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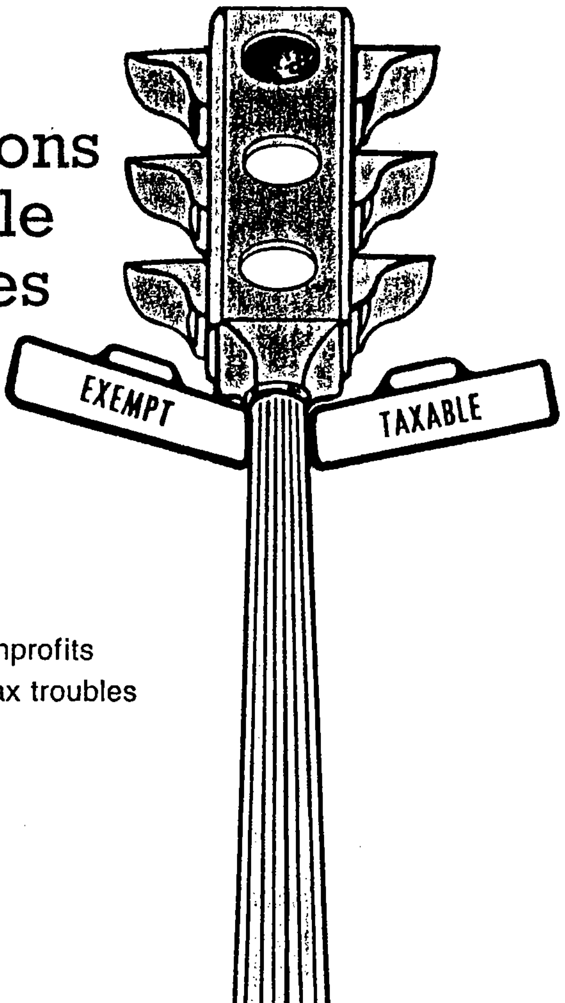
Exempt Organizations and Taxable Subsidiaries

Wendell R. Bird



The cash cows some nonprofits set up may pose more tax troubles than they are worth.

SURPRISINGLY LITTLE has been written about the permissibility of taxable subsidiaries to nonprofit organizations. Yet the Internal Revenue Service ("Service") has the impression that the floodgates of taxable subsidi-

aries are wide open, and Congress is considering proposals to restrict or prohibit taxable subsidiaries of nonprofit organizations.

This article addresses the taxability of feeder organizations under Internal Revenue Code ("Code") section 502, the exceptions for some service organizations, and the tax treatment of parent organizations under section 512. (All section references are to the Code unless otherwise indicated.)

FEEDER ORGANIZATIONS • Exempt organizations often have formed taxable subsidiaries for several reasons. First, the exemption of the parent is protected by shifting unrelated trade or business income to a separate subsidiary, so that the parent's unrelated business income cannot rise to a point where it might indicate a commercial purpose and jeopardize the exemption of the parent. Second, the assets of the exempt parent are protected from claims generated by the trade or business. Third, allocation problems are avoided by operating separate corporations. For example, some expenses may not lend themselves to precise allocation between related activities and unrelated activities, and indirect costs possibly may not be deductible against unrelated business income because they are not "directly connected with" it. §512(a). Fourth, efficiencies result from a single organization providing a needed service to multiple exempt organizations.

History

Before 1950 many exempt organizations maintained profit-making subsidiaries. The exempt organizations paid no tax on the subsidiaries' income or on the organizations' receipt of dividends. In the Revenue Act of 1950, however, the income of these "feeder organizations" was subjected to tax, along with the unrelated business income of exempt organizations. §502

Thereafter, litigation developed about whether the taxable subsidiary could claim a corporate charitable contribution deduction for contributions made to its exempt parent when the subsidiary was controlled by the exempt parent, enabling the exempt parent to recast nondeductible dividends into deductible charitable contributions. The Service ruled that a charitable contribution was really a dividend from a taxable wholly owned subsidiary to its exempt foundation parent, even though additional distributions were made as dividends. Rev. Rul. 68-296, 1968-1 C.B. 105; *See Dave Investment Co. v. Commissioner,* 462 F.2d 1373 (9th Cir. 1972), *aff'g* T.C. Memo. 1970-291.

