



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

200405016

Date: NOV 05 2003

Contact Person:

Identification Number:

Telephone Number:

Uniform Issue List #
501.06-00
513.00-00

T. E. O. B. 2

Employer Identification Number:

Legend:

M =

N =

O =

m =

Dear Applicant:

This letter is in reply to the letter from M dated April 30, 2002, in which M requested certain rulings with respect to its establishment and operation of a wholly-owned, for-profit, taxable subsidiary.

M is a trade association recognized by the Internal Revenue Service as exempt from federal income tax under section 501(c)(6) of the Internal Revenue Code. M states that it represents firms in the m trade in a two State area, and that its primary source of income is from membership fees. As a benefit to its members, M provides a weekly bulletin of m projects, insurance services, safety services, labor relations, plan rooms, legislation/lobbying, workforce development, national membership, standard forms/documents, membership roster and buying guide, and public relations.

M states that it maintains Plan Rooms/Service Offices throughout its two State area that includes hundreds of plans and specifications on public and private m projects. To minimize the time and expense incurred by M's members in traveling to M's plan rooms, M contacted N to discuss the offering of plans and specifications via the Internet (the Project). N is a for profit organization that is not connected to M. M realized that the Project could benefit both its members and non-members, and that the subscription fees generated by the Project could result in substantial income for both M and N. M states that because this income would not be related to its trade or business, and thus subject to taxation as unrelated business income, M formed O to serve as the focal point for the majority of the activities related to the Project.

O was incorporated as a for-profit corporation, and M owns all of O's issued and outstanding shares. M initially capitalized O with a certain amount of money, and has advanced

O funds to pay for its initial operating expenses. M states that O will lease office space from M in an amount that reflects the fair market value of the space. O's financial, accounting, and tax records are separately maintained from M.

M states that O's Board of Directors includes M's current president. None of O's other Directors are officers, directors, or employees of M. None of O's officers also serve as M's officers. M states that O will lease its administrative and management employees from M, and that these employees will carry out, among other things, budgeting, human resources, operations, product development, and marketing services for O. O will pay M a fee to lease these employees which will equal a portion of the salaries and related employee costs they receive from M. Among other things, the fee will take into consideration the percentage of time each employee works for O.

N and O entered into a Partnering Agreement, pursuant to which N maintains a website housing content consisting of plans for publicly bid m projects in M's two State area (Internet Plan Room). The Internet Plan Room can be accessed only by subscribers who sign up with N and pay the appropriate site access fees. In addition, N maintains on "on Line Bulletin" advertising certain jobs. Subscription to the Internet Plan Room includes access to the On Line Bulletin. Finally, under the Partnering Agreement, N will develop and maintain a section of its website housing content consisting of privately bid m projects, which can be accessed only by invitation (Private m Office). The organization or entity placing the project for bid would pay N a fee for maintaining its Private m Office. M's members, as well as non-members, can subscribe to any of the Internet services provided by N.

Under the Partnering Agreement, O is responsible for "harvesting" information for the Internet Plan Room and the On Line Bulletin, entering this data into the website software, and coordinating with various entities to ship their plans and specifications for scanning. O also shares responsibility with N for marketing the website and recruiting subscribers. O makes office space available to N's employees who perform marketing and sales functions for the Internet Plan Room and related components of the website. O provides N information related to plans for the Internet Plan Room and On Line Bulletin. O will contract with M to harvest this information because M currently collects similar information for the Plan Rooms/Service Offices it maintains. M will charge O a fee based on the amount it costs M to collect and process this information.

N and O have entered into a revenue sharing relationship whereby N splits with O a portion of N's revenue from the Internet Plan Room and Private m Offices, as well as any revenue generated by N from other products that M helped N develop. The percentage of revenue shared with O may vary based upon a number of factors, including the number of subscribers to the various Internet services, total revenues, and other factors. Once revenue sharing begins, O expects to retain all payments received by N to fund O's continued operations. However, in the future, it is anticipated that revenues will exceed operational expenses, and the excess revenues not required for O's operation could be paid to M, O's sole shareholder, as a dividend. M states that it does not anticipate reducing membership fees as a result of the dividend income, nor does it expect a decrease in other sources of support related to its exempt purposes.

M has requested rulings that (1) the formation and operation of O will not jeopardize M's tax exempt status under section 501(c)(6) of the Code, (2) the earnings of O will not be attributed to M and considered unrelated business income, and (3) the dividend income M receives from O will not be unrelated taxable income subject to the tax imposed under section 511 of the Code.

Section 501(c)(6) of the Code provides for the exemption from federal income tax of business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions and modifications.

Section 512(b)(1) of the Code provides that the modifications referred to in section 512(a)(1) include the exclusion of all dividends.

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 the function constituting the basis of its exemption.

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 causal relationship to the achievement of exempt purposes; and it is "substantially related" only if the causal relationship is a substantial one. The regulation continues that 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.

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 incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That is, where a corporation is organized with the bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. Britt, supra, 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 entity of the subsidiary may be disregarded. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 438 F. 2d 1098, 1106 (5th Cir. 1973).

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The statutes, regulations, and cases cited above make it clear that a determination of whether the formation of a for-profit subsidiary will jeopardize the exempt status of an organization described in section 501(c)(6) of the Code is based on the facts and circumstances of the subsidiary's formation and operations. The activities of a separately incorporated subsidiary ordinarily cannot be attributed to its parent organization unless the facts provide clear and convincing evidence that the subsidiary is in reality an integral part of the parent. The facts in this ruling request, as set forth above, show that O is organized for a bona fide business purpose and is managed by a Board of Directors independent from its parent. Any dividend income M may receive from O is specifically excluded from the definition of unrelated business taxable income pursuant to section 512(b)(2).

Accordingly, based on the facts and circumstances concerning M's proposed establishment and operation of a wholly-owned, for-profit, taxable subsidiary, as stated above, we rule that:

- (1) the formation and operation of O will not jeopardize M's tax exempt status under section 501(c)(6) of the Code,
- (2) the earnings of O will not be attributed to M and will not be considered unrelated business income to M, and
- (3) the dividend income M receives from O will not be unrelated taxable income to M or be subject to the tax imposed under section 511 of the Code.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any such change should be reported to the Tax Exempt and Government Entities (TE/GE) Customer Service office. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records. A copy of this ruling is being forwarded to the TE/GE Customer Service office.

Except as we have specifically ruled herein, we express no opinion as to the consequences of these transactions under the cited provisions or under any other provisions of the Code.

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 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.

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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 yours,

(signed) Terrell M. Berkovsky

Manager, Exempt Organizations
Technical Group