IRS LETTER RULINGS

Letter Ruling Alert

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A Blueprint for Creating a Taxable Subsidiary

Introduction

Exempt organizations have been creating taxable subsidiaries for many years to meet a variety of needs, including spinning off unrelated businesses, protecting the parent organization from potential liabilities, and providing a means of sharing the profits from money making ventures with employees. In a recent private letter ruling (LTR 200225046 (March 28, 2002), reprinted on p. 322), the IRS has provided a comprehensive blueprint for creating and structuring an exempt organization's relationship with such a subsidiary. The ruling not only addresses the more routine topics of how to protect the tax-exempt status of the parent organization and whether certain payments from the subsidiary to the parent will be treated as unrelated business taxable income, but also provides guidance regarding how to structure resource sharing arrangements and how to grant stock and stock options to employees of both the subsidiary and the parent. Although the Service imposed a few requirements that go beyond those existing in current law and did not resolve all of the unrelated business taxable income questions raised by the facts before it, the ruling provides both a helpful summary of the legal principles that apply to taxable subsidiaries and a useful example of the application of those principles.

Facts

M is a section 501(c)(3) educational organization engaged in various endeavors relating to a certain subject. It has dues-paying members from around the world, and serves all levels of practitioners, educators, and students. Its activities include producing a magazine and other publications, hosting workshops, seminars, and conferences, and facilitating the networking of its members.

M created a taxable entity, *N*, to operate an Internet portal ("N.com") that will serve as a comprehensive source of information, products, and services targeted at business professionals working in *M*'s area of concentration. *N*'s specific activities will include establishing links to merchants through affiliate agreements, providing online recruiting and career resources, producing industry directories, and providing advertising. Although not explicitly stated in the ruling, it appears that *M* will be transferring essentially all of its Internet activities to *N*. *M* provided three reasons for making this transfer: to insulate itself from liability arising from affiliate agreements related to *M*'s Web site with third parties; to carry out certain activities in a manner that would not affect *M*'s exempt status under section 501(c)(3); and to minimize *M*'s potential liability for unrelated business income tax under section 511.

The actual creation of *N* was straightforward. *M* caused *N* to be incorporated as a for-profit corporation, and then contributed cash and certain intangible assets to *N* in exchange for shares of *N*'s common stock, making *N* a wholly owned subsidiary of *M*. *N* will establish a separate telephone number and separate telephone listing(s), bank accounts, and stationery, although *N* will have the same mailing address as *M*, at least initially. *N* will also obtain a benefits package for its employees and insurance to cover its operations, and will not comingle or combine its funds and assets with those of *M*. *N*'s board of directors will have regular meetings throughout the year, will maintain complete and accurate minutes of meetings, and will be the sole governing and policy-making body for *N*.

Although not stated explicitly, *M* will presumably appoint all of the members of *N*'s board of directors, at least as long as *M* is *N*'s sole shareholder. A majority of the five directors will not, however, be officers or directors of *M*. The board will initially consist of M's CEO, a member of *M*'s board or *M*'s executive committee, the president/CEO of *N*, and two individuals who are not currently directors, officers, or employees of *M*. *M* also has veto power over certain actions by *N* as long as *M* continues to hold more than 50 percent of *N*'s outstanding voting stock. These actions include: amending *N*'s governing documents; major corporate actions such as a merger, consolidation, reorganization, dissolution, filing for bankruptcy, creating a subsidiary, changing taxable status, and issuing shares of capital stock; removing any director appointed by *M*; disposing of any material asset other than in the ordinary course of business for fair market value consideration; and any action that could be reasonably expected to have a material adverse effect on *M*'s tax-exempt status.

N's first two employees will be its president/CEO and its "director, Web site architecture." Neither of these employees will be an employee of *M*, although the director, Web site architecture had previously worked for *M*. *N*'s officers and employees will be in charge of *N*'s day-to-day activities.

M and *N* plan to enter into the following series of agreements governing financial transactions between them; *M* submitted copies of the agreements to the Service as part of the ruling request.

