199931042

Internal Revenue Service

Department of the Treasury

U.I.L. Nos: 103.00-00, 115.00-00
141.00-00, 145.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:
CC:DOM:FI&P:5/PLR-108188-98

Date: APR 30 1999

198

LEGEND:

I =

K =

L =

M =

N =

P =

Q =

R =

S =

V =

W =

X =

Y =

Z =

County =

A Bonds =

B Bonds =

C Bonds =

D Bonds =

E Bonds =

F Bonds =

H Bonds =

AA Bonds =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Dear Sir or Madam:

This is in response to a letter from your authorized representative requesting a series of rulings on your behalf regarding tax consequences associated with the transactions described below. You represent the following set of facts.

FACTS

GENERAL

Q and I (collectively, the "Districts", and individually a "District") are political subdivisions of the state of R, created under the laws of R. The state legislature of R formed each entity to provide health care for residents of County, regardless of ability to pay, and for making health care facilities available to the residents of County. Both Q and I have developed hospital systems to meet their responsibilities under R law.

200

R law provides for cooperation among governmental entities in the State. Accordingly, Q and I have signed an Interlocal Agreement of Affiliation (the "Agreement") pursuant to state law. The Agreement provides for the cooperation and coordination of the Q and I hospital systems to create an integrated health care delivery system (the "System"). The Agreement provides for the joint planning, coordination, management, and financing of operations of K, L, S, V, W, X, Y, Z, and any entity subsequently admitted to the System. These entities are collectively referred to as the "Controlled Entities", and individually referred to as a "Controlled Entity". These activities are carried out by and through a newly incorporated entity, M. The Agreement does not provide for the direct sharing of profits or losses among the Controlled Entities or Districts. Any financial sharing between the Controlled Entities or Districts is accomplished through M.

The purpose of the Agreement is to provide coordination of patient care services, which is expected to reduce unnecessary duplication of resources, increase efficiencies, and decrease costs to health care consumers; provide additional patient access to specialized services; improve strategic planning; and enhance expertise in the clinical, medical, educational, marketplace, planning, finance, and management services areas. The Agreement will not be implemented until the receipt of favorable letter rulings on all issues for which consideration was requested.

Pursuant to the Agreement, M has been incorporated to serve as the parent of the System. The System will include the following entities (1) K and L, which are currently subsidiaries of I, and (2) S, V, W, X, Y, and Z, which are currently subsidiaries of Q. The Agreement requires that the governing instruments of each of these entities, except X, be amended to provide that M is the sole member. Q is and will remain the sole member of X, but X will be subject to the same requirements as the entities of which M will be the sole member. The Agreement also requires that the governing instruments of all the Controlled Entities be amended to provide M with the powers over each Controlled Entity specified in the Agreement.

In addition to the Controlled Entities, Q has a subsidiary P, which will not be a Controlled Entity. P, a nonprofit corporation, was formed to perform services that would otherwise have to be performed by Q.

THE PARENT

The Districts will be the sole members of M. M has been recognized as an organization described under § 501(c)(3) and as a nonprivate foundation under § 509(a)(3). The purposes of M are to assist the Districts in carrying out their duties and responsibilities pursuant to state law and pursuant to the Agreement. The planning and implementation of all activities by

M must be consistent with the mission statement, purposes, and principles identified by the Districts in the Agreement. The Agreement provides that, subject to the powers reserved to the Districts, M will support, benefit, and carry out in accordance with the terms of the Agreement some or all of the charitable purposes of the Controlled Entities by (1) providing overall management to the Controlled Entities, including planning, directing, and establishing policy related to the development and ultimate delivery of health care services by the Controlled Entities on an integrated, cost-effective basis without unnecessary duplication; (2) providing overall planning and coordination of the delivery of health care services, facilities, and programs in Districts' respective service areas; (3) coordinating the provision of patient care services, including the implementation, development, and improvement of managed care strategies; and (4) securing and arranging capital to provide for the operation and implementation of the Controlled Entities' facilities and programs.

Under the Agreement, the board of directors of M will be composed of an equal number of commissioners from Q and I. The initial board of directors of M consists of sixteen members, including seven members each of the Board of Commissioners of Q and I, as appointed from time to time by the Governor of R, and one representative of the medical staff of each of the Districts designated by the Chief of Staff of each medical staff. Each District will approve the appointment of the representative of the medical staff of that District. Any additional directors will be appointed by the District that such director will represent. No more than 20% of the M directors may be physicians who are employed by, or otherwise retained to provide services to, or hold an appointment to the medical staff of one or more of the Controlled Entities. Each District may remove a director of M who represents that District, other than a director who is a member of the Board of Commissioners of that District, with or without cause. Any appointment or removal of a director by a District must be approved by a simple majority vote of the governing board of that District. The president/CEO of M must be elected by M's board of directors from among a slate of persons that has been approved in writing by the Districts.

Upon creation of M, each of the Districts must make an initial cash capital contribution to the corporation. Upon dissolution of M, all of the assets of M remaining after payment of all costs and expenses of such dissolution, and after adequate provision has been made for the discharge or assumption of its liabilities, will be distributed to Q and I to be used exclusively for a public purpose. The articles of incorporation and bylaws of M may not be amended without the approval of the Districts.

