OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations)

SUBJECT:

This Field Service Advice responds to your memorandum dated March 19, 1999, discussing the position of your office on whether to pursue litigation or settlement with respect to issues raised in an examination of the above referenced taxpayer. In your memo, you indicate that you believe that a decision of how to proceed requires legal and policy decisions by the Exempt Organizations Division and CC:EBEO, including decisions on how to resolve other cases. The purpose of this memorandum is to describe our current approach to the issues you raise. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND : Parent =

ISSUES: Is a wholly-owned subsidiary an agent of Parent.

FACTS: Parent is a tax exempt organization that has incorporated a wholly-owned subsidiary to engage in business unrelated to Parent's exempt purposes. Parent has represented that it will not control the business of the subsidiary. Subsidiary will have independent board of directors, separate employees, separate payroll and other structural features as necessary to ensure the subsidiary's separateness.

LAW AND ANALYSIS:

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. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438. “The mere fact of the existence of a corporation with one or several stockholders, regardless of the corporation’s business activities, does not make the corporation an agent of its stockholders.” 319 U.S. at 440.

Although the independent existence of a subsidiary or an unrelated entity is generally accepted under tax law, under certain circumstances the actions of the subsidiary or entity may be attributed to the corporation under an agency theory. See State Police Association of Massachusetts v. Commissioner, 72 T.C.M. (CCH) 582, aff’d, 125 F.3d 1(1st Cir. 1997). In that case, the Tax Court found, and the First Circuit agreed, that an organization controlled an independent contractor’s activities because it retained a tight control over the method and manner in which the contractor conducted its business.

Recently, the Tax Court held that amounts received by Sierra Club in connection with an affinity credit card program were royalties within the meaning of section 512(b)(2). Sierra Club v. Commissioner, TC Memo 1999-86 (Mar. 23 1999). The Tax Court concluded that the agreement between Sierra Club and ABS made available for ABS’s use Sierra Club’s name, marks, logo, and certain other intangible property used in marketing, and provided ABS access to the members by way of mailing lists. Although the court did not address the agency issue, it clearly found that Sierra Club did not control the marketing of the affinity credit card, that Sierra Club’s reserving approval rights did not indirectly put Sierra Club in the business of marketing and that existence or exercise of approval rights was not inconsistent with a royalty arrangement. The court also found that the agreement did not compensate Sierra Club for services.

In United Cancer Council v. Commissioner, 165 F.3d 1173 (7th Cir 1999), the Seventh Circuit reversed the Tax Court’s decision that a charity’s contract with its fundraiser so overwhelmingly favored the fundraiser as to cede control of the charity to the fundraiser. The appellate court refused to find that the fundraiser controlled the charity, stating “[we can find nothing in the facts to support the IRS’s theory....The Service and Tax Court are using “control” in a special sense not used elsewhere, so far as we can determine, in the law, including the federal tax law.” 165 F.3d at 1178.

In the employment tax area, the question of agency was presented in two lines of cases involving whether a business was required to report to the Service certain payments made from customers directly to workers. In Howard's Yellow Cabs, Inc. v. United States, 987 F. Supp. 469, 478-480 (W.D. N.C. 1997), the Government argued that when the cab driver retained fares and turned over to the company only a portion of the fares, there was constructive receipt of the entire fare by the cab company and constructive payment of a portion of the fare to the driver by the company, because the driver was an agent of the cab company when he received the fares. The argument was based on United States v. Fleming, 293 F.2d 953 (5th Cir. 1961) (remuneration accruing from a service rendered by an employee in employment does not cease to be wages merely because it is based on a commission and withheld by the employee to simplify accounting). The court in Howard's Yellow Cab rejected that theory because the Government "presented no facts, case law, or legislative history" to support its assertion that the drivers were agents when they collected fares. 987 F. Supp at 478. The court believed the fee-splitting arrangement was more like that described in Manchester Music Co. v. United States, 773 F. Supp. 473 (D. N.H. 1990) (splitting proceeds from juke box was more in the nature of joint venture than payment from one party to another), 987 F. Supp. at 478. See also J&J Cab Service, Inc. v. United States, 75 A.F.T.R.2d 618, 621-622 (W.D. N.C. Jan. 3, 1995) (same).

Courts also have found that no agency existed in cases where the government argued that payments (from customers to exotic dancers) that are retained by the dancer are constructively received by the club and then constructively paid by the club to the dancer. See JJR, Inc. v. United States, 82 A.F.T.R. 2d. 5849 (9th Cir. July 31, 1998) (dancers did not account to club for money received from customers so no agency existed; this situation more in the nature of payments to caddies that golf club was not required to report pursuant to Rev. Rul. 69-26, 1969-1 C.B. 251); Marlar, Inc. v. United States, 82 A.F.T.R.2d 5476 (9th Cir. July 31, 1998) (club did not exercise control over the dancers); Taylor Blvd. Theatre, Inc. v. United States, 82 A.F.T.R.2d 5102 (May 13, 1998) (specific arrangement with club indicates income is split; no payments are made)

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As you know, we have had extensive discussions on this issue, which benefitted greatly from analytic memoranda prepared by your office. As a result of these discussions, while recognizing that reasonable minds can differ, [redacted].

Under Moline, Parent's ownership of the subsidiary does not require attribution of the subsidiary's activities to the parent, although the separateness required by Moline does not prohibit an agency relationship. In your memorandum of October 22, 1998, you indicated that you agree with this basic proposition but believed that sufficient control existed that would attribute the subsidiary's acts to the taxpayer under an agency theory. The taxpayer in this case has repeatedly stated that it will not control the activities of the subsidiary and is willing to agree to terms that would establish the subsidiary's independence in the conduct of its business. Without that control, we do not believe that a court would conclude that the subsidiary is the agent of the taxpayer.

The recent opinion in Sierra Club is the latest example of courts' unwillingness to challenge the nature of payments as royalties where an exempt organization enters into a contract to allow a third party the use of its intangible property, even where the organization retains approval rights over the use of that property. The opinion also shows the court's unwillingness to impute control of an independent contractor to a party with whom it contracts. The court refused to find that the Sierra Club's retention of approval rights gave it the ability to control the independent contractor ABS.

United Cancer Council and the employment tax cases discussed above show that judicial resistance to imputing control is not limited to royalty cases.

Accordingly, in light of Sierra Club and these other cases, we have advised our client that absent direct control by the taxpayer of the subsidiary's business, we do not believe that the acts of the subsidiary would be attributed to the taxpayer by a court under an agency theory. [redacted]

Good Faith of the Taxpayer

[redacted].

Other Issues

With respect to past years, we cannot assess the strength of the Service's case until we see the hazards of litigation memorandum being prepared by your office; [redacted]

Other Cases

As you note, there are other cases with facts that are, in some respects, similar to those in this case. We believe that there is some misunderstanding as to our views on those cases. Our view is that they differ sufficiently from the taxpayer's proposal so that they may be distinguished; we acknowledge that this requires a detailed analysis and that other facts in these cases are undeniably similar. We agree with your point that it is appropriate for the National Office to provide guidance on how to handle these cases. In order to do so, we would appreciate your providing us with information on the number of cases in suspense and the organizations and fact patterns involved.

MARY OPPENHEIMER