Internal Revenue Service

Department of the Treasury

Washington, DC 20224

199914042

Contact Person:

S.I.N.:
512.01-00
513.00-00

Telephone Number:

In Reference to: OP:E:EO:T:2

Date: JAN 7 1999

Employer Identification Number:
Key District:

Legend:

M =
N =
O =

Dear Applicant:

This letter is in reply to the letter from your authorized representative dated March 16, 1998, in which you requested rulings with respect to the tax consequences of your proposed formation of a taxable subsidiary as described below. On December 3, 1998, you amended your request by deleting a question about whether certain payments received by you from N would constitute royalties.

You are an organization recognized by the Internal Revenue Service as exempt from federal income tax as business leagues under section 501(c)(6) of the Internal Revenue Code.

M is a trust recognized by the Service as exempt from federal income tax under section 501(c)(6) of the Code. You currently pay M rent for use of its offices which are owned by M.

N is a trust taxed as a U.S. Property and Casualty Insurance Company with principal offices located at the same address as you. N provides worker's compensation insurance to businesses in and related to a particular industry. N currently pays you for administrative services and overhead you are providing to N. You provide bookkeeping, loss control, and administrative services to N, for which N is paying you a certain percentage of its billed premiums. These administrative fees presently constitute unrelated business taxable income to you.

You state that you intend to form a wholly-owned for-profit subsidiary, O. You state that O will be a separate and distinct corporate entity. You state that you will transfer personnel as

well as assets used in your administrative functions on behalf of N to O in exchange for 100% of O's single class of common stock. You also state that the formation of O and transfer of personnel and assets will occur as soon as practical after receipt of a favorable ruling from the Service. You state that you and O will be independent and maintain separate corporate identities as follows:

(1) A majority of O's directors will not at any time be your directors, officers, or employees. O will be managed by a board of directors consisting of five members, three of whom are unrelated to you (i.e., are not your officers, employees, or directors). You will not direct, or actively participate in, the day-to-day management of O.

(2) N will negotiate with O on an arm's length basis for O to provide administrative services to N on substantially the same terms as presently exist between you and N.

(3) Your officers and employees and O's officers and employees will be separate and independent, except as noted in (9), below.

(4) O will rent office space from M at a fair market rental value.

(5) You will continue to rent office space from M at a fair market rental value.

(6) Your and O's financial, accounting, and tax records will be separately maintained.

(7) O's arm's length fees for its administrative services will support its operational cost and will be the primary source of its income. Except for the initial capital contribution, you will not provide financial support to O. The assets to be contributed to O by you have an estimated fair market value based on net book value. After formation of O, you will sell certain automobiles to O at fair market value for use by O's employees.

(8) O's formation and operation will not change your exempt functions or operations except that O would provide necessary administrative or other similar services to N for a fee based on the fair value of the services rendered.

(9) O and you would have some shared employees. Although the cost of such employees would be shared proportionately

between O and you based on work performed, O would make salary payments based on a common paymaster agreement.

You state that any O accumulated profits not required for O operations could be paid as a dividend to you, and that you intend to remain the sole shareholder of O. You state that the purpose for the formation of O is to segregate and centralize administrative services and simultaneously segregate unrelated business taxable income away from you as a tax exempt entity and place such taxable income in a for-profit subsidiary, and this separation of nonexempt functions should safeguard your tax exempt status.

Section 501(c)(6) of the Code provides for the exemption from federal income tax of business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(6)-1 of the Income Tax Regulations provides that a business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

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)(1) 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 and modifications.

Section 512(b)(1) of the Code provides that the modifications referred to in section 512(a)(1) include the exclusion of all dividends.

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 the function constituting the basis of its exemption.

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 causal relationship to the achievement of exempt purposes; and it is "substantially related" only if the causal relationship is a substantial one. The regulation continues that 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.

It is the position of the Service that a parent organization which holds all of the stock of a taxable subsidiary corporation is not thereby precluded from recognition of exemption under section 501(c) of the Code where the subsidiary is formed for a *bona fide* business purpose and is not a mere instrumentality of the parent organization and where the parent organization does not actively participate in the day-to-day management of the subsidiary. The transfers and actions you have described, in and of themselves, will have no adverse effect on a determination of exempt status. Further, the proposed formation of O does not involve the regular carrying on of unrelated trade or business within the meaning of section 513 of the Code.

Accordingly, based on the facts and circumstances concerning the reorganization and related transactions as stated above, we rule as follows:

(1) The formation of O as a wholly-owned subsidiary, including the transfer of administrative assets and personnel, will not jeopardize your tax-exempt status under section 501(c)(6) of the Code.

(2) O's performance of administrative services on behalf of N and N's payment of an arm's length administrative services fee to O will not jeopardize your tax-exempt status under section 501(c)(6) of the Code.

(3) The operations, earnings, and taxable income of O will not be considered unrelated business taxable income attributable to you.

(4) Amounts received by you from O as dividends will not be unrelated business taxable income to you pursuant to section 512(b)(1) of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Any such change should be reported to the EP/EO key district office. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records. A copy of this ruling is being forwarded to the EP/EO key district office.

Except as we have specifically ruled herein, we express no opinion as to the consequences of these transactions under the cited provisions or under any other provisions of the Code.

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.

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

Sincerely yours,

(signed) Garland A. Carter

Garland A. Carter
Chief, Exempt Organizations
Technical Branch 2