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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MICHAEL W. BITNER, DISTRICT COUNSEL
KANSAS-MISSOURI DISTRICT
MIDSTATES REGION CC:MSR:KSM
Attn: Donald L. Wells, Special Litigation Assistant

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) CC:EBEO:5

SUBJECT: Affiliation of Nonprofit Corporations with a Consolidated Group of Corporations

This Field Service Advice responds to your memorandum dated September 14, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

A	=	
B	=	Not-For-Profit Corporations
C	=	
D	=	
E	=	
F	=	Taxable Corporations
G	=	
H	=	
I	=	
Act	=	Nonprofit Corporation Act
Act § 1	=	
Act § 2	=	
Act § 3	=	
Act § 4	=	
Articles	=	Articles of Incorporation of the Not-For-Profit Corporations
Bylaws	=	Bylaws of the Not-For-Profit Corporations
Date 1	=	
Date 2	=	

Official = Attorney General
State =
Statute § 1 =
X % =
Y Amount =
Year 1 =
Year 2 =

ISSUES

1. Whether B are exempt from taxation under section 501 and would not, therefore, qualify as “includible corporations” for purposes of section 1504?

2. Whether the prohibition against private inurement in section 501(c)(3) applies to B as a matter of federal tax law?

3. Whether B are includible in the affiliated group (within the meaning of section 1504(a)) of corporations of which A is the common parent and may, therefore, join with A in filing a consolidated federal income tax return.

CONCLUSIONS

1. B are not exempt from taxation under section 501(c)(3) and would not be precluded thereby from qualifying as “includible corporations” for purposes of section 1504.

2. The prohibition against private inurement set forth in section 501(c)(3) does not apply to B.

3. Based on the facts submitted, B may not be allowed to join in the filing of A’s consolidated return. Additional information is needed to make a final determination.

FACTS

A was incorporated under the General and Business Corporation Law of State on Date 1, under the name of G. It changed its name to A on Date 2. During Year 2, A was the X % shareholder of F and the sole member of B. B are incorporated under the Act of State. Pursuant to the Act, they are organized for caritable, educational, religious and scientific purposes and are not entitled to issue stock A is the grantor of I. None of B have applied for federal tax exempt status under section 501 or filed annual information returns on Form 990.

The common stock of A is wholly owned by C, an organization recognized as exempt under section 501(c)(3). The sole member of C is D, an order of E. C also is the sole member of several not-for-profit entities and, along with other taxable and not-for-profit entities, forms an integrated enterprise known as H.

The Articles of each B designate A as the sole member of each such corporation. The Articles prohibit B from issuing stock or paying any dividends or profits to any of their officers or directors. Further, no part of the net income of B may inure to the benefit of any of their members, directors, officers or other private persons. Upon dissolution, any remaining net assets shall be distributed to C (or its successor) if such entity qualifies as a section 501(c)(3) organization. Otherwise, the board of directors shall distribute the net assets to section 501(c)(3) entities selected by A. If such assets are not so disposed of, then the circuit court of the county in which the principal office of B is located shall dispose of the net assets to organizations that are organized and operated for charitable purposes. The Articles may be amended by the board of directors, in accordance with the Act and the Bylaws of B, provided that any amendment is approved by A.

For Year 2, A filed a consolidated federal income tax return pursuant to section 1501 as the common parent of B, F and I (Group). Each of the B operated at a loss in each year of its existence and in most cases has generated substantial operating losses. Operating losses generated by members of the Group have been carried to prior and current years to offset A's consolidated federal taxable income. As of Year 1, unused net operating losses (from consolidated return years and from separate return years of some members of the Group) totaled $ Y Amount.

LAW AND ANALYSIS

ISSUE 1: Tax Exempt Status

Section 1501 provides that an affiliated group of corporations generally shall have the privilege of making a consolidated return. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through stock ownership with a common parent corporation. Section 1504(b)(1) provides that the term "includible corporation" does not include corporations exempt from taxation under section 501.

The Code and regulations set forth certain affirmative requirements an organization must satisfy to be exempt for federal income tax purposes under section 501. Section 501(a) provides that an organization described in section 501(c) generally shall be exempt from federal income taxation. Section 501(c)(3) exempts corporations organized and operated exclusively for charitable, religious or other specified purposes, no part of the net earnings of which inure to the benefit of any private shareholders or individuals. An organization is operated exclusively for

exempt purposes only if it engages primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3). Treas. Reg. § 1.501(c)(3)-1(c)(1). An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Treas. Reg. § 1.501(c)(3)-1(c)(2). Private shareholders or individuals are persons having a personal and private interest in the activities of the organization. Treas. Reg. § 1.501(a)-1(c). An organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). The organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 508(a) generally provides that any organization organized after October 9, 1969 shall not be described in section 501(c)(3) unless that organization has applied for recognition of such status. The Code and regulations except from this requirement churches and their integrated auxiliaries, public charities with gross receipts of $5,000 or less and subordinate organizations covered by a group exemption letter. Section 508(c); Treas. Reg. § 1.508-1(a)(3)(i). An organization applying for recognition of exempt status under section 501(c)(3) must file Form 1023 with the Service. Treas. Reg. § 1.508-1(a)(2).