RELATIONSHIP AMONG M AND THE DISTRICTS

The Agreement sets forth certain M actions that must be approved or ratified by the Districts. Subject to the powers reserved to the Districts individually, together the Districts have the following rights and powers with respect to M:

(a) The Districts have the power to interpret and change the mission and philosophy of M and approve in advance any change to the mission and philosophy of M and approve any change to the mission and philosophy statement contained in corporate documents of the Controlled Entities.

(b) The Districts have the power to ratify the strategic plans for M.

(c) The Districts must approve, prior to their adoption, the operating and capital budgets of M. In addition, the Districts have the power to establish thresholds above which M must seek approval in advance of the expenditures from the Districts for budgeted and unbudgeted capital and operating expenditures.

(e) The Districts have the power to establish limits on M's authority to incur new debt or to approve the incurrence of debt by a Controlled Entity.

(f) The Districts have the power to establish a policy governing the entry of any entity owned or controlled by M into a joint venture, partnership, affiliation, or similar relationship with any entity not owned or controlled by M and approving any action that is inconsistent with that policy. M may not enter, or permit any of the Controlled Entities to enter, into any such relationship in a manner inconsistent with that policy without the approval of the Districts.

(g) The Districts have the power to establish a policy governing the creation or admission of any new Controlled Entity in or to the System and approving any action that is inconsistent with that policy.

(h) The Districts must approve, in advance, the merger, dissolution, or consolidation of M and the sale or alienation of all or substantially all of the assets of M.

(i) The Districts have the power to approve the addition of any new entities as members of the System.

(j) In addition to any other reporting formats it may choose, M must report financial information about the assets and operations of the individual Controlled Entities on a District by District basis and on a consolidated basis.

(k) The Districts have the power to demand an audit of the books and records of M. A copy of the annual audit of the books and records of M shall be provided to each District.

(l) Through joint action, the Districts may veto the following actions taken by M:

(i) M's appointment and removal of directors of the Controlled Entities;

(ii) M's approval of the merger, dissolution, or consolidation of any Controlled Entity, or the sale or mortgage of all or substantially all of the assets of any Controlled Entity;

(iii) M's approval of the operating and capital budgets of the Controlled Entities and M's approval of subsequent changes or to the operating and capital budgets of a Controlled Entity;

(iv) M's approval of an expenditure by a Controlled Entity that is not contained in Controlled Entity's approved budget and that is in excess of any transaction threshold established by M; and

(v) M's approval of the slate from which a Controlled Entity's board may select the Controlled Entity's CEO/president.

The Districts individually have the following reserved rights and powers with respect to M:

(a) Each District has the power to appoint directors to M's Board to represent that District and to remove such directors with or without cause.

(b) Each District must approve, in advance, any sale, transfer, or other alienation of an interest in assets owned by that District or any Controlled Entity that was previously a subsidiary of that District.

(c) Each District has the power to ratify or reject recommendations made by M's Board which would significantly affect access to appropriate local health care delivery within the geographic boundaries of the District.

(d) Each District has the power to ratify M's approval of any amendments to the corporate documents of a Controlled Entity that was previously a subsidiary of that District.

(e) Each District has the power to collect and use district funds for the purposes provided in that District's enabling act as permitted by R law and the covenants of any financing arrangements to which the District is a party.

(f) Each District has the responsibility to comply with the state licensure and federal payment program requirements for each Controlled Entity within the District, unless such responsibilities are assumed directly by the affected Controlled Entity.

(g) Each District has the right to ratify or veto the appointment of the hospital administrators proposed by M for the hospitals of the Districts.

(h) Each District has the power to approve and renew operating leases for the Controlled Entities of the Districts.

In addition, each of the Districts has the right to take such actions as it deems necessary to enforce the commitments made to it pursuant to the Agreement.

THE CONTROLLED ENTITIES

K has been recognized as an organization described under § 501(c)(3) and as a nonprivate foundation under § 509(a)(1). K leases from I and operates an acute care hospital, and provides home health care, social services, dietary counseling, and patient and community education.

L is a taxable, not-for-profit corporation that provides primary care physician services throughout the community. L's articles provide that no part of the net earnings of L shall inure to the benefit of any private individual.

K and L were organized by I to assist I in carrying out its duties under state law. In addition, the articles of incorporation of each of these entities either provide, or it is represented that they will be amended upon receipt of this letter ruling to provide, that upon dissolution the residual assets of each of these entities will be distributed to I to be used exclusively for public purposes. The bylaws of each of these entities either provides, or it is represented that they will be amended upon receipt of this letter ruling to provide, that the sole member of each entity may remove any director from the board of directors of each entity, with or without cause, and the president/CEO of each entity will be elected or chosen from a slate of persons that has been approved in writing by the president/CEO of the sole member.

S has been recognized as an organization described under § 501(c)(3) and as a nonprivate foundation under § 509(a)(3). S was formed to perform services that would otherwise have to be performed by Q. S was organized to assist Q in carrying out its duties and responsibilities under state law. S currently provides staff to Q to operate an acute care hospital, which includes a trauma center, neonatal intensive care unit, skilled nursing facility, psychiatric facilities, and numerous community programs. In connection with the transactions described herein, it is anticipated that S will enter into an agreement with Q pursuant to which S will lease, operate, and manage the acute care hospital. S's articles of incorporation provide that S's board of directors always will be identical to the membership of Q's governing body.

V has been recognized as exempt from federal income tax under § 501(c)(3) and as a nonprivate foundation under § 509(a)(1). V's purpose is to provide health care services and health care related services to Q. V provides palliative and supportive care for terminally ill patients and their families.