- Administrative services agreement: *N* may, at least during its start-up phase, obtain administrative services from *M* in exchange for reimbursing *M* for the costs *M* incurs in providing those services.
- Advertising agreement: *M* will receive banner advertising space on *N*'s Internet portal, and *N*, in exchange, will receive a proportionate amount of advertising space in *M*'s publications. *M* will report the value of the advertising space it receives as unrelated business taxable income.
- Affiliate agreement: This agreement will govern the terms of the sale of *M* products and services on *N*'s Internet portal, with *M* determining the pricing for such items and *N* receiving a commission on the sale of any such items through *N*'s portal.
- Directory agreement: *N* will receive a non-exclusive, non-transferable license to *M*'s directory of service providers for a term of 10 years, with a 10-year automatic renewal unless *N* provides written notice of nonrenewal. In exchange, *N* will market, promote, and make available on the Internet the directory information, and will pay *M* an annual royalty with a fixed minimum plus 50 percent of the gross revenues from the sale of directory listings in excess of that minimum. *M* will also establish standards and guidelines for the permitted use and depiction of directory information.
- Lease: *N*'s office, at least initially, will be a separate area in *M*'s office, with the rent paid to *M* set at *M*'s cost for that space.
- Licensing agreement: Under this agreement,
  - *N* will license from *M M*'s trademark, logos, and domain name, and certain content from *M*'s publications, for use in and relating to *N*'s Internet portal. *N* will also license *M*'s membership database, which contains contact, financial transaction, and demographic information about *M*'s members and which *M* does not license or rent to other parties.
  - *N* will provide on *N*'s Internet portal an *M* "members only" section, links to M Chapter Web sites, and priority positioning for *M*'s products and services.
  - *N* will try to obtain discounts for *M*'s members on products and services provided through *N*'s affiliate programs with third parties.
  - *N* will pay *M* a royalty of 10 percent of "gross revenues," as defined in the agreement, with a minimum royalty guaranteed for the first two fiscal years.
  - *N* will not provide comparable Web site hosting services to any other entity selling products or services targeting those with an interest in *M*'s subject matter.
  - *M* will not license its content to any other Web site that is directed toward the North American community.
  - *M* will have the option of extending the terms of the Agreement to any foreign jurisdiction that *N* seeks to enter for purposes of establishing an Internet portal.
  - Upon termination, *M* will be granted a royalty-free perpetual (but apparently non-exclusive) license to the software developed to operate *N*'s Internet portal, *N* will assign to *M* all of *N*'s third-party affiliate agreements for its Internet portal, and *M* will have the option of purchasing *N*'s Internet portal hardware at fair market value.

  The Agreement will have a 10-year term, with an automatic 10-year renewal absent a written notice from *M* of nonrenewal.

N will adopt a stock grant plan as part of the compensation to be paid to its officers, directors, and employees for their services, subject to the total compensation paid being reasonable, as determined by a compensation consultant. *N* may also in the future seek other investors to provide additional capital, including through possibly forming one or more joint ventures. *M* will offer *N* stock and stock options to *M*'s key employees, subject to the total compensation, including the fair market value of any *N* stock or stock option granted, received by any employee being reasonable.

IRS Conclusions and Rationale

Separate Entities

The Service first addressed the most important aspect of the creation of *N*: whether *M* had succeeded in creating a separate entity, the activities of which would not be attributable to *M*. Relying on the familiar cases of *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943) and *Britt v. United States*, 431 F.2d 227 (5th Cir. 1970), as well as *Krivo Industrial Supply Co. v. National Distillers and Chemical Corp.*, 483 F.2d 1098 (5th Cir. 1973), which involves a lengthy discussion of when one corporation is an "instrumentality" of another corporation such that the liability of the first corporation can be attributed to the second corporation, the Service concluded that *M* had succeeded in creating an entity with a bona fide business purpose and which was not a "mere instrumentality" of *M*.

