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

Date: JUN 26 2000

Contact Person:

ID Number:

Telephone Number:

OP:E:EO:T

Legend:

B =
C =
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F =
G =
H =

Ladies and Gentlemen:

This is in reply to a letter dated April 28, 2000, from your legal representative in which she requested rulings concerning the income tax consequences of certain transactions arising from a proposed corporate reorganization.

B currently operates a not-for-profit educational facility in C that focuses on middle school (grades 5-8) education of students from economically disadvantaged backgrounds. All students attend the facility on full scholarships provided by contributions to the school. B has been determined to be exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code and has received an advance ruling that it is described in section 509(a)(2). The advance ruling period is still pending with respect to the determination of private foundation status for B pursuant to section 509(a) of the Code.

Pursuant to the plan of restructuring, B has caused four not-for-profit educational facilities to be formed: E, F, G and H. B proposes to reorganize its corporate structure in order to: (i) separate each educational facility location from other locations and enhance local community involvement; (ii) lessen exposure of endowment funds to third party liability; (iii) provide more efficient local planning and administration and

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fundraising that are subject to coordination through B; and (iv) improve the quality of educational programming, attract high quality personnel, and increase the ability of the organization to attract the attention of national funding sources that have an interest in the education of disadvantaged children.

Pursuant to the proposed plan of restructuring, which will be implemented upon receipt of the rulings requested in this letter, the operations of B's existing educational facility located in C will be transferred to E.

B will lease the land and building to E for $4,000 per year, which is an amount equal to the mortgage payments due on the school real property. E will assume responsibility for teaching and administrative staff and all other aspects of the educational operations that are required for operation of the C facility. B will become the sole member of E, F, G and H, creating a parent holding company/subsidiary type relationship between the entities.

Pursuant to the proposed plan of restructuring any existing and future endowment funds and contribution pledge receivables could be held by either B or E, F, G or H. However, B will coordinate fundraising activities of E, F, G and H. B will provide services related to the development and enhancement of educational programs which will then be implemented by E, F, G and H. B will also continue to own the land and improvements thereon which constitute the educational facility located in C that will be operated by E after the restructuring.

The proposed plan of restructuring anticipates that three additional educational facilities will be opened, one each by F, G, and H, to serve students in their respective locations. The time for opening the new facilities and the exact location and nature of ownership of operating assets, including whether educational facilities will be owned or leased, have not been determined. B intends to identify individuals in each community who are interested in the mission of B, for designation as trustees of F, G, and H. Decisions regarding location of the school and specific fundraising activities that are focused on the particular facility will be determined by the trustees of B and F, G and H, based upon the facts and circumstances applicable to the particular community.

F, G and H have each applied for exemption under section 501(c)(3) and requested nonprivate foundation status under sections 509(a)(1) and 170(b)(1)(A)(vi). E has applied for exemption under section 501(c)(3) and requested nonprivate foundation status under sections 509(a)(1) and 170(b)(1)(A)(ii)

because it will operate the C school upon completion of the transaction.

We have determined that F, G and H are tax-exempt under section 501(c)(3) and other than private foundations under sections 509(a)(1) and 170(b)(1)(A)(vi)of the Code in separate correspondence. These organizations are promoting education within the meaning of section 501(c)(3) of the Code but are not yet operating as schools within the meaning of section 170(b)(1)(A)(ii). We have also determined that E is tax-exempt under section 501(c)(3) and other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(ii) in separate correspondence.

It is expected that E, F, G and H will directly raise required funds from contributions to E, F, G and H. In some cases E, F, G and H may make distributions of funds and/or assets or provide services to either B or E, F, G or H. In addition, it is expected B, the sole member of E, F, G and H, will also engage in fundraising and may distribute portions of the contributions it receives to E, F, G and H, based either upon directions given by the donors or the need of E, F, G or H, determined by B. B may also provide assets and services to E, F, G and H, including program enhancements, fundraising coordination, and assistance with staff recruiting.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of an organization organized and operated exclusively for educational or charitable purposes, no part of the net earnings of which 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).

Section 512(a)(1) of the Code defines unrelated business taxable income generally as gross income received by an exempt organization from an unrelated trade or business regularly carried on by it, less allowable deductions.

Section 513(a) of the Code defines an unrelated trade or business, in the case of any organization subject to the tax imposed by section 511, 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 its exempt purpose.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is related to exempt purposes only where the conduct or the business activity has a causal relationship to the achievement of an exempt purpose, and is substantially related for purposes of section 513, only if the causal relationship is a substantial one.

Rev. Rul. 78-41, 1978 C.B. 148 described a trust whose sole purpose was to accumulate and hold funds for use in satisfying malpractice claims against an exempt hospital. The trust was determined to be an integral part of the hospital because it was controlled by the hospital and because it was performing a function that the hospital could do directly. The organization was ruled to be exempt under section 501(c)(3) of the Code.

The facts and circumstances of this case indicate that the proposed reorganization will not adversely affect the tax-exempt status of B as an organization described in section 501(c)(3) of the Code. Moreover, the reorganization will not result in the classification of B as a private foundation under section 509(a) of the Code. After the reorganization, E, F, G and H will continue to provide the educational programs and services previously performed by B. Therefore, the reorganization will not alter B's principal purpose which is to educate students from economically disadvantaged backgrounds.

The facts and circumstances further indicate that the transfer of assets and the provision of services among B, E, F, G and H serve to facilitate their exempt activities and promote the achievement of the exempt purposes of each related organization. Therefore, these transactions will not adversely affect the tax-exempt status of B.

To the extent that income is realized as a result of the sharing of assets and services among B, E, F, G and H, it will not give rise to unrelated business income to B so long as these business activities are substantially related to the exercise and performance of the exempt purposes of B.

Accordingly, based on the facts and circumstances as stated above, we rule that:

1. The restructuring of B and transfer of its C operations to E will not adversely affect the tax exempt status of B, nor will the restructure of B result in the classification of B as a private foundation under section 509(a) of the Code.

2. The restructuring and transfer of assets pursuant thereto will not result in unrelated business taxable income under section 511 to B.

3. Any sharing of assets and services or the transfer of funds among B, E, F, G or H after the reorganization will not constitute unrelated business taxable income under section 511 to B.

This ruling is based on the understanding that there will be no material changes in facts upon which it is based.

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

We are informing the TE/GE office of this action. Please keep a copy of this ruling in your permanent records.

Sincerely yours,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4