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**INTERNAL REVENUE SERVICE**
**TE/GE Technical Advice Memorandum**

Through: EO Mandatory Review Staff

**T:EO:B1**

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Years Involved: and

Date of Conference: None

LEGEND:

M =
N =
O =
P =
x =
y =
z =

ISSUES:

1. Whether, for purposes of section 512(b)(13) of the Internal Revenue Code, M controls N so imputed interest on loans, excess dues and assessments, and funds advanced by N to O constitute unrelated business taxable income under section 512(a)(1) with respect to M.

2. Whether, for purposes of section 512(b)(13) of the Code, the activities of N should be attributed to M, so imputed interest on loans, excess dues and assessments, and funds advanced by N to O constitute unrelated business taxable income under section 512(a)(1) with respect to M.

3. Whether M continues to meet the requirements for classification as a supporting organization under section 509(a)(3) of the Code, or whether M should be reclassified as a private foundation under section 509(a).

FACTS:

M, N and O are organizations that are members of a reorganized hospital system. M is the exempt parent organization, N is an exempt hospital, and O is a taxable subsidiary.

In accordance with an amendment to its Certificate of Incorporation, M's primary purpose is to promote, support and further the charitable purposes of N and other affiliated and related nonprofit health care organizations, which are described in section 501(c)(3) of the Code and are not private foundations under section 509(a). M is exempt under section 501(a) of the Code as an organization described in section 501(c)(3) and has been classified as a supporting organization under section 509(a)(3). In M was reconfigured to be the parent of an integrated delivery system. Article 2 of M's Certificate of Incorporation states it was formed exclusively for charitable, scientific, and educational purposes.

There are Directors on M's Board: N elects members ( percent), P elects members ( percent), and another organization elects members ( percent). Article 6.3.1 of M's Bylaws provides that P shall appoint percent of M's Board of Directors. Article 12.1(a) and (b) of M's Bylaws in effect during the years under examination give M certain reserved powers, including the right to appoint or remove the Directors of its subsidiaries, and approve any amendments or changes to such subsidiaries' Charter or Bylaws. Article 12.1(c) of its Bylaws gives M the right to approve the annual operating and capital budgets of any subsidiary. Article 12.1(e) of M's Bylaws gives it the right to approve proposed transfers, borrowing and lending of funds involving a specified dollar amount by any subsidiary.

M is the parent of N, which is exempt under section 501(a) of the Code as an organization described in section 501(c)(3). N has been classified as a hospital under sections 509(a)(1) and 170(b)(1)(A)(iii). An amendment to N's Certificate of Incorporation states there shall be one member of N, which shall be M. The member shall have the right to elect its Directors, to approve any alteration, amendment, restatement, or repeal of its Certificate of Incorporation, and the rights provided in the Bylaws. There are Directors on N's Board: M elects members ( %), and P elects members ( %) pursuant to an affiliation agreement.

In N and P entered into an affiliation agreement which changed the relationship between M and N because it granted P certain powers. The agreement gave P the right to appoint percent of the Board of Directors of M and N. M was neither a party to nor did it sign the agreement. The administrative file contains no written documentation stating M approved the transaction pursuant to section 12.1 of its Bylaws.

In O was incorporated as a nonprofit taxable corporation. M is the sole member of O, whose activities include the implementation of health care strategies including the creation of a health care network, an integrated delivery system, a management services organization, the cultivation of relationships with primary care physicians, and the negotiation of managed care contracts.

Article 4.1 of O 's Bylaws, as in effect for the years under examination, and Article Second of O 's Certificate of Incorporation provide that one of O 's purposes is to provide management of the business and operations of the health care system developed by M. This includes but is not

limited to the management of the business of the development of M 's integrated health care delivery systems for the benefit of the health care entities affiliated with O.

The administrative file shows that O derived its support primarily from membership dues and assessments. Minutes of M's Board of Directors stated, "[t]he Board was reminded that N would provide up to $ to support [O]...." Therefore, when membership dues and assessments failed to cover O's operating expenses, N advanced funds. During the two years under examination, , and , N paid dues and assessments in the amounts of $x and $2x, respectively. As of the end of the first year under examination, O showed an amount due to N of $y and as of the second year under examination, the amount due N was $z. N did not charge O interest on these amounts.

