E. FOR-PROFIT SUBSIDIARIES OF TAX-EXEMPT ORGANIZATIONS

1. Introduction

Taxable for-profit subsidiaries of organizations exempt under IRC 501(c) are not a new phenomenon. The formation of such organizations, however, has increased markedly in recent years.

The creation of these subsidiaries is encountered most frequently in those hospital reorganizations where the reorganizing hospital creates a for-profit subsidiary to perform some service. As hospital reorganizations take such a variety of forms, there can be no simple characterization of the various activities that might be conducted by a for-profit subsidiary created pursuant to this kind of reorganization. There is, however, another, more easily described, field in which for-profit subsidiaries have proliferated. IRC 501(c)(3) organizations that engage in research (colleges and universities, as well as research laboratories and various other types of scientific organizations) are establishing nonexempt corporations to conduct research leading to the development of commercially marketable products. This is a developing area because the pace of discovery, particularly in the life sciences, is increasing dramatically, and both academic and scientific organizations have the expertise to quicken the transition from research to commercial application.

The purpose of this topic is to discuss whether the activities of a taxable subsidiary will jeopardize its parent organization's exempt status and, if not, under what circumstances income that a parent receives from such a subsidiary will be considered unrelated business taxable income.

2. Whether the Activities of a Taxable Subsidiary Will Jeopardize Exempt Status

A. Principles

A parent's exempt status may be jeopardized if the commercial activities of its subsidiary can be considered to be, in fact, activities of the parent. However, where the subsidiary is incorporated (as is virtually always the case with taxable subsidiaries), there is a significant legal barrier to overcome before the commercial activities of a subsidiary may be attributed to its parent.

The barrier arises because, 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, 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 entity of the subsidiary may be disregarded. (See IRC 482; see also 1 W. Fletcher, Cyclopedia of the Law of Private Corporations Section 43.10 (Perm. Ed. 1983).)

B. Application of Principles

Whether the activities of a separately incorporated taxable subsidiary may be attributed to its parent is, therefore, a question of evidence. Basically, once it is established that a taxable subsidiary was formed for a valid business purpose, the activities of such a subsidiary cannot be attributed to its parent unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent, or integral part of the parent. This presents a considerable evidentiary burden that is not easily overcome.

Clear and convincing evidence of the subsidiary's lack of separate existence could be produced, however, in situations where the parent is involved in the day-to-day management of the subsidiary, where the subsidiary's Board of Directors has no independence of action, or where transactions between the two entities are conducted on a basis that is otherwise than at arm's length. (Transactions between parent and subsidiary should be scrutinized carefully from another point of view: the possibility of inurement always exists, and a parent-subsidiary relationship cannot function as a shield against the assertion of inurement.)

3. Under What Circumstances Will Income Received by a Tax-Exempt Parent from a Taxable Subsidiary Be Considered Unrelated Business Taxable Income?

A. Introduction

Formation of a taxable subsidiary is advantageous to an exempt parent from several points of view. As we have discussed, if the subsidiary is indeed a separate entity, its activities cannot be attributed to its parent. Thus, tax-exempt status (and, in certain cases, public charity status) that might be otherwise jeopardized by for-profit activities would remain unaffected.

But what about income the exempt parent receives from the taxable subsidiary? The general rule, of course, is that income from a trade or business that is regularly carried on and unrelated to an organization's exempt functions will avoid taxation only if it falls within one of the specific exclusions of IRC 512(b), IRC 513(a)(1)-(3), or 513(e), (f) and (g). (See Reg 1.513-1(a).) The issue most frequently encountered in the exempt parent-taxable subsidiary situation is whether an item will be excluded from taxation under IRC 512(b). Most items of income that a tax-exempt parent receives from its taxable subsidiary (or in connection with its ownership of that subsidiary), are excluded from treatment as unrelated business taxable income by IRC 512(b)(1), (b)(2), (b)(3), or (b)(5). However, most items of income mentioned in IRC 512(b)(1), and all items of income mentioned in IRC 512(b)(2) and (b)(3), would nevertheless be taxable if the provisions of IRC 512(b)(13) apply. (IRC 512(b)(13) is concerned with income from controlled organizations.) Furthermore, if the property involved is debt-financed, all items of income mentioned in IRC 512(b)(1), (b)(2), (b)(3), and (b)(5) would be taxable (to the extent the property is debt-financed), because of the overriding provisions of IRC 514. Examples of items of income mentioned in IRC 512(b)(1), (b)(2), (b)(3), or (b)(5) that a tax-exempt parent might receive from (or due to its ownership of) a taxable subsidiary are as follows:

1. A tax-exempt parent might (and in most cases does) receive dividends from a taxable subsidiary. Dividends are mentioned in IRC 512(b)(1).

