

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:

T:ED:B3

Employer Identification Number:

Legends

Parent =

B =

C =

X =

Dear Sir or Madam:

This letter responds to the request of counsel for Parent, B and C, dated January 5, 2001, for a ruling regarding a proposed reorganization of one charity, B, along with the creation of two new supporting charities, Parent and C.

B is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code ("Code") and is classified as a public charity under section 509(a)(2). Simultaneously with the submission of the ruling request, Parent and C submitted applications for recognition of exemption from federal income tax under section 501(c)(3) and requested classification as supporting organizations under section 509(a)(3). Favorable determination letters were issued to both Parent and C.

Initially B was formed as a resource to serve X, a governmental agency, in dealing with current and expected changes under the federal student loan program. Since its formation, B has served X by using its technical and processing resources to resolve issues, initiating a pilot program for comprehensive processing of death and disability claims, and assuming the guarantor responsibilities for a particular state. In order for B to assist X, the revenues generated by B's bankruptcy processing services were intended to serve as an interim financing mechanism to subsidize the activities requested by X. The reserve generated by bankruptcy processing services is restricted to funding initiatives of X.

In response to dramatic changes in the student loan industry, B has been forced to reconsider its overall operations strategy so that it will be able to sustain its guarantor and bankruptcy services for the benefit of the student borrowers. In connection with this strategic reexamination, B has concluded that it should form taxable subsidiaries to carry on certain activities that are highly regarded in the market place but which are not directly related to, or an integral part of, B's mission, or would otherwise be regarded as potential sources of unrelated business income if directly conducted by B.

To adequately segregate B's nonexempt activities from B's exempt activities, and to protect B from potentially excessive unrelated business activities, the newly formed taxable subsidiaries, which will be wholly-owned by Parent, will undertake the expanded activities.

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As a result of the reorganization, Parent will be established and will exercise oversight of B, C and the taxable entities. Parent will provide strategic direction, provide oversight to operations, authorize amendments to the Certificates of Incorporation and Bylaws of the above entities, and appoint and remove members of the Boards of Directors of B, C and the taxable entities. The Board of Directors of Parent shall consist of nine members. Seven of the members will be current B Board members. It is anticipated the remaining two members shall be independent persons with backgrounds similar to those currently on B's Board.

B will continue to provide guarantor services for a particular state and provide bankruptcy processing services with respect to student loans on a national basis. No change in B's charitable purposes or activities/services is contemplated.

C will provide grants for education related projects in furtherance of the exempt purposes of B. The funding for C will come primarily from the profits of the taxable subsidiaries, via distributions of dividends received by the Parent. The initial Board of Directors of C will consist of nine members. All of the members will be members of the Parent's Board of Directors and will be appointed by Parent.

Parent intends to form one taxable holding company to oversee the taxable subsidiaries. The taxable holding company shall own the stock of the taxable subsidiaries that will undertake the expanded activities. The taxable holding company and the taxable subsidiaries are expected to conform to substantially similar structural and operational guidelines initially established by Parent and subsequently implemented by the respective boards of directors of such taxable subsidiaries. After the reorganization is complete, Parent has represented that it will have general oversight powers but will not be involved in the day-to-day management of the taxable holding company or any of the taxable subsidiaries. The taxable subsidiaries will provide services to Parent, B, C and other unrelated entities. The taxable entities will provide technology services and management services, manage default aversion programs and collection services for unrelated parties, and market and manage alternative student loans. Parent has represented that any services provided by the taxable subsidiaries to Parent, B and/or C shall be at cost.

Parent will maintain control over the taxable holding company through its appointment powers to the holding company's Board. This governance structure will allow Parent to maintain control of the holding company without being involved in the day-to-day management decisions of the holding company. There are not expected to be any common officers of Parent and the holding company and the responsibilities for the day-to-day operations of the holding company will be vested in individuals who do not share such responsibilities with Parent, B or C.

In connection with the reorganization, funds, assets, services and/or personnel may be transferred by and among the various entities. To the extent Parent, B or C provides funds, assets, services and/or personnel to the taxable subsidiaries, Parent, B and C have represented that those transactions will be structured on an arm's length basis to ensure that the tax-exempt participants are paid at least fair market value for their participation subject to X's regulatory limitations. Further, any such transactions with the taxable subsidiaries will produce revenues that are insubstantial to the specific exempt organization when compared to the exempt organization's total financial receipts, and will be incidental to the exempt organization's primary purpose.

B will share office space, furniture, and computer equipment with the taxable subsidiaries. The sharing of office space, done pursuant to written agreements, will be based upon units of measure reflective of costs incurred by the separate entities. For example, expenses associated with real and personal property, including utilities and cleaning, will be allocated based upon usage. Contemporaneous

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time logs will be maintained and shared expenses monitored to ensure that B does not subsidize the holding company and its subsidiaries.

B proposes to reorganize in order to enhance the loan services provided and assure they are delivered to students in the most high quality and cost-effective manner. The reorganization will improve B's viability, stability and strength and it will be more readily able to provide efficient delivery of loan services with minimal operating costs. Furthermore, the new separate taxable subsidiaries will enable further growth of the organization by attracting talented professionals, which will benefit B's existing beneficiaries with more services, and will benefit C's charitable class with funding. Lastly, the reorganization will enable B to make its services more accessible through enhanced Internet applications and improved economies of scale.

