



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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LEGEND:

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Dear

This is in response to the request for rulings on the consequences of a re-organization involving three corporations. The transactions are described in detail below.

Q was incorporated to construct, own and operate a senior living community. The Internal Revenue Service (IRS) issued a ruling letter recognizing it as exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code (the Code). Q has continued to own and operate the senior living center consisting of independent living units, assisted living units, and a skilled nursing facility. Q's business is managed by a thirteen-member board of directors, all of whom are volunteer community leaders.

The apartments that comprise the independent living section are located in two apartment buildings connected to a central building that houses various common areas including a living room, dining room, kitchen, lounges, recreation rooms, and administrative offices. The assisted living portion consists of apartments and associated special common areas in a separate building, also connected to the central building. The nursing home facility contains intermediate and skilled nursing beds, and

its own common areas.

Altogether, this facility provides for the varying levels of care that elderly residents may need. It addresses the physical, social, psychological and emotional needs of the elderly, and includes many features such as lever hardware, emergency call response systems (monitored 24 hours per day), special bathing facilities, and front control appliances that accommodate the physical limitations of the elderly. The buildings meet the building codes of the Americans with Disabilities Act, and the health and life safety codes of the state.

The health needs of the residents of the independent living units are addressed in a number of ways. The residency agreement contains a contractual obligation to provide life care services if necessary. The facility also conducts a number of wellness and preventive health maintenance programs. Its residents have access to transportation services for medical appointments, on site vaccination clinics, and accommodations for special diets. Extensive support from the nursing facility and staff is available to independent living residents who need it temporarily.

A recent market study conducted by an independent consultant shows that Q's independent living facility (an expansion of which was under consideration) is affordable to 62% of the households with residents age 75 or over in its primary market area. The residency agreement contains a commitment to maintaining in residence those who become unable to pay, to the extent financially feasible.

Applications are considered without regard to marital status, race, sex, creed, or national origin.

Over the past few years, Q states that it has encountered increasing difficulty in procuring professional liability insurance and umbrella insurance in suitable amounts at a reasonable cost. Insurance carriers have refused to submit separate quotes for different types of coverage to multiple facilities operated by a single corporation. Q states that from a regulatory compliance perspective, it makes sense to separate the assisted living and nursing home operations, which are regulated by state and federal authorities and thus operate in a very different business environment from the independent living portion, which is not regulated by the state. Furthermore, reorganization could allow flexibility for new business ventures such as a new senior living center or a drop-in senior day care center. Such new ventures could be pursued without creating risk for the existing facilities.

Therefore, Q decided to reorganize its corporate structure into three affiliated corporations. A new nonprofit corporation, P, has been organized to act as the parent, and sole member of both the original entity, Q, and another new exempt organization, R, which will operate the assisted living and nursing home facilities. The two new

organizations have been recognized as exempt under section 501(c)(3) of the Code. The board of directors of Q will also be elected and will serve as the directors of all three organizations. The Bylaws of the three affiliated corporations authorize joint meetings, but require that actions taken in the name of each corporation be done separately and reflected in the separate minutes maintained for each corporation. R will lease the facility (real and personal property and equipment) from Q. Q will also provide administrative services under contract to R.

The three organizations have requested the following rulings regarding the reorganization:

1. Q will continue to be recognized as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3), and not a private foundation under section 509(a)(2).
2. R will continue to be recognized as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3), and not a private foundation by reason of being an organization whose principal source of financial support will be payments for exempt services as described in section 509(a)(2).
3. P will continue to be recognized as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3), and not a private foundation by reason of being a supporting organization described in section 509(a)(3).
4. Transfers of payments from Q to either P (to provide initial capitalization, organizational expenses, and allocated operational expenses) or to R (upon implementation of the reorganization) will constitute "unusual grants" within the meaning of sections 1.509(a)-3(c)(3) and (4) of the regulations. Therefore, the transfers shall be excluded for the purposes of applying the support tests described in section 509(a)(2) of the Code to R, insofar as applicable.
5. Q's provision of management, administrative, and support services to R, substantially at cost, will not constitute unrelated trade or business and compensation for it will not constitute unrelated business taxable income to Q.
6. Rental payments under the lease of facilities and equipment to R will not constitute unrelated business taxable income to Q under section 512 of the Code or be treated as income from "debt-financed property" taxable as unrelated business taxable income to Q under section 514.
7. All three corporations will continue to qualify as organizations described in

sections 501(c)(3) and 509(a) of the Code, to which contributions are deductible as provided in section 170.

