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

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Date:

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Contact Person:
ID Number:
Telephone Number:

Employer Identification Number:

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Legends

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Dear Sir or Madam:

This letter responds to the request of counsel for B, C and D, dated June 1, 2000, for a ruling regarding a proposed reorganization of two charities, B and C, along with the creation of a new charity, D.

The proposed transaction involves an attempt to reorganize, for purposes of efficiency and cost savings, the administrative activities of two related and structurally interconnected charities, B, which operates foster homes, and C, which operates private and non-public schools, largely in connection with the foster homes of B. B and C have established a new nonprofit, tax-exempt corporation, D whose primary function will be to provide administrative support to B and C. Additionally, B and C have formed a for-profit corporation, X. D will hold all of the stock of X and D will provide services to X at cost. There are no plans to issue X's stock to any other shareholders, but if such stock is issued to shareholders other than X, then D will provide services to X at fair market value. D may also provide loans to X if X needs funds to help capitalize its early operations.

B, C and D are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code ("Code"). B and C are classified as public charities under sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code. There is significant overlap on the Boards of Directors of B and C. Only two of the C Directors are not also currently on the B Board. The CEO of B and C is A. D is classified as a public charity because it is an "operated, supervised or controlled by" supporting organization described in section 509(a)(3). D's Board of Directors is appointed by B and it will be comprised solely of B or C Board members.

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X will be the parent corporation in a new for-profit group of companies, which will operate private, for-profit schools, and will sell school supplies and equipment, throughout the country. The operation of schools by X and its subsidiaries will be carried out in a manner consistent with C's exempt purposes. For example, each of these schools will satisfy the non-discrimination requirements of the Code.

As part of the reorganization, B and C propose to take core administrative functions, along with employees, buildings and equipment needed to carry out these functions, and transfer them to D. B and C will each receive services from D, for which they will reimburse D, at cost.

You have requested a ruling that

(1) the reorganization will not adversely affect the tax-exempt status of either B or C under section 501(c)(3) of the Code;

(2) D's income from providing administrative services to B and C will not be taxable as unrelated trade or business income;

## *I. TAX EXEMPT STATUS OF B AND C*

Law

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

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations ("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 1.502-1(b) of the regulations states that if a subsidiary organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because as a matter of accounting the subsidiary derives a profit from its dealings with the parent, for example, a subsidiary providing electric power to a tax-exempt parent educational organization. The regulation goes on to state, however, that a subsidiary is not exempt if it is operated for the primary purpose of carrying on a trade or business that would be an unrelated trade or business if regularly carried on by the parent organization. The regulation provides examples of this by describing: (1) a subsidiary organization operated primarily for the purpose of furnishing electric power to consumers other than the parent and its tax-exempt subsidiary organizations; and (2) an organization owned by several unrelated exempt organizations and operated for the purpose of

furnishing electric power to each of them. The regulation states that organizations are related for purposes of section 1.502-1(b) if they consist of a parent organization and one or more subsidiary organizations, or subsidiary organizations having a common parent organization. Further, exempt organizations are not related merely because they both engage in the same type of exempt activities.

In Rev. Rul 78-41, 1978-1 C.B. 148, a trust was created by an exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the hospital, and from which the hospital directs the bank-trustee to make payments to claimants, is operated exclusively for charitable purposes.

After the reorganization, the stated purposes of B and C will be the same charitable purposes which first qualified them for recognition of exemption. Their activities will be in furtherance of those purposes. The sharing of assets and services among these related and structurally interconnected exempt entities will be for the more efficient provision of providing foster homes and schools to the community like the organization described in Rev. Rul. 78-41, 1978-1 C.B. 148. Therefore, because B and C continue to be organized and operated for charitable purposes as defined in section 1.501(c)(3)-1(d)(2) of the regulations, the reorganization and the transactions involved in it will not affect the status under section 501(c)(3) of the Code of B and C.

## *II. UNRELATED TRADE OR BUSINESS INCOME*

### Law

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) of the Code.

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 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 function.

Section 513(c) of the Code provides 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.

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Section 1.513-(1)(a) of the regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of non-exempt organizations.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, 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. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rev. Rul. 68-225, 1968-1 C.B. 283, provides that a charity, which conducts charitable and educational programs that foster and promote fair housing, would not generate unrelated business taxable income by receiving a fee for providing consulting services to local businesses relating to securing housing for the minority employees of those businesses.

In Rev. Rul. 69-463, 1969-2 C.B. 131, a hospital provided administrative services and leased space to a private medical group. The ruling noted that the presence of the medical group contributed importantly to the hospital's mission, and therefore, the rental income was not unrelated business taxable income.

D's receipt of income from the provision of administrative services to B and C will not constitute unrelated trade or business income because providing such services is substantially related to D's exempt purpose, which is to support the charitable activities of related and structurally interconnected B and C.

Accordingly, we rule as follows:

(1) the reorganization will not adversely affect the tax-exempt status of either B or C under section 501(c)(3) of the Code;

(2) D's income from providing administrative services to B and C will not be taxable as unrelated trade or business income;

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

This ruling is limited only to the applicability of sections 501(c)(3) and 512(a)(1) of the Code to the issues above and does not purport to rule on any facts that were not represented in the ruling request or any changes of these facts.

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,

Robert C. Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3