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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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UIL Nos.
0501.03-00
0511.00-00
0512.01-00
0514.01-00

Dear Sir or Madam:

This letter responds to X's request dated August 31, 2000, for rulings pertaining to the proper treatment of charitable organization's establishing a for-profit subsidiary under sections 501(c)(3) and 511 through 514 of the Internal Revenue Code.

FACTS

X is a tax-exempt organization under section 501(c)(3) of the Internal Revenue Code. X promotes economic development in a metropolitan area through the use of such programs as the Small Business Administration's loan programs and other similar activities. Currently, X's primary source of revenue is derived from the origination and servicing of a portfolio of loans.

X has established Y, which is a wholly owned for-profit subsidiary, to serve as the sole general partner of Z, a limited partnership. Z intends to operate a venture capital fund, which will make investments in small businesses located primarily in the part of the state in which X operates. The fund's purpose is twofold: (a) providing a satisfactory rate of return to the fund's investors, and (b) promoting economic development in the area through the growth of smaller entrepreneurial companies not typically serviced by other financing sources. X has purchased all the outstanding stock of Y and elects all the members of its board of directors. Limited partnership interests in Z will be marketed to interested investors.

Y is a separate legal entity with its own board of directors, officers, and staff. No more than three of the seven members of its board of directors are also members of X's board of directors. X will have no involvement in the daily operations of the subsidiary. Both organizations will maintain separate accounting and corporate records. Y will receive its ongoing funding from its share of the profits of Z and from fees for the management services it will provide to Z. In turn it will pay dividends to the X based on its 100 percent stockholding in Y.

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Y will pay X for the services of some X employees, on the basis of their prorated salary with X.

As the sole general partner in Z, Y will have the responsibility to evaluate investment opportunities and will make all investment, distribution and valuation decisions. Y will maintain a close working relationship with X. This will include renting office space at fair market value. X represents that any rental income derived by X from Y will be includable as an item of gross income pursuant to the allocation provisions of section 512(b)(13) of the Code. Y will also purchase certain administrative and professional services at fair market value from X, as well as sharing investment leads. X will treat these fees as income from unrelated business.

X and Y may also co-invest in companies. X represents that its transactions with Y will only produce an insubstantial return when compared with X's total financial receipts and will be strictly incidental to X's tax-exempt functions. The formation of Y was designed to limit liability for legal claims to the assets of each organization and to isolate exempt activities from activities that may be unrelated. At the same time, X desires to maintain sufficient control over Y to assure that Z's investment funds are used to promote economic development in the area in a manner consistent with X's exempt purposes.

X also represents that its investment in the stock of Y is not debt financed property within the meaning of section 514(b) of the Code.

RULINGS REQUESTED

X requests rulings that the organization and operation of Y and the receipt of dividends on its stock in Y will not affect its tax-exempt status under section 501(c)(3) of the Code and will not give rise to private inurement or private benefit or to unrelated business taxable income under sections 511 through 514 of the Code.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations, which are organized and operated exclusively for charitable 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(a)(1) of the Income Tax Regulations provides that an organization must be both organized and operated exclusively for one or more of the purposes specified in section 501(c)(3) of the Code in order to be exempt as an organization described in such section.

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 is engaged 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.

Section 1.501(c)(3)-l(d)(ii) of the regulations states that an organization is not organized

or operated for one or more exempt purposes unless it serves a public rather than a private interest. Accordingly, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator, shareholders, or persons controlled, directly or indirectly, by such private interests.

Section 511 (a) of the Code imposes a tax upon the unrelated business taxable income of organizations exempt from federal income tax.

Section 512(b)(1) of the Code excludes among other items all dividends and interest payments from the computation of an exempt organization's unrelated business taxable income.

Section 512(b)(1) of the Code excludes from the computation of unrelated business taxable income all dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5) of the Code), and annuities, and all deductions directly connected with such income.

Section 512(b)(5) of the Code generally excludes all gains or losses from the disposition of property from the computation of unrelated business taxable income.

Section 512(b)(13) of the Code provides that, notwithstanding subparagraphs (b)(1), (2) or (3) of section 512 of the Code, interest, rents, and royalties derived from a controlled organization (within the meaning of section 368(c) of the Code) shall be included in gross income in a ratio determined according to that section.

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the court held that 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, unless the subsidiary is a sham or acts as a mere agent of the parent.

In Britt v. United States, 431 F.2d 234 (5 th Circuit 1970) the court emphasized that 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. 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.

ANALYSIS

The activities of a separately incorporated subsidiary cannot ordinarily be attributed to its parent organization unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent or integral part of the parent. The facts set forth in this request indicate that the subsidiary is organized for a bona fide business purpose and is managed by an independent board of directors. Therefore, the commercial activities of the subsidiary are not

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attributable to the parent for purposes of determining its tax-exempt status.

Y has a separate corporate existence and business purpose and conducts its activities independently from X. Furthermore, the facts indicate that X does not actively participate in the day-to-day management of Y. Therefore, Y is not a mere instrumentality of the X and its corporate existence is not disregarded for federal income tax purposes.

Section 512(b) of the Code generally excludes from unrelated business taxable income all income received from dividends. As established above, the investment in Y's stock by X will be a passive investment in a separately operated and managed corporation. Therefore, X's investment, organization and operation of Y will not give rise to unrelated business taxable income. In addition, there are no facts indicating that Y's operations will improperly benefit private shareholders or individuals of X or other private interests.

The integral part doctrine "provides a means by which organizations may qualify for exemption vicariously through related organizations, as long as they are engaged in activities which would be exempt if the related organizations engaged in them, and as long as those activities are furthering the exempt purposes of the related organizations."(Gesinger Health Plan v. Comm'r, 985 F.2d 1210(3rd Cir. 1993)). The provision of management services to a for-profit organization is not an exempt activity. Any fee derived from the provision of such services is unrelated business income.

X controls Y within the meaning of Section 512(b)(13). X owns more than fifty percent of Y's stock. Therefore, rents derived from Y, shall be included in X's gross income in a ratio determined according to that section.

CONCLUSION

Accordingly, we rule as follows:

1. The organization and operation of Y and the receipt of dividends on its stock in Y will not affect X's tax-exempt status under section 501(c)(3) of the Code.

2. The organization and operation of Y will not give rise to unrelated business taxable income to X under sections 511 through 514 of the Code, except for rents from Y as provided in Section 512(b)(13) and the provision of management and other services to Y for a fee.

3. Any rental income derived from X from Y will be includable as an item of gross income pursuant to the allocation provisions of section 512(b)(13) of the Code.

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

Sincerely,

/S/

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2

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