UIL: 501.03-28
511.00-00

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

200215057

Date: JAN 15 2002

Contact Person:

Identification Number:

Telephone Number:

T:EO:B1

Employer Identification Number:

Legend

P=
H=
C=
F=
A=
W=
M=

Dear Sir or Madam:

You requested rulings under sections 501(c)(3) and 511-514 of the Internal Revenue Code. This letter responds to your request.

Facts

H

H is an organization recognized as exempt from federal income tax under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(iii). H has over 100 licensed beds and provides a wide range of patient care services, including general surgery, orthopedic surgery, ophthalmology, urology, obstetrics, maternity care, pediatrics, outpatient surgery and general medical care.

P

P is a newly formed non-profit corporation recognized as exempt from federal income tax under section 501(c)(3) of the Code and is described in section 509(a)(3). Upon completion of the proposed transaction (Transaction), P will oversee and coordinate the activities of its affiliates, H, C and F, which, together with P, are hereafter referred to as "System."

294

C

C is a newly formed non-profit corporation recognized as exempt from federal income tax under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(iii). Upon completion of the proposed transaction, C will operate an outpatient clinic.

F

F is newly formed non-profit corporation recognized as exempt from federal income tax under section 501(c)(3) of the Code and is described in section 509(a)(3). Upon completion of the proposed transaction, F will engage in fundraising on behalf of the System.

PROPOSED TRANSACTIONS

H's board of directors determined it could better achieve its charitable purposes by integrating local physicians into its healthcare activities and mission. H negotiated the purchase of the practices of 28 physicians previously employed by A, a large multi-specialty physician group operating in H's service area. Pursuant to the asset purchase agreement, H agreed to purchase from A the assets and operations of three freestanding practice sites. The Transaction also includes the sole membership interest in W, a freestanding ambulatory surgery center. It is currently anticipated the closing of the asset purchase agreement (the "Closing") will occur on or before December 31, 2001.

H states the negotiations were conducted at arm's-length with the assistance of legal counsel from various law firms as well as an independent third-party healthcare consultant. H also obtained a discounted cash flow analysis as well as a fairness opinion to verify the proposed purchase price was reasonable. It is anticipated the purchase price will be in the range of M.

Upon completion of the proposed transaction, the composition of the various System boards will be as follows:

P's Board	**H's Board**
13 voting directors: 8 community (including H's chair, additional H director, and F's chair) 5 physicians (including C's president and C's chair) 1 non-voting director: System CEO	11-19 voting directors: 7-15 community At least 3 physicians (including chief of medical staff) System CEO 2 non-voting directors: H's president (if different from System CEO) Auxiliary organization president or designee

295

C's Board 7 voting directors: 6 physicians System CEO 2 non-voting directors: Clinic president Clinic administrator	**F's Board** Up to 15 voting directors: Up to 12 community 2 auxiliary organization designees System CEO

P's board of directors will be charged with overall responsibility for the strategic direction and charitable mission of System. The boards of the System entities will be subject to a substantive conflicts of interest policy. P's board will hold certain reserved powers with respect to key organizational and operational matters affecting H, C, and F. Specifically, P's board of directors will retain the following authority over H, C, and F:

1. Review and approve any amendments or restatements of the articles of incorporation or bylaws of the corporation.

2. Develop and approve the mission and vision statement of the corporation.

3. Ratify the election of the board of directors of the corporation, and remove any directors so elected for cause (*i.e.*, for any act or omission inconsistent with the purposes, mission, vision and/or written policies of the corporation).

4. Ratify the election of the officers of the corporation, and remove any or all officers so elected.

5. Develop and approve System wide policies, including financial transactions approval guidelines and a conflicts of interest policy.

6. Review and approve all accounting and treasury systems and functions relating to the corporation.

7. Review and approve the annual operating and capital budgets of the corporation.

8. Review and approve the strategic plan(s) of the corporation and, as part thereof, review and evaluate existing and proposed services in order to ensure they meet the needs of the corporation's and the System's service area and are consistent with such strategic plan.

9. Review and approve any borrowings, guarantees or other forms of indebtedness to be incurred by the corporation.

10. Approve the executive compensation policies, plans and arrangements (including incentive compensation) for executives employed by the corporation. In the case of C, P also has the authority to approve C's annual budget for all professional compensation, and to approve all compensation policies and plans (including incentive compensation) for physicians employed by C.

11. Review and approve any unbudgeted capital expenditures of the corporation exceeding $500,000, individually or in the aggregate, in any fiscal year.

12. Review and approve the plan of dissolution of the corporation.

13. Review and approve any sale of assets or operations of the corporation exceeding $500,000, individually or in the aggregate, in any fiscal year.

14. Approve the merger or consolidation with, the acquisition of or by, or the affiliation with any hospital, clinic or physician group relating to the corporation.

15. In the case of H, approve the selection of any new site(s), as recommended by H's board.

After the Transaction, System will continue H's historic commitment to ensuring broad community access to health care. Both H and C will provide charitable medical services in response to the needs of indigent and underserved individuals in the community. Charity care does not refer to care provided to Medicare or Medicaid patients, nor does it include write-offs, nor discounted fee-for-service arrangements negotiated with payors. In addition, H and C will work together for the benefit of the local community through programs, seminars, workshops, and other types of activities directed at ensuring public awareness of matters related to individual physical, psychological and emotional health, welfare and safety.

