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

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Date: MAY 24 2001

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Dear Sir or Madam:

This is in response to a letter from your authorized representative requesting a series of rulings on your behalf regarding the tax consequences associated with the affiliation of two hospital systems.

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A is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and is classified as a nonprivate foundation under section 509(a)(1). A was organized to promote health by acting as the parent of a nonprofit healthcare system by raising funds and otherwise supporting the system. A is controlled by a community-based board of directors and both prior to and following the proposed affiliation, A has acted as the parent of various health care corporations.

G is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii). It owns and operates an acute care hospital.

H is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a)(2). It provides outpatient medical services to communities in the service area of G.

M is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a)(3). It provides home health services including free or discounted care based on the ability of the patient to pay.

I, whose name has been changed to J as part of the affiliation, is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation section 509(a)(3). I is the sole member of L, which is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation section 509(a)(2). L has a controlling interest in and operates an outpatient surgical center. I is also the sole shareholder of Q, a business corporation.

K, whose name has been changed to P, is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a)(2).

N, O, and R, which is presently inactive, are exempt from federal income tax under section 501(c)(3) of the Code and are classified as nonprivate foundations under section 509(a). M is the sole member of these entities.

E is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a)(3). Prior to the affiliaition, its mission was to promote health care by acting as the parent of a section 501(c)(3) health care system.

U is a for-profit corporation which was wholly owned by E prior to the affiliation. It operates a diagnostic testing center and three retail pharmacies. Its stock was

transferred to D as part of the affiliation.

Prior to the affiliation, E was the sole member of D and F, which are exempt from federal income tax under section 501(c)(3) of the Code and are classified as nonprivate foundations under section 509(a). D owns and operates an acute care hospital, while F supports it by raising funds and making contributions to or for the benefit of D.

Prior to the affiliation, A (then named C), and E operated separate health care systems in their respective service areas. They concluded that by combining their systems they could benefit the community by, among other things, achieving new operating efficiences, consolidating redundant functions and thereby reducing costs.

You have stated that A and E entered into an affiliation agreement . As a result, E became a membership nonprofit corporation, the sole member of which is D; D became the sole member of F and the sole shareholder of U. A (having changed its name from B and C), became the sole member of D. Following the affiliation, A maintained its relationship as either the sole member or shareholder, or the indirect member or shareholder, of each of its pre-affiliation affiliates.

You have stated that A, as sole member of D, exercises broad and substantial control and supervision over D and its affiliates as the parent of the integrated health care system of which G and its affiliates are also a part. A supports, benefits and carries out the purposes of D and the other affiliates, coordinates and directs the health care related activities of D and the affiliates and plays an active supervisory and long-range planning role in their affairs and provides management support services to D and the other affiliates. In addition, A may conduct fundraising activities in support of the system members, may hold funds and assets for the system and its members, and may make grants, distributions and transfers to or for the benefit of the affiliated entities.

You have stated that A's articles of incorporation and bylaws have been amended to facilitate its request for a change in its nonprivate foundation classification from section 509(a)(1) to section 509(a)(3). Specifically, D, G and the other section 509(a)(1) and (2) organizations in the new A system have been specifically named as organizations which A is operated to support. In addition, the articles of incorporation and bylaws of D, G and other affiliated entities have been or will be amended to reflect the fact that their charitable purposes include supporting the health care related activities of A and the other nonprofit, tax-exempt health care organizations comprising the system.

You have stated that pursuant to the affiliation agreement A has become the parent of D and remains the direct or indirect parent of the S section 501(c)(3) affiliates.