You have requested a ruling that

- (1) After amendment of the Bylaws of B and the reorganization, including the proposed transfers of assets and activities and the sharing of personnel, services, facilities and expenses by and between Parent, C and the taxable subsidiaries, B will continue to qualify as an organization described in section 501(c)(3) of the Code, and as an organization other than a private foundation as described in section 509(a)(2) of the Code.
- (2) The activities of the taxable subsidiaries will not be attributed to Parent, B or C and will not jeopardize the continued tax-exempt status of Parent, B or C.
- (3) B's transfer of assets and liabilities in the reorganization to C and Parent will not generate unrelated business taxable income to B, C or Parent under sections 511 through 514 of the Code.
- (4) Parent's transfer of assets and liabilities to the taxable subsidiaries in exchange for the common stock of the taxable subsidiaries will not generate unrelated business taxable income to Parent under section 512(a)(1) of the Code.
- (5) Neither the earnings of the taxable subsidiaries, nor the dividend income received by the Parent, will constitute unrelated business taxable income to B, C or Parent under sections 511-514 of the Code.

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.

Rev. Rul. 67-149, 1967-1 C.B. 133, provides that an organization that carries on no other operations other than to receive contributions and incidental investment income and make contributions to section 501(c)(3) organizations qualifies for exemption from tax under section 501(c)(3) of the Code.

In Rev. Rul. 78-41, 1978-1 C.B. 148, a trust 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 will be the same charitable purposes, which first qualified B for recognition of exemption. B's activities will be in furtherance of those purposes. The sharing of assets and services among these related exempt entities contribute to the accomplishment of B's purposes in a manner similar to the organization described in Rev. Rul. 78-41, 1978-1 C.B. 148. Therefore, because Parent, 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 exempt status of Parent, B and C under section 501(c)(3) of the Code.

A parent's exempt status may be jeopardized if the commercial activities of its subsidiary can be considered to be activities of the parent. For federal income tax purposes, a parent corporation and its subsidiaries 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 Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943). 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 v. U.S., 431 F.2d 227, 234 (5th Cir. 1970). However, where the parent corporation so controls the affairs of the subsidiary that it is a mere 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).

Whether the activities of a separately incorporated taxable subsidiary may be attributed to its parent is a question of fact. Clearly, in this instance, the taxable subsidiary was formed for a valid business purpose. B is assured that the Parent and C will be responsible to B's needs after the reorganization. The activities of a separately organized subsidiary of parent will not be attributed to the Parent where the day-to-day management of the subsidiary is separate from the parent and a majority of the subsidiary's directors are unrelated to the parent. Therefore, the mere ownership of stock of a taxable subsidiary and receipt of dividends on that stock will not adversely affect the exemption of B, C and the Parent.

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 512(b)(1) of the Code sets forth the modifications referred to in section 512(a) of the Code, which excludes all dividends from the computation of unrelated business income.

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.

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.

Section 512(b)(13) of the Code provides special rules for certain amounts of income an exempt organization receives from a controlled entity.

Section 512(b)(13)(A) of the Code provides that notwithstanding sections 512(b)(1), (2) and (3) of the Code an organization (controlling organization) receiving a specified payment from another entity which it controls (controlled entity), shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.

Section 512(b)(13)(C) of the Code provides that the term "specified payment" means any interest, annuity, royalty, or rent.

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.

Because the transfers of cash, assets and personnel by B among Parent and C permit them to carry out their respective tax-exempt operations, these activities are related to their tax-exempt status. Accordingly, such transfers will not constitute unrelated business activity, and therefore will not give rise to unrelated business taxable income under sections 511 through 514. Additionally, the mere investment of a capital contribution, the transfer of assets and liabilities, will not, in and of itself, cause the Parent to receive unrelated business taxable income.

The Parent's receipt of dividends will be excluded from the computation of unrelated business taxable income because section 512(b)(13)(A) of the Code provides that "specified payments" a controlling organization receives from another entity which it controls is included in the gross income derived from an unrelated trade or business. However, section 512(b)(13)(C) does not include dividends in the definition of the term "specified payment".

Moreover, the taxable income of the taxable subsidiaries will not be construed as unrelated business taxable income to Parent, B and C. For federal income tax purposes, Parent, B and C are respected as separate entities since Parent, B and C were established with a bona fide intention that they will have real and substantial business functions. Therefore, their existence will not be disregarded.

Accordingly, we rule as follows:

- (1) After amendment of the Bylaws of B and the reorganization, including the proposed transfers of assets and activities and the sharing of personnel, services, facilities and expenses by and between Parent, C and the taxable subsidiaries, B will continue to qualify as an organization described in section 501(c)(3) of the Code, and as an organization other than a private foundation as described in section 509(a)(2) of the Code.
- (2) The activities of the taxable subsidiaries will not be attributed to Parent, B or C and will not jeopardize the continued tax-exempt status of Parent, B or C.
- (3) B's transfer of assets and liabilities in the reorganization to C and Parent will not generate unrelated business taxable income to B, C or Parent under sections 511 through 514 of the Code.
- (4) Parent's transfer of assets and liabilities to the taxable subsidiaries in exchange for the common stock of the taxable subsidiaries will not generate unrelated business taxable income to Parent under section 512(a)(1) of the Code.
- (5) Neither the earnings of the taxable subsidiaries, nor the dividend income received by the Parent, will constitute unrelated business taxable income to B, C or Parent under sections 511-514 of the Code.

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 to the applicability of the provisions of the sections of the Code as noted above. This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

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

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