The 1969 Act

The Tax Reform Act of 1969 ("1969 Act") denied the exempt parent an exclusion for unrelated business income tax on annuities, royalties, rents, and interest payments received from a subsidiary that it controls. Also in the 1969 Act, the category of

excludable rents was narrowed under section 512, and a corresponding change was made to section 502: "the term 'trade or business' shall not include . . . the deriving of rents which would be excluded under section 512(b)(3), if section 512 applied to the organization." §502(b)(1).

The 1969 Act also created exclusions from the section 502 tax on feeder organizations for "any trade or business in which substantially all the work . . . is performed for the organization without compensation," or "any trade or business which is the selling of merchandise, substantially all of which has been received by the organization as gifts." §502(b)(2)-(3).

The primary congressional reason for denying exemption to feeder organizations was avoidance of unfair competition. Congress felt that a macaroni factory that could be tax exempt by paying all of its profit via dividends to an exempt parent had a competitive advantage over a macaroni factory that had to pay tax on profits before distributing any dividends.

In fact there would be no competitive advantage as long as the subsidiary of the exempt parent was required to distribute all profit to the exempt parent, and the competitive advantage was limited only to the accumulated earnings in the case of the subsidiary that distributed some but not all of its profit to its exempt parent. In that sense, Congress went beyond what was necessary to terminate unfair competition; the rationale only supported taxing undistributed income of the subsidiary.

Related Income Exceptions

The Treasury Regulations recognize that not all subsidiaries of exempt organizations are taxable feeder organizations. A feeder organization is defined as "an organization operated for the primary purpose of carrying on a trade or business for profit" even though "all the profits for such organization are payable to one or more organizations exempt from taxation under section 501." Treas. Reg. §1.502-1(a). These feeder organizations are not eligible for tax exemption under section 501. However, an exempt subsidiary is possible even though it generates paper profits in dealings with the exempt parent and even though its profits are all payable to the exempt parent.

"If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization. . . ." Treas. Reg. §1.502-1(b)

Volunteer Work and Donated Merchandise

Before 1969, problems arose with subsidiaries that sold merchandise that

had been contributed to the parent exempt organization and with service subsidiaries for which work was performed without compensation. In one case, a subsidiary veterans' organization received contributed merchandise from the general public and resold that merchandise to turn the profits over to its exempt parent veterans' organization. The parent would not have been taxed under section 511 on the profits had it performed the sales, but there was no comparable exclusion under section 502 for the subsidiary. *Veterans Foundation v. United States,* 281 F.2d 912 (10th Cir. 1960); *Veterans Foundation v. Commissioner,* 38 T.C. 66 (1962), *aff'd on other grounds,* 317 F.2d 456 (10th Cir. 1963). A nonprofit subsidiary whose sole activity was operating a thrift shop to sell donated goods with the use of volunteer workers was found to be a taxable feeder organization also. Rev. Rul. 68-439, 1968-2 C.B. 239; *Disabled Veterans Service Foundation, Inc. v. Commissioner,* 29 T.C.M. 202 (1970).

In the Tax Reform Act of 1969 these problems were resolved by an amendment to section 502 that provided that "the term 'trade or business' shall not include . . . (2) any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation, or (3) any trade or business which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions." §502(b)(2)-(3).

Unrelated Parents and Businesses

Although the regulations give the above example of an exempt subsidiary that would itself be exempt on the ground that its activities are an integral part of the exempt activities of its parent, they also provide that a subsidiary, even if its services benefit unrelated exempt organizations, is nonexempt just as if its services were a trade or business to the general public. "However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is unrelated to exempt activities) if regularly carried on by the parent organization." Treas. Reg. §1.502-1(b). Yet it seems odd that a service that would be an exempt activity if regularly performed for an exempt parent becomes an unrelated trade or business if regularly performed for several exempt organizations.

Service Organization Exceptions

The most important litigation on this subject has involved hospital subsidiaries and college subsidiaries. *See Hospital Bureau of Standards & Supplies v. United States,* 158 F. Supp. 560 (Ct.Cl. 1958) (a corporation organized to purchase supplies for exempt member hospitals and to maintain a research department for establishing uniform quality standards was exempt when profits were passed back to its member institutions, and no parent-subsidiary relationship existed). *Contra* Rev. Rul. 54-305, 1954-2 C.B. 127 (a corporation was disqualified from exemption when its primary purpose was to operate a purchasing agency for the benefit of its unrelated members, which were exempt organizations).

