Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person:

Telephone Number:

In Reference to: OP:E:EO:T:1

Date:

JAN 4 1999

Employer Identification Number:
Key District:

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Dear Sir or Madam:

This is in reply to your request for rulings as to the consequences of several proposed transactions on your status as an organization described in section 501(c)(3) of the Internal Revenue Code and your status as other than a private foundation under section 509(a) of the Code.

FACTS

A, formerly known as B, was the surviving corporation in a merger with C and D. A has been recognized as exempt from federal income taxation 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)(vi) of the Code.

E was incorporated on May 3, 1995, as a nonstock corporation with no members. Concurrently with the issuance of this letter, E is being recognized as exempt under section 501(c)(3) of the Code and is being classified as other than a private foundation under section 509(a)(3) of the Code.

E is F's sole member. F also requested exemption from federal income taxation under section 501(c)(3) and status as a public charity under section 509(a)(2) of the Code. F withdrew its application for exemption since it has not carried on any

activities and at this time, there are no plans for F to carry on any activities.

A, a licensed home health agency, recently evaluated its structure, operations, and programs. As a consequence of this evaluation, A determined that a corporate reorganization would further its best interests by enabling it to respond to the challenges and opportunities presented by the evolving health care environment. According to the proposed corporate reorganization plan adopted by A, E will become the parent holding company for A and two taxable subsidiaries, G and H, as well as for F.

G is a nonprofit corporation subject to federal income taxation. G's purpose is to provide a wide variety of health care and supportive services in the home and community, including care and support to individuals who are chronically ill and to their family members. G has since its creation provided private duty nursing services. G's original Board of Directors consisted of five directors, two of which were designated by A's Board of Directors but no more than two of which could be on A's Board of Directors or affiliated with A. By amendment and restatement of G's Certificate of Incorporation, E became G's sole member.

H is a for profit corporation subject to federal income tax. E is H's only shareholder. The primary purpose of H is to develop and provide health care related and other services on a for profit basis.

In order to implement the corporate reorganization, A will amend and restate its Certificate of Incorporation and amend its Bylaws to designate E as its sole member. These changes were approved by A's Board of Directors on March 9, 1995, to be effective contingent on the Internal Revenue Service's issuance of a favorable ruling.

As required by E's Bylaws, at least a majority of directorships on E's Board of Directors must be held by directors of A. Initially, the Board of Directors of E was identical in name and number to the those individuals serving on A's Board of Directors. At present six of the eleven directors of E are also directors of A. The boards of directors of A, F, G, and H, as required by each of their bylaws, shall each have at least one director who is also a director of E. A majority of the directors of H, as required by H's Bylaws, will be persons who are not directors, officers or employees of E, A or F.

The Board of Directors of E will have the power to act on behalf of E in exercising E's powers as sole member of A, F, and G. Among its powers as sole member, E will elect the Board of Directors, approve the annual operating and capital budgets, approve significant programs and expenditures and approve significant affiliation agreements of each of these subsidiaries.

E, as the parent entity in the corporate reorganization of A, will not directly provide health care services, but will plan for, develop and coordinate the corporate system of related health care entities described in this letter. Thus, E will perform strategic and long-term planning and other management functions on a system-wide basis. The Board of Directors and management of each affiliate will handle the day-to-day management and specific operations of each separate organization.

E's Certificate of Incorporation provides that one of E's principal purposes is to benefit, perform the functions of, carry out the purposes of, and uphold, promote and further the welfare, programs and activities of A by:

1. Initiating, developing, recommending, and carrying out for A the goals and priorities for new or expanded programs for the benefit of A;

2. Continuously reevaluating, maintaining and revising a master plan for the programs and facilities of A; and

3. Performing public relations work on behalf of A and soliciting and receiving subscriptions and gifts for the exclusively charitable purposes of A.

E's Certificate of Incorporation also states that E will initiate, develop, operate and maintain for and in cooperation with A and other health care organizations programs aimed at improving the quality, variety and cost-effectiveness of health care services delivered to communities and individuals (and to A's service area in particular), as well as educational and other programs and activities for health care professionals and for the general public designed to promote the health status of the communities served.

A will continue to operate as a Medicare certified, licensed home health care agency. G will continue to provide private duty nursing services and may become a licensed home health agency or may engage in offering health related services in the home or community. H may develop and market health care consulting and administrative services and health related products and services

such as fitness, hygiene, and cosmetology programs to health care and related organizations.

A will transfer cash to E as working capital when the reorganization is implemented. E will purchase 100 percent of the stock issued by H. The proceeds of the stock sale will be H's initial capital. After the reorganization, there may be additional gratuitous transfers of cash among the tax-exempt corporations. A, and E may share some facilities, personnel and services in order to reduce the cost and improve the quality of health care services delivered. It is not anticipated that any of the exempt corporations will provide assets or furnish services to the taxable subsidiary, H, but to the extent any such transactions occur, you represented that they will be conducted at arm's length and related charges will be at fair market value.