The System entities will also provide financial and other resources among themselves for the achievement of their overall common goal of best serving the health care needs of the community. H, C, F and P will coordinate the methods, locations, personnel, and resources for the direct provision of patient care. For example, this may mean the consolidation of particular types of health care activities or support functions in particular entities or physical locations best suited to patient care, convenience, efficiency and cost minimization.

The System entities will also engage in certain administrative arrangements with each other. For example, certain management-level employees of H, C and F may become P employees. In some cases, individual employees may have responsibility for multiple entities. Under the direction of P's board and System management, various inter-company arrangements likely will be established. Such inter-organizational arrangements may include, billing and collection services; information systems; laboratory services; certain administrative functions; materials management; strategic planning; community relations and marketing; managed care contracting; budgeting and finance; compliance; and the lease of facilities and/or personnel. Any and all of such arrangements will be structured to achieve cost savings and maximize efficiencies in organizations' resources and facilities. Such arrangements may call for reimbursement on either a cost basis or at market levels.

In connection with the formation of System, H will provide the initial capital to allow P, C and F to become operational. Aside from initial capital needs, it is possible other contributions and/or loans will be made between the System entities. This is consistent with the expectation that all assets and resources of the System will be applied for System needs, irrespective of how such assets are titled or where they are located.

RULINGS REQUESTED

You requested the following rulings:

1. H's purchase from A of the assets and activities to be associated with C's operations will not adversely impact H's section 501(c)(3) tax exempt status.

2. H's participation in the formation of the System will not adversely impact H's section 501(c)(3) tax exempt status.

3. Transactions and arrangements between P, H, C, and F will not result in unrelated business taxable income under section 511 of the Code to P, H, C, and F and will not otherwise adversely impact P's, H's, C's, and F's tax exempt status.

LAW

Section 501(c)(3) 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, recognizes 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 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.

Providing management and consultant's services to other, unrelated exempt organizations for a fee sufficient to produce a small profit does not further an exclusively exempt purpose. See BSW 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).

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 if a subsidiary organization of a tax-exempt organization would itself be exempt on the ground 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 an entity seeking exemption as an integral part of another cannot primarily be engaged in an activity that 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 examples state 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 an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

Analysis

Based on all the facts and circumstances, we conclude H will not adversely affect its tax exempt status under section 501(c)(3) of the Code by its involvement in the Transaction as it will continue to promote health within the meaning of Revenue Ruling 69-545, supra. The sharing of assets, personnel and/or resources will not adversely affect the section 501(c)(3) status of H, F, C, and P because these activities promote health within the meaning of Revenue Ruling 69-545, supra.

Sections 511 Through 514 of the Code

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

Section 512(a)(1) of the Code defines the term unrelated business taxable income as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions, computed with the modifications listed in section 512(b).

Section 512(b)(3) of the Code provides generally that rents from real property (and its incidental related personal property) are not unrelated business income unless the property is debt-financed under section 514 of the Code. Debt-financed property does not include any property substantially related to the exercise or performance by such organization of its charitable functions.

Section 512(b)(4) of the Code requires that notwithstanding paragraphs (1), (2), (3) or (5), the net income realized with respect to debt-financed property must be included in unrelated business taxable income.

Section 512(b)(5) of the Code exempts from the definition of unrelated business taxable income all gains and losses from the sale, exchange or other disposition of non-inventory items and items not held for sale in the ordinary course of business.

Section 512(b)(13) of the Code limits the exclusion of interest, annuities, royalties, and rents provided by section 512(b)(1), (2), and (3) where such amounts are derived from a controlled organization.

Section 1.512(b)-1(l) of the regulations provides if an exempt organization has control of another organization, the controlling organization shall include as an item of gross income in computing its unrelated business taxable income the amount of interest, annuities, royalties, and rents derived from the controlled organization, determined in accordance with the formula described in section 512(b)(13) of the Code and section 1.512(b)-1(l)(3) of the regulations.

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 income or funds or the use it makes of the profits derived) to the exercise of the organization's exempt purposes or functions.

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.

Section 1.513-1(d)(2) of the regulations provides a trade or business is related to exempt purposes, in the relevant sense, only where the conduct of business activities has a causal relationship to the achievement of exempt purposes; and it is substantially related only if the causal relationship is a substantial one. The regulation states that 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 performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 514 of the Code provides for the taxation under section 512 of income from debt-financed property. Section 514(b)(1)(A)(i) of the Code, however, provides that the definition of debt-financed property does not include any property substantially all the use of which is substantially related to the exercise or performance by such organization of the charitable purposes constituting the basis for its exemption under section 501.

Analysis

With respect to unrelated trade or business, section 513(e) of the Code makes it clear 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 a parent and subsidiary relationship, 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 section 1.502-1(b) of the regulations. Therefore, transactions and arrangements between P, H, C and F will not result in unrelated business taxable income within the meaning of sections 511-514 of the Code.

Conclusion

1. H's purchase from A of the assets and activities to be associated with C's operations will not adversely impact H's section 501(c)(3) tax exempt status.

2. H's participation in the formation of the System will not adversely impact H's section 501(c)(3) tax exempt status.

3. Transactions and arrangements between P, H, C, and F will not result in unrelated business taxable income under section 511 of the Code to P, H, C, and F and will not otherwise adversely impact P's, H's, C's, and F's tax exempt status.

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

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

Please keep a copy of this ruling letter in your permanent records.

A copy of this letter will be furnished to your Exempt Organizations Area Manager.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1