Hospital Service Organizations

The conflict was resolved in 1968 when a new provision was added to the Code, section 501(e). Under this provision tax exemption and tax deductible status were granted to a cooperative organization that was organized and operated solely to perform specified services exclusively for multiple exempt hospitals. "Clinical services" were added by amendment in 1976. The Service has taken the position that any additional service, such as laundry service, will disqualify the organization from exemption.

The Service immediately interpreted section 501(e) to indicate congressional intent to deny exemption to all other cooperatives that are service organizations assisting exempt organizations. An investment service for exempt organizations was denied exemption under the questionable rationale that, if carried on by a single exempt organization, it would be an unrelated trade or business. Rev. Rul. 69-528, 1969-2 C.B. 127.

Any activity of a subsidiary that was arguably a business serving multiple exempt organizations would be fully taxable, regardless of whether entered into for profit, unless the services performed for the member exempt organizations were performed substantially below cost. Rev. Rul. 72-369, 1972-2 C.B. 245. More specifically, at least 85 per cent of the operating costs of the subsidiary must come from outside organizations such as private foundation grants or governmental grants, and no more than 15 per cent of the total costs of operation may be provided by service charges on the member institutions. Rev. Rul. 71-529, 1971-2 C.B. 234.

Similarly, an organization then providing managerial and consulting services solely to exempt organizations, although at cost, was not qualified for exempt status. Rev. Rul. 72-369, 1972-2 C.B. 245. *See also* Rev. Ruls. 69-160, 1969-1 C.B. 147; 69-633, 1969-2 C.B. 121 (an organization offering laundry services to member hospitals would not qualify for exempt status under section 501(e)). *But see United Hospital Services, Inc. v. United States,* 384 F. Supp. 776 (S.D. Ind. 1974) (allowing exemption under section 501(c)(3) for a joint laundry service organization, in part because "the Court has difficulty in finding any basis in the statute for [this] portion of the regulation" that deemed a cooperative subsidiary to be a taxable feeder organization).

College Service Organizations

A growing discrepancy between college operating expenses and college income and student accounts has led many colleges and universities to explore cooperative activities that bring economies of scale. The Service was not more tolerant of multi-college service organizations than of multi-hospital service organizations. *See* Rev. Rul. 69-177, 1969-1 C.B. 150.

Section 501 was amended in 1974 to provide for certain investment services to colleges by the addition of section 501(f). The legislative report expressly precluded any Service use of section 501(f) to deny exemption to other university cooperatives. S. Rep. No. 88, 93rd Cong., 2d Sess. 3 (1974).

Shortly after the enactment of section 501(f), the Service issued a very limited ruling approving the exemption of a regional network of computers owned or leased by member colleges and universities "to collect and disseminate scientific and educational information to the exempt members, faculties and students." Rev. Rul. 74-614, 1974-2 C.B. 164. The ruling was limited because the organization itself did not own or lease computers, the network was not used for administrative activities, and the organization conducted research.

It is difficult to see why the rationale for the hospital and college provisions for exempt service organizations for multiple exempt organizations in section 501(e) and (f) does not justify exempt service organizations for multiple exempt organizations in all other areas.

Other Approaches

If a service organization cannot obtain exemption, an alternative better than status as a taxable subsidiary might be status as a cooperative under sections 1381 or as a regulated investment company under section 851. The former alternative follows the Service's suggestion in Rev. Rul. 69-633 that, "if all of the organization's net earnings derived from dealings with patrons are distributed or allocated pursuant to a preexisting obligation to the patron hospitals within the time and manner prescribed for cooperative organizations in section 1381-83, the organization would have no taxable income from such dealings." Rev. Rul. 69-633, 1969-2 C.B. 121. However, that alternative may not be very beneficial because it might involve heavy start-up costs for the less customary tax category, it might have to pay state and municipal property, sales, and income taxes, and it might be ineligible for private foundation grants or some federal and state grants.

TAXABILITY OF EXEMPT PARENTS • In general, exempt parents are not taxed on income from taxable subsidiaries that they do not control within the meaning of section 368. Note that private foundations may only own up to 20 per cent of the voting stock of taxable subsidiaries, with exceptions. §4943.