In reaching this conclusion, the Service relied on the fact that *N*'s Internet portal would benefit not only the members of *M* but also other professionals, that a majority of *N*'s board would not be board members or officers of *M*, and that the day-to-day management of *N* would be in the hands of officers of *N* who will be independent of *M*. The Service also relied on the fact that *N* would maintain separate books and records, financial reports, employee benefits, and insurance, and that financial transactions between *N* and *M* would be carefully documented, with *M* being fully reimbursed for any use by *N* of *M*'s office space or administrative services.

Given this conclusion, the Service then ruled that neither the formation nor the initial capitalization of *N* would adversely affect *M*'s tax-exempt status as an organization described under section 501(c)(3) or result in UBTI to *M*. The Service also ruled that *N*'s taxable income would not be treated as UBTI to *M*, any proceeds from the sale of stock by *N* would not result in UBTI to *M*, and any dividends received by *M* from *N* would be excluded from *M*'s UBTI by section 512(b)(1).

Payments from Taxable Subsidiary to Exempt Parent

The Service also ruled on the treatment of various payments received by *M* from *N*. Turning first to the Licensing Agreement, the Service noted that the payments for the intangible property rights obtained by *N* from *M* qualified as royalties within the meaning of section 512(b)(2), which provides an exclusion from UBTI for royalties. In reaching this conclusion, the Service relied on the first situation described in Rev. Rul. 81-178, 1981-2 C.B. 135, where the Service found that the licensing of a section 501(c)(5) labor organization's trademarks, trade names, service marks, and copyrights, along with its members' names, photographs, likenesses, and facsimile signatures, qualified as royalties under section 512(b)(2). The Service also relied on the line of cases concluding that payments for the rental of mailing lists constitute royalties within the meaning of section 512(b)(2). *See Sierra Club Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996); *Common Cause v. Commissioner*, 112 T.C. 332 (1999); *Planned Parenthood Federation of America Inc. v. Commissioner*, 77 T.C.M. (CCH) 2227.

The Service specifically did not rule, however, on whether the royalty payments might still constitute UBTI under section 512(b)(13). Section 512(b)(13) provides that if a controlling organization receives a specified payment from a controlled entity, the payment shall be included in UBTI notwithstanding sections 512(b)(1), (2), and (3) to the degree such payment reduces the net unrelated income of the controlled entity. Specified payments are interest, annuities, royalties, and rents. Section 512(b)(13)(C). "Control" generally means, for a corporation, ownership, by vote or value, of more than 50 percent of stock in such corporation. Section 512(b)(13)(D).

The Service also ruled that the payments received by *M* pursuant to the directory agreement qualified as royalties under section 512(b)(2), and indicated that the rental payments from *N* to *M* under the lease would qualify as rent under section 512(b)(3), which excludes rent from UBTI. As with the licensing agreement royalty payments, however, the Service did not rule regarding whether those payments might still constitute UBTI under section 512(b)(13). The Service also did not rule on whether the payments by *N* to *M* for administrative services might constitute UBTI. The Service did note that *M* had represented that it would report any compensation received under the advertising agreement as UBTI.

Stock and Stock Options

Citing the prohibitions on private inurement found in section 501(c)(3) and reg. section 1.501(c)(3)-1(c)(2) and on serving private interests found in reg. section 1.501(c)(3)-1(d)(1)(ii), the Service also reviewed whether the planned distribution of stock by *N* to its employees and of stock and stock options by *M* to its employees violated those prohibitions. The Service first noted that since *M* and *N* are separate legal entities, and the stock to be provided by *N* to its employees would constitute reasonable compensation for the services they would render, the provision of such stock by *N* was not incompatible or inconsistent with *M* carrying out its exempt purposes. The Service took particular note of the fact that a compensation consultant would be retained by *N* to ensure the reasonableness of the total compensation paid by *N* to its directors, officers, and employees.

The Service also concluded that *M*'s provision of *N* stock or stock options would not violate these prohibitions "so long as the total compensation to be paid by *M* to an employee is reasonable in amount." Relying on *M*'s representation that this condition would be satisfied, the Service concluded that the provision by *M* of such stock or stock options to its employees would not adversely affect *M*'s tax-exempt status under section 501(c)(3).

