JUL 26 2001

INTERNAL REVENUE SERVICE 200151045
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Area Manager,
EO Examinations
Through: EO Mandatory Review Staff (Dallas)

Uniform Issue List:
501.03-11
512.02-00

Taxpayer's Name:

Taxpayer's Address:

T:EO:B1

Taxpayer's Identification
Number:

Year Involved:

Conference Held:

Legend:

A =
B =
C =
D =

E =
v =
w =
x =
y =
z =

Issues:

1. Does the organization qualify for exemption as an organization described in section 501(c)(3) of the Internal Revenue Code?

2. Does the management of a limited partnership whose business activity is the operation of a magnetic resonance imaging ("MRI") facility constitute a charitable activity within the meaning of section 501(c)(3) of the Code?

3. Are the management fees received by the organization from the limited partnership for providing management services subject to unrelated business income tax under section 511 of the Code?

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4. Are the income distributions that an exempt organization receives as the general partner in a limited partnership subject to unrelated business income tax under section 511 of the Code?

5. Should the organization be granted relief pursuant to section 7805(b) of the Code?

Facts:

A was recognized as an organization described in section 501(c)(3) of the Internal Revenue Code by letter dated October 29, 1987. It was classified as other than a private foundation under section 509(a)(1) of the Code as being described in section 170(b)(1)(A)(iii).

A was incorporated on July 25, 1985, pursuant to the Nonprofit Corporation Act of the State of E. Its stated purposes include (1) to establish, maintain, operate and support either directly, through subsidiary organizations, or in cooperation with other organizations, such facilities and services providing health care for sick, injured, disabled, indigent, or aged persons and providing for the preservation of health as the Board of Directors may determine from time to time to be appropriate, including, without limitation, hospitals, ambulatory care services, long-term care facilities, and agencies or facilities providing care for persons in their homes, and in particular to own, operate and manage a lithotripter and a facility for same; (b) to engage in, promote, or support, either directly or through subsidiary organizations, or in cooperation with other organizations, any activity designed to promote the general health, rehabilitation, or social needs of the public, either within or without the State of E. The Articles further provide that A shall be organized and operated exclusively for purposes listed in section 501(c)(3) of the Code.

A was formed as part of a joint undertaking by a consortium of ten section 501(c)(3) tax-exempt hospitals in the central area of the state of E, including C, the primary teaching hospital affiliated with D, an E state educational institution. A was formed to provide health care services in the form of extracorporeal shock wave lithotripsy ("ESWL") to residents of central E.

The hospitals acted collectively to establish A because the State of E limited the number of lithotripsy facilities that it would authorize under a certificate of need ("CON"), choosing to take a regional approach to granting CONs.

A formed B, (the "Partnership"), a limited partnership organized under the laws of the state of E, to own and operate the lithotripsy center ("Center"). B's sole activity has been to operate the lithotripter. A informed the State of E of its intention to operate the facility pursuant to a partnership. A is the sole general partner of the Partnership. The sale of limited partnership interests in the Partnership helped finance the acquisition of the lithotripter, the machine used to perform ESWL.

The CON was granted on January 15, 1987. The CON expressly conditioned the Partnership's right to operate the lithotripter on its agreement to:

- have an open staff and allow privileges to any urologist who successfully completed ESWL training;

- treat all patients in need regardless of ability to pay;
- provide indigent care to any and all indigents with income eligibility determined by state income guidelines;
- participate in the state Medicaid program and treat Medicaid recipients; and,
- accept Medicare assignment.

Failure by the Partnership to comply with the conditions imposed by the CON would result in the loss of the right to operate the lithotripter.

EO Examinations conducted an examination of A. It concluded that A does not qualify for exemption as an organization described in section 501(c)(3) of the Code. That office reasoned that because A was formed by two or more unrelated hospitals to operate on a centralized basis, section 501(e) of the Code is controlling. It further determined that management services performed by A for the Partnership do not come within the scope of any of the services enumerated in section 501(e). It maintained that the Partnership's operation of the lithotripsy facility, which possibly could qualify as a clinical service, cannot be attributed to A, because A is an entity separate and apart from the Partnership.

The Partnership consists of 37 partnership units, including 36 limited partnership units and 1 general partnership unit. Member hospitals own six limited partnership units; physicians of member hospitals own seven limited partnership units; board members, trustees, and other individuals own seventeen limited partnership units; and other organizations own six limited partnership units. Limited partners own a total percentage share of seventy-five percent of the Partnership. A, the general partner, owns a twenty-five percent share of the Partnership. A contributed $v to the Partnership. Each limited partner contributed $w.