The Act allows a not-for-profit corporation to be organized for certain specified purposes, including charitable, religious, health or similar purposes. Act § 1. If B has members, the members (or their delegates) shall elect the board of directors. Act § 2. On liquidation, the corporation may distribute its assets as provided in its articles or bylaws. Act § 3. In the absence of an express provision, a mutual benefit corporation may distribute its assets to its members, and a public benefit corporation may transfer its assets for one or more purposes described in section 501(c)(3) or to another public benefit corporation. *Id*. The Act defines a public benefit corporation as a corporation that is recognized as exempt under section 501(c)(3) or that must distribute all of its assets at liquidation to a 501(c)(3) organization. Act § 4. The State franchise tax exempts “corporations not organized for profit.” Statute § 1. The State tax exemption is not based upon an organization’s qualification for federal tax exempt status.

Each of B was organized after 1969 under the Act. We understand the Articles of each B generally conform to the organizational requirements of section 501(c)(3) and the regulations thereunder. We also understand the operational activities of B may satisfy the requirements of section 501(c)(3). It appears unlikely B would violate the Code’s proscriptions against private inurement or private benefit, because the ultimate beneficiary of the activities of B is C, a 501(c)(3) organization.

Nevertheless, we understand none of B have taken any affirmative steps to claim or apply for federal tax-exempt status, nor have any of them filed annual information returns on Form 990. Instead, we understand each of B has joined in filing a consolidated federal return on Form 1120 with the Group. Further, we are not aware of pertinent facts to establish a basis for disregarding the separate corporate existence of A and B for federal tax purposes. We therefore conclude B are not exempt from taxation under section 501(c)(3) and would not be precluded thereby from qualifying as “includible corporations” for purposes of section 1504.

ISSUE 2: Inurement

No part of the net earnings of an organization exempt under section 501(c)(3) may inure to the benefit of certain persons with a private interest in that organization. § 501(c)(3). As discussed above, none of B are exempt under section 501(c)(3). Therefore, B are not subject to this prohibition of federal income tax law. (However, C, an organization described in section 501(c)(3), which owns and controls A, and through A, controls B, is subject to the inurement proscription.)

ISSUE 3: Affiliated Group

Section 1501 allows an affiliated group to file a consolidated federal income tax return, in lieu of separate returns. Guidelines for such returns are contained in the legislative regulations promulgated under section 1502. Definitions of terms used in these sections are contained in section 1504.

Section 1501 of the Code provides, *inter alia*, that an affiliated group of corporations shall have the privilege of filing a consolidated income tax return. Section 1504(a) defines the term "affiliated group”. That definition provides that the term includes one or more chains of includible corporations connected through stock ownership by an includible common parent corporation. The common parent must own directly stock possessing at least 80 percent of the voting power of all classes of an includible corporation’s stock *and* at least 80% of the value of each class of an includible corporation’s stock. Furthermore, stock meeting the above requirements in each of the includible corporations (other than the common parent) must be owned directly by one or more of the other includible corporations.

Section 1504(a)(4) further provides, *inter alia,* that the term stock as used therein does not include any stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

Treasury Regulation § 1.1502-75(f)(1) provides that, if the income of a corporation which was not a member of the group is included in the consolidated return, the consolidated return will be considered as including only the income of the actual members of the group.

The issue of whether A properly included B in its consolidated income tax return turns on whether A “directly owned” (within the meaning of section 1504(a)) at least 80 percent of the voting power, and 80 percent of the value of all classes of stock, of B. The direct ownership requirement of section 1504(a) has been interpreted to mean beneficial ownership. *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977). Courts have frequently determined that the beneficial owner should be treated as the “direct owner” of a corporation, for purposes of filing a consolidated return. "The direct ownership required by the statute is not merely possession of the naked legal title, but beneficial ownership, which carries with it dominion over the property." *Macon, Dublin & Savannah Railroad Co. v. Commissioner*, 40 B.T.A. 1266, 1273 (1939), *acq.*, 1940-1 C.B. 3. The court in *Macon* premised its decision on the Supreme Court's statement that "taxation is not so much concerned with the refinement of title as it is with actual command over the property taxed." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

In ascertaining the beneficial owner of B, it is necessary to understand the nature of A’s membership interest. Generally, the beneficial owner of an entity possesses: 1) the right to vote on matters affecting the entity, thereby exercising control; 2) the right to share in current earnings and accumulated surplus; and 3) the right to share in the entity’s net assets on liquidation.