2. In a less common situation, a tax-exempt parent might receive interest income from its taxable subsidiary if, for example, it extended credit to the subsidiary or concluded a sale to the subsidiary on an installment basis. Interest is also mentioned in IRC 512(b)(1).

3. A tax-exempt parent might license a patent to its taxable subsidiary in consideration of a royalty. Royalties are mentioned in IRC 512(b)(2).

4. A tax-exempt parent might lease realty to its taxable subsidiary. Rents from real property are mentioned in IRC 512(b)(3). (Rents from personal property come within the

ambit of IRC 512(b)(3) only if (1) the personal property is leased with the real property and (2) the rents received from the personal property are only an incidental part of the total rents received from both the real and personal property.)

5. A tax-exempt parent might receive a gain from the sale of stock it owns in a taxable subsidiary or it might sell property to the subsidiary. Gains or losses from the disposition of any property are excluded from treatment as unrelated business taxable income under IRC 512(b)(5) except for property that is held primarily for sale to customers in the ordinary course of business or property that is stock in trade or inventory. (The terms "ordinary course of business," "stock in trade," and "inventory" have well developed meanings from usage in other parts of the IRC. A discussion of these terms is beyond the scope of this topic.)

Whether, in particular situations, the provisions of IRC 512(b)(13) or IRC 514 will be applicable so that "excluded" items of income ultimately will be treated as unrelated business taxable income will now be discussed.

B. The Overriding Provisions of IRC 512(b)(13)

(1) IRC 512(b)(13) in a Nutshell

Under IRC 512(b)(13), the exclusion of interest, annuities (a rare occurrence in the tax-exempt parent-taxable subsidiary situation), royalties, and rents provided by IRC 512(b)(1), (b)(2), and (b)(3) do not apply where such amounts are derived from controlled organizations (whether or not the activities from which such amounts are derived represent a trade or business or are regularly carried on). Therefore, where a tax-exempt organization has control of an organization, the interest, annuities, royalties, and rents received by it are taxable to the controlling organization at a specific ratio depending on whether it is income from exempt or nonexempt functions. All deductions directly connected with amounts included in an organization's gross income are allowed.

This general description raises three questions. What is the meaning of control? Why are dividends (the most common form of income a tax-exempt parent would derive from a taxable subsidiary) not mentioned in IRC 512(b)(13)?

What is the method for determining the amounts of interest, annuities, royalties, and rents received from a nonexempt controlled organization that are includible in the controlling organization's unrelated business taxable income? The following subsections of this topic will address these questions.

(2) What is the Meaning of "Control"?

The organization from whom the interest, annuities, royalties, and rents are received is called the "controlled organization" and the exempt organization receiving the amounts is called the "controlling organization." The term "control" is defined in IRC 368(c). Where the controlled organization is a stock corporation (the typical formation of a taxable subsidiary by a tax-exempt parent involves a transfer of assets in return for stock), "control" means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares in all other classes of stock of the corporation. Control of a nonstock corporation means at least 80 percent of the directors or trustees of such organization are either representatives of, or directly or indirectly controlled by, the controlling organization. If control is gained or lost during the taxable year, amounts of interest, annuities, royalties, and rents are included in the controlling organization's unrelated business taxable income only for that portion of the taxable year in which it has control. (See Reg. 1.512(b)-1(1)(4).)

In most situations, tax-exempt parents will wholly own taxable subsidiaries, a fact that will trigger the applicability of IRC 512(b)(13). Control may be lost, however (if, for example, the tax-exempt parent brings in an outside investor). There may be, moreover, situations in which "control" is unclear. As noted above, "control" is defined in IRC 368(c), a section that is not ordinarily interpreted by Exempt Organizations specialists. It is known, however, that in J.E. and L.E. Mabee Foundation v. United States, 533 F.2d 521 (10th Cir. 1976), the court recognized that mere "mechanical formality" would not be sufficient to avoid taxation under IRC 512(b)(13). In that case, the Court found that the exempt organization had structured transactions so that it received payments from the third parties who would normally have paid the controlled organization. The income received from the third parties was treated as being derived from the controlled subsidiary and held to be unrelated business taxable income of the controlling organization under IRC 512(b)(13). This principle was also invoked in G.C.M. 38878, July 16, 1982, to conclude that IRC 512(b)(13) was sufficiently broad in scope to cover a situation where wholly-owned subsidiaries transact business among themselves and not directly with the parent organization, so that the parent might have to include, as an item of its own gross income, rental payments received by its tax-exempt subsidiary from its for-profit subsidiary. It is not known, however, how this principle would be applied in determining "control" under IRC 368(c) for purposes of IRC 512(b)(13) in a situation where, for example, a tax-exempt parent owned less than 80 percent of stock of an organization, if only its shares were counted, but would own more than 80 percent if shares of related organizations were included. Where such a situation exists, and the applicability of IRC 512(b)(13) is at issue, the case should be forwarded to the National Office for resolution.