A made a start-up loan and a revolving credit loan to G. Subsequently, A made additional loans to G. The loans bear interest at prime plus 2 percent per annum, are secured by all the assets of G (including receivables), and are payable on demand. A also provided certain management services to G for which A charged G on an hourly basis. As represented by the applicants, these charges were commercially reasonable and represented market rates for these services. After the reorganization is implemented, A will continue to hold the loans to G, which will continue to bear interest at prime plus 2 percent, to be secured, and to be payable on demand. A may also provide management assistance to G on commercially reasonable terms.

RULINGS REQUESTED

You requested the following rulings:

1. After the amendment to the Certificate of Incorporation and Bylaws of A and the proposed reorganization, A will continue to qualify as an organization described in section 501(c)(3) of the Code and, provided it continues to meet the support tests, will continue qualifying as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code.

2. After the proposed reorganization, E will continue to qualify as an organization described in sections 501(c)(3) and 509(a)(3).

3. After the proposed reorganization, G will continue to qualify as an organization described in section

501(c)(3) of the Code and, provided it meets the support tests thereunder, 509(a)(2) of the Code.

4. E's ownership of 100 percent of the issued and outstanding voting stock of H and E's receipt of dividends from H will have no adverse effect on E's status under sections 501(c)(3) and 509(a)(3) of the Code.

5. The taxable income of H will not be construed to be unrelated business income to E, and any dividends received by E from H will not be unrelated business taxable income to E under sections 511-514 of the Code.

6. The proposed transfers of cash and other assets and the sharing of personnel and services by and between A and E will not (a) jeopardize the continued tax-exempt status of A and E as organizations described in section 501(c)(3) of the Code or (b) give rise to unrelated business taxable income under sections 511-514 of the Code to any of the involved exempt organizations.

7. After the proposed reorganization, the loans from A to G on commercially reasonable terms will have no adverse effect on A's continued status under section 501(c)(3) of the Code, and interest payments received by A will not constitute taxable unrelated trade or business income to A.

ANALYSIS

Section 501(a) of the Internal Revenue Code exempts from federal income taxation organizations described in subsection (c)(3), which includes corporations organized and operated exclusively for charitable and educational purposes. Furthermore, the aforementioned subsection requires that no part of the organization's net earnings inure to the benefit of any private shareholder or individual, that no substantial part of its activities is to influence legislation, and that it does not participate in any political campaign on behalf of or in opposition to any candidate for public office.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that to be exempt as an organization described in section 501(c)(3) of the Code an organization must be both organized and operated exclusively for purposes specified in said section of the Code. If an organization fails to meet either test, it is not exempt.

Section 1.501(c)(3)-1(b)(1)(i)(a) of the regulations provides that an organization's articles of organization must limit its purposes to one or more exempt purposes.

Section 1.501(c)(3)-1(b)(1)(iii) of the regulations provides than an organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities that are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(b)(1)(iv) of the regulations provides that in no case shall an organization be considered organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(b)(4) of the regulations provides that an organization organized exclusively for exempt purposes dedicates its assets to an exempt purpose. To meet this requirement its articles of organization must provide that in the event of dissolution its assets are to be distributed for exempt purposes.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that in order for an organization to be considered operated for one or more exempt purposes, it must engage primarily in activities that accomplish one or more exempt purposes specified in section 501(c)(3).

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated for an exempt purpose unless it serves a public rather than a private interest.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" as used in section 501(c)(3) of the Code includes its generally accepted legal sense. The promotion of health is a recognized charitable purpose. Rev. Rul. 56-185, 1956-1 C.B. 202, as modified by Rev. Rul. 69-545, 1969-2 C.B. 117; Rev. Rul. 80-114, 1980-1 C.B. 115; and Rev. Rul. 83-157, 1983-2 C.B. 94.

Unrelated Trade or Business Income

Section 511(a) of the Code imposes a tax on the unrelated business income of organizations described in section 501(c). Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by an

organization from any unrelated trade or business regularly carried on by it, less the allowable deductions that are directly connected with the carrying on of the trade or business, with certain modifications. Section 512((b)(1) excludes from unrelated business taxable income all dividends and interest payments received as consideration for entering into agreements to make loans.

Section 513(a) of the Code defines unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of the organization for funds or the use it makes of the profits derived) to the exercise of the organization's exempt purpose or functions.

Section 514 of the Code imposes a tax on the income produced by the unrelated use of debt-financed property.

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 (See Britt v. United States, 431 F.2d 227, 233 (5th Cir. 1970)); and the corporation was not created to contravene directly or indirectly the policies of the Internal Revenue Code See Gregory v. Helvering, 293 U.S. 465, (1935). See also National Carbide Corp. v Commissioner, 336 U.S. 422 (1949). 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. See 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. See Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1111 (5th Cir. 1973).

However, generally, the activities of one corporation cannot be imputed to another for federal 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. The standards for reaching such a finding are stringent. To demonstrate that an entity is an agent of another requires more than a showing that one entity is owned by the other. Its business purpose must be the carrying on of the normal duties of an agent and if the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal. See Roccaforte, et al., v. Commissioner, 708 F.2d 986, 989 (5th Cir.

