DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: FEB 25 2003

Contact Person:

Identification Number:

Telephone Number:

SIN: 501.03-00
512.01-00

T:EO:B3

Employer Identification Number:

LEGEND:

A =
B =
C =
D =
X =
Y =

Dear Sir or Madam:

We have considered your ruling request dated September 20, 2002, relating to the tax consequences flowing from the reorganization of the ownership structure of a wholly-owned for-profit subsidiary, C, and a limited liability company, D, in which C is a member. B is a religious organization exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code (hereinafter the "Code"). B engages in a variety of activities in furtherance of its religious purposes, including providing spiritual resources for members of its community, providing services to the poor and needy in its local area, and supporting individuals and religious organizations working in other countries. B also produces a religious television show and purchases airtime for that show on television stations in the United States and in other countries.

1. Background

In 1997, a for-profit corporation, A, and its shareholders approached B about purchasing an equity interest in A. A and its shareholders were unrelated to B and to the directors and officers of B. A was the owner of a FCC construction permit for a new commercial television station in B's community. After negotiations, B purchased a minority interest in A in exchange for a cash payment and a commitment to "build out" the station. B also agreed to become the manager of the station. The other shareholders of A retained a majority interest in A and a right to a majority of the net income from the operation of the station.

In order to create a structure under which B would be able to (1) insulate itself from any liability arising from the operations of the station, (2) avoid any threat to its tax-exempt status under section 501(c)(3) of the Code, (3) minimize its possible liability for tax on unrelated business income under section 511, and (4) not engage in a commercial business, B incorporated C to produce programming for the station and others and formed a limited liability company, D, to manage and operate the station. B created two entities because B wanted to engage in production as well as broadcasting activities, but the other shareholders of A did not desire to participate in production activities.

Since 1997, B has made significant capital contributions to C, including B's interest in A. No other persons have made any capital contributions to C. C has in turn made significant capital contributions to D and is currently the 99 percent equity owner and member of D. An individual, X, who is also currently the chief executive officer of B, is the other member and one percent equity owner of D. X received the membership interest in exchange for services contributed to D in 1997, before X became chief executive officer of B. No other persons have made any capital contributions to D. D is classified as a partnership for tax purposes.

D operates the television station, which is on the air. C develops programming for D, B and others. Neither C nor D has made any distributions of income to B, X or any other person, and do not expect to make any such distributions with respect to 2002.

2. Proposed Transaction

B, C and D now propose to reorganize the ownership of C and D. B makes representations as described in this and the next five paragraphs concerning the proposed transaction. C will issue common stock to B in recognition of B's capital contributions to C, effective as of the dates of those capital contributions. C will not issue stock to any other person. C will therefore become a wholly owned subsidiary of B. B, as the sole shareholder of C, will then elect a new Board of Directors for C. The new Board of Directors will have five members: two persons who may be employees, officers and/or directors of B; Y, who has been functioning as the chief executive officer of C and D and who is not an officer, director or employee of B; and two other individuals chosen for their relevant expertise who are also not officers, directors or employees of B. A majority of the Board of Directors of C will therefore not be officers, directors or employees of B. The Board of Directors of C will then formally appoint Y as chief executive officer of C.

X will contribute X's 1 percent membership interest in D to B. B will in turn contribute that membership interest to C. C will therefore become the sole member of D. X states that he has not received any financial benefit from ownership of this membership interest as D has not made any distributions to its members, and X has not claimed any of the losses reported by D on X's personal income tax returns. X will also not claim a charitable contribution deduction for the contribution of the 1 percent membership interest to B. The transfers of the membership interest will occur effective January 2003. C's new board of directors will formally appoint Y as the manager and chief executive officer of D.

C and D will continue to operate as separate entities from B. D will have a single member, C, and D will elect to be a disregarded entity in relations to C for federal income tax purposes under sections 301.7701-2(b), 301.7701-3(a) and 301.7701-3(b)(1) of the Income Tax Regulations ("regulations"). D will not treat itself as a separate entity from C for federal income tax purposes.

C and D will continue to maintain separate facilities, addresses, telephone numbers, telephone listings, operational records, bank accounts and other financial records, stationary and tax filings from B. They will also continue to maintain separate liability and other insurance as needed, and will enter into direct contractual relationships with third parties as needed. Y, or other employees of C or D who are not officers, directors of employees of B, will be in charge of all day-to-day operations of both C and D.

To the degree that C provides programming services to B or D, B and D will pay no more than reasonable compensation for such services. To the degree B purchases broadcasting time from D, B will pay no more than reasonable compensation for such broadcasting time.

B represents that C and D may hire as employees or independent contractors persons who are also employees or independent contractors of B, but no such persons will be in overall charge of the day-to-day operations of C or D or receive more than reasonable compensation for their services to C or D. C and D may also rent studio or office space or obtain administrative services from B, on an as needed basis, with C and D reimbursing B for its costs in providing such space or services.

