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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

199918066

Contact Person:

Badge Number:
Telephone Number:

In Reference to: OP:E:EO:T:1

Date: FEB 11 1999

Employer Identification Number:
Key District Office:

Legend:

R =
S =
T =
U =
V =
W =
X =
Y =

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 transactions described below.

S and one of its wholly-owned subsidiaries, T, are each exempt from federal income tax under section 501(c)(3) of the Code and are classified as nonprivate foundations under sections 509(a)(1) and 170(b)(1)(A)(iii), respectively.

U is a political subdivision of R described in section 115 of the Code. W is a statutorily authorized university under the governance of U. X is a statutorily authorized college of medicine under the governance of U.

V is a newly formed, not-for-profit corporation organized under the laws of R, which is being recognized as exempt from federal income tax under section 501(c)(3) of the Code and as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) by letter of even date. S and U are equal (50%/50%) members of V.

You have stated that the respective hospital, ambulatory care and clinic facilities of S, T and W will be combined and operated by V, which has the same charitable purpose, the promotion of health, as that of S, T and W.

Geographically, the respective acute care hospitals and some of the ambulatory care and clinic facilities of S, T and W are located on the same campus.

You have stated that the purpose of this transaction is to attain an integrated health care delivery system with greater operational and economic efficiencies, improved access to care, and enhanced quality in the delivery of health care services.

You have stated that V will contract with S and T through a joint operating agreement to operate T and its related ambulatory care facilities and clinics. In the same fashion, V will contract with U through a joint operating agreement to operate Y and its related ambulatory care facilities and clinics.

You have stated that the relevant property, plant and equipment of T and W has been leased to V.

V will have two members, S and U, with each member electing six representatives to the Board of Directors of V and each member capitalizing V by equal contributions.

V will have the following delegated powers under its Articles of Incorporation:

(a) Complete governance and sole operating authority over the business and related, defined activities and affairs of T's acute care hospital and its related ambulatory care facilities and clinics and W's Y hospital and its related ambulatory care facilities and clinics, including, but not limited to, strategic planning; authority over the physical plants of each hospital, ambulatory care sites, and clinics; determination of service sites; and allocation of resources, services, employees and equipment to the appropriate health care delivery site.

(b) Complete authority in the acquisition, sale, conveyance, transfer or other disposal of any material asset used by V, except with respect to those assets which are subject to a lease between V and its members of the physical plant, property and equipment of the members existing on the closing date, which is to remain the respective properties of the members; new acquisitions of property, plant and equipment to be owned or leased and operated by V.

(c) Authority over admission of a new member, unless such admission would: reduce the number of directors elected by the incorporating members; change the size of the Board of Directors; change the quorum requirements applicable to the Board; adversely affect the academic mission of W; or change the majority or

super-majority voting requirements applicable to the Board of Directors of V.

In addition, the Board of Directors of V has delegated the following authority to the President/Chief Executive Officer, who will have authority for all day to day operations of all facilities of V including, but not limited to: analyzing and managing productivity; consolidating management; developing common, centralized accounting and information systems; developing and administering operational plans; developing capital and operating budgets, with authority to approve major expenditures, debt, contracts, managed care agreements and capital expenditures; setting fees and prices; managing and overseeing daily operations; overseeing, conducting and carrying out marketing and business development strategies; conducting contract negotiations and implementation; implementing human resource policies; representing V in insurance product negotiations with the objective of having single managed care contracts for all facilities and providers; undertaking capital expenditures not otherwise reserved to S and U; entering into an academic affiliation agreement with U to help fulfill the mission of W; working with other health care, government and community organizations for the promotion of health and the health care needs of the service area and monitoring medical-dental staff acountabilities.