W has been recognized as tax-exempt under § 501(a) as an organization described in § 501(c)(3) and as a nonprivate foundation under § 509(a)(3). W was formed by Q to provide services that Q otherwise would have had to perform. W provides community preventive care and safety programs, and administers locally the state's program that promotes healthy kids.

X has been recognized as exempt from federal income tax under § 501(c)(3) and as a nonprivate foundation under § 509(a)(2). X, a nonprofit membership corporation, was formed by Q to acquire the assets and business of an existing health maintenance organization. X is a federally qualified, staff model health maintenance organization, serving a broad segment of the population of the district and a neighboring county. Q appoints the board of X, subject to the restriction that the directors must be, and have been for at least six months, subscribers of the health maintenance organization.

Y has been recognized as an organization described in § 501(c)(3) and as a nonprivate foundation under § 509(a)(2). Y operates a nursing home facility.

Z is a taxable, not-for-profit corporation that was formed to assist Q in carrying out its duties under state law. Z provides primary care physician services throughout the community. In addition, Z's articles provide that no part of the net earnings of Z may inure to the benefit of any private individual.

S, X, and P have each received rulings that upon the amendment of their articles and by-laws as represented, they would each meet the criteria of Rev. Rul. 57-128, 1957-1 C.B.

206

311, and, therefore, would be instrumentalities of Q. In addition, S, X, and P have each received rulings that upon the amendment of their articles and by-laws as represented, the respective incomes of each would be excludable from gross income under § 115. All of the represented amendments have been made.

S, V, W, X, Y, and Z were organized by Q to assist Q in carrying out its duties under state law. In addition, the articles of incorporation of each of these entities either provide, or it is represented that they will be amended upon receipt of this letter ruling to provide, that upon dissolution the residual assets of each of these entities will be distributed to Q to be used exclusively for public purposes. The bylaws of each of these entities either provides, or it is represented that they will be amended upon receipt of this letter ruling to provide, that the sole member of each entity may remove any director from the board of directors of each entity, with or without cause, and the president/CEO of each entity will be elected or chosen from a slate of persons that has been approved in writing by the president/CEO of the sole member.

RELATIONSHIP AMONG M AND THE CONTROLLED ENTITIES

Subject to the powers reserved to the Districts, M has the following rights and powers with respect to each of the Controlled Entities:

(a) Without the prior approval of M, no controlled entity may adopt an operating or capital budget, and each Controlled Entity's budget must be consistent with the plans developed by M. In addition, M must approve any subsequent changes to the operating and capital budgets of a Controlled Entity.

(b) Without the prior approval of M, no Controlled Entity may make an expenditure that is not contained in such Controlled Entity's approved budget and that is in excess of any transaction threshold established by M. In addition, M has the power to order an audit of any of the Controlled Entities.

(c) M must approve, by three-fourths majority of M's directors, the incurrence of debt by a Controlled Entity in excess of threshold amounts established by M.

(d) M will develop and approve the strategic plans for and implementation of the provision of clinical services, clinical research, and support systems on an integrated and cost-effective basis, which avoids unnecessary duplication.

(e) M will develop the overall managed care strategy for each Controlled Entity. M also will be the primary entity to negotiate with third party payors on behalf of the

Controlled Entities, and will establish all terms and conditions of new or renewed managed care contracts. In addition, M has the power to require each Controlled Entity to participate in any managed care contract.

(f) M has the power to operate each Controlled Entity through a lease or other contractual arrangement.

(g) M will establish policies governing (1) the creation by any Controlled Entity of any new health care service or any new location for the delivery of health care services, and (2) the formation and operation of primary care controlled entities within the System. M must approve any action by a Controlled Entity that is not consistent with these policies. M also must approve any health care service integration or expansion, any physician alignment initiatives, and any new joint venture health care services.

(h) M has the right to appoint and remove with or without cause the members of the boards of directors of each Controlled Entity. Appointment and removal of such directors requires the approval of a simple majority of M's directors representing Q and a simple majority of M's directors representing I.

(i) M has the power to adopt uniform human resources policies for the System, including position descriptions and compensation ranges. Each Controlled Entity is required to adopt such policies for its operations.

(j) M may make, or direct any Controlled Entity to make, certain transfers of assets (including operating surplus) among the Controlled Entities in the System and M. In addition, M must approve in advance any merger, consolidation, or dissolution to which any Controlled Entity is a party, or the sale of all, or substantially all, of the assets of any Controlled Entity.

(k) M must approve, by a three-fourths majority of M's Board, the admission of additional hospitals, systems, or other entities to the System as Controlled Entities and will recommend to the Districts the merger, consolidation, dissolution, sale, or mortgage of substantially all of the assets of a Controlled Entity. M also has the right to participate in negotiations involving, and must approve participation in any new joint venture, partnership, affiliation, association, system, alliance, or similar relationship, and agreements entered into by a Controlled Entity with any entity not owned or controlled by M.

(l) M has the power to develop, approve, and revise the mission or vision statement of each Controlled Entity.

(m) M must approve, by a three-fourths majority of M's directors, any amendments to a Controlled Entity's corporate documents, including its articles and bylaws.

(n) M has the power to adopt, by a three-fourths majority of M's directors, resolutions expanding the list of actions by any Controlled Entity that need prior approval of M.

