Bond Case Briefs

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IRS LTR: Supporting Organization's Ownership Interest in For-Profit Won't Jeopardize Exemption.

The IRS ruled a supporting organization's ownership interest in a newly formed holding company resulting from a restructuring transaction won't adversely affect its tax-exempt status.

Employer Identification Number: * * *

LEGEND:

Center = * * *

Group = * * *

Network = * * *

Health = * * *

Dear * * *:

This is in reply to your letter of June 30, 2011, in which you request a ruling on the effect to your tax-exempt status of your proposed ownership (through a wholly-owned disregarded entity) in a for-profit Subchapter S corporation.

FACTS

You are tax-exempt under I.R.C. § 501(c)(3), and a § 509(a) supporting organization of the Center and its School of Medicine. The Center is part of a state-chartered university system. You are a faculty group practice that assists the Center in carrying out its mission, particularly as it relates to the Center's clinical practice function. You consist of the faculty of the clinical departments of the Center. Through you, the Center's faculty is able to enter into contractual relationships with health plans, community providers, and businesses to provide health care services and thereby operate a health care delivery system. The health care delivery system, which you facilitate, promotes the charitable, educational, and research programs of the Center by providing it with the clinical programs and patient populations with which to educate its students and conduct research, while also providing healthcare services to the public regardless of ability to pay.

You are the sole member of the Group, a wholly owned subsidiary that is treated as a disregarded entity for federal tax purposes. The Group provides professional medical services as a participating independent physician association ("IPA") in the Network. The Network is organized as a for-profit corporation, and serves as a third party administrator providing medical necessity review organization services to its clients under state licenses. The Group owns * * * percent of the issued and outstanding common shares of the Network. The Network has six additional IPA shareholders that are unrelated to the Group. The Network is currently a C corporation for federal income tax purposes. These six additional IPA shareholders comprise for-profit corporations and a partnership.

The Network has four wholly owned subsidiaries. Three of the subsidiaries are limited liability companies that are disregarded as separate entities for federal income tax purposes. The fourth subsidiary, Health, is a C corporation and insurance company for federal income tax purposes. All four wholly owned subsidiaries are involved in healthcare or healthcare related services.

In addition to being a participant IPA in, and shareholder of, the Network, the Group has an exclusive management agreement with the Network under which the Network provides certain administrative and contract services to the Group. These services include collecting revenue, paying claims, contracting with healthcare providers, and performing other administrative functions necessary to manage the Group. For its services, the Network collects * * *% of all collected revenues. At the year-end, the Network reconciles its actual management costs incurred on behalf of the Group and remits any overpayments to the Group. The Group remits to you the overpayments it receives from the Network.

Proposed Restructuring Transaction

In order to achieve an ownership structure that is eligible for S corporation status, the following restructuring transaction is proposed:

A new entity, the “Holding Company,” will be established, and will make an “S” election as of the date of formation.

The Group and the other shareholders of the Network will contribute their shares of the Network to the capital of the Holding Company, thus making the Network a wholly owned subsidiary of the Holding Company.

The Holding Company will make a qualified subchapter “S” subsidiary (“QSSS”) election for the Network.

The Network will distribute its membership interests in its three subsidiaries that are disregarded entities for federal tax purposes to the Holding Company. The Network will continue to own all of the issued and outstanding common shares of Health.

Once the proposed transaction is completed, the Group will hold * * *% of the Holding Company. The remaining * * * % will be owned by the 54 individuals that currently own the six other shareholders of the Network. All of the entities involved in the proposed transaction will continue to operate for the same business purposes as they did prior to the transaction.

The Holding Company will have a board or directors consisting of seven members. The Group will have the right to elect one board member and the other unrelated shareholders will elect the remaining six board members. The Network will have a board of directors consisting of 14 members. The Group will have the right to elect two board members and the other unrelated shareholders will elect the remaining 12 board members.

Health will have a board of directors consisting of six members. Three of the members will be selected by the Network’s board of directors from among its members, and the other three members will be selected from the Network’s senior management team. The three subsidiaries of the Holding Company that are disregarded entities for federal income tax purposes will be managed by a non-shareholder manager selected by the Holding Company.

The Holding Company and its subsidiaries will each develop, maintain, and manage its own financial systems independent of you and the Group. The Holding Company and its subsidiaries will each by operated by a professional staff with expertise in the relevant business areas, which are independent

and unrelated to you. Neither you nor the Group will be involved in the day-to-day management of the Holding Company or any of its subsidiaries.

RULING REQUESTED

You have requested the following ruling:

Your ownership, through your wholly-owned disregarded entity, Group, in a for-profit Subchapter "S" corporation, together with the flow-through allocation of "S" tax items subject to the unrelated business income tax, has no effect on the your tax exempt status.

LAW

I.R.C. § 501(c)(3) provides 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 private shareholder or individual.

Treas. Reg. § 1.501(c)(3)-1(a)(1) provides that, in order to qualify as an organization described in § 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it does not qualify for exemption.

Treas. Reg. § 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it is engaged primarily in activities which accomplish one or more of such exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

I.R.C. § 511(a) imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under I.R.C. § 501(c).

I.R.C. § 512(e) provides that if an organization described in § 1361(c)(6) holds stock in a S corporation — (A) such interest shall be treated as an interest in an unrelated trade or business; and, (B) notwithstanding any other provisions of this part — (i) all items of income, loss, or deduction taken into account under § 1366(a), and (ii) any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the unrelated business taxable income of such organization.

I.R.C. § 1361(c)(6) provides that, for purposes of subsection (b)(1)(B) (which defines the term "small business corporation"), an organization which is (A) described in § 401(a) or 501(c)(3), and (B) exempt from taxation under § 501(a), may be a shareholder in an S corporation.