Comment

The ruling provides a helpful guide for creating and structuring financial relationships with a taxable subsidiary. The discussion of stock and stock options in particular may be the first instance of the Service ruling on the provision of stock and stock options of a taxable subsidiary by the exempt parent to its employees, although the Service has ruled before on the ramifications of a taxable subsidiary of an exempt parent providing stock or stock options to the subsidiary's employees. (See, e.g., PLR 9722032 (Feb. 28, 1997); *Doc 97-15432 (9 pages)*; or *97 TNT 104-34*.) The ruling suggests, however, that the Service has adopted a few positions that do not appear to be completely consistent with settled law, and also leaves several important UBTI issues unresolved.

Separate Entities

The Service's conclusion that *N* should be treated as separate from *M* for federal tax purposes is clearly correct, and the detailed description of the creation of *N* and the financial relationships between *M* and *N* provides helpful information regarding how to ensure this result. For example, it is useful to have it confirmed that an exempt parent can have (apparently) complete control over the selection of the members of the governing body of the wholly owned subsidiary, and also have reserved powers over major actions on the part of the subsidiary, and yet still be able to treat the subsidiary as a separate entity.

One troubling aspect of the Service's reasoning, however, is that the Service appears to have considered crucial certain facts that appear to go beyond what is required by the case law cited by the Service. It is certainly true that to be treated as a separate entity, the subsidiary must have a bona fide business purpose, although carrying on actual business activity also is sufficient. See *Moline Properties*, 319 U.S. at 438-39. The Service's reason for apparently relying on the fact that *N* will be serving people beyond *M*'s members to demonstrate that *N* had a bona fide business purpose is unclear, however. It seems reasonable to assume that an exempt organization could form a wholly owned taxable subsidiary for the purpose of engaging in business activities that benefit only the exempt organization's members, and still have that subsidiary qualify as a separate entity for tax purposes. For example, in PLR 199938041 (June 28, 1999), profiled in this space in March 2000, the Service appeared to have no difficulty treating a wholly owned taxable subsidiary as a separate entity for federal tax purposes even though the entity's role was to contract with various service providers who provided services to the exempt parent's members. A better reading of the Service's reliance on the scope of the beneficiaries of *N*'s activities may be that providing services to persons other than *M*'s members helped demonstrate *N*'s bona fide business purpose but was not determinative. (For PLR 199938041, see *The Exempt Organization Tax Review*, March 2000, p. 478; *Doc 1999-30923 (16 original pages)*; or *1999 TNT 186-26*.)

The Service's apparent conclusion that for a subsidiary to be considered a separate entity it must have both separate day-to-day management and a majority of board members who are not officers or employees of the exempt parent, is even more troubling. The *Krivo* case, which the Service apparently relies on for the proposition that a subsidiary cannot be a "mere instrumentality" if it is to be regarded as separate for federal tax purposes, imposes no such requirement. It explicitly provides that stock ownership, and therefore presumably board control, does not per se resolve the instrumentality question. See *Krivo*, 483 F.2d at 1104. More importantly, the court concluded in that case that even if the dominant organization shared managerial responsibility for some of the subservient corporation's operations, this was not enough to justify disregarding the subsidiary's separate corporate existence. *Id.* at 1112. Rather, evidence showing that the dominant organization had "actual, operative, total control of the subservient corporation" was required. *Id.* at 1109.

The Service's reliance on *Krivo* is also misplaced for another reason. *Krivo* was not a tax case; rather it involved the question of whether a creditor could seek payment from the dominant corporation for the subservient corporation's debt. A case decided after *Krivo* explicitly noted that disregarding an entity for liability purposes is subject to a different, and apparently lower, standard than disregarding an entity for federal tax purposes. *Avco Delta Corp. Canada Ltd. v. United States*, 540 F.2d 258, 264 (7th Cir. 1976), *cert. denied sub nom. Canadian Parkhill Pipe Stringing Ltd. v. United States*, 429 U.S. 1040 (1977). The Supreme Court has affirmed that in applying the principles of *Moline Properties*, "when a corporation carries on business activity the fact that the owner retains direction of its affairs down [to] the minutest detail, provides all of its assets and takes all of its profits can make no difference tax-wise." *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 431-32 (1949).