Under the terms of the amended and restated partnership agreement ("partnership agreement"), the profit and loss sharing ratio of the general partner shall equal one minus the sum of the profit and loss sharing ratios of all the limited partners. The profit and loss sharing ratio of each limited partner is determined by dividing the number of units held by such limited partner by the aggregate units held by all limited partners and multiplying the result by ninety-five percent until such limited partner has received distributions equal to such limited partner's capital contribution. After any limited partner has received distributions equal to his or her capital contribution, such limited partner's profit and loss sharing ratio is determined by dividing the number of units held by such limited partner by the aggregate units held by all limited partners and multiplying the result by seventy-five percent.

The partnership agreement provides that the purpose of the Partnership is the research and provision of health care through the acquisition of a kidney lithotripter and the creation and operation of a kidney stone treatment center. The partnership agreement further provides that the Partnership business shall be managed by the general partner, A. The partnership agreement states that the general partner shall decide matters of management and control over the Partnership business and assume direction of all of the operations thereof.

During the examination, A was asked to establish the amount of patient charity care it provides. Review of the charity care and revenue reports for tax periods ending December 31, 1995 through December 31, 1999, disclosed that Medicare patients accounted for approximately between 19 to 22 percent of all patients; Medicaid patients accounted for approximately 1 to 2 percent of all patients; and that indigent care patients accounted for approximately 1 to 2 percent of all patients.

Lithotripsy is a specialized service that requires prior diagnosis of kidney stones. Therefore, the Center generally only serves patients that are referred there for treatment by their physicians. When patients are referred, they receive a form in which they are asked to provide their insurance provider, if any, and instructed that if they do not have an insurance provider, they should contact the Center to make payment arrangements. At that time, they are provided with an application for financial assistance, together with a statement of income and assets criteria for charity care. In addition, every patient receives a statement of rights that provides that the patient has the right to treatment regardless of ability to pay. A stated that the Partnership facility provides lithotripsy services to patients in need, regardless of whether the application for financial assistance has been received and approved prior to the procedure. The Center operated by the Partnership has never turned away any patient who could not afford treatment.

The Partnership facility maintains open staff privileges, and is required to do so by its CON. Membership in the Partnership has no bearing on a physician's ability to obtain ESWL privileges. The Center, operated by the Partnership, will grant clinical privileges to all doctors licensed by the State of E who are Board certified or active candidates for certification in urology, who maintain sufficient malpractice insurance coverage, and who have completed training in lithotripsy. Physicians appointed to the medical staff of the Center agree to provide continuous care of all patients of the Center regardless of ability to pay. At present, 88 urologists located in central E maintain staff privileges at the Center.

A maintains close ties with D, and particularly with its urology residency program. It trains all urology residents from D in lithotripsy and sponsors the medical school's visiting professor program. In addition, several members of the Center's medical staff are on the faculty of the medical school, including one of the Center's two medical directors, who also serves as the chairman of the medical school's urology department.

The Center also offers lithotripsy training to all interested urologists, regardless of their affiliation with D. To date, the Center has trained 13 urologists other than D's urology residents. The Center also trains non-physician staff in lithotripsy.

Additional educational efforts included:

- Producing a newsletter to foster education regarding lithotripsy and the Center's activities;
- Organizing a symposium on positron emission tomography to educate physicians, government and health care administrators, and others, in this new technology;
- Providing an annual educational grant;

- Educating public school students about lithotripsy (including providing summer employment to public school students in the health professional scholars program);
- Sponsoring dinner meetings around E for urologists, engaging nationally known speakers to make presentations on lithotripsy or other topics relevant to the practice of urology;
- Supporting the activities of the American Lithotripsy Society, including making presentations at the society's national meetings.

The Center operated by the Partnership also promotes and supports various research studies and activities, particularly in connection with its affiliation with D. The Center also participates in the American Lithotripsy Society's lithotripsy database, which provides data about procedures to researchers.

A and the Partnership entered into a management agreement on October 1, 1987, for A to manage the lithotripter facility. The management agreement provides that the Partnership will compensate A on a calendar year basis at the basic rate of $x per annum plus a set amount per procedure. The Management Agreement was amended in 1994 to provide for compensation at a fixed annual rate of $y. Beginning in calendar year 1995, the annual rate of compensation was to be increased annually by an amount equal to the previous year's annual rate of compensation multiplied by a percentage equal to the percentage increase, if any, occurring in the Consumer Price Index for all urban areas during the preceding calendar year.