> ***Exempt organizations are allowed certain forms of passive income without being taxed as unrelated business income.***

Passive Income Exclusion

Exempt organizations are allowed certain forms of passive income that will not be taxed as unrelated business income. Before the Tax Reform Act of 1969, passive income including rent, interest, royalty, and annuity income generally was free of tax to exempt organizations, except under a few court decisions. The Service made many attempts to tax the exempt parents on the passive income paid by taxable subsidiaries, generally on the rationale that they were not separate entities but one integrated entity. A federal district court refused to integrate an exempt foundation, finding that the two corporations were in fact separate and had different membership to their boards of directors. *Ammon G. Carter Foundation v. United States*, 58-1 U.S.T.C. ¶9342 (N.D. Tex. 1958). The Fifth Circuit of the U.S. Court of Appeals reached a similar result. *U.S. v. Robert A. Welch Foundation*, 334 F.2d 774 (5th Cir. 1964).

Under the 1969 Act, the exclusion was maintained only as long as the exempt parent did not control the subsidiary organization. The primary problem impelling change was "rental" by exempt organizations of their physical plant to wholly owned taxable corporations for 80 per cent or 90 per cent of all net profits before taxes and before rent deductions. That arrangement enabled the taxable subsidiary to escape nearly all of its income taxes because of the large "rental" deduction.

The current exclusion of passive income from noncontrolled subsidiaries, whether exempt or nonexempt, is governed by section 512(b)(1)-(5).

Separate Subsidiaries

The receipt of passive income from a noncontrolled subsidiary is permissible, as is the formation of a taxable subsidiary for business activities, without any threat to the exempt status of the parent and without any unrelated trade or business income being attributed to the parent, so long as the subsidiary is dealt with at arm's length as a truly separate corporation. The Service position is outlined in General Counsel Memoranda 39326 and 39598. The first G.C.M. found that the exempt parent did not jeopardize its exemption, and was not taxable on subsidiary profits, when its taxable subsidiary was dealt with on an arm's

length basis, without the parent's involvement in daily management, and with the subsidiary's board of directors not consisting primarily of the parent's directors, officers, or employees. G.C.M. 39598 emphasized the same factors, but found it permissible for all subsidiary board members to be taken from the exempt parent's board. However, a majority of nonaffiliated board members frequently is mentioned as a positive factor showing nonattribution. *E.g.*, Pvt. Letter Ruls. 8821044 (Feb. 26, 1988); 8718066 (Feb. 5, 1987); 8747033 (Aug. 25, 1987).

In analyzing a section 501(c)(3) parent corporation that formed a taxable subsidiary for all publishing activities, the Service found:

"The formation of the Subsidiary as a for profit corporation is an operating efficiency and investment of yours. Investing in a for profit corporation does not jeopardize the exempt status of a section 501(c)(3) organization. Also, creating and investing in a for profit organization is not a normal business activity nor could it be considered to be regularly carried on and would not be an 'unrelated trade or business regulary carried on.' It would not, therefore, generate any income that would be taxed to you as unrelated business income." Pvt. Letter Rul. 8519037 (Feb. 12, 1985)

The Service in a national office Technical Advice Memorandum applied the same rationale, and reached the same result, even when a section 501(c)(6) parent had four taxable subsidiaries, and when one of them that carried on insurance activities had double the total income of the exempt parent. Pvt. Letter Rul. 8706012 (Oct. 31, 1986).

The taxable subsidiary generally will be treated as a separate corporation rather than disregarded or consolidated with the exempt parent for tax purposes. The Service outlined its general position in Pvt. Letter Rul. 8706012 (Oct. 31, 1986).

Other factors mentioned were limited time spent by the parent's board in reviewing the subsidiary's activities, the corporate tax returns filed by the subsidiary, the lack of private inurement of the parent's income, and the lack of net income to the parent above its cost for shared services reimbursed by the subsidiaries. *Id. See also* T.A.M. 8625078 (Mar. 27, 1986).

Other favorable examples include taxable subsidiaries performing contract research for unrelated third parties, management services to physicians and other healthcare providers, and distribution of a food product. Pvt. Letter Ruls. 8716054 (Jan. 20, 1987), 8747033 (Aug. 25, 1987), 8625078 (Mar. 27, 1986).