In Moline Properties, Inc. v. Comm'r, 319 U.S. 436, 438-39 (1943), the Supreme Court said that "[t]he doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. . . . In general, in matters relating to the revenue, the corporate form maybe disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." In response to the argument that a corporation is a mere agent of its sole stockholder, the court said that "the mere fact of the existence of a corporation with one or several stockholders, regardless of the corporation's business activities, does not make the corporation the agent of its stockholders. Id. at 440.

In National Carbide Corp. v. Comm'r, 336 U.S. 422, 437 (1949), the Supreme Court said that a finding of a "true agency" relationship turns on several factors. "Whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. If the corporation is a true agent, its relations with the principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purposes must be the carrying on of the normal duties of an agent."

In National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2nd Cir. 1944), the court said that "to be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation; in other words, that the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning; and that escaping taxation is not 'business' in the ordinary meaning."

In Britt v. U.S., 431 F.2d 227, 237 (5th Cir. 1970), the court said that "business activity is required for recognition of the corporation as a separate taxable entity; the activity may be minimal."

In Krivo Indus. Supply Co. v. Nat'l Distillers & Chem. Corp., 483 F.2d 1098, 1106 (5th Cir. 1973), the Court said that "the control required for liability under the 'instrumentality' rule amounts to total domination of the subservient corporation, to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes of the dominant corporation."

ANALYSIS

For taxable years beginning before January 1, 1998, tax exempt organizations described in § 501(c)(3) could not be shareholders in an S corporation. In 1996, Congress enacted the Small Business Job Protection Act, Pub. L. No. 104-188, 110 Stat. 1755, authorizing the ownership of S corporation stock by tax-exempt organizations described in § 501(c)(3). The Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in the 104th Congress (JCS-12-96), December 18, 1996, Sec. 1316, p. 130, describes the reason for the change in law as follows —

The Congress believed that the present-law prohibition of certain tax-exempt organizations being S corporation shareholders may have inhibited employee ownership of closely-held businesses, frustrated estate planning, discouraged charitable giving, and restricted sources of capital for closely-held businesses. The Congress sought to lift these barriers by allowing certain tax-exempt organizations to be shareholders in S corporations. However, the provisions of subchapter S were enacted in 1958 and substantially modified in 1982 on the premise that all income of the S corporation (including all gains on the sale of the stock) would be subject to a shareholder-level income tax. This underlying premise allows the rules governing S corporations to be relatively simple . . . because of the lack of concern about "transferring" income to non-taxpaying persons. Consistent with this underlying premise of subchapter S, the provision treats all the income flowing through to a tax-exempt shareholder, and gains and losses from the disposition of the stock, as unrelated business taxable income.

As a result of the legislation, tax-exempt organizations described in § 501(c)(3) are allowed to be shareholders in an S corporation under § 1361(c)(6). Furthermore, under § 512(e), items of income or loss of an S corporation will flow through to tax-exempt shareholders as unrelated business taxable income regardless of the source or nature of such income. In addition, gain or loss on the sale or other disposition of stock of an S corporation will be treated as unrelated business taxable income. These provisions, however, do not cause the for-profit activities of the S corporation to be

attributed to the tax-exempt shareholder. See Moline Properties, Inc., 319 U.S. at 440. In determining whether the activities of a for-profit S corporation subsidiary is attributable to its tax-exempt parent, the separate identity principles annunciated in Moline Properties, Inc. v. Comm'r should apply lest the intent of Congress to remove barriers for investment in S corporations by tax-exempt entities be frustrated.

For federal income tax purposes, a parent corporation and its subsidiaries are treated as separate and distinct taxable corporate entities as long as each entity has a valid business purpose and engages in at least a minimal amount of business activity. See Moline Properties, Inc., 319 U.S. at 438; National Investors Corp., 144 F.2d at 468; Britt, 431 F.2d 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 identity of the subsidiary may be disregarded. See, Krivo, 483 F.2d at 1106.

Hence, the activities of a for-profit subsidiary will not be attributed to its tax-exempt parent unless (1) the subsidiary lacks a business purpose, or (2) the subsidiary is an arm or agent of the parent.

In your case, your relationship with the Holding Company does not fail the first prong, i.e., that the subsidiary have a business purpose and conduct some amount of business activity. The Holding Company and its four subsidiaries have been, or will be, organized to perform bona fide and substantial business functions. The Holding Company and all of its subsidiaries maintain activities that are separate, distinct, and independent from you. Therefore, their existence may not be disregarded for tax purposes.

Additionally, your relationship with the Holding Company does not fail the second prong, i.e., that the parent not control the day-to-day operations of the subsidiary. The Holding Company has its own corporate identity and interests, and its own independent board of seven directors, only one of which is chosen by you. The other six directors are chosen by unrelated shareholders. Furthermore, each of the Holding Company's subsidiaries has its own management and employees independent of you. Furthermore, neither your investment in the Holding Company nor your management agreement with the Network exhibits any of the attributes of a "true agency" relationship identified in National Carbide Corp., 336 U.S. at 437. Therefore, neither the Holding Company nor its subsidiaries can be considered a sham or under your "total domination." Consequently, the activities of the Holding Company and its subsidiaries would not be attributable to you.

CONCLUSION

In light of the foregoing, we rule as follows:

Your ownership interest in the Holding Company, a for-profit subchapter S corporation, through Group, together with the flow-through allocation of the Holding Company's "S" tax items subject to the unrelated business income tax, would have no effect on your tax-exempt status as an organization described in § 501(c)(3).

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolved questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Peter A. Holiat

Acting Manager,

Exempt Organizations

Technical Group 1

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