A’s arguments go to the very heart of the three criteria listed above. A contends that it operates, manages and controls B. It therefore argues it could direct them to distribute their assets in liquidation to another related tax-exempt entity, which could contribute the same assets in turn to A. Accordingly, A contends the Official of State would likely allow B to distribute their assets on liquidation directly to A. These bold assertions by A are the very issues that must be factually addressed prior to making a determination of who beneficially owns B.

As a starting point, we note that we agree with A that membership in a consolidated group does not turn on whether an entity issues formal shares of stock. Rather, “stock” is considered as having the meaning of “shares of stock” *i.e.*, the right which the owner has in the management, profits, and ultimate assets of the corporation. Rev. Rul. 69-591, 1969-2 C.B. 171. The presence or absence of legal title, standing alone, will not be determinative. The courts and the Service have long recognized that substance trumps form in resolving ownership issues. *See* Rev. Rul. 84-79, 1984-1 C.B. 190.

Turning to the first requirement of beneficial ownership, *i.e.*, the right to vote, and thereby control the operation and management of B, the courts and the Service have looked to whether there are any restrictions imposed on the title holder’s ownership rights. A repeatedly has asserted that it operates, manages and controls B. However, no facts have been submitted to us that support this statement. In order to determine whether A has the requisite control, the nature of A’s interest in

B must be analyzed. In particular, it would be helpful to know whether, and to what extent, C or other entities (other than A) have control over the management of B. That is, who actually controls the appointment of directors and officers, influences the decisions of the directors, controls dissolution decisions and controls amendments to the corporate charter? To the extent the board of directors may amend the Articles, pending the approval of A, how much control does C (as opposed to A) actually exert over such amendments? Does C control A's right to sell its membership interest? The answers to these questions will allow the Service to determine whether, in fact, A controls the management of B. To the extent C controls these decisions, an argument may be made that C actually is in control of the voting power of B.

In determining whether A has the required ownership interests in B for purposes of section 1504, it is also necessary to examine whether A holds sufficient interest in the value of each of B. The determination of value flows directly from the second and third tests of beneficial ownership enumerated above, *i.e.,* the right to share in current earnings and accumulated surplus and the right to share in the entity's net assets on liquidation. To the extent A can show that its rights as the member of B include the right to share in the profits of the entities through dividend distributions, and to ultimately share in the profits of the entities on liquidation, A's interests arguably resemble a direct stock ownership. Accordingly, we turn next to the question of whether, and to what extent, A possesses the right to share in the profit and liquidation proceeds of B.

The Articles set forth A's profit and liquidations rights. Under article 8(a), no "dividend or profit [shall] ever be declared or paid to any Officer or Director… ." Under article 8(b) "no part of the net earnings of the Corporation shall inure to the benefit of or be distributable to its Member, Directors, Officers or other private persons, except that the Corporation" may pay reasonable compensation for services and make payments in furtherance of its charitable purposes. Finally, on dissolution, Article 9 provides that any remaining net assets of B shall be distributed to C (or its successor), if such entity qualifies as a section 501(c)(3) corporation. If not, the board of directors shall distribute the net assets to section 501(c)(3) entities selected by A. If such assets are not so disposed of, then the circuit court of the county in which the principal office of B is located shall dispose of the net assets to such organizations that are organized and operated for charitable purposes.

You interpreted the above articles as a prohibition against any part of the entity's net income inuring to the benefit of any member, and upon dissolution, any assets being distributed to its member. Instead, the assets must be distributed to section 501(c)(3) organizations or other charitable organizations. Accordingly, you concluded that since the restrictions prohibit A from sharing in any corporate growth, they effectively contradict the stock ownership concepts required by section 1504.

A argues that the same articles support its contention that A holds the right to participate in the profits of B. First, A argues that, as a member, it may receive dividend distributions since article 8(a) only specifically prohibits the corporation's officers or directors from receiving such payments (while not specifically excluding such distribution to its member, A). Second, A recognizes that the first clause of article 8(b) states that no part of the net earnings of the corporation may inure to the benefit of or be distributed to its member, directors or officers. However, A argues that it may receive profit distributions in the form of transfers in furtherance of the charitable purposes of B, as the second clause of article 8(b) authorizes. It reasons that, as the wholly owned subsidiary through which C invests in B, A would be the appropriate entity to receive any operating surpluses from one entity in order to reallocate them to another not-for-profit use within the C network. Finally, although A acknowledges that article 9 limits its right to directly share in the liquidation proceeds, it asserts it actually has the ability to share in such proceeds because it has the authority to direct how the assets are distributed at liquidation and the Official of State is likely to approve a direct asset transfer to A.