Exemption Threat from Disregarded Corporation

Excessive involvement of the exempt parent in the taxable subsidiary on a day-to-day basis will cause the Service to ignore the separate corporations and to attribute subsidiary income to the parent. Pvt. Letter Rul. 8606056 (Nov. 14, 1985). The same will be true of non-arm's length dealings.

Recommendations for Noncontrolled Subsidiaries

To avoid attribution of the taxable subsidiary's activities to the exempt parent, a number of safeguards must be followed that have been mentioned in letter rulings.

General Relationship

The exempt parent must deal at arm's length with the subsidiary, and must not be involved in the day-to-day management of the subsidiary, or the subsidiary will not be treated as a separate entity. The subsidiary must have a business purpose, and as many restrictions should be built into its articles of incorporation and by-laws as possible to avoid parental intervention.

Directors

The board of directors of the taxable subsidiary should consist, as much as possible, of people unaffiliated with the parent, even though the parent by definition elects all or most of the board based on its stock ownership. This is particularly true when there is officer overlap. However, the fact that subsidiary directors are all directors or employees of the exempt parent is not necessarily fatal. Pvt. Letter Ruls. 8706012 (Oct. 31, 1986); 8805059 (Nov. 13, 1987). Nevertheless, a lack or minority of interlocking directorates is cited often as a favorable factor, and restriction of removal of independent directors to stated causes would also doubtless be a positive factor. Pvt. Letter Ruls. 8821044 (Feb. 26, 1988); 8718066 (Feb. 5, 1987); 8747033 (Aug. 25, 1987). In any event, the two boards should have "separate meetings" and "separate minutes." Pvt. Letter Rul. 8821044 (Feb. 26, 1988).

Officers

The officers of the taxable subsidiary should consist, as much as possible, of people unaffiliated with the exempt parent, particularly when there is board overlap. Otherwise, the parent may be deemed to be involved in day-to-day management.

Employees

The employees also should be, as much as possible, nonoverlapping. Any shared employees should be leased on an arm's length basis with a written agreement that avoids private inurement, and should keep written time records to disprove inurement. Pvt. Letter Ruls. 8805059; 8504058.

Facilities

Facilities for the parent and subsidiary must be separate, although offices can be adjacent and office equipment can be shared with arm's length payment under a written agreement. However, a level of sharing that becomes a substantial purpose of the exempt parent could terminate the

parent's exemption, as could a lack of separate books and records. In any event, maximum separation is a positive factor. Pvt. Letter Ruls. 8821044 (Feb. 26, 1988).

Capitalization

An investment by the exempt parent in such a taxable subsidiary should be as permissible as an investment in a blue chip stock, but as a practical matter it will be much more scrutinized. Hence, a one-time initial investment is preferable to multiple investments, particularly if there are other shareholders, and the amount transferred should be related to the subsidiary's business (such as assets involved in what would otherwise be unrelated business income ("UBI") and should be reasonable in view of the expected return to the parent. Pvt. Letter Ruls. 8337040 (large transfer by hospital); 8346103 (total transfer by health organization of nonexempt function assets).

Passive Income Taxability of a Controlled Subsidiary

By contrast, passive income in the forms of interest, rent, royalties, and annuities paid by an exempt or nonexempt subsidiary to an exempt parent is taxable to the exempt parent if that parent has control as defined in section 368(c). §512(b)(13). However, dividends are not so taxed. The primary motivation for the provision was to restrict sale-leasebacks between exempt parents and taxable subsidiaries and similar arrangements.

The current provision taxes exempt parents on interest, annuities, royalties, and rents from controlled subsidiaries—whether or not the income arises from a trade or business or is regularly carried on. §512(b)(13). The amount taxed to the parent controlling organization depends on whether the subsidiary is exempt or nonexempt.

Exempt Subsidiaries

If the controlled organization is exempt, the same ratio of its interest, annuities, royalties, and rents from the controlled organization is taxed as the ratio of unrelated business taxable income of the controlled organization to the greater of taxable income of the controlled organization (computed as though the controlled organization were nonexempt) or unrelated business taxable income of the controlled organization (disregarding any amounts paid directly or indirectly to the controlling organization). Treas. Reg. §1.512(b)-1(*l*)(2). Thus, if a controlled organization's unrelated business taxable income equals or exceeds its taxable income, the entire amount of its interest, annuities, royalties, and rents received by the controlling organization would be includable in the controlling organization's unrelated business taxable income.