(o) M must approve, by a three-fourths majority of its board, any sale, transfer, or other alienation of an interest in a Controlled Entity's assets that is not in the ordinary course of its business. In addition, M has the power to sell, transfer, or alienate any interest in assets of the Controlled Entities in the ordinary course of M's business without the requirement for any vote of the directors of the Controlled Entity.

(p) If M dissolves or otherwise ceases to be the sole member of a Controlled Entity, the articles and bylaws of the Controlled Entity must be amended to provide that Q, I, or both will have the same powers with respect to the Controlled Entity as held by M before M dissolved or ceased to be the sole member.

PREVIOUSLY RECEIVED RULINGS

You have previously received the following rulings that are relevant to this ruling request:

1. S, U, V, W, X, Y, and P are affiliates of a governmental unit, as that term is used in Rev. Proc. 95-48, 1995-2 C.B. 125, and are relieved from filing Form 990 pursuant to § 1.6033-2(g)(6).

2. Execution and implementation of the Agreement will not cause M or any Controlled Entity that is exempt from income tax under § 501(c)(3) to be engaged in an unrelated trade or business within the meaning of § 513(a).

3. The transfer of assets, personnel, or resources, and the performance of activities and services by any party exempt from income tax under § 501(c)(3) for any other party that is exempt under § 501(c)(3) pursuant to the Agreement will not cause M or any Controlled Entity exempt under § 501(c)(3) to be engaged in an unrelated trade or business within the meaning of § 513(a).

4. The creation of M, Q and I's execution of the Agreement, the parties' implementation of the transactions contemplated by the Agreement, and M's and the Controlled Entities' participation in the System will not, alone or collectively,

adversely affect the status of any party as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3).

5. Q qualifies as a political subdivision of the state of R within the meaning of § 1.103-1(b).

6. Upon amendment of their articles and bylaws, S, X, and P will each meet the criteria of Rev. Rul. 57-128, and, therefore, will be instrumentalities of Q, a political subdivision of the state of R. It has been represented that the amendments to the articles and bylaws of S, X, and P have been made.

7. The respective incomes of S, X, and P are excludable from gross income under § 115.

THE BONDS

A Bonds

Q issued the A Bonds on Date 1 and used the proceeds, togther with other Q funds, to (1) advance refund all of an outstanding issue of revenue bonds, (2) deposit funds in a debt service reserve fund, and (3) pay the costs of issuance of the A Bonds. Prior to the implementation of the Agreement, the A Bonds were governmental bonds whose interest was excludable from gross income under § 103. After the implementation of the Agreement, Q and S will to be the only direct users of the facilities financed or refinanced with the proceeds of the A Bonds, and no more than five percent of these facilities will be used by other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3.

B Bonds

Q issued the B Bonds on Date 2 and used the proceeds, togther with other Q funds, to (1) finance the acquisition of a health maintenance organization and certain related assets (2) deposit funds in a debt service reserve fund, and (3) pay the costs of issuance of the B Bonds. Prior to the implementation of the Agreement, the B Bonds were governmental bonds whose interest was excludable from gross income under § 103. After the implementation of the Agreement, X will to be the only direct user of the facilities financed with the proceeds of the B Bonds, and no more than five percent of these facilities will be used by other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3.

C Bonds

Q issued the C Bonds on Date 3 and used the proceeds, together with other Q funds, to (1) advance refund the D Bonds previously issued by Q, (2) deposit funds into a debt service reserve fund, and (3) pay the costs of issuance of the C Bonds. Prior to the implementation of the Agreement, the C Bonds were governmental bonds whose interest was excludable from gross income under § 103. After the implementation of the Agreement, Q and S will to be the only direct users of the facilities financed or refinanced with the proceeds of the C Bonds, and no more than five percent of these facilities will be used by other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3.

E Bonds

Q issued the E Bonds on Date 4 and used the proceeds, togther with other Q funds, to (1) currently refund outstanding revenue bonds, (2) finance the acquisition, construction and installation of various improvements to the main hospital facilities of Q, (3) deposit funds in a debt service reserve fund, and (4) pay the costs of issuance of the E Bonds. Prior to the implementation of the Agreement, the E Bonds were governmental bonds whose interest was excludable from gross income under § 103. After the implementation of the Agreement, Q and S will to be the only direct users of the facilities financed or refinanced with the proceeds of the E Bonds, and no more than five percent of these facilities will be used by other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3.

F Bonds

F Bonds were issued by Q on Date 5 to finance a loan from Q to P. The proceeds of that loan were used by P to acquire an option and purchase real estate improvements from unrelated parties that were previously leased by Q from those parties. Prior to the implementation of the Agreement, the F Bonds were governmental bonds whose interest was excludable from gross income under § 103. After the implementation of the Agreement, Q, P, and S will to be the only direct users of the facilities financed with the proceeds of the F Bonds, and no more than five percent of these facilities will be used by other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3.

H Bonds

On Date 6, I issued the H Bonds as qualified § 501(c)(3) bonds. The proceeds of the H Bonds were used, together with other I funds, to (1) finance the cost or reimburse I for the

cost of capital expenditures for K, including expenditures relating to expansion and renovation of facilities owned by K, (2) deposit funds into a debt service reserve fund, (3) finance capitalized interest with respect to the H Bonds, and (4) pay the costs of issuance of the H Bonds. Prior to the implementation of the Agreement, the only users of the facilities financed by the H Bonds have been I and K. After the implementation of the Agreement, I and K will continue to be the only direct users of the facilities, and no more than five percent of these facilities has been or will be used by other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3.