(3) Why Dividends Are Not Mentioned in IRC 512(b)(13)

Congress amended IRC 512(b)(13) (formerly IRC 512(b)(15)) in the Tax Reform Act of 1969 (Pub. L. 91-172). The House Report (H.R. Rep. No. 91-413, Part 1, 91st Cong., 1st Sess. 49 (1969), 1969-3 C.B. 232), indicates that the amendment was designed to eliminate a potential loophole in the unrelated business income tax by preventing the following type of abuse:

> In certain cases exempt organizations do not engage in business directly but do so through nominally taxable subsidiary corporations. In many such instances the subsidiary corporations pay interest, rents, or royalties to the exempt parent in sufficient amount to eliminate their entire income, which interest, rents, and royalties are not taxed to the parent even though they may be derived from an active business.
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> This problem is remedied under the bill by removing the exemption from the unrelated business tax for passive income if it is in the form of interest, rents, and royalties received from controlled corporations.

Specifically, as to "rent" payments by subsidiary organizations, the Senate Report (S. Rep. 91-552, 91st Cong., 1st Sess. 73 (1969), 1969-3 C.B. 471), states:

> Some exempt organizations "rent" their physical plant to a wholly owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enables a taxable corporation to escape nearly all of its income taxes because of the large "rent" deduction. While courts have occasionally disallowed some, or

all, of the rent deductions, the issue is a difficult one for the Internal Revenue Service.

Congress, therefore, sought to prevent subsidiary organizations that rent real property from their tax-exempt parent organization from artificially lowering their income taxes by offsetting their income with large purported "rent" deductions. By manipulating its corporate structure, a tax-exempt organization could transform what would otherwise be unrelated business taxable income into nontaxable income. In effect, IRC 512(b)(13) overruled decisions in cases like United States v. Robert A. Welch Foundation, 334 F.2d 774 (5th Cir. 1964) and Amon Carter Foundation v. United States, 58-1 U.S.T.C. Par. 9342 (N.D. Tex. 1958), in which otherwise taxable "working interests" in oil and gas leases were "spun-off" in return for nontaxable royalties (G.C.M. 38878, supra).

Since a dividend is, in short, a distribution to shareholders out of a corporation's current or accumulated after-tax earnings and profits (see IRC 316 and Reg. 1.316-1(a)(1) for the complete definition), dividends are not susceptible to manipulation in the same manner as rents and royalties. Accordingly, dividends are not mentioned in IRC 512(b)(13). (The same reasoning explains the omission of the gains described in IRC 512(b)(5) from IRC 512(b)(13).)

It may be important for purposes of IRC 512(b)(13) to determine whether income received by the controlling organization is properly classified as dividend (nontaxable) or interest (taxable) income, which will require a determination under IRC 385 as to whether an interest in a corporation is to be treated as stock or indebtedness. Private Letter Ruling 8414001 involves such a determination.

(4) Method for Determining the Amounts of Interest, Annuities, Royalties, and Rents Received from a Nonexempt Controlled Organization That Are Includible in a Controlling Organization's Unrelated Business Taxable Income. (Reg. 1.512(b)-(1)(1)(3))

If a nonexempt controlled organization is present, any interest, annuities, and royalties paid to the controlling exempt organization is taxed as income from an unrelated business basically according to the percentage of the income as if the controlled organization were exempt. This is accomplished by multiplying a fraction times the pertinent income item. "Excess taxable income" is used in the numerator of the fraction. (See Reg. 1.512(b)-1(1)(3)(i).) "Excess taxable income" is that portion of the controlled organization's taxable income that would constitute unrelated business taxable income, all determined as if the income of the controlled organization were directly derived by the controlling organization. (See Reg. 1.512(b)-(1)(1)(3)(ii).) The denominator consists of the greater of taxable income of the controlled organization or excess taxable income. Both amounts are determined without regard to amounts paid to the controlling organization.

Reg. 1.512(b)-1(1)(3)(iii) illustrates the computation with the following examples:

> Example (1). A, an exempt university described in section 501(c)(3), owns all the stock of M, a nonexempt organization. During 1971, M leases a factory and a dormitory from A for a total annual rent of $100,000. During the taxable year, M has $500,000 of taxable income, disregarding the rent paid to A:
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> $350,000 from the operation of a factory which is a business unrelated to A's exempt purpose. A's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. Under these circumstances, $56,000 of the rent paid by M will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

M's taxable income (disregarding rent paid to A)	$ 500,000
Less taxable income from dormitory	150,000
Excess taxable income	350,000
Ratio ($ 350,000/$ 500,000)	7/10
Total rent paid to A	$ 100,000
Total deductions ($ 4,000 + $ 16,000)	20,000
Rental income treated as gross income from an unrelated trade or business (7/10 of $ 100,000)	$ 70,000
Less deductions directly connected with such income (7/10 of $ 20,000)	14,000
Net rental income included by A in computing its unrelated business taxable income	$ 56,000