Nonexempt Subsidiaries

If the controlled organization is a nonexempt subsidiary, the controlling organization is taxed on an amount bearing the same ratio to its interest, annuities, royalties, and rents from the controlled organization as the excess taxable income of the controlled organization (all of its taxable income except that which would not be unrelated business taxable income if earned directly from the controlling organization) bears to the greater of the taxable income of the controlled organization or the excess taxable income of the controlled organization (both determined without regard to any amounts paid directly or indirectly to the controlling organization). Treas. Reg. §1.512(b)-1(*l*)(3). The income that would not be UBI is determined with a "functionally related" test, according to a Service technical advice memorandum. T.A.M. 8729005 (Apr. 13, 1987). Thus, if a controlled organization's excess taxable income equals or exceeds its taxable income, the entire amount of its interest, annuities, royalties, and rents received by the controlling organization would be includable in the controlling organization's unrelated taxable income. There are numerous private letter rulings in which the Service has found payments taxable to the exempt parent. Pvt. Letter Ruls. 8528080, 8504046, 8504058, 8435162, 8432122.

Note that income from debt-financed property is subject first to section 512(b)(13), and only the remainder is then taken into account as income under the debt-financed income provisions. Treas. Reg. §§1.512-(b)-1(*l*)(5), 1.514(b)-1(b)(3) (Example 3). *See generally* Bird & Reach, *Unrelated Debt-Financed Income,* 10 Bender's Federal Tax Service § J (1988).

Definition of Control

The definition of "control" given in section 512(b)(13) is the same as that given in section 368(c), and in the regulations for applying an 80 per cent test. (At the time this is written, Congress has been considering a change to a 50 per cent test, and appears likely to adopt a 50 per cent test.)

Control of For-Profit Subsidiaries

The term "control" for stock corporations means "ownership by an exempt organization of the stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of such corporation." Treas. Reg. §1.512(b)-1(l)(4)(i)(a). *See generally* G.C.M. 39286; G.C.M. 38878; Rev. Rul. 56-613, 1956-2 C.B. 212. The Internal Revenue Manual (Exempt Organizations Handbook portion) gives further detail about the 80 per cent requirement for stock corporations: "control means ownership of the stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number

of shares of all other classes of stock of the corporation." I.R.M. Part 7751, at § (37)8(13).2.

A widely practiced approach is issuance of preferred stock to one parent and of common stock to another, so that their control ratio is 21 per cent/79 per cent or 50 per cent/50 per cent. The Service has approved that approach in one technical advice memorandum, when 23 per cent of the total capital stock was nonvoting preferred stock owned by another nonprofit organization, and was sufficient to avert control by the nonprofit parent. T.A.M. 8414001 (Apr. 11, 1984). The Service emphasized that the preferred stock created real rights and a real expectation of profits, and thus had a purpose beyond tax avoidance. *Id.* A Service continuing education program agreed. IRS, *Exempt Organizations Continuing Professional Education Technical Instruction Program for 1987,* at 67-68 (1987).

Another approach, if followed by the Service, is to transfer the stock of the taxable subsidiary to a wholly owned subsidiary, which will receive dividends, but to keep in the exempt parent's hands the mortgage note that generates interest payments (or the royalty right that generates royalty payments). T.A.M. 8439001 (Oct. 3, 1984). However, the Service probably would not follow the advice there, because an internal instructional coursebook would deny rental deductions to a subsidiary of a parent of a nonprofit hospital. IRS, *Exempt Organizations Continuing Professional Education Technical Instruction Program for 1987,* at 70-71 (1987).

Control of Nonprofit Subsidiaries

The term "control" for a nonstock organization, means "at least 80 per cent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization." A trustee or director is a representative of an exempt organization if he is a trustee, director, agent, or employee of this exempt organization. A trustee or director is controlled by an exempt organization if the organization has the power to remove that trustee or director and designate a new trustee or director." Treas. Reg. §1.512(b)-1(*l*)(4)(i)(b).