This conclusion is also consistent with how the Service treats related organizations in the section 501(c)(3)/501(c)(4) context, where it has found that overlapping directorates and personnel do not prevent related organizations from being treated as separate entities for federal tax purposes as long as the organizations maintain separate finances and held themselves out as separate organizations. See, e.g., Ward L. Thomas & Judith E. Kindell, "Affiliations Among Political, Lobbying and Educational Organizations," *Exempt Organizations Technical Instruction Program for FY 2000*, at 255, 257-60 (*Doc 1999-28450 (12 original pages)*; *1999 TNT 169-30*). There are therefore strong legal grounds for asserting that even if an exempt organization parent's officers, directors, or employees make up the entire membership of the board of directors of a taxable subsidiary, and even if the exempt organization controls the day-to-day activities of the taxable subsidiary through overlapping officers or other mechanisms, the subsidiary must be treated as a separate entity for federal tax purposes as long as the appropriate corporate formalities are observed and the finances of the subsidiary are kept separate from those of the parent.

Unrelated Business Taxable Income

The Service's conclusions that various income streams fall within the section 512(b)(1) and section 512(b)(2) exceptions to UBTI for dividends and royalties are helpful, if not surprising, particularly in light of the line of cases concluding that payments for the use of intangibles such as mailing lists were royalties within the meaning of section 512(b)(2). The lack of conclusions with respect to some of the other income streams is disappointing, however. This is not to fault the Service, since presumably *M* intentionally chose not to request rulings with respect to the other income streams.

With respect to the royalty and rental payments from *N* to *M*, those payments undoubtedly fall within the section 512(b)(13) provision that renders those types of payments UBTI, in spite of sections 512(b)(1) and 512(b)(2), given that *M* will apparently own more than 50 percent of *N*'s stock, by voting and value, for at least the immediate future.

What is more troubling, however, is the Service's suggestion that whether the payments by *N* to *M* for the provision of administrative services is UBTI is an open question. Although the Service may have only been making it clear that it was not addressing this issue, many related organizations share such services, on a reimbursement basis, and do not treat the reimbursements as UBTI. For example, many section 501(c)(3) and 501(c)(4) affiliates routinely share the costs for such services because it would be highly inefficient to have, for example, two separate information services departments or two separate accounting departments. The 501(c)(3)/501(c)(4) situation may be different because of the related missions of such affiliates and the constitutional issues that require that administrative burdens associated with a 501(c)(3) organization creating and maintaining a section 501(c)(4) affiliate be minimal, but it is still the model with which many exempt organizations are familiar and so use for their taxable subsidiaries as well. The Service has also appeared to bless this model, at least in the 501(c)(3)/501(c)(4) context. See, e.g., Judith E. Kindell & John Francis Reilly, "Election Year Issues," *Exempt Organizations Technical Instruction Program for FY 2002*, at 335, 368-69 (*Doc 2001-25435 (128 original pages)*; *2001 TNT 193-50*.).

If merely being reimbursed for such services results in UBTI, this issue needs to be clarified as many organizations undoubtedly do not view such reimbursements in this fashion. This is particularly true given that it is probably possible to avoid creating UBTI if the subsidiary pays the employees of the exempt parent directly for the portion of their time used by the subsidiary, with the exempt parent reducing the compensation it pays proportionately, since then the subsidiary would not be making any direct payments to the exempt parent. This solution is awkward, significantly increases the paperwork of both entities, and may cause employee benefit or other employment-related problems, so it would not be advisable absent a clear indication that such reimbursements are in fact UBTI.