The Board of Directors of V has also delegated to the President/Chief Executive Officer certain responsibilities as to which he is accountable to the Dean of X, involving issues essential to integration of the academic and research missions of W with the clinical care rendered by the hospitals, ambulatory care facilities and clinics of V. These items include: system-wide strategic planning, including appropriate resource allocation; new program development; insurance product contracting; educational and clinical research enhancement; affiliation decisions related to the academic affiliation agreement and joint recommendation of clinical affiliation decisions to the Board of Directors of V.

You have stated that the following are additional delegated powers: distribution of capital surplus and changing the percentage of distribution of capital surplus to the two members; changes in the Bylaws of the medical staff and changes in the academic affiliation agreement entered into between V and U.

You have stated that the powers partially reserved to the members, which first are subject to the affirmative recommendation of the Board of Directors of V include: amendment of the Articles of Incorporation and Bylaws of T or U to the extent such amendment affects V; merger, liquidation or

dissolution of T or U to the extent such merger, liquidation or distribution affects V and debt issuance which would result in a debt to equity ratio for the combined T, U and V entities in excess of a defined amount.

The powers which are fully reserved to the members include: amendments to V's Articles of Incorporation and Bylaws; amendment to, or declaration of default under the joint operating agreement; merger, liquidation or dissolution of V; disposition of defined member assets; additional capital investments in V not identified in the joint operating agreement; capital expenditures by the members for defined projects relating to V in excess of a stated amount; and admission of additional members if such admission is beyond the powers delegated to V.

You have requested the following rulings in connection with this series of transactions:

1. The participation of S, T and U as equal members in the ownership of V will not adversely affect their status as exempt from federal income tax under section 501(c)(3) of the Code or S and T's status as nonprivate foundations under sections 509(a)(1) and 170(b)(1)(A)(iii).

2. Neither S, T and U's receipt of lease payments from V and V's return of capital surplus to S, T and U, nor capital contributions, transfers of assets and/or loans among these entities will cause these entities to be engaged in an unrelated trade or business within the meaning of 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, 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 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 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 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.

A joint operating or affiliation agreement 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 B.S.W. 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 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 Rev. Rul. 77-72, supra.

At issue, then, is whether the joint operating or affiliation agreement has established a parent and subsidiary relationship such that corporate services and payments provided between the participating entities will not be treated as unrelated trade or business income because the activities are essential to the accomplishment of exempt purposes, could be conducted by a participating entity for itself without giving rise to unrelated trade or business income, and occur in the context of a close relationship among them.

Based on all the facts and circumstances, we conclude that the affiliation agreement effectively binds S, T and W under the common control of V so that the participating organizations are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of V's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating entities have ceded authority under the affiliation agreement to V's governing body to establish their budgets, including major expenditures, debt, contracts, managed care agreements, and capital expenditures; and to monitor and audit their compliance with its directives. In addition, the governing body and its committees meet regularly to exercise overall responsibility for operational decisions

involving the day-to-day and long range strategic management decisions that have been delegated by the participating entities. Therefore, services provided between the previously unrelated section 501(c)(3) tax exempt organizations through the affiliation agreement are 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 parties will not adversely affect their tax exempt status under section 501(c)(3) of the Code by the proposed transactions as they will continue to promote health within the meaning of Revenue Ruling 69-545. The transfer of resources and the sharing or provision of goods, facilities, and services among the section 501(c)(3) entities will not produce unrelated business income under sections 511 through 514 of the Code because the above organizations are financially and structurally related as part of an alliance to promote the health of the community.

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

1. The participation of S, T and U as equal members in the ownership of V will not adversely affect their status as exempt from federal income tax under section 501(c)(3) of the Code or S and T's status as nonprivate foundations under sections 509(a)(1) and 170(b)(1)(A)(iii).

2. Neither S, T and U's receipt of lease payments from V and V's return of capital surplus to S, T and U, nor capital contributions, transfers of assets and/or loans among these entities will cause these entities to be engaged in an unrelated trade or business within the meaning of 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 organization that requested them. Section 6110(j)(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 key District Director of this action. Please keep a copy of these rulings in your permanent records.

Sincerely,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1