Parent's Exemption

The UBI provision for controlled subsidiaries, under section 512(b)(13), implicitly assumes the permissibility of exempt parent ownership of controlled subsidiaries, whether taxable or exempt. The feeder organization section presupposes the same thing. §502. And a 1986 change in the tax exempt leasing rules implicitly posits the same, in treating controlled taxable subsidiaries (using a 50 per cent or more test) as the same as the exempt parent for purposes of the stretched-out deductions for tax exempt leasing. Tax Reform Act of 1986, at §201. §168(h)(6)(F)(iii).

The many instances of private letter rulings that found no threat to the parent's exemption from a controlled taxable subsidiary, as long as it was treated as a true separate corporation at arm's length, include:

- An exempt publisher that owned all common stock of the subsidiary;
- A church that formed a for-profit corporation to build and sell retirement centers, nursing homes, children's homes, and handicapped centers; and
- A nonprofit that created a taxable subsidiary to administer an insurance trust to provide health insurance to the nonprofit parent's employees. Pvt. Letter Ruls. 8701051 (Oct. 9, 1986); 8821044 (Feb. 26, 1988); 8805059 (Nov. 13, 1987).

However, as with noncontrolled taxable subsidiaries, a controlled taxable subsidiary that is not treated at arm's length as a true separate corporation, but is used as an instrumentality of the parent nonprofit, will be disregarded with consequent UBI treatment and exemption loss. *Puritan Lawn Memorial Park Cemetary v. United States,* 15 Ct.Cl. 234 (1988). Also, under the Revenue Act of 1987, income from an interest in a master limited partnership is taxable to the exempt organization owner of the interest.

CONCLUSION • The policy question is whether taxable subsidiaries should be further regulated or deregulated, further taxed or less taxed. This author prefers less taxation and less regulation. The unfair competition rationale for regulation does not apply to the extent a taxable subsidiary transfers funds by any means to its exempt parent, and does not apply to the extent nonprofit organizations were in a field first such as hospital provision.

Furthermore, concerns about service organizations selling to the public do not warrant denial of exemption to service organizations providing integral activities to multiple exempt organizations, particularly when the same integral activities are clearly related and nontaxable when performed directly by each of those exempt organizations. The rationale for the controlled organization rules, that they are necessary to prevent collusively characterized transfers between taxable subsidiary and exempt parent that should be nondeductible dividends, does not require the controlled organization rules because ordinary recharacterization rules suffice.

The Supreme Court may have been right with the destination of income test before 1985, and Congress may have been right with no feeder organization rule or might make more economic sense by eliminating the percentage ceiling on the corporate charitable deduction.

As Edmund Burke warned two centuries ago, "All is disputed where everything is [regulated]."

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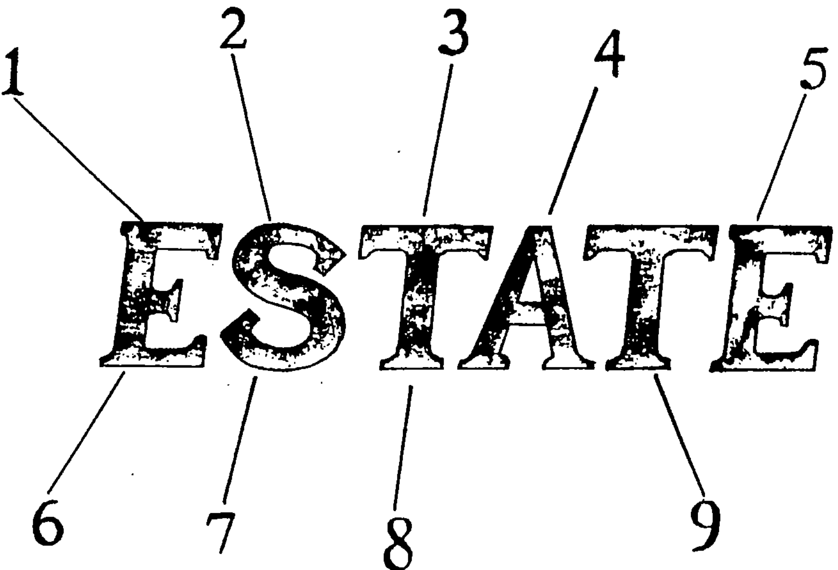

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(with Form)

Edward R. Finch, Jr.

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