides, in part, that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Sections 512(b)(1), (2) and (3) of the Code exclude from the computation of unrelated business taxable income interest, dividends, royalties and rents from real property, and rents from personal property leased with such real property, if the rents attributable to such personal property are only an incidental amount of the total rents received under the lease.

Section 512(b)(13) of the Code provides special rules for certain amounts of income an exempt organization receives from a controlled entity.

Section 512(b)(13)(A) of the Code provides that notwithstanding sections 512(b)(1), (2), and (3), an organization (controlling organization) receiving a specified payment from another entity which it controls (controlled entity), shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.

Section 512(b)(13)(B)(i) of the Code defines "net unrelated income" for the purposes of a controlled entity not described in section 501(a), as the portion of the entity's taxable income which would be unrelated business taxable income if such entity were exempt under section 501(a) and had the same exempt purposes as the controlling organization, or in the case of a controlled entity, which is exempt under section 501(a), as the amount of the unrelated business taxable income of the controlled entity.

Section 512(b)(13)(B)(ii) of the Code defines "net unrelated loss" as the net operating loss adjusted under the rules set forth in section 512(b)(13)(B)(i).

Section 512(b)(13)(C) of the Code defines "a specified payment" as any interest, annuity, royalty, or rent.

Section 512(b)(13)(D)(i) of the Code provides, in part, that the term "control" means in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of such corporation, and in any other case (other than a corporation or a partnership) ownership of more than 50 percent of the beneficial interests in the entity.

Section 512(b)(13)(D)(ii) of the Code provides that section 318 (relating to constructive ownership of stock) shall apply for purposes of determining ownership of stock in a corporation, and similar principles shall apply for purposes of determining ownership of interests in any other entity.

Section 318(a)(2)(C) of the Code provides that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all of the stock in such corporation.

Section 318(a)(3)(C) of the Code provides that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly by or for such person.

Section 1.512(a)-1(c) of the regulations provides, in part, that where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead) shall be allocated between the uses on a reasonable basis. Similarly, where personnel are used to both carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis.

An exempt organization can invest its endowment and other funds without jeopardizing exemption. Whether investing through capital contributions or through guaranteeing debt or securing debt of a subsidiary, the activity is not changed into one which would jeopardize exemption, as it is still pledging assets in the expectation of a financial return.

The activities conducted by B and C were previously conducted by A, and these activities furthered A's purposes. The fact that A established B and C to conduct these activities does not affect A's tax-exempt status. Thus, A's providing of financial support, guaranteeing and securing debt, providing equipment and office space to B and C, and B and C's contractual use of A's employees will not jeopardize A's exemption and foundation status.

B and C are separate legal entities with their own activities and management separate from A. A is not involved in the day-to-day management or operations of B and C. Under these circumstances neither the activities nor the income of B and C are attributable to A, which will continue to have its own activities separate and apart from B and C.

The establishment of D, a for-profit corporation, needs to be analyzed to determine whether its activities are distinct from those of the Interested Parties, so as not to jeopardize any of the Interested Parties' tax-exempt status under section 501(c)(3) of the Code.

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,

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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, 431 F.2d 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).

D, which will be created by C, is a for-profit subsidiary with a bona fide intention that it will have a real and substantial business function. The Interested Parties will not be involved in the day-to-day management of D and will continue to have their own activities separate and apart from D. It has been represented that any services provided to D will be at an arm's length basis, and that office space and its operations will be separate. Under these circumstances, D's existence will not be disregarded, and, consequently, D's activities will not be attributed to the Interested Parties. Accordingly, the creation of D by means of a transfer of property, will not adversely affect A, B, or C's tax-exempt status under section 501(c)(3) of the Code.

D, which will be a distinct and separate corporation from the Interested Parties, will pay rent to them and dividends to C. The receipt of dividends is not taxable to C, because section 512(b)(1) of the Code excludes dividends from unrelated business taxable income, and the rules of section 512(b)(13) do not apply to the payment of dividends.

Normally, the receipt of rental income from real property would be excluded from unrelated business taxable income under section 512(b)(3) of the Code, unless the income received was from a controlled entity as described in section 512(b)(13). Section 512(b)(13) treats specified payments of interest, annuities, royalties and rent as unrelated business taxable income if the payment is from a controlled entity.

In this case, A will be treated as owning all of the beneficial interests in both B and C. Consequently, with regard to B and C, A will be a controlling organization, and B and C will each be a controlled entity. Since C will own all of the stock of D, C will be treated as a controlling organization with respect to D, and D will be treated as a controlled entity with respect to C. Under section 318(a)(2)(C) of the Code, because A owns all of the beneficial interests in C, A will be treated as also owning all of the stock interest in D. Thus, A will be a controlling organization with respect to D, and D will be a controlled entity with respect to A. Under section 318(a)(3)(C), because A owns all of the beneficial interests in B, B will be treated as owning all of the stock interest in D, because it is

deemed to own all of the stock that its more than 50 percent owner (A) owns. Thus, B will be a controlling organization with respect to D, and D will be a controlled entity with respect to B.