ISSUES 1 and 2 – LAW AND ANALYSIS:

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

Section 512(a)(l) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions, computed with the modifications listed in section 512(b).

Section 512(b)(1) of the Code, in part, excludes interest from the computation of unrelated business taxable income under section 512(a)(1).

In 1997 new rules were adopted with respect to certain amounts received by exempt organizations from their controlled organizations. For taxable years ending before August 5, 1997, section 512(b)(13) of the Code, in part, provides that notwithstanding section 512(b)(1), amounts of interest derived from the "controlled organization" of which the "controlling organization" has control shall be included as an item of gross income. "Control" is defined in section 368(c).

Section 1.512(b)-1(l)(4)(i)(b) of the Income Tax Regulations provides that in the case of a nonstock organization, the term "control" means that at least 80 percent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization. A trustee or director is a representative of an exempt organization if he or she is a trustee, director, agent, or employee of such exempt organization. A trustee or director is controlled by an exempt organization if such organization has the power to remove such trustee or director and designate a new trustee or director.

In accordance with the unrelated business income tax rules set forth in sections 511-514 of the Code, amounts of interest derived by an exempt organization are generally excluded from tax under section 512(b)(1). However, if such amounts are attributable to debt-financed property under section 514, or are received from a controlled organization under section 512(b)(13), the general exclusion for interest under section 512(b)(1) is not available. In this

case, before determining whether interest on amounts advanced by N to O should be imputed to M, it is necessary to apply the rules of section 512(b)(13) as applicable during the years under examination, 1995 and 1996.

Prior to being amended in 1997, section 512(b)(13) of the Code provided that notwithstanding section 512(b)(1), interest received by a controlling organization from a controlled organization must be included in computing unrelated business taxable income. The standard for determining "control" was contained in section 368(c). With respect to a nonstock organization, at least 80 percent of the directors or trustees of such organization must be either representatives of or directly or indirectly controlled by an exempt organization. See section 1.512(b)-1(l)(4)(i)(b) of the regulations.

In determining whether imputed interest on the amounts advanced to O by N should be subject to the tax on unrelated business income, relevant organizing documents and the organizations' actual practices in effect during the years under examination must be scrutinized. For purposes of section 512(b)(13) of the Code, the designation or characterization of one organization as the "parent" or "sole corporate member" of another organization is not determinative. Consistent with section 1.512(b)-1(l)(4)(i)(b) of the regulations, M would have control over N if at least 80 percent of N's Directors were representatives of or controlled by M. Since there are 24 directors on N's Board, in order for M to control N, M would need to appoint at least 20 Directors to N's Board. However, M has the ability to appoint only 18 Board members (75 percent), as P appoints 25 percent of N's Board. Thus, the 80 percent standard required by section 1.512(b)-1(l)(4)(i)(b) of the regulations is not met. Consequently, M does not control N, and if interest were imputed on the amounts due N from O, such interest would not be subject to the tax on unrelated business income by virtue of section 512(b)(13) of the Code.

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 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, supra 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).

Only in very limited circumstances can one corporation's activities be attributed to another for tax purposes. To disregard the corporate entity requires a finding that the corporation or transaction involved was a sham or fraud without any valid business purpose, or a finding of a true agency or trust relationship between the entities. Here, the available information supports a conclusion that the separate corporate identities of M, N, and O should not be disregarded. N has submitted information that O was organized for the real and substantial purpose of the implementation of health care strategies including the creation of a

health care network, an integrated delivery system, a management services organization, the cultivation of relationships with primary care physicians and the negotiation of managed care contracts. M was formed to manage the business and operations of its health care system, the development of its integrated health care delivery systems, to deliver cost effective health care with physician and other provider participation, and to provide enhanced patient services. M, N and O were organized with the bona fide intention that they have a real and substantial business function. Therefore, their existence may not be disregarded for federal tax purposes. Furthermore, there is no evidence to support a finding of a true agency or trust relationship among M, N and O, all of which are separate corporations whose activities cannot be attributed to each other.