Section 501(c)(3) of the Code recognizes as exempt from federal income tax entities that are organized and operated exclusively for charitable purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual.

Section 509(a) of the Code defines private foundation as an organization described in section 501(c)(3), other than organizations that demonstrate public support in specific ways.

Section 509(a)(2) of the Code excludes from the definition of private foundation organizations that normally receive more than one-third of their support from any combination of (i) gifts, grants, contributions and membership fees; (ii) gross receipts from admissions, sales, performance of services, or furnishing of facilities; and normally receives not more than one-third of its support in each taxable year from gross investment income and unrelated business income.

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

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived from any unrelated trade or business which it carries on regularly.

Section 512(b)(3) of the Code excludes from unrelated business taxable income rents from real property.

Section 513 of the Code defines the term "unrelated trade or business" as one that is not substantially related to the exercise or performance by an organization of its charitable purpose or function constituting the basis for its exemption.

Section 514(a)(1) of the Code requires that with respect to each debt-financed property, a proportion of the income derived from an unrelated trade or business be included in gross income.

Section 514(b)(1)(A)(i) of the Code excludes from the term "debt-financed property," the income from which must otherwise be included in gross income, property that is substantially related to the exercise or performance of the organization's charitable function.

Section 1.170A-9(e)(6)(ii) of the Income Tax Regulations permits the exclusion of "unusual grants" from the analysis of support to determine whether an organization is

publicly supported. No single factor is determinative, but the Service may consider factors similar to those listed in section 1.509(a)-3(c)(4). Among those listed as favorable factors are grants that are: in the form of assets which further the exempt purpose of the organization, whether the organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution, and whether the organization has a representative governing body.

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 one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized and operated exclusively for exempt purposes unless it serves a public rather than a private interest.

Section 1.501(c)(3)-1(e)(1) of the regulations states that an organization exempt under section 501(c)(3) of the Code may operate 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 purposes. Exemption will be denied to an organization that is organized or operated for the primary purpose of carrying on an unrelated trade or business.

Section 1.502-1(b) of the regulations explains that a subsidiary of a tax-exempt organization that provides a service to the exempt organization will not lose its exemption because, as a matter of accounting between the two, the subsidiary derives a profit. However, the subsidiary must not have a primary purpose of carrying on a trade or business that would be an unrelated business if regularly carried on by the parent. An example distinguishes between an organization that furnishes electric power for a parent university, and furnishing electric power for several unrelated organizations.

Section 1.509(a)-3(c)(3) of the regulations define "unusual grants" that may be excluded from the support calculation as those that are (i) attracted by the publicly supported nature of the organization, (ii) are unusual or unexpected and, (iii) would by reason of their size adversely affect the status of the organization as normally meeting the one-third support test for any of the applicable periods described in sections 1.509(a)-3(c), (d), or (e).

Section 1.509(a)-3(c)(4) of the regulations provides that in determining whether a particular contribution may be excluded, all pertinent facts and circumstances will be taken into account including:(a) whether the contribution was made by a disqualified

person, (b) whether the contribution was in the form of cash or assets which further the exempt purposes of the organization, and (c) whether the organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution.

Section 1.509(a)-4(h) of the regulations describes a supporting organization that derives its exempt status from being "supervised or controlled in connection with" a publicly supported organization. The control or management of the two organizations must be vested in the same persons.

Section 1.513-1(d)(2) of the regulations state that a trade or business is related to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes, and it is substantially related for the purpose of section 513 only if the causal relationship is a substantial one. Thus, for the conduct of a 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.

Section 1.513-1(d)(4) provides that gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of an unrelated trade or business.

Revenue Ruling 72-124, 1972-1 C. B. 145 finds that operating a home for the elderly can be an exempt purpose if it meets the needs of the elderly for housing, health care, and financial security.

Revenue Ruling 79-18, 1979-1 C. B. 194 elaborates on the provision of financial security by a retirement home. It found that it was sufficient to meet the definition of charitable that a retirement home have a policy to maintain in residence those who can no longer afford to pay the full price and that the retirement home be reasonably available to a significant portion of the elderly in the community.