While D retains a separate corporate identity and board of directors, and has become the sole member of F and E and sole shareholder of U, parental authority has been transferred to A's board of directors. A's parental responsibilities and duties include the following: with respect to those affiliates of which A is the sole member or shareholder, including D, A is entitled to exercise all rights vested in members under state nonprofit corporation law or in shareholders under state business corporation law, except in the limited instances described below. Moreover, except in those limited instances, with respect to each affiliate in the A system, other than F, including G, D and E, A, as parent, is empowered pursuant to the terms of the affiliation agreement and the bylaws of each A affiliate to initiate and implement any of the following actions, and if such action is otherwise initiated by any such affiliate, such action shall not become effective unless approved by A in its capacity as parent: (1) the adoption, amendment or revocation of the affiliate's articles of incorporation or bylaws; (2) the termination, liquidation, reorganization, division, conversion or dissolution of the affiliate, or the merger, consolidation or combination of the affiliate with another person; (3) any change or transfer of A's membership or shareholder interest in the affiliate, or the creation or issuance of any additional membership or shareholder interest in the affiliate; (4) the investment of the affiliate's assets other than in accordance with A's investment policy or, in the absence of a current policy, any investment other than in the ordinary course of business; (5) the incurrence by the affiliate of indebtedness in excess of such amounts as may reasonably be designated by A from time to time, except pursuant to a budget approved by A or ordinary course indebtedness such as routine trade payables in amounts less than the amounts designated by A; (6) the conveyance, transfer, lease or sale of any of the affiliate's assets with a fair market value in excess of such aggregate amount as may be designated by A from time to time, except pursuant to a budget approved by A, or the conveyance, transfer, lease, or sale of any of the affiliate's assets to A or another affiliate; (7) the making of any capital expenditure or the incurrence of any capital obligations by or on behalf of the affiliate in excess of such annual aggregate amounts as may be designated by A from time to time, except pursuant to a budget approved by A; (8) the incurrence of any obligation (whether actual or contingent) by the affiliate to guarantee or be responsible for the debts or obligations of any person in excess of such amounts as may be designated by A from time to time, except pursuant to a budget approved by A or ordinary course obligations in amounts less than the amounts designated by A; (9) the approval of the affiliate's operating and capital budgets, or any material changes thereto; (10) the voluntary granting of any lien or encumbrance with respect to the affiliate's assets, except in the ordinary course of business; (11) the surrender of or material change in any permit, approval, or license of the affiliate; (12) the selection of the affiliate's outside auditors, general legal counsel, or investment advisors; (13) the requirement that A make any capital contribution to or purchase the shares of the affiliate; (14) the ratification of appointments and reappointments to the board of directors of each affiliate; (15) the approval of the affiliate's strategic and operating

plans or any changes thereto; (16) the approval of the affiliate's statements of purpose, vision or mission or any changes thereto; (17) the creation by the affiliate of any new lines of business, sites of business, subsidiary corporations, or partnerships or other joint ventures or any material changes in existing services, or participation by the affiliate in any key strategic relationships outside the A system and (18) all health care services contracting by the affiliate that could materially impact A or the system.

During the first three years following the affiliation, A action with respect to certain matters listed below requires the affirmative vote of at least two-thirds of the board of directors of A (including at least two of the D appointed directors). Following the first three years, only those actions specified in (1), (2) and (3) require a two-thirds vote. The matters requiring a two-thirds vote are: (1) changes to the articles of incorporation or bylaws of A; (2) the acquisition, transfer or sale of material assets, stock or membership interests of or the dissolution of A or any affiliate, whether done in a single transaction or a series of related transactions, which, in the aggregate, involve material assets; (3) the affiliation of additional health systems with A in a transaction which results in a change in A governance; (4) removal for cause of D appointees to the board of directors of A; (5) changes in the number of D appointees to the board of directors of A or the maximum number of directors permitted on the A board; (6) approval of D, E and U's annual strategic objectives and budget (including capital and operating budgets) and (7) appointment of A's corporate officers, including A's CEO.

In addition, during the first three years of the affiliation, A is not permitted to take certain action with respect to D, E and/or U without the approval of D's board of directors. Following the first three years, only those actions specified in (1), (2), (3) and (4) below require approval of D's board of directors: (1) changes to the name of D; (2) the merger of D, E or U into another operating A affiliate, or a dissolution of any of those entities which has the same effect as a merger into another A affiliate; (3) elimination or material reduction of clinical services provided as of the date of the affiliation in the area served by D and/or U (in order to assure the maintenance of needed community health services); (4) amendments to the articles of incorporation or bylaws of D relating to the appointment, term and removal of D's directors; (5) approval of an annual capital budget for D in an amount less than $2.5 million; (6) disapproval of the development of new clinical services which have been determined by D's board to be necessary to meet the community's needs (up to an aggregate operating cost of $500,000 per fiscal year; (7) dissolution of D and (8) selection of the initial six D appointees to the A board of directors.

You have stated that while A's authority is limited in those few instances described above, the parental authority expressly granted to A under the affiliation agreement and those powers granted A as sole member of D under state nonprofit corporation law effectively permit A to take any action (other than those described above) with respect to D and E with or without the approval of those entities. Moreover, even in those areas in

which D reserves the right to approve proposed action by A, the affiliates of D are powerless to act without A's approval.

You have stated that in order to achieve greater operating efficiencies, whenever feasible, D and E and (to an insubstantial extent) U will receive management support services from A including planning, finance, human resources, community relations, purchasing, billing, collections, biomedical engineering, managed care contracting, medical and management information, risk management, insurance and legal services. Under the affiliation agreement, it is the parties' intent to make A management support services available to F in the same manner as with respect to D and E, in order to achieve greater system-wide operating efficiences, but not to require F to accept such services. To the extent A provides such services to D and E they will generally receive these services at cost, while any for-profit subsidiaries, such as U, will be charged fair market value.