AA Bonds

On Date 7, I issued the AA Bonds as qualified § 501(c)(3) bonds. The proceeds of the AA Bonds were used, together with other I funds, to (1) finance the cost or reimburse I for the cost of capital expenditures for facilities owned by K, (2) deposit funds into a debt service reserve fund, (3) finance capitalized interest with respect to the AA Bonds, and (4) pay the costs of issuance of the AA Bonds. Prior to the implementation of the Agreement, the only users of the facilities financed by the AA Bonds have been I and K. After the implementation of the Agreement, I and K will continue to be the only direct users of the facilities, and no more than five percent of the facilities financed by the AA Bonds has been or will be used by other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3.

The A Bonds, B Bonds, C Bonds, E Bonds, and F Bonds are collectively referred to as the "Q Bonds". The H Bonds and AA Bonds are collectively referred to as the "I Bonds".

RULINGS REQUESTED

You have requested the following rulings:

1. Upon implementation of the Agreement and upon amendment of the articles and bylaws of L, V, W, and Z as represented, L, V, W, and Z each will meet the criteria of Rev. Rul. 57-128, and, therefore, each will be an instrumentality of the Districts, each of which are political subdivisions of the state of R.

2. M meets the criteria of Rev. Rul. 57-128, and, therefore, is an instrumentality of the Districts, each of which are political subdivisions of the state of R.

3. Neither the creation of M, the Districts' execution of the Agreement, the Parties' implementation of the transactions contemplated by the Agreement, nor M's and the Controlled

Entities' participation in the System will, alone or collectively, adversely affect the status of S, X, and P as an instrumentality of one or more governmental units.

4. Upon implementation of the Agreement and upon amendment of the articles and bylaws of V, W, and Z as represented, the respective incomes of each will be excludable from gross income under § 115(1).

5. M's income is excludable under § 115(1).

6. Neither the creation of M, the Districts' execution of the Agreement, the Parties' implementation of the transactions contemplated by the Agreement, nor M's and the Controlled Entities' participation in the System will affect adversely, alone or collectively, the exclusion of the income of S, X, and P from gross income under § 115(1).

7. M is "an affiliate of a governmental unit" as that term is used in section 4 of Rev. Proc. 95-48, 1995-2 C.B. 418, and is relieved from filing Form 990 pursuant to § 1.6033-2(g)(6) of the Regulations and section 3 of Rev. Proc. 95-48.

8. The creation of M, the Districts' execution of the Agreement, the parties' implementation of the transactions contemplate by the Agreement, and M's and the Controlled Entities' participation in the System will not affect adversely, alone or collectively, the status of P or any tax-exempt Controlled Entity, other than K, as "an affiliate of a governmental unit" as that term is used in section 4 of Rev. Proc. 95-48.

9. The execution and implementation of the Agreement will not result in the creation of an entity separate from M for federal tax purposes.

10. The execution and implementation of the Agreement will not result in a change in use of the proceeds of any series of the Q Bonds that would cause that series of the Q Bonds to be private activity bonds under § 141.

11. The execution and implementation of the Agreement will not result in a change of use of the proceeds of any series of the I Bonds that would cause that series of the I Bonds to be other than qualified 501(c)(3) bonds under § 145(a).

LAW AND ANALYSIS

INSTRUMENTALITY (Ruling Requests #1, #2, and #3)

Under Revenue Ruling 57-128, the following factors are taken into account to determine whether an entity is an instrumentality of one or more governmental units: (1) whether the organization is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in a public authority or authorities; (5) whether express or implied statutory or other authority is necessary for the creation and/or use of the instrumentality, and whether this authority exists; and (6) the degree of financial autonomy of the entity and the source of its operating expenses.

Ruling Request #1

V, W, and Z each performs a governmental function on behalf of Q, and through each entities' participation in the Agreement upon its implementation, on behalf of I. L performs a governmental function on behalf of I, and through its participation in the Agreement upon its implementation, on behalf of Q. The Districts are both political subdivisions of the state of R, and under the Agreement, the Districts jointly and equally control M. Entities V, W, and Z were formed by Q, and L was formed by I in accordance with state law to assist it in carrying out the duties and responsibilities of the political subdivisions under state law. In addition, under the terms of the Agreement, L, V, W, and Z must operate in accordance with the policies and procedures established by M, which is wholly controlled by the Districts, and policies established by the Districts directly. Accordingly, once the Agreement is implemented, each entity will function on behalf of Q and I, both political subdivisions of the state of R.

Upon implementation of the Agreement, all four entities will become Controlled Entities and must conform to all policies established by M. As noted above, M has control over the merger, consolidation, or dissolution; budgets; significant expenditures; and incurrence of significant new debt of any Controlled Entity. In addition, M has the power to operate each Controlled Entity through a lease or other contractual arrangement, and M has the right to appoint and remove with or without cause the boards of directors of Controlled Entity. M may make, or direct any Controlled Entity to make certain transfers of assets (including operating surplus) among the Controlled Entities in the System and M.

214

M must approve in advance the sale of all, or substantially all, of the assets of any Controlled Entity. Likewise, M must approve, by a three-fourths majority of its directors, any sale, transfer, or other alienation of an interest in a Controlled Entity's assets that is not in the ordinary course of its business, and M has the power to sell, transfer, or alienate any interest in assets in the ordinary course of its business without the requirement for any vote of the directors. M has the power to develop and revise the mission or vision statement of each Controlled Entity, and M must approve, by a three-fourths majority of its directors, any amendments to a Controlled Entity's corporate documents. Finally, M has the power to adopt, by a three-fourths majority of its directors, resolutions expanding the list of actions by any Controlled Entity that need prior approval of M.