In summary, pursuant to section 512(b)(13)(D) of the Code and consistent with such provision's 50% control test and the attribution rules contained in section 318, A, B, and C will be controlling organizations, and D will be a controlled entity. Based on the information submitted, D's payments of rental income to any of the Interested Parties, each of which will be a controlling organization by either direct stock ownership of D or indirect control of D, will be subject to the rules under section 512(b)(13).

The net unrelated income transferred to A, B, or C for purposes of section 512(b)(13) of the Code consists of D's taxable income that would be unrelated business income if D were exempt under section 501(a) and had the same exempt purposes as one of the Interested Parties. If D conducts an activity that is not an unrelated business activity under section 501(a), then D would have no unrelated income to be reduced and no income for A, B, or C to include as an item of gross income from an unrelated trade or business under section 512(b)(13).

If D conducts an activity that would produce unrelated business taxable income, assuming D is exempt under section 501(a) of the Code and has the same exempt purposes as A, B, or C, then D's "net unrelated income" would be computed in a manner consistent with the "fragmentation rule" and the "dual use rule." If the net unrelated income were reduced by interest, annuity, royalty or rental payments to A, B, or C, the amount of such reduction would be included as an item of gross income from an unrelated trade or business to A, B, or C.

The "fragmentation rule" and "dual use rule" may be used in computing the gross income from an unrelated trade or business of any of the Interested Parties. The "fragmentation rule" would separate an Interested Party's operations into component activities (i.e., taxable unrelated activity, nontaxable related activity, and nontaxable section 512(b) modification), and the "dual use rule" would be applied to each separate activity/use for purposes of allocating the specific portion or amount of the income or expense items proximately and primarily related to the respective use/activity.

Based on the foregoing, we rule as follows:

(1) A's tax-exempt status under section 501(c)(3) of the Code and classification as an organization described in section 509(a)(1) will not be jeopardized by entering into the above described transactions, including the formation of B, A's capital

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contributions to B, A's guaranteeing and securing debt of B, B's lease of A's equipment and office space/facilities, or B's contractual use of employees and other resources of A.

(2) A's tax-exempt status under section 501(c)(3) of the Code and classification as an organization described in section 509(a)(1) will not be jeopardized by entering into the above described transactions, including the formation of C, A's capital contributions to C, A's guaranteeing and securing debt of C, C's lease of A's equipment and office space/facilities, or C's contractual use of employees and other resources of A.

(3) A's tax-exempt status under section 501(c)(3) of the Code and classification as an organization described in section 509(a)(1) will not be jeopardized by the formation of D, A's capital contributions to D, A's guaranteeing and securing debt of D, D's rendering of services to persons or entities unrelated to A, and D's receipt of earnings with respect thereto, A's receipt of interest, annuity, royalty or rental income from D, D's lease of A's equipment and office space/facilities, or D's contractual use of employees and other resources of A. D's activities will not be attributed to A.

(4) When D is formed by C, A will be a "controlling organization" and D will be a "controlled entity" within the meaning of section 512(b)(13) of the Code. Therefore, amounts received by A from D as interest, annuity, royalty or rental payments will be included as an item of gross income derived from an unrelated trade or business to the extent such payment reduces D's "net unrelated income" (or increases any net unrelated loss) as defined in section 512(b)(13)(B)(i). Also, amounts received by A from D as interest, annuity, royalty or rental payments will not be included as an item of gross income derived from an unrelated trade or business to the extent such payment does not reduce D's unrelated income (or does not increase any net unrelated loss) as defined in section 512(b)(13)(B)(i).

(5) In computing D's "net unrelated income," if any, or the portion, if any, of D's taxable income which would be unrelated business taxable income as defined in section 512(a)(1) of the Code if D were exempt from tax under section 501(a) and had the same exempt purposes as A, the general rules set forth in sections 511 - 513 will apply, including the "fragmentation rule" under section 513(c) and section 1.513-1(b) of the regulations, and the "dual use rule" under sections 1.512(a)-1(c) and 1.513-1(d)(4)(iii).

(6) In computing the portion, if any, of A's gross income derived from an unrelated trade or business, the general rules set forth in sections 511 - 513 of the Code will apply, including the "fragmentation rule" and the "dual use rule," cited above.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative.

We are providing your Key District Office with a copy of this ruling. You should keep a copy of this letter in your permanent records.

This ruling is directed only to the organization that requested it. Section 6110(j)(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 appear in the heading of this letter.

Sincerely,

(signed) Marcus S. Owens
Marcus S. Owens
Director, Exempt Organizations
Division