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

Date: JUL 22 1999

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Contact Person:

ID Number:

Telephone Number:

Fax Numbers:

Employer Identification Number:

Legend

A =
B =
C =
D =

Dear Sir or Madam:

This is in reply to your request for rulings that the establishment and operation of a wholly-owned subsidiary will not jeopardize your exempt status under section 501(c)(3) of the Internal Revenue Code and will not result in tax liability under section 511 of the Code.

FACTS

A owns and operates two kidney dialysis centers. A has been recognized as exempt from federal income tax under section 501(c)(3) of the Code and as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

A concluded that it can better serve its service area by expanding its facilities to provide a third kidney dialysis center. In structuring the new dialysis center, A is aware that such a center could be established by local physicians as a for-profit entity unrelated to A which action would be detrimental to A. In order to encourage the physicians to continue the rendition of services at A's centers and to encourage the physicians to travel to the new center for the purpose of providing required nephrology services, A and the physicians have formed a general partnership to own and operate the new dialysis center to be known as B.

A has established a wholly-owned for-profit subsidiary known as C to hold its partnership interest. Four local physicians providing nephrology services at A's kidney centers have established a for-profit corporation known as D to hold their partnership interests. None of the physicians serve as board members of either C or A.

C and D have formed B to operate the new dialysis center. A has funded C to the extent of 40 percent of the required initial capital contribution to B. Similarly, the physicians have funded D to the extent of 60 percent of the required initial capital of B. C and D have ownership interests in

358

B proportional and equal in value to their respective contributions. As provided in the Partnership Agreement, all income and losses and distributions of cash flow are distributed among the partners in proportion to their ownership interests.

C has separate and independent management from A. The Board of Directors of C consists of six community leaders. Three of the directors are also directors of A, while the remaining three directors have no affiliation with A. The Partnership Agreement of B provides the following:

1) All decisions with respect to the management and control of the Partnership are required to be approved by a Seventy-Five Percent (75%) vote of the partners. Accordingly, the governing documents may only be amended with the approval of both partners (Section 5.01 Partnership Agreement).

2) C, as Managing Partner (Section 5.06 of the Partnership Agreement) is charged with conducting the day to day affairs of the partnership.

3) Section 5.01 of the Partnership Agreement further provides that C shall have the unilateral right of approval or disapproval with respect to any proposed action of the partnership where C reasonably believes that a proposed action or inaction may negatively affect the qualification of A as a tax exempt entity under section 501(c)(3) of the Code.

4) Paragraph 1.03 of the Partnership Agreement provides that "the dialysis center shall be open to all residents of the community without regard to the ability to pay; it being the intent that B shall serve the needs of the community in the same manner and to the same extent as A."

C's Board of Directors consists of three community leaders who are members of A's Board of Directors and three members who are community leaders having experience with exempt entity matters and who do not engage on business transactions or have any affiliation of any nature with A.

B has entered into an employee leasing agreement with A pursuant to which A provides skilled employees to B facility for the purpose of providing kidney dialysis services. Pursuant to the employee leasing agreement, B shall pay A an amount equal to the total costs incurred by A plus an administrative fee equal to five percent (5%) of the amount so determined. The term of the agreement is five (5) years;provided, however, that either party may terminate the agreement upon ninety (90) days prior written notice.

REQUESTED RULINGS

1. That C's earnings will not be considered as unrelated business income attributable to A.

2. That the operations of C will not jeopardize A's status as an organization described in Section 501(c)(3) of the Code.

3. That the dividends received by A from C will not constitute unrelated business taxable income.

LAW AND ANALYSIS

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

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3) of the Code.

Section 513 of the Code defines the term "unrelated trade or business" to mean, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for funds) to the exercise of performance by the organization of the purpose or function that constitutes the basis for exemption under section 501.

Section 512(b)(1) of the Code excludes dividends and interest from the calculation of unrelated business taxable income.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. The providing of medical care to the community without regard to the ability to pay has long been recognized as a charitable purpose.

Section 1.501(c)(3)-1(c)(1) of the 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). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

For federal income tax purposes, a parent corporation and its subsidiary 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 the 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., 438 F.2d 1098, 1101 (5th Cir. 1973); 1 W. Fletcher, Cyclopedia of the Law of Private Corporations, section 43.10 (Perm. Ed. 1983).

CONCLUSION

An organization recognized exempt under section 501(c)(3) can hold all of the stock in a for-profit subsidiary where the subsidiary is formed for a bona fide business purpose and is not

a mere instrumentality of the parent and where the parent does not actively participate in the day to day management of the subsidiary. Accordingly, A can own all the stock in C without jeopardizing its exempt status under section 501(c)(3) of the Code. Therefore, A will continue to qualify as an organization described in section 501(c)(3) of the Code following the formation and funding of C as a general partner of B because A will continue to operate exclusively for charitable purposes. Furthermore, A's principal activity will continue to be the providing of kidney dialysis services to the community. Thus, A remains an organization described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

Furthermore, the activities of C and the income derived from its activities will not be attributable to A for purposes of determining A's tax exempt status under section 501(c)(3) of the Code. Dividends paid by C will not jeopardize the exempt status of A and will not be taxable income to A because the dividends are excluded under section 512(b)(1) of the Code.

RULINGS

Therefore, we rule as follows:

1. C's earnings will not be considered as unrelated business income attributable to A.

2. The operations of C will not jeopardize A's status as an organization described in Section 501(c)(3) of the Code.

3. The dividends received by A from C will not constitute unrelated business taxable income.

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.

The rulings in this letter only apply the specifically indicated sections of the Code and regulations to the facts that you have represented. In this letter we do not rule on the applicability of any other sections of the Code and regulations to your case.

Because this letter could help resolve any future questions about your income tax responsibility, please keep a copy of this ruling in your permanent records.

Sincerely,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1