Under the terms of the management agreement, A has the right and obligation at all times to operate the facility in accordance with its charitable purposes, including, but not limited to, the provision of health care, and the provision of some degree of indigent care (in amounts to be determined by A in its discretion), the provision of programs for medical research and the provision of programs for medical education.

A entered into a management services subcontract ("subcontract agreement") on December 28, 1987, with C. A's board of directors determined that it was in the best interest of A to subcontract certain of its management and staffing obligations for the Partnership to C, one of the member hospitals. C agreed to fulfill all of A's obligations to the Partnership to provide the established level of staffing, certain designated medical equipment and certain office furnishings, with the exception of the medical director and any other obligations arising out of A's capacity as general partner of Partnership. Any operating profit made in the management of the Partnership is to be divided equally between A and C in accordance with the Subcontract Agreement.

A entered into an agreement dated December 29, 1987, with the Department of Surgery of D to obtain the services of a physician to serve as the facility's medical director.

During the year under examination, A received an administrative management fee of $z. The primary expenses on the Form 990 for the year under examination were the subcontract fee paid to C, and the medical director fee paid to D. A review of the board meeting minutes revealed that the board held two meetings during the year under examination.

APPLICABLE LAW:

Exemption issues under section 501(c)(3) of the Code.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes, provided that no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 501(e) of the Code provides that an organization shall be treated as an organization organized and operated exclusively for charitable purposes if (1) such organization is organized and operated solely to perform for two or more exempt hospitals on a centralized basis one or more of the following services, which if performed on its own behalf by an exempt hospital would constitute activities in exercise of the function constituting the basis for its exemption: data processing, purchasing, billing and collection, food, clinical, laboratory, record center; (2) such organization is organized and operated on a cooperative basis; and (3) all of its stock is owned by patron hospitals.

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) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372; Scott on Trusts, sections 368, 372.

Rev. Rul. 69-545, 1969-2 C.B. 117, establishes the community benefit standard, which focuses on a number of factors indicating the operation of a hospital or health care facility benefits the community rather than serving private interests. The revenue ruling requires all relevant facts and circumstances to be weighed in each case. The revenue ruling concludes that a hospital meets the community benefit standard and serves public rather than private interests when the hospital is controlled by a board composed of independent civic leaders, has an open medical staff, an open, accessible emergency room, and serves persons with third party payors such as Medicare.

Rev. Rul. 98-15, 1998-1 C.B. 718, compares two situations where an exempt hospital forms a joint venture with an unrelated for-profit entity and then contributes its hospital and all of its other operating assets to the joint venture, which then operates the hospital. The revenue ruling affirms that for federal income tax purposes, the activities of a partnership are considered to be the activities of the partners. Thus, the activities of a limited liability company ("LLC") treated as a partnership for federal income tax purposes are considered to be the activities of an exempt organization that is a member of the LLC when evaluating whether the exempt organization is operated exclusively for exempt purposes. Situation 1 concludes that the hospital organization's principal activity continues to be the provision of hospital care, even when such activities are conducted through an LLC treated as a partnership, because the exempt hospital retains control over the LLC and the LLC serves charitable purposes.

Unrelated business income tax.

Section 511 of the Code imposes a tax on the unrelated business income of an exempt organization.

Section 512 of the Code defines unrelated business taxable income as the gross income derived from any unrelated trade or business regularly carried on, less the allowable deductions that are directly connected with the carrying on of the trade or business, both computed with certain modifications.

Section 512(c) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions connected with such gross income.

Section 513(a) of the Code provides that the term "unrelated trade or business" includes any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501(a).

Section 1.513-1(d)(1) of the regulations provides that gross income derives from unrelated trade or business within the meaning of section 513(a) of the Code if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

DISCUSSION:

Exemption issues under section 501(c)(3) of the Code.

A was created by ten unrelated exempt hospitals. The members joined to operate a lithotripter for the local area. The lithotripsy service is a patient care service provided to the general public. It is not a service provided directly to the member hospitals as contemplated in section 501(e) of the Code. Therefore, section 501(e) of the Code, dealing with hospital cooperative service organizations that perform certain administrative and other services for other hospitals, is not controlling.