1983); Collins v. United States, 386 F. Supp. 17 (S.D. Ga. 1974), aff'd per curiam, 514 F.2d 1282 (5th Cir. 1975).

In the National Carbide case the Supreme Court held that the corporation, organized to avoid state usury laws, was not the agent of a partnership. This result was reached even though the partners owned 100 percent of the corporation's stock, the corporation was controlled and dominated by the partners, the corporation and its partners did not deal at arm's-length, the corporation was not compensated for services performed, and was never reimbursed by the partners for the expenses the corporation incurred.

Private Foundation Status

Sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code provide that organizations that received a substantial part of their support from contributions are other than a private foundation.

Section 509(a)(2) of the Code provides that an organization that receives less than one third of its financial support from investments and more than one third from a combination of contributions, membership fees, and gross receipts from activities related to its exempt functions, is other than a private foundation.

Section 509(a)(3) of the Code provides that an organization that meets the following requirements is other than private foundation:

1. It is organized, and at all times thereafter is 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) and 170(b)(1)(A) of the Code other than in clauses (vii) and (viii), as well as in section 509(a)(2);

2. It is operated, supervised, or controlled by or in connection with one or more organizations described in sections 509(a)(1) and 170(b)(1)(A) other than in clauses (vii) and (viii), as well as in section 509(a)(2); and

3. It is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in sections 509(a)(1) and

170(b)(1)(A) of the Code other than in clauses (vii) and (viii), as well as in section 509(a)(2).

RATIONALE

The post reorganization operations of A will continue to promote the health of its service community, which is a charitable purpose. Therefore, A's exempt status under section 501(c)(3) of the Code will not be affected by the reorganization. Its amended Articles of Incorporation include language that meets the organizational and operational tests under section 509(a)(3) of the Code and A is not controlled by disqualified persons other than foundation managers and organizations described in sections 509(a)(1) and 170(b)(1)(A)(vi) or 509(a)(2) of the Code. If A's sources of support do not change, it will continue to meet the support tests under sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code. Nevertheless, once its Articles of Incorporation are amended, A will qualify under section 509(a)(3) as a supporting organization of its subsidiaries.

The transfer of A's assets to E will not constitute an unrelated trade or business since it will merely be the transfer of assets from one exempt entity to another within the same commonly controlled system. The provision of management services by A to E and to other of A's exempt subsidiaries will also not constitute an unrelated trade or business. The income generated from those services will not be subject to the payment of the tax imposed by section 511(a) of the Code because the purpose of these activities is to improve the delivery of services to the community that constitute the basis for the exemption of A and its subsidiaries. The interest received by A as consideration for the loan granted to G does not have to be included in A's unrelated business income since it is interest income and thus excluded from taxation under section 512(b)(1) of the Code.

J operates a nursing home which, as has been represented, will continue to be operated in compliance with the requirements of Rev. Rul. 72-124, supra. Its principal source of financial support will continue to be payments for services. Therefore, it will continue to qualify as other than a private foundation under section 509(a)(2) of the Code. Also, A's subsidiaries, D, E, and H will continue to carry on charitable activities and thus will continue to qualify for exemption under section 501(c)(3) and for classification as other than private foundations under section 509(a)(2) of the Code.

As decided by the court in Britt, supra, as long as H was formed for the equivalent of business activities or carries on

business activities, the taxable income of H will not be construed to be unrelated business income to E, and any dividends received by E from H will not be unrelated business income to E under sections 511-514 of the Code, as provided under section 512(b)(1) of the Code.

RULINGS

Therefore, we rule as follows:

1. After the amendment to the Certificate of Incorporation and Bylaws of A and the proposed reorganization, A will continue to qualify as an organization described in section 501(c)(3) of the Code and, provided it continues to meet the support tests, will continue qualifying as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code.

2. After the proposed reorganization, E will continue to qualify as an organization described in sections 501(c)(3) and 509(a)(3).

3. After the proposed reorganization, G will continue to qualify as an organization described in section 501(c)(3) of the Code and, provided it meets the support tests thereunder, 509(a)(2) of the Code.

4. E's ownership of 100 percent of the issued and outstanding voting stock of H and E's receipt of dividends from H will have no adverse effect on E's status under sections 501(c)(3) and 509(a)(3) of the Code.

5. The taxable income of H will not be construed to be unrelated business income to E, and any dividends received by E from H will not be unrelated business taxable income to E under sections 511-514 of the Code.

6. The proposed transfers of cash and other assets and the sharing of personnel and services, by and between A and E will not (a)jeopardize the continued tax-exempt status of A and E as organizations described in section 501(c)(3) of the Code or (b) give rise to unrelated business taxable income under sections 511-514 of the Code to any of the involved exempt organizations.

7. After the proposed reorganization, the loans from A to G on commercially reasonable terms will have no adverse

effect on A's continued status under section 501(c)(3) of the Code, and interest payments received by A will not constitute taxable unrelated trade or business income to A.

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 yours,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1