Revenue Ruling 81-19, 1981-1 C.B. 353 concerns an organization formed to support and assist a particular university by receiving contributions, providing financial management to the academic departments, and managing vending machines. The university may operate vending facilities for the convenience of its students and faculty. Thus operating the vending facilities is part of the educational program, and the organization was fulfilling its exempt purpose of furthering the university's educational program by performing for it various administrative functions including operating the vending machines. The Rev. Rul. pointed out that if the organization provided convenience items to another organization, income would be subject to unrelated

business income tax. However, performing the tasks for an affiliated entity is "substantially related" to the organization's exempt purpose.

In *BSW Group v. Commissioner*, 70 TC 352 (1978), the Court found that a corporation formed to provide consulting services was not exempt under section 501(c)(3) of the Code because its activities constituted the conduct of a trade or business that is ordinarily carried on by commercial ventures organized for profit. Its primary purpose was not charitable, educational, nor scientific, but rather commercial.

The Court explained that the corporation had completely failed to demonstrate that its services were not in competition with commercial businesses. Also, the organization's financing did not resemble that of the typical organization described in section 501(c)(3) of the Code. It had not solicited, nor had it received, voluntary contributions from the public. Its only source of income was from fees from services, and those fees were set high enough to recoup all projected costs, and to produce a profit. Moreover, it did not appear that the corporation ever planned to charge a fee less than "cost." And finally, the corporation had failed to limit its clientele to organizations that were section 501(c)(3) exempt organizations.

Issue 1: Q, the independent living home for the elderly, will continue to be recognized as an organization described in section 501(c)(3) of the Code because it meets the requirements of providing charitable housing for the elderly. Rev. Rul. 72-124 (*supra*) establishes the Service position that the elderly comprise a separate charitable class. Therefore, housing for the elderly may be a charitable purpose, even if the residents are not in financial distress. Charitable housing for the elderly must accommodate the special physical needs of the elderly, and provide healthcare and financial security. Q has described a number of physical features designed to support and assist its elderly residents. These include adaptations in the living units such as grab bars, emergency call buttons, and more convenient locations for appliances. It has also integrated social, recreational, and physical support and activities within its facility.

To meet the health care concerns of the residents, Q provides a number of preventive and supportive programs such as 24 hour emergency access to the nurses, transportation to medical appointments, on-site wellness programs and access to the nursing facility for temporary conditions.

Q has demonstrated that its facility is reasonably available to a significant portion of the elderly in the community from which most of its residents move. Q also has a policy of maintaining in residence people who lose the ability to pay the required fees, to the best of its ability. Together these facts demonstrate that Q provides a level of financial security to the elderly, as required by Rev. Rul. 79-18, *supra*.

Q's primary activity of operating a housing facility for the elderly is closely related to its exempt purpose. Section 1.501(c)(3)-1(e)(1) of the regulations says that an exempt organization may operate a business as a substantial part of its operations, so long as it is in furtherance of the exempt purpose of the organization.

Issue 2: The newly organized assisted living and nursing care entity, R, is recognized as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3) and is not a private foundation by reason of being a home for the elderly and an organization whose principal source of financial support will be payments for exempt services provided as described in section 509(a)(2). In addition to being elderly, the residents of this facility will all have some health problems, and thus also be regarded as a charitable class because of their physical distress.

Both facilities expect to earn more than the required 33% of their total support from fees and performance of services for related activities, and to receive less than 33% of their total support from investment income and unrelated businesses.

Issue 3: The newly organized parent corporation, P, is recognized as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3) and is not a private foundation by reason of being a supporting organization described in section 509(a)(3). Its governing documents restrict its purposes to benefiting two specified supported organizations and other such affiliated organizations addressing the housing, healthcare, psychological or social needs of senior citizens. P's activities consist of providing educational programs and other charitable activities to Q and R, as well as administrative, management, financial, advisory and other services. It will be operated solely as a supporting organization by making payments to and providing services to the supported organizations.

P is "supervised or controlled in connection with" Q and R, as described by section 1.509(a)-(4)(h) of the regulations. The relationship described in this subsection is characterized by common supervision and control between the controlled and controlling organizations. The governing instruments of Q and R provide that the members of their boards will be identical to the board of P. This meets the requirement that the management of the supporting organization be vested in the same persons that perform the function for the supported organizations. The supporting organization will be responsive to the needs of the publicly supported organizations and will clearly maintain a significant involvement in their operations.

Finally, P is not controlled, directly or indirectly, by disqualified persons.