The question is whether A is organized and operated exclusively for charitable purposes. For federal income tax purposes, the activities of a partnership are considered to be the activities of the partners. See Butler v. Commissioner, 36 T.C. 1097 (1961), acq., 1962-2 C.B. 4. Such aggregate treatment is consistent with the treatment of partnerships for the purpose of unrelated business income tax under section 512(c) of the Code. Rev. Rul. 98-15, supra, notes that in light of the aggregate principle reflected in section 512(c), the aggregate approach also applies for purposes of the operational test set forth in section 1.501(c)(3)-1(c) of the regulations. Thus, the

activities of a partnership or other joint venture are considered to be the activities of an exempt organization that is a partner in the partnership when evaluating whether the exempt organization is operated exclusively for exempt purposes.

An organization exempt under section 501(c)(3) of the Code may form and participate in a partnership and meet the operational test if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of any for-profit partners. Rev. Rul. 98-15. See also Plumstead Theatre Society v. Commissioner, 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982); Housing Pioneers v. Commissioner, 65 T.C.M. (CCH) 2191 (1993), aff'd, 49 F.3d 1395 (9th Cir. 1995), amended, 58 F.3d 401 (9th Cir. 1995).

In evaluating whether A is operated exclusively for charitable purposes, the activities of the Partnership are considered the activities of A. Thus, A's primary activities consist of the health care services it provides through the Partnership. The first question then is whether the Partnership furthers the charitable purpose of promoting health for a broad cross section of the community. Any physician or hospital may refer a patient to the lithotripter facility. The facility has a charity care policy that is advertised to the public through its financial forms. The facility serves Medicare, Medicaid, and indigent patients with the same services that are provided to any patient. No patient is turned away for lack of ability to pay. It has broad-based community board representation by the member hospitals. It participates in or sponsors medical educational activities, community educational activities, and medical research projects. As such, for the years under examination, the Partnership of which A is a partner satisfied the community benefit standard of Rev. Rul. 69-545, supra.

The next question is whether the Partnership arrangement permits A to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of the physicians and other non-exempt partners. A received an interest in the Partnership equal in value to its contribution to the Partnership, and its returns are in proportion to its investment in the Partnership. A has control over the policies of the Partnership as well as the day to day activities of the lithotripsy facility. A can ensure that the assets it owns through the Partnership and the activities conducted by the Partnership are used primarily to further exempt purposes. Thus, for the years under examination, A could ensure that the benefit to the for-profit limited partners was incidental to the accomplishment of charitable purposes.

Although in the examination year the partnership agreement did not specifically provide that charitable interests have priority over profit interests, the facts show that B was operationally consistent with Situation 1 of Rev. Rul. 98-15 during that time.

Accordingly, A qualifies for exemption under section 501(c)(3) of the Code for the examination year. A's participation in the Partnership is its primary activity. A primarily furthered exempt charitable purposes through its participation in the Partnership and the operation by the Partnership of the lithotripsy center.

Unrelated business income tax.

Section 512(c) of the Code provides that those distributions to an exempt organization from a partnership in which the organization is a partner that come from an unrelated trade or business conducted by the partnership result in unrelated business taxable income to the organization. So long as the activities of the Partnership are substantially related to the exempt purposes of A, such Partnership activities are not unrelated trade or business. The Partnership activity of providing lithotripsy services, overseen by a physician, furthers charitable purposes of providing health care for a broad cross-section of the community. Since the lithotripsy facility is not an activity that is an unrelated trade or business with respect to A, the Partnership distributions to A are not subject to unrelated business income tax under section 511 of the Code.

A also received fees for management services provided for the Partnership pursuant to the Management Agreement. Under the management agreement, payment was received for the extra time and expense required to carry out its duties as general partner in managing the Partnership's affairs, providing a medical director, and planning activities, staff responsibilities preparation of budgets, and other management services. According to the management agreement, these activities were to be conducted in a manner to further A's exempt charitable status. Because these services are generally limited to medical and staffing responsibilities, as well as A's responsibilities as general partner, these activities are substantially related to the exempt purposes of A. As such, fees received in connection with these services are not unrelated business income.

CONCLUSIONS:

1. A qualifies for exemption as an organization described in section 501(c)(3) of the Code.

2. A's participation as a general partner in the Partnership, which operates a lithotripsy facility in accordance with the community benefit standards outlined in Rev. Rul. 69-545, furthers charitable purposes under section 501(c)(3) of the Code.

3. A's receipt of fees for management services provided to the Partnership does not result in unrelated business taxable income to A.

4. A's receipt of distributions from the Partnership does not result in unrelated business taxable income because the Partnership's activities are substantially related to the furtherance of the exempt purposes of A.

5. There is no need to grant relief under section 7805(b) of the Code because we have concluded that A qualifies for exemption under section 501(c)(3) of the Code.

This technical advice memorandum is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

END