Given the contradictory interpretations placed on the Articles, it is clear that understanding the nature and character of A's profit and liquidation rights involves more than simply reading the Articles. It also requires an understanding of the provisions of the Act governing profit and liquidation distributions of B, as well as an understanding of how State actually applies the Act. Any resolution of this case will require, as a prerequisite, an in-depth analysis of the Articles and Bylaws of B, in conjunction with a literal and practical evaluation of the Act. However, we offer the following observations, based on the limited facts available to us.

In terms of the correct interpretation of the interplay between articles 8(a) and (b), we note that we are likewise confused. While 8(a) states that the corporation is prohibited from distributing any "dividend or profit" to any officer or director, article 8(b) provides that no part of the net earnings of the corporation shall inure to the benefit of the corporation's member, directors or officers. We are uncertain of the distinction being made by these two subsections. We recommend that you determine whether there is something peculiar to the Act that will explain this distinction. However, if there is not, then we believe the language of 8(b) is broad enough to prohibit A from receiving dividends, and thus A most likely does not have a profits interest in B.

In terms of A's argument that B could make payments to A in furtherance of their charitable purposes pursuant to the second clause of article 8(b), we believe this argument actually cuts against the A's assertion that this provides it with a profits or liquidation interest as a shareholder. It is important to recognize that A actually wears two hats in its relationship to B; first, it is the member of each corporation, and second, A and B are both part of a larger group of entities that deliver services to a community. In establishing that it has a beneficial ownership

interest in B, it is incumbent upon A to show that it may receive profit and liquidation proceeds as a result of its membership interest. To the extent A has the potential to receive funds under the second clause of article 8(b), it is no different from any other entity that furthers the charitable goals of B. Any funds A receives under this provision are simply not received in A's ownership capacity. Accordingly, A's ability to receive funds under this provision of the Articles actually detracts from its argument that it is the beneficial owner of B. However, we stress that you must research whether there is something unique to the Act that would alter our position on this issue.

Finally, in light of A's assertion that the Official of State would allow B to make a distribution in contravention of specific sections of the Articles and of the Act, we strongly recommend that you evaluate the Act, especially with regard to the distribution of liquidation proceeds. It would be helpful to know not just the actual wording of the Act, but also how the Act actually is applied.

To the extent the Act precludes profit and liquidation proceeds from being distributed to A, and if the Act is strictly construed, we believe there is a strong argument that A does not possess the requisite indicia of beneficial ownership in B. The fact that A asserts it is entitled to these benefits will not override the specific provisions of the Act prohibiting such distributions, especially if the Act historically has been strictly applied.

Finally, we agree with you that *Stevens Bros. Foundation, Inc. v. Commissioner*, 324 F.2d 633 (8th Cir. 1963), *aff'g in part, rev'g in part* 39 T.C. 93 (1962), stands for the proposition that membership in a nonstock company may be the equivalent of stock if the members possess the right to share in the company's profits, either currently or ultimately, on dissolution. Although the Eighth Circuit reversed the Tax Court's holding that the members were, in substance, the shareholders of the nonstock company, the appellate court based its decision on the factual conclusion that the members did not have the right, under specific State law statutes, to share in the current or accumulated profits of the company. They did not overturn the standard articulated by the Tax Court (*i.e*, that a member, to be considered the equity owner of a company, must possess the right to share in the company's profits).

We find no merit in A's assertion that its case is distinguishable from *Stevens* based on the fact that A, unlike the individuals in the *Stevens* case, is wholly-owned by a tax exempt organization and would be allowed to receive a distribution of profits from B in furtherance of their charitable purposes. The holdings of both the Tax Court and the Circuit Court were based on the presumption that the member either did, or did not, possess a profits and liquidation interest in the association as a result of its membership interest. As noted above, the ability of A to receive money in its capacity to further the charitable purposes of B must be distinguished

from A receiving funds in its ownership capacity. The ability of A to receive funds in furtherance of the charitable purposes of B simply does not lead to the conclusion that A is the beneficial owner of such entities. To support such a finding, A must show that it is entitled to receive the profit and liquidation proceeds in its membership capacity. Accordingly, we are unpersuaded that A's case is distinguishable from *Stevens*.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

None.

If you have any questions regarding this matter, please contact Don Spellmann in EBEO at 202-622-6070 with respect to issues 1 and 2 and Alison Burns in FS:CORP at 202-622-7930 with respect to Issue 3.

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