Issue 4: Transfers of payments from Q to either P (to provide initial

capitalization, organizational expenses, and allocated operational expenses) or to R (upon implementation of the reorganization) will constitute "unusual grants" within the meaning of sections 1.509(a)-3(c)(3) and (4) of the regulations. The grants are from related organizations, not from outside persons. The transfers to R will consist of assets that further the exempt purpose of the recipient. This substantiates the claim that the grant is for a charitable purpose. In addition, R is expected to attract significant public support in the form of fees for services in the future. It will not be dependent upon a repetition of the unusual grant. The transfers to P are for specific start-up purposes, which are not expected to recur. Therefore, the transfers are excluded for the purposes of applying the support tests described in section 509(a)(2) of the Code to P and R, insofar as applicable.

Issue 5: Q's provision of management, administrative, and support services to R, substantially at cost, will not constitute unrelated trade or business. The services are substantially related to the exempt purposes of both organizations, and contribute directly and importantly to their accomplishment. Rev. Rul. 81-19, *supra*, explains that services performed for affiliated organizations which would be exempt if performed by the recipient organization and which contribute importantly to the accomplishment of the exempt purposes are treated as related. Therefore, compensation for them will not constitute unrelated business taxable income to Q.

Issue 6: Rental payments under the lease of facilities and equipment to R will not constitute unrelated business taxable income to Q under section 512 of the Code because the property is used to accomplish the exempt purpose of an affiliated entity that is also closely connected to Q and that furthers its exempt purpose. Like the organization in the example used by section 1.502-1(b) of the regulations, and that in Rev. Rul. 81-19, *supra*, Q will provide services and equipment to an organization that Q supports and that furthers Q's exempt purpose. The situation in *BSW Group, supra* is different from this proposed transaction. There, the organization provided services to unrelated, albeit exempt, organizations. The recipients were not connected to BSW Group and did not further its exempt purpose. However, in this case, the elderly persons served are often the same people at different stages of their lives.

The rent that Q receives from leasing property to R will also be excluded from the definition of income from "debt-financed property" taxable as unrelated business taxable income to Q under section 514 because it is substantially related to Q's purpose.

Issue 7: For the reasons described above, both Q and R are recognized as exempt under section 501(c)(3) of the Code and as public charities under section 509(a)(2). Therefore, contributions to Q and R will be deductible under section 170. P is recognized as exempt under section 501(c)(3) as described in section 509(a)(3) and therefore contributions to it will also be deductible under section 170.

For these reasons, based on the facts presented, we rule as follows:

1. Q will continue to be recognized as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3), and not a private foundation under section 509(a)(2).
2. R will continue to be recognized as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3), and not a private foundation by reason of being an organization whose principal source of financial support will be payments for exempt services provided as described in section 509(a)(2).
3. P will continue to be recognized as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3), and not a private foundation by reason of being a supporting organization described in section 509(a)(3).
4. Transfers of payments from Q to either P (to provide initial capitalization, organizational expenses, and allocated operational expenses) or to R (upon implementation of the reorganization) will constitute "unusual grants" within the meaning of sections 1.509(a)-3(c)(3) and (4) of the regulations. Therefore, the transfers shall be excluded for the purposes of applying the support tests described in section 509(a)(2) of the Code to R, insofar as applicable.
5. Q's provision of management, administrative, and support services to R, substantially at cost, will not constitute unrelated trade or business and compensation for it will not constitute unrelated business taxable income to Q.
6. Rental payments under the lease of facilities and equipment to R will not constitute unrelated business taxable income to Q under section 512 of the Code or be treated as income from "debt-financed property" taxable as unrelated business taxable income to Q under section 514.
7. All three corporations will continue to qualify as organizations described in sections 501(c)(3) and 509(a) of the Code, to which contributions are deductible as provided in section 170.

These rulings rely on the understanding that there will be no material changes in the facts upon which they are based. Any such change should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service Office. A copy of this ruling is being forwarded to the Ohio TE/GE Customer Service Office.

This ruling is directed only to the organizations that requested it. Section 6110(k)(3)

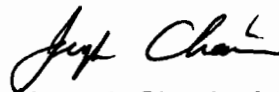
of the Code provides that it may not be used or cited as precedent.

Except as we have specifically ruled herein, we express no opinion as to the consequences of these transactions under the cited provisions or under other provisions of the Code. We also express no opinion as to the future activities that P, Q, and R intend to implement.

Because this letter could help resolve any future questions about your income tax responsibilities, please keep a copy of this ruling in your permanent records.

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,



Joseph Chasin, Manager
Exempt Organizations
Technical Group 2