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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: DEC 4 2002

Contact Person:

Identification Number:

S.I.N. 513.04-00

Telephone Number:

T:EO:B1

Employer Identification Number:

Legend

O=
T=
U=
M=
N=
P=

Dear Sir or Madam:

This is in reply to your request for a ruling regarding the federal tax consequences associated with the transactions described below.

O is a community hospital located in T. O is recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (the Code) and is classified as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code. O serves the citizens of T and U and their surrounding communities. The policy of O is to provide services to any resident of the state, regardless of the ability of the individual to pay for those services, in accordance with the provisions of its charity care guidelines and its mission.

Its parent corporation, M, wholly controls O. M is recognized as exempt under section 501(c)(3) of the Code and is classified as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code. One of M's direct subsidiaries, N, is a taxable corporation. In turn, N has several taxable subsidiaries, including P. You indicate that since its inception, P has never experienced a fiscal year in which it generated a net profit.

You state that P's purpose is to provide physician services for residents of T and U and surrounding communities. P employs approximately 40 physicians and approximately 10 mid-

level providers. You state that when P was first formed, careful consideration was given as to whether P should be formed as a tax-exempt entity under section 501(c)(3) of the Code. Ultimately, a decision was made not to seek tax exempt status primarily because at that time certain restrictions existed relative to employee benefits for exempt entities, such as a 401(k) plan.

You represent that O proposes to operate a provider-based clinic that would offer to the community a broad spectrum of physician services. O will have these services provided by certain physicians who are currently employed by P. You state that O will establish two arrangements for obtaining these services. First, certain physicians will cease being employees of P and will instead become O employees under terms and conditions very similar to those of their current employment contracts with P. Second, other physicians will remain employees of P and O will pay P an arm's-length fee for their services. The amount of the fee that O will pay P for a physician's services will equal the amount of the physician's compensation and benefits plus the portion of P's overhead costs that are reasonably allocable to that physician. You state that under either of these arrangements, the physicians will accept patients regardless of their ability to pay and will be required to treat Medicare and Medicaid patients.

You further represent that the physicians, all of whom are currently P employees, all currently have employment contracts that:

- were negotiated at arm's length;
- are reasonable in amount in light of the services performed and amounts paid by comparable organizations for comparable services;
- contain, if any incentives at all, only fairly modest ones that in no way rise to impermissible diversion of profits to private individuals; and
- require the physicians to accept patients regardless of ability to pay or payment source

You also represent that after the physicians are employed by O the total amount of each physician's compensation will not exceed the customary range for physician compensation for their branch of medicine and geographic area.

Based on the above facts, along with other materials provided, you have requested a ruling that the revenue received by O for services provided by the physicians should not be treated by O as income from an unrelated trade or business under section 513 of the Internal Revenue Code.

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

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations (the regulations) provides that the term "charitable" is used in Code section 501(c)(3) in its generally accepted legal sense. The promotion of health has long been regarded as a charitable purpose. See Restatement Second

of Trusts, sections 368, 372 (1959); 4A Scott and Fratcher, The Law of Trusts, sections 368, 372 (4th ed. 1989); Rev. Rul. 69-545, 1969-2 C.B. 117.

In Rev. Rul. 69-545, 1969-2 C.B. 117, the Service established the community benefit standard as the test by which the Service determines whether a hospital is organized and operated for the charitable purpose of promoting health.

Section 511 of the Code imposes a tax on the unrelated trade or business income of exempt organizations.

Section 513(a) of the Code defines the term "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 or performance by such organization of the purpose or function constituting the basis for its exemption.

Section 1.513-1(d)(2) of the regulations states that a trade or business is related to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of an exempt purpose, and is substantially related for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of a 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 those purposes.

Section 1.513-1(d)(4) of the regulations states that gross income derived from charges for the promotion of exempt functions does not constitute gross income from the conduct of unrelated trade or business.

You represent that the provider-based clinic will provide physician services as a division of O. You indicate that the clinic will have the same licensor, governing board, organizational documents and supervisory and administrative procedures as O. The clinic will be subject to Medicaid's requirements to offer access to care to everyone regardless of their ability to pay because O is and will remain a Medicaid provider. You state that the physician care services of the clinic will be fully integrated with those of O in virtually every way, with the overall effect of improving the quality of care and eliminating certain administrative redundancies.

Finally, you indicate that no physician will have any financial interest in the clinic, other than compensation as an employee, and the total amount of the physicians' compensation will not exceed the customary range for physician compensation for their branch of medicine and geographic area.

Accordingly, based on the facts and circumstances presented herein, we rule that the revenue received by O for services provided by the physicians is not income from an unrelated trade or business under section 513 of the Code because it will be derived from an activity which is substantially related to O's exempt purpose of promoting the health of the residents of

its service area.

This ruling does not address whether the compensation arrangements with physicians result in the payment of reasonable compensation.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

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

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