



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

200425050

Date: MAR 24 2004

513.04.00

Contact Person:

ID Number:

Telephone Number:

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Employer Identification Number:

Legend:

M =

N =

Dear Applicant:

This is in response to M's letter dated July 25, 2003, requesting the following rulings:

1. Whether the formation of N by M, the activities of N and M's continued relationship with N will not have an adverse impact on N's tax-exempt status under section 501(c)(3) of the Code.
2. Whether M's ownership of all the capital stock of N will not cause the revocation of and will not jeopardize nor affect M's recognition of exemption from federal income tax under section 501(c)(3) of the Code.
3. Whether the transfer of the ownership rights in the software and the reimbursement of the cost of employees, supplies, etc. will result in unrelated business taxable income to M under sections 511 through 513 of the Code.
4. Whether the stock dividends to be declared and paid by N to M will jeopardize the tax exempt status of M under section 501(c)(3) of the Code or result in unrelated business income under section 512(b)(1) and 512(b)(13) of the Code.

M is recognized as exempt from federal income tax under section 501(c)(3) of the Code and is a publicly supported charity. M's purpose is to improve the quality of life of the elderly by operating a multi-service geriatric center. M receives substantial funding from the Department of Health and Human Services, Department for the Aging. M is required to track the many services that it provides to the elderly and make reports to its funding sources. M's computer department has developed software for this purpose.

M is now planning to market this software through a for-profit subsidiary, N. N will issue all of its capital stock in exchange for M's transfer of all of its rights, title and interest in the software and technology. No additional stock will be issued. M will own 100% of N. M will select the initial Directors of N. Only one member out of the initial five members of N will be a Director or

employee of M. Once the software is sold to a third party and it becomes financial feasible, some employees will be transferred from M to N into separate office space that is controlled by N.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations that are organized and operated exclusively for charitable and educational purposes, no part of the net earnings of which inures to the benefit of any individual.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations provides that in order to be exempt as an organization described in section 501(c)(3) of the Code, the organization must be one that is both organized and operated exclusively for one or more of the purposes specified in that section. An organization that fails to meet either the organizational or the operational test is not exempt.

Section 1.501(c)(3)-1(c) of the regulations provides that an organization will not be regarded as "operated exclusively" for one or more exempt purposes if more than an insubstantial part of its activities is not in furtherance of a purpose described in section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet these requirements, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations states that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. Such terms includes: relief of the poor and distressed or the underprivileged; advancement of religion; advancement of education or science; erection or of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and to combat community deterioration and juvenile delinquency; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

Section 1.501(c)(3) -1(e)(1) of the regulations provides that an organization may meet the requirements of section 501(c)(3) of the Code although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size of the trade or business which are in furtherance of one or more exempt purposes.

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

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Section 512(a)(1) of the Code provides that the term unrelated business taxable income means gross income derived by an organization from any unrelated trade or business regularly carried on by it less certain deductions and modifications.

Section 512(b)(1) of the Code provides that dividends are excluded from the unrelated business taxable income.

Section 512(b)(13) of the Code provides for special rules for controlled entities for amounts that would not be included in unrelated business taxable income by operation of section 512(a)(1), or which are excluded by operation of section 512(b)(1), (2), or (3), nevertheless may be included in unrelated business taxable income under section 512(b)(13).

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 its charitable educational, or other purpose or function forming the basis for its exemption under section 501.

The information submitted shows that M will be creating a separate for-profit organization, N, to market software to other organizations. The software was developed by M. N will be funded by selling stock to M. M will own _____ of the stock of N. Any dividends that are declared by N will be paid only to M. N will be operated as a separate entity with separate facilities and employees. Initially, there will only be one common Board of Director between M and N. Once the software is sold to a third party and it becomes financial feasible, some employees will be transferred from M to N into separate office space that is controlled by N. These above activities are related to separating the software from M to N and are incidental to M's exempt purposes. All the income from the sale of the software will be received by M's controlled for-profit organization, N. N will be paying tax on this income and will not be receiving any special deduction of income from M to avoid paying tax on this income.

Accordingly, we rule as follows:

1. The formation of N by M, the activities of N and M's continued relationship with N will not have an adverse impact on N's tax-exempt status under section 501(c)(3) of the Code.
2. M's ownership of all the capital stock of N will not cause the revocation of and will not jeopardize nor affect M's recognition of exemption from federal income tax under section 501(c)(3) of the Code.
3. The transfer of the ownership rights in the software and the reimbursement of the cost of employees, supplies, etc. will not result in unrelated business taxable income to M under sections 511 through 513 of the Code.
4. The stock dividends to be declared and paid by N to M will not jeopardize the tax exempt status of M under section 501(c)(3) of the Code or result in unrelated business income under section 512(b)(1) and 512(b)(13) of the Code.

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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.

We are informing the EP/EO key district office of this ruling. Because this letter could help resolve any questions about M's exempt status, M should keep it in its permanent records.

If there are any questions about reporting requirements or about excise, employment, or other federal taxes, please contact the EP/EO Customer Service office at (a toll free number) or send correspondence to the following address: Internal Revenue Service, EP/EO Customer Service, P.O. Box 2508, here are any immediate questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

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Michael Seto
Acting Manager, Exempt Organizations
Technical Branch 2