You have stated that following the first three years of the affiliation, the affiliation may not be unilaterally terminated by any party. During the first three years, A and D have a limited termination right subject to a substantial financial penalty as described below. During the first three years, either party desiring to terminate the affiliation must give notice of its intent to the other party. Thereafter, the parties will make their best efforts to determine how the affiliation can be preserved. If, following such action, either party still desires to terminate the affiliation, that party must pay damages to the other party. The agreement requires the terminating party to pay liquidated damages to the non-terminating party in the amount of $5,000,000, unless the termination is the result of a material breach of the agreement which remains uncured by the breaching party following notice of the breach and an opportunity to cure or is the result of an inability to obtain private letter rulings from the Internal Revenue Service in connection with the affiliation.

You have stated that the following proposed transactions are planned, subject to governing board and where applicable, regulatory approval: (1) L, whose sole member is currently I, will be merged into I, with I (renamed J) the surviving entity; (2) E will be merged into K (renamed P), whose sole member is J. Following the merger, P will perform most of the activities and functions previously performed by E. P's articles of incorporation and bylaws will be amended to provide that it is organized and operated exclusively for charitable, scientific and educational purposes for the benefit of D in addition to G and H. In addition, the bylaws of P will be amended to provide that certain of its governing board members are required to be governing board members of D.

You have requested the following rulings in connection with the affiliations and subsequent activities and transactions described above:

1. The affiliation and subsequent activities and transactions do not adversely affect the tax-exempt status under section 501(c)(3) of the Code of A and the S section 501(c)(3) affiliates and D, E and F (the T section 501(c)(3) affiliates).

2. The affiliation and subsequent activities and transactions do not adversely affect the status of A, the T section 501(c)(3) affiliates and the S section 501(c)(3) affiliates as public charities described in section 509(a) of the Code, and following the affiliation, A, P and F will each qualify as a public charity described in section 509(a)(3) of the Code.

3. The transfer of assets or sharing or provision of services between and among the tax-exempt organizations in the new A system, including A and the S and T section 501(c)(3) affiliates and including the transfer of stock of U from E to D will not constitute an unrelated trade or business or produce unrelated business income under sections 511 through 514 of the Code.

Section 501(a) of the Code provides an exemption from federal income tax for organizations described in section 501(c)(3), including organizations that are organized and operated exclusively for charitable, educational or scientific purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

Revenue Ruling 69-545, 1969-2 C.B. 117, acknowledges that the promotion of health is a charitable purpose within the meaning of section 501(c)(3) of the Code.

Revenue Ruling 78-41, 1978-1 C.B. 148, concludes that a trust created by an exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the hospital is operated exclusively for charitable purposes and is exempt under section 501(c)(3) of the Code.

Section 1.509(a)-4(f)(1) of the regulations provides that section 509(a)(3)(B) of the Code sets forth three different types of relationships, one of which must be met in order to meet the requirements of the subsection. One of those relationships is operated, supervised or controlled in connection with. Section 1.509(a)-4(f)(4) of the regulations provides that in the case of supporting organizations which are supervised or controlled in connection with one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors.

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

Section 512(a)(1) of the Code defines unrelated business taxable income as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of the trade or business, with certain modifications.

Section 513(a) of the Code defines unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of the organization for funds or the use it makes of the profits derived) to the exercise of the organization's exempt purposes or functions.

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

Providing management and consultants' services to other, unrelated exempt organizations for a fee sufficient to produce a small profit does not further an exclusively exempt purpose. See B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978).

An organization providing laundry services on a centralized basis to exempt hospitals does not qualify for exemption under section 501(c)(3). See HCSC-Laundry v. United States, 450 U.S.1 (1981).

Section 513(e) of the Code provides that in the case of a hospital, the term "unrelated trade or business" does not include the furnishing of one or more of the services described in section 501(e)(1)(A) to one or more hospitals if such services are furnished solely to such hospitals which have facilities to serve not more than 100 inpatients, such services, if performed on its own behalf by the recipient hospital, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption, and such services are provided at a fee or cost which does not exceed the actual cost of providing such services.

Rev. Rul. 77-72, 1977-1 C.B. 157, provides that indebtedness owed to a labor union by its wholly owned tax-exempt subsidiary is not acquisition indebtedness within the meaning of section 514 of the Code since the parent and subsidiary relationship

shows the indebtedness to be merely a matter of accounting.