If it were not for the need to report all UBTI on Form 990 and Form 990-T, this issue would also be irrelevant. This is because if the administrative services are truly provided at cost, the deductions associated with providing such services will cancel out the income received from the taxable subsidiary for such services. It therefore seems to be a relatively useless exercise to require an exempt parent to report such reimbursements as UBTI, at least when the payments are designed merely to reimburse the parent for its costs and so will not result in any net UBTI that would be subject to tax.

Private Inurement and Private Benefit

The stock and stock option conclusions are certainly reasonable, although again it is helpful to have these conclusions spelled out, albeit in a nonprecedential ruling. The key issue is whether the total compensation paid to each employee, whether at the exempt parent or the taxable subsidiary level, is reasonable. Given the Service's favorable cite to the taxable subsidiary's use of a compensation consultant, it is probably advisable to obtain outside expertise when incorporating such difficult-to-value items in the compensation of employees of either the parent or the subsidiary.

It is also useful to see that the Service was apparently untroubled by the fact that *N* is only paying *M* its costs for office space and administrative services, even though *N* will in the near future be owned in part by private individuals (*N*'s directors, officers, and employees, as well as *M*'s key employees). The Service may simply have assumed that *M*'s costs were essentially equal to the fair market value of the office space and administrative services being provided by *M*, given that those costs were primarily or exclusively determined by *M*'s arm's-length arrangements with third parties, such as *M*'s landlord and employees. If this was the case, and the ruling is not clear on this point, it certainly makes determining the appropriate amounts to pay for such items relatively easy, as opposed to requiring the entities involved to determine the fair market value rate for such items based on market comparables.

The Service may, however, not have commented on this point for the same reason it left some of the UBTI issues unresolved — *M* did not ask for a ruling relating to the appropriateness of these reimbursement arrangements under section 501(c)(3). The Service may also not have commented on this point because the Administrative Services Agreement and the Lease appeared to be temporary arrangements, expected to last only as long as it took for *N* to become sufficiently established to justify renting its own office space and hiring its own administrative staff. Given the uncertainty on this point, probably little weight should be attributed to the lack of a ruling on this point.

Conclusion

As the number and sophistication of exempt organizations grows, it is inevitable that they will adopt more complex corporate structures to manage their tax and liability issues. This ruling is a good step toward providing exempt organizations with a better sense of how best to create subsidiaries while still preserving tax-exempt status and minimizing UBTI. Although it does not answer every question, and appears to use a flawed analysis with respect to the issue of the standard for separate entity treatment although reaching the correct conclusion in this case, it provides a helpful roadmap of the relevant legal issues and shows, in part, how to address them for exempt organizations considering creating taxable subsidiaries.

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IRS Technical Advice

Section 42 — Low-Income Housing Credit

IRS MODIFIES TAM: CONSTRUCTION LOAN COSTS FOR LOW-INCOME HOUSING NOT INCLUDABLE IN BASIS. The Service has released a modification to TAM 200043016, in which it ruled that local impact fees and construction loan costs that a partnership incurred in the construction of a low-income housing building are not includable in eligible basis under section 42(d)(1). (For TAM 200043016, see *The Exempt Organization Tax Review*, December 2000, p. 345; *Doc 2000-27576 (18 original pages)*; or *2000 TNT 210-60*.)

This TAM modifies TAM 200043016 to make it consistent with Rev. Rul. 2002-9, 2002-10 IRB 614, as it applies to the issue of impact fees. (For Rev. Rul. 2002-9, see *Doc 2002-4065 (8 original pages)* or *2002 TNT 33-16*.)

Further, this TAM lifts the suspension on consideration of the impact fee issue in TAM 200203013 where the taxpayer requested, in part, that relief under section 7805(b)(8), as to the issue of impact fees, be extended to it and that TAM 200043016 be applied without retroactive effect. Based on the holding in Rev. Rul. 2002-9 and the modification of TAM 200043016 by this TAM, section 7805(b)(8) is not applicable. (For TAM 200203013, see *Doc 2002-1413 (5 original pages)* or *2002 TNT 14-28*.)