ISSUE 3 – LAW AND ANLYSIS:

Section 509(a) of the Code provides that the term "private foundation" means an organization described in section 501(c)(3) other than one described in sections 509(a)(1), (2), (3), or (4).

Section 509(a)(3) of the Code excludes from the definition of a private foundation an organization that is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in sections 509(a)(1) or 509(a)(2). The supporting organization must also be operated, supervised or controlled by the supported organization; supervised or controlled in connection with the supported organization; or operated in connection with the supported organization in order to be classified under section 509(a)(3).

Section 509(a)(3)(C) of the Code prohibits direct or indirect control by one or more disqualified persons (as defined in section 4946), other than foundation managers or 509(a)(1) or (a)(2) organizations.

Section 1.509(a)-4 of the regulations describes in general terms the various tests that a supporting organization must meet in order to be classified as an organization described in section 509(a)(3) of the Code.

Section 1.509(a)-4(b) of the regulations states that in order to qualify as a supporting organization under section 509(a)(3) of the Code, an organization must be both organized and operated for the benefit of, to perform the functions of, or to carry out the purposes of one or more publicly supported organizations and not be controlled by disqualified persons.

Section 1.509(a)-4(c)(1) of the regulations specifies the requirements for the supporting organization's articles of organization. The articles must:

1. Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A) of the Code;

2. Not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in section 509(a)(3)(A) of the Code;

3. State the specified publicly supported organizations on whose behalf such organization is operated; and

4. Not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations.

Section 1.509(a)-4(e)(1) of the regulations provides that a supporting organization will be regarded as operated exclusively to support one or more specified publicly supported organizations only if it engages solely in activities which support or benefit the specified publicly supported organizations. However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more of the specified publicly supported organizations. Section 1.509(a)-4(e)(2) provides that a supporting organization is not required to pay over its income to the supported organizations to meet the operational test. A supporting organization may satisfy the test by using its income to carry on an independent activity or program that benefits the specified publicly supported organizations.

A supporting organization must also be operated, supervised, or controlled by, or in connection with, one or more organizations described in sections 509(a)(1) or (2) of the Code.

Section 1.509(a)-4(f)(2) of the regulations describes the types of relationships required between the supporting organization and the publicly supported organization under section 509(a)(3)(B) of the Code. This section of the regulations states that section 509(a)(3)(B) sets forth three different types of relationships, at least one of which must be met in order to meet the requirements of section 509(a)(3). A supporting organization may be either: (i) operated, supervised, or controlled by; (ii) supervised or controlled in connection with; or (iii) operated in connection with one or more publicly supported organizations.

M and O were created by N to advance its exempt purpose of providing health care to its community. M is operated exclusively for the benefit of, to perform the functions of, and carry out the purposes of N. These are exempt purposes under section 501(c)(3) of the Code that are advanced primarily by N in conjunction with M. The information presented indicates that M assists N in providing health care services in the community. Under the circumstances described, M meets the organizational and operational tests for continued classification as an organization described in section 509(a)(3). Further, O's activities as a separate corporation cannot be imputed to M as a separate corporation for the reasons described above. Moreover, M is operated in connection with N, an organization that is described in section 509(a)(1) of the Code. As such, the relationship between M and N falls within the meaning of section 1.509(a)-4(f)(2) of the regulations. Therefore, M meets the requirements of section 509(a)(3) of the Code and is not a private foundation.

CONCLUSIONS:

1. For purposes of section 512(b)(13) of the Code, M does not control N, so that if there were imputed interest on loans, excess dues and assessments, and funds advanced by N to O, such amounts would not constitute unrelated business taxable income under section 512(a)(1) with respect to M.

2. For purposes of section 512(b)(13) of the Code, the activities of N should not be attributed to M, so that if there were imputed interest on loans, excess dues and assessments, and funds advanced by N to O, such amounts would not constitute unrelated business taxable income under section 512(a)(1) with respect to M.

3. M continues to meet the requirements for classification as a supporting organization under section 509(a)(3) of the Code and should not be reclassified as a private foundation under section 509(a).

A copy of this memorandum should be given to the organization. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

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