In Geisinger Health Plan v. United States, 30 F.3rd 494 (3rd Cir. 1994) (Geisinger), the court recognized that an organization may qualify for exemption based on the integral part doctrine, which arises from an exception to the "feeder organization" rule set forth in section 1.502-1(b) of the regulations, which states that 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 the parent organization. The court also noted that an entity seeking exemption as an integral part of another cannot primarily be engaged in activity which would generate more than insubstantial unrelated business income if engaged in by the other entity. In this regard, the court followed the reasoning of section 1.502-1(b), which contains an example of a subsidiary organization that is not exempt from tax because 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. The example states that if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations) it is not exempt because such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

Accordingly, the court in Geisinger determined that application of the integral part doctrine requires at a minimum that an organization be in a parent and subsidiary relationship and that it not be carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

An affiliation between previously independent hospitals to provide corporate services among the participants raises exemption qualification and unrelated trade or business issues. With respect to exemption qualification, the courts have been clear that exemption under section 501(c)(3) of the Code is not generally available where an organization is established to provide corporate services to unrelated exempt organizations, other than through the application of section 501(e) of the Code for cooperative hospital service organizations. See BSW Group, Inc., supra, and HCSC-Laundry, supra. Furthermore, exemption under the integral part doctrine requires a parent and subsidiary relationship and the absence of unrelated trade or business. See Geisinger, supra, and Rev. Rul. 78-41, supra. With respect to unrelated trade or

business, section 513(e) of the Code makes clear that if a hospital provides regularly carried on corporate services to another unrelated exempt organization for a fee, then such services are unrelated trade or business unless they fall within the exception for certain hospital services provided by section 513(e). However, if the participating exempt organizations are in an affiliated system of organizations with common control, then corporate services provided between them necessary to their being able to accomplish their exempt purposes are treated as other than an unrelated trade or business and the financial arrangements between them are viewed as merely a matter of accounting. See Rev. Rul. 77-72, supra.

At issue, then, is whether the affiliation established an affiliated system with sufficient common control such that corporate services and payments provided between the participating affiliates will not be treated as unrelated trade or business income.

Based on all the facts and circumstances, we conclude that the affiliation effectively binds the participating affiliates under the common control of A so that the participating entities are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of A's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating affiliates have ceded authority to A's governing body as sole member of D under state nonprofit corporation law and under the affiliation agreement and applicable bylaws to take any action (other than those previously stated) with respect to D and its affiliates with or without the approval of those entities. A exercises control with respect to strategic plans, operating budgets, capital budgets (provided they are not less than certain specified amounts during the first three years of the affiliation), rate schedules and charges for goods and services and use of facilities furnished by the T affiliates, and the incurrence of indebtedness by those organizations. A has effective control with respect to policies and procedures for health care services to the indigent, write-offs for uncollectible accounts, and over pricing with third-party payors. In addition, A is empowered to execute and deliver third party payor contracts on behalf of the T affiliates and to cause the development of new services and new strategic alliances and affiliations. In addition, A's board of directors meets regularly to exercise overall responsibility for operational decisions and to monitor the affiliates' compliance with its decisions. Therefore, the transfer or sharing or provision of assets or services between and among the tax-exempt organizations in the system is treated as other than an unrelated trade or business.

Contributions to organizations exempt from federal income tax under section 501(c)(3) of the Code do not fall within the definition of unrelated business income under section 512, nor create taxable gain or loss to the transferor or transferee.

The participating affiliates will not adversely affect their tax exempt status under section 501(c)(3) of the Code by reason of the affiliation and subsequent activities as they will continue to promote health within the meaning of Revenue Ruling 69-545. The participating entities will continue to qualify as nonprivate foundations under section 509(a) of the Code because they will continue to maintain the relationships and/or activities serving as the basis for their nonprivate foundation status. In addition, A, P and F qualify as nonprivate foundations under section 509(a)(3) because they now have the appropriate relationships and/or activities serving as the basis for this classification.

Accordingly, based on all the facts and circumstances described above, we rule:

1. The affiliation and subsequent activities and transactions do not adversely affect the tax-exempt status under section 501(c)(3) of the Code of A and the S section 501(c)(3) affiliates and D, E and F (the T section 501(c)(3) affiliates).

2. The affiliation and subsequent activities and transactions do not adversely affect the status of A, the T section 501(c)(3) affiliates and the S section 501(c)(3) affiliates as public charities described in section 509(a) of the Code, and following the affiliation, A, P and F each qualify as a public charity described in section 509(a)(3) of the Code.

3. The transfer of assets or sharing or provision of services between and among the tax-exempt organizations in the new A system, including A and the S and T affiliates and including the transfer of stock of U from E to D will not constitute an unrelated trade or business or produce unrelated business income under sections 511 through 514 of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based.

These rulings are directed only to the organizations that requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited by others as precedent.

These rulings do not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

We are informing your Area Office of this action. Please keep a copy of these rulings in your permanent records.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1