The articles of incorporation of V, W, and Z either provide, or it is represented will be amended to provide, that upon dissolution of each of the corporations, all residual assets of the corporation will be distributed to Q, a political subdivision of the state of R, to be used exclusively for public purposes. It is represented that the articles of incorporation of L will be amended to provide that upon its dissolution, all residual assets of the corporation will be distributed to I, a political subdivision of the state of R, to be used exclusively for public purposes. In addition, V is a § 501(c)(3) organization, with no inurement of its net earnings to a private individual. W has applied for § 501(c)(3) status, and its articles of incorporation provide that there will be no inurement of W's net earnings to any private individual. L and Z operate as not-for-profit corporations, and their articles of incorporation provide that none of their net earnings will inure to a private individual.

It is represented that the by-laws of V, W, and Z have been amended, or will be amended, to provide that (1) Q may remove any director of the respective board of directors, with or without cause, and (2) the president or chairman, as the case may be, of each entity will be elected or chosen from a slate of persons that has been approved in writing by the president/CEO of Q. It is further represented that the by-laws of L have been amended, or will be amended, to provide that (1) I may remove any director of the respective board of directors, with or without cause, and (2) the president or chairman, as the case may be, of each entity will be elected or chosen from a slate of persons that has been approved in writing by the president/CEO of I.

Applying the criteria of Rev. Rul. 57-128 to the facts as represented, we conclude that upon amendment of the articles and bylaws of L, V, W, and Z as represented, L, V, W, and Z will qualify as instrumentalities of the Districts, which are both political subdivisions of the state of R.

215

Ruling Request #2

M was formed in accordance with state law in order to assist the Districts in the performance of their duties and responsibilities under state law. The Districts have the power to appoint and remove all of the directors of M and have significant approval and ratification powers over the actions of M. The Districts must approve significant expenditures; establish limits on M's ability to incur new debt; approve the entry of M into a joint venture, partnership, affiliation, or similar relationship with any entity not owned or controlled by M; approve the merger, dissolution, or consolidation of M and the sale or alienation of all or substantially all of the assets of M; and ratify or reject recommendations made by M's directors which would significantly affect access to appropriate local health care delivery within the geographic boundaries of the Districts. In addition, M must report financial information about the assets and operations of the individual Controlled Entities to the Districts, and each of the Districts has the right to order an audit of M's books and records. Upon dissolution of M, all residual assets of the corporation will be distributed to the Districts to be used exclusively for public purposes. In addition, M is a § 501(c)(3) organization, with no inurement of its net earnings to a private individual.

Applying the criteria of Rev. Rul. 57-128 to the facts as represented, we conclude that M qualifies as an instrumentality of the Districts, which are both political subdivisions of the state of R.

Ruling Request #3

With respect to S, X, and P, neither the creation of M, the District's execution of the Agreement, the implementation of the transactions contemplated by the Agreement, nor M's and Controlled Entities' participation in the System will, alone or collectively, adversely affect the status of S, X, and P as an instrumentality of one or more governmental units. By participating in the Agreement, S and P will become partly controlled by M and I and will begin to function, in part, for the benefit of M and I. Because M is an instrumentality of Q and I, and I is a political subdivision, S, X, and P will continue to function on behalf of one or more political subdivisions.

SECTION 115 (Ruling Requests #4, #5, and #6)

Section 115 provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision of a state.

Rev. Rul. 71-589, 1971-2 C.B. 94, provides that the income from property held in trust by a city that was to be used by the city for certain charitable purposes is not subject to federal income tax. Although Rev. Rul. 71-589 does not explicitly so

state, the holding in the revenue ruling means that a determination was made that the income in question was derived from the exercise of an essential governmental function and accrued to a political subdivision within the meaning of § 115(1). Rev. Rul. 71-589 specifically mentions several types of functions that the trust might perform, such as support of a hospital, schools, maintenance of a park, or other purposes ordinarily recognized as a municipal function.

Rev. Rul. 90-74, 1990-2 C.B. 34, concerns an organization that is formed, operated, and funded by political subdivisions to pool their casualty risks, or other risks arising from their obligations concerning public liability, workers' compensation, or employees' health. Rev. Rul. 90-74 states that the income of the organization is excluded from gross income under § 115(1) if private interests do not participate in the organization or benefit more than incidentally from the organization. In Rev. Rul. 90-74 the benefit to the employees of the political subdivisions was excepted as incidental.

Ruling Request #4

V, W, and Z were formed by Q to perform services that otherwise would be performed by Q in furtherance of its statutory purposes. Just as the trust described in Rev. Rul. 71-589 is viewed as a necessary incident of the power of the state and its political subdivisions, V, W, and Z are necessary to Q's obligation to provide health care services in the County. Thus, V, W, and Z, like the trust described in Rev. Rul. 71-589, perform an essential governmental function within the meaning of § 115.