LAW:

Section 501(c)(3) of the Code provides for exemption from federal income tax of organizations organized and operated "exclusively" for religious and other specified exempt purposes, "no part of the net earnings of which inures to the benefit of any private shareholder or individual," and which does not engage in substantial lobbying activities or proscribed political activities.

Section 1.501(c)(3)-1(c)(1) of the 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 such purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Thus, in construing the meaning of the phrase "exclusively for educational purposes" in Better Business Bureau v. United States, 326 U.S. 279, 283 (1945), 1945 C.B. 375, 376, the Supreme Court of the United States stated, "This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number of importance of truly educational purposes."

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(1) of the Code provides, in part, that all dividends shall be excluded from the computation of unrelated business taxable income.

Section 512(b)(13) of the Code provides special rules for treatment 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.

Section 512(c) of the Code provides that if a trade or business is regularly carried on by a partnership of which an organization is a member, and if the partnership business is unrelated to the exempt purpose of the organization, the organization shall include its allocable share (whether or not distributed) of partnership gross income.

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 513(c) of the Code provides that the term "trade or business" includes any activity that 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, in part, that unless one of the specific exceptions of section 512 or 513 of the Code applies, the gross income of an exempt organization subject to the section 511 tax 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(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. For this relationship to exist, the production or the performance of the service from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends, in each case, upon the facts and circumstances involved.

ANALYSIS:

In general, for federal income tax purposes, a parent corporation and its subsidiary are separate taxable entities so long as the purposes for which the subsidiary is formed are the equivalent of business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943). Where a corporation is an organization 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. See Moline Properties, Inc. at 440. Subsidiary corporations are separate entities from a taxable parent, provided the organizational purpose of the subsidiary is a business purpose. So, the subsidiary cannot avoid being separately taxed. This rationale also applies to the parent. However, where the parent-corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the separate corporate entity of the subsidiary may be disregarded. See generally, National Carbide Corp. v. Commissioner, 336 U.S. 422, 437 (1949) and Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098 (5th Cir. 1973).

The first issue is whether the activities of C and D are attributable to B. If the activities of C and D are attributed to B, its exemption from federal income tax under section 501(c)(3) of the Code may be adversely affected because B maybe considered as not operating exclusively for exempt purposes. As discussed above, attribution occurs where a subsidiary does not have a business purpose and is merely an instrumentality, arm, agent or integral part of the parent.

The information submitted in this case indicates that C and D, for-profit organizations, are formed for a real and substantial business purpose, producing television programs and operating a television station. Thus, the threshold question of whether C and D have a business purpose must be answered affirmatively. The second question is whether B is involved in, or in control of, the day-to-day operations of C or D so that both organizations are merely instrumentalities, agents or arms of B. The information and representations provided indicate that B does not control or is not involved in the day-to-day operations of C or D. For example, a majority of C's Board of Directors will not be officers or directors of B. The chief executive officers of C and D will not be employees or officers of B. They will manage the day-to-day operations of C and D. C and D will also maintain separate facilities, addresses, telephone numbers, telephone listings, operational records, bank accounts and other financial records, stationary, tax filings and insurance from B. To the extent that C or D leases office space from B or receives administrative services from B, C and D will reimburse B for such space and services based on reasonable compensation. Based on the information submitted and representations made, we conclude that the activities of D and C will not be attributed to B, and, therefore, the proposed restructuring will not adversely affect the tax-exempt status of B under section 501(c)(3) of the Code.

The second issue is whether the income earned by C or D is attributed to B. Because C and D are separate entities for federal income tax purposes and their activities are not attributed to B, neither the gross income earned by C nor D is attributed to B.

The third issue is whether the dividends B may receive from C will be excluded from the definition of unrelated business income. In accordance with section 512(b)(1) of the Code, dividends are excluded from computation of unrelated business taxable income. Also, dividend income is not subject to the "controlled organization" rules of section 512(b)(13) of the Code. Hence, the dividends B may receive from C, a controlled organization as defined in section 512(b)(13)(A) and (D) of the Code, will not be subject to the unrelated business income tax.

RULINGS:

1. The proposed restructuring of the ownership of C and D, and the continued operation by D of a commercial television station and the continued programming activities of C under this new ownership structure, will not have an adverse effect on B's tax-exempt status under section 501(c)(3) of the Code.

2. The gross income realized by either C or D will not be treated as unrelated business taxable income to B under section 512(a)(1) of the Code.

3. Dividends that B may receive from C will be excluded under section 512(b)(1) of the Code from the computation of unrelated business taxable income under section 512(a)(1).

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under any provisions of the Code. This ruling is provided only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent

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

Sincerely,

(signed) Robert C Harper, Jr

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3