> Example (2). Assume the facts as stated in example (1), except that M's taxable income (disregarding rent paid to A) is $300,000 consisting of $350,000 from the operation of the factory and a $50,000 loss from the operation of the dormitory. Thus, M's "excess taxable income" is also $300,000 since none of M's taxable income would be excluded from the computation of A's unrelated business taxable income if received directly by A. The ratio of M's "excess taxable income" to its taxable income is therefore one ($300,000/$300,000). Thus, all the rent received by A from M ($100,000), and all the deductions directly connected therewith ($20,000), are included in the computation of A's unrelated business taxable income.

The above computations might not be the final measure of liability, however, if IRC 514 is involved. This matter will be discussed below.

C. The Overriding Provisions of IRC 514

By virtue of IRC 512(b)(4), IRC 514 taxes income described in IRC 512(b)(1), (b)(2), (b)(3), and (b)(5) but only to the extent that the income is debt-financed. (IRC 514 is the subject of a separate topic in this year's CPE; accordingly, the present discussion will be limited to its effect in a parent-subsidiary relationship.) IRC 514's reach is potentially broader than IRC 512(b)(13), as it affects dividend income and income described in IRC 512(b)(5). Also, a computation under IRC 514 may produce liability additional to liability under IRC 512(b)(13) in a situation where both subsections apply. This is illustrated by the following example (Example 3), Reg 1.514(b)-1(b)(3):

> Example (3). (a) Z, an exempt university, owns all the stock of M, a nonexempt corporation. During 1971, M leases from Z a university factory unrelated to Z's exempt purpose and a dormitory for the students of Z, for a total annual rent of $100,000: $80,000 for the factory and $20,000 for the dormitory. During 1971, M has $500,000 of taxable income, disregarding the rent paid to Z: $150,000 from the dormitory and $350,000 from the factory. The factory is subject to a mortgage of $150,000. Its average adjusted basis for 1971 is determined to be $300,000. Z's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. In accordance with subdivision (ii) of this subparagraph, IRC 514 applies only to that portion of the rent which is excluded from the computation of unrelated business taxable income by operation of IRC 512(b)(3) and not included in such computation pursuant to IRC 512(b)(13). Since all the rent received by Z is derived from real property, IRC

512(b)(3) would exclude all such rent from computation of Z's unrelated business taxable income. However, 70 percent of the rent paid to Z with respect to the factory and 70 percent of the deductions directly connected with such rent shall be taken into account by Z in determining its unrelated business taxable income pursuant to IRC 512(b)(13), computed as follows:

M's taxable income (disregarding rent paid to Z)	$ 500,000
Less taxable income from dormitory	150,000
Excess taxable income	$ 350,000
Ratio ($ 350,000/$ 500,000)	7/10
Total rent paid to Z	$ 100,000
Total deductions ($ 4,000 + $ 16,000)	20,000
Rental income treated under section 512(b)(13) as gross income from an unrelated trade or business (7/10 of $ 100,000)	$ 70,000
Less deductions directly connected with such income (7/10 of $ 20,000)	$ 14,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 512(b)(13)	$ 56,000

(b) Since only that portion of the rent derived from the factory and the deductions directly connected with such rent not taken into account pursuant to section 512(b)(13) may be included in computing unrelated business taxable income by operation of IRC 514, only $10,000 ($80,000 minus $70,000) of rent and $2,000 ($16,000 minus $14,000) of deductions are taken into account. The portion of such amounts to be taken into account is determined by multiplying the $10,000 of income and $2,000 of deductions by the debt/basis percentage. The debt/basis percentage is the ratio which the average acquisition indebtedness ($150,000) is of the average adjusted basis of the property ($300,000). Thus, the debt/basis percentage for 1971 is 50 percent (the ratio of $150,000 to $300,000). Under these circumstances, Z shall include net rental income of $4,000 on its unrelated business taxable income for 1971, computed as follows:

Total rents	$ 10,000
Deductions directly connected with such rents	2,000
Debt/basis percentage ($ 150,000/$ 300,000)	50 percent
Rental income treated as gross income from an unrelated trade or business (50% of $ 10,000)	$ 5,000
Less the allowable portion of deductions directly connected with such income (50% of $ 2,000)	$ 1,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 514	$ 4,000

In a situation where both IRC 512(b)(13) and IRC 514 apply, IRC 512(b)(13) must be considered first, because IRC 514(b)(1)(B) makes IRC 514 inapplicable to income taxed under any other provision of IRC 511-514. Thus IRC 514 comes into play only in a situation where an organization is otherwise not liable for tax, or its tax liability would be increased by the application of IRC 514.