Section 115 also requires that any income derived from an essential governmental function accrue to a State or political subdivision thereof. No funds may accrue to the benefit of any private party. Upon liquidation, all residual assets of V, W, and Z, will be distributed to Q to be used exclusively for public purposes. The governing corporate documents of V, W, and Z all provide that there will be no inurement of the net earnings of the entity to a private individual. In addition, M, which operates for the benefit of Q and I, retains complete authority in appointing the directors of V, W, and Z. Upon amendment of the articles and bylaws of V, W, and Z as represented, Q will have complete authority in removing the directors of V, W, and Z. At that time, the respective incomes of V, W, and Z will be regarded as accruing to the State or a political subdivision within the meaning of § 115.

Ruling Request #5

M was formed by Q and I to perform services that otherwise would be performed by Q in furtherance of its statutory purposes. Just as the trust described in Rev. Rul. 71-589 is viewed as a necessary incident of the power of the state and its political subdivisions, M is necessary to Q and I's obligation to provide

health care services in the County. Thus, M, like the trust described in Rev. Rul. 71-589, performs an essential governmental function within the meaning of § 115.

Section 115 also requires that any income derived from an essential governmental function accrue to a State or political subdivision thereof. No funds may accrue to the benefit of any private party. Upon liquidation, all residual assets of M will be distributed to Q and I to be used exclusively for public purposes. The governing corporate documents of M provide that there will be no inurement of the net earnings of the entity to a private individual. In addition, Q and I retain complete authority in appointing the directors of M. Upon amendment of the articles and bylaws of M as represented, Q and I will have complete authority in removing the directors of M. At that time, the income of M will be regarded as accruing to the State or political subdivisions of the State within the meaning of § 115.

Ruling Request #6

S, X, and P have already received rulings that once specified amendments to their corporate governing documents were made, the respective incomes of each would be excludable from income under § 115(1). Since the receipt of the ruling, the represented amendments to the corporate governing documents have been made. The only changes to their operation and organization are that each entity will no longer be controlled exclusively by Q and each entity will no longer operate solely for the benefit of Q. Upon implementation of the Agreement, control of each of the entities will be shared by Q, I, and M. As previously discussed, Q and I are political subdivisions, and M is wholly owned, controlled, and operated for the benefit of Q and I. S, X, and P will continue to perform services that otherwise would be performed by governmental entities in furtherance of their statutory purposes. S, X, and P will continue to perform an essential governmental function within the meaning of § 115, and the governing corporate documents of S, X, and P will continue to provide that there will be no inurement of the net earnings of the entity to a private individual. In addition, the respective incomes of S, X, and P will continue to be regarded as accruing to the State or a political subdivision within the meaning of § 115.

Accordingly, we rule that neither the creation of M, the District's execution of the Agreement, the Parties' implementation of the transactions contemplated by the Agreement, nor M's and the Controlled Entities' participation in the System will, alone or collectively, adversely affect the exclusion of the income of S, X, and P from gross income under § 115(1).

AFFILIATE OF A GOVERNMENTAL UNIT (Ruling Requests #7 and #8)

Section 6033(a)(1) generally requires the filing of annual information returns by organizations exempt from taxation under section 501(a).

Section 6033(a)(2)(B) provides discretionary exceptions from filing such returns where the Secretary determines that such filing is not necessary to the efficient administration of the internal revenue laws.

Section 1.6033-2(g)(6) of the Regulations delegates authority to the Commissioner to relieve any organization or class of organizations from filing the annual information return.

In Revenue Procedure 95-48, 1995-2 C.B. 418, the Commissioner exercises discretionary authority to except from filing Form 990 any organization which is an affiliate of a governmental unit.

Rev. Proc. 95-48 provides, in part, that an organization that has a ruling or determination letter from the Service which determines its status for certain other purposes of the Code (sections 170(c)(1), 115, 3121(b)(7), 3306(c)(7) or 103) would be an affiliate of a governmental unit. An organization that does not have such a letter would nevertheless qualify as an affiliate of a governmental unit if the Service determined based on all the relevant facts and circumstances, that (1) the organization was closely affiliated with one or more governmental units, and (2) the organization's filing of Form 990 was not otherwise necessary to the efficient administration of the internal revenue laws.

Ruling Request #7

M is "an affiliate of a governmental unit" as that term is used in section 4 of Rev. Proc. 95-48, 1995-2 C.B. 418, and is relieved from filing Form 990 pursuant to § 1.6033-2(g)(6) of the Regulations and section 3 of Rev. Proc. 95-48.

Ruling Request #8

The creation of M, the Districts' execution of the Agreement, the parties' implementation of the transactions contemplate by the Agreement, and M's and the Controlled Entities' participation in the System will not affect adversely, alone or collectively, the status of P or any tax-exempt Controlled Entity, other than K, as "an affiliate of a governmental unit" as that term is used in section 4 of Rev. Proc. 95-48.

PARTNERSHIP (Ruling Request #9)

Ruling Request #9

The Agreement provides for the joint planning, coordination, management, and financing of operations of the various Controlled Entities. These activities are carried out by and through M. The Agreement does not provide for the direct sharing of profits or losses among the Controlled Entities or Districts. Any financial sharing between the Controlled Entities or Districts is accomplished through M.

The execution and implementation of the Agreement will not result in the creation of an entity separate from M for federal tax purposes.

CHANGE IN USE (Ruling Requests #10 and #11)

Under § 103(a), gross income does not include interest on a State or local bond. Section 103(b)(1) provides that § 103(a) does not apply to any private activity bond, unless it is a qualified bond under § 141. Section 141(e)(1) provides that qualified bonds include qualified § 501(c)(3) bonds.

Section 141(a) provides that the term "private activity bond" means any bond issued as a part of an issue (1) which meets the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2), or (2) which meets the private loan financing test of § 141(c). Section 141(b)(1) provides in general that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use.

Section 141(b)(2) provides in general that an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of the issue is (under the terms of the issue or any underlying arrangement) directly or indirectly

(A) secured by any interest in property used or to be used for a private business use, or payments in respect of such property, or

(B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Section 141(b)(6) provides that the term "private business use" for purposes of § 141(b) means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business.

Section 1.141-1(b) provides that a governmental person means a state or local governmental unit under § 1.103-1 or any instrumentality of a governmental unit.

Section 145(a) provides that, except as otherwise provided in § 145, the term "qualified 501(c)(3) bond" means any private activity bond issued as a part of an issue if all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and such bond would not be a private activity bond if

(1) 501(c)(3) organizations were treated as governmental units with respect to their activities that

do not constitute unrelated trades or businesses, determined by applying § 513(a); and

(2) Paragraphs (1) and (2) of § 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and "net proceeds" for "proceeds" each place it appears.

Thus, the private activity bond rules set forth in § 141(b) are incorporated by reference in § 145, with certain modifications.

Ruling Request #10

Once the Agreement is implemented and the changes discussed above are made to the organizational documents of the various entities, the only entities in the System that are not political subdivisions or instrumentalities will be Y and Z. The trade or business of an instrumentality is that of the governmental unit for which it acts. Cf. Rev. Proc. 82-26, 1982-1 C.B. 476. No more than five percent of the facilities financed by the Q Bonds have been or will be used by Y, Z, or any other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3. Accordingly, the use of the facilities by any member of the System will not constitute private business use within the meaning of § 141(b), and the execution and implementation of the Agreement, by itself, does not result in a change in use of the proceeds of the Q Bonds that would cause that series of the Q Bonds to be private activity bonds under § 141.

Ruling Request #11

The execution and implementation of the Agreement will result in § 501(c)(3) organizations, political subdivisions, and instrumentalities using property owned by I, K, and M and financed by proceeds of the I Bonds. I is a governmental unit, and K and M are § 501(c)(3) organizations. For the purposes of determining if the I Bonds are qualified 501(c)(3) bonds, § 501(c)(3) entities are treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses determined by applying § 513(a). Therefore, the use of the financed facilities by the § 501(c)(3) organizations in the System is treated as governmental use, to the extent their activities are not unrelated trade or businesses. You have received rulings that the participation in the System by Controlled Entities that are also § 501(c)(3) entities does not cause them to be engaged in an unrelated trade or business within the meaning of § 513(a). As a result, use of these facilities by the Controlled Entities that are also § 501(c)(3) entities does not result in private business use of the facilities.

Use of these facilities by the political subdivisions is governmental use and, accordingly, does not result in private business use. The trade or business of an instrumentality is that

of the governmental unit for which it acts. Cf. Rev. Proc. 82-26. As a result, use of the facilities by instrumentalities within the System does not result in private business use of the facilities.

You have represented that no more than five percent of the facilities will be used by other persons whose use would be private business use within the meaning of § 141(b)(6) and § 1.141-3.

Accordingly, the execution and implementation of the Agreement will not result in a change of use of the proceeds of any series of the I Bonds that would cause that series of the I Bonds to be other than qualified 501(c)(3) bonds under § 145(a).

CONCLUSION

Based solely upon the representations and information submitted, we rule on your requests as follows:

1. Upon implementation of the Agreement and upon amendment of the articles and bylaws of L, V, W, and Z as represented, L, V, W, and Z each will meet the criteria of Rev. Rul. 57-128, and, therefore, each will be an instrumentality of the Districts, each of which are political subdivisions of the state of R.

2. M meets the criteria of Rev. Rul. 57-128, and, therefore, is an instrumentality of the Districts, each of which are political subdivisions of the state of R.

3. The creation of M, the Districts' execution of the Agreement, the parties' implementation of the transactions contemplated by the Agreement, and M's and the Controlled Entities' participation in the System will not, alone or collectively, adversely affect the status of S, X, and P as an instrumentality of one or more governmental units.

4. Upon implementation of the Agreement and upon amendment of the articles and bylaws of V, W, and Z as represented, the respective incomes of each will be excludable from gross income under § 115.

5. M's income is excludable under § 115(1).

6. The creation of M, the Districts' execution of the Agreement, the Parties' implementation of the transactions contemplated by the Agreement, and M's and the Controlled Entities' participation in the System will not, alone or collectively, adversely affect the exclusion of the income of S, X, and P from gross income under § 115(1).

7. M is "an affiliate of a governmental unit" as that term is used in section 4 of Rev. Proc. 95-48, 1995-2 C.B. 418, and is relieved from filing Form 990 pursuant to § 1.6033-2(g)(6) of the Regulations.

8. The creation of M, the Districts' execution of the Agreement, the parties' implementation of the transactions contemplate by the Agreement, and M's and the Controlled Entities' participation in the System will not affect adversely, alone or collectively, the status of P or any tax-exempt Controlled Entity, other than K, as "an affiliate of a governmental unit" as that term is used in section 4 of Rev. Proc. 95-48.

9. The execution and implementation of the Agreement will not result in the creation of an entity separate from M for federal tax purposes.

10. The execution and implementation of the Agreement will not result in a change in use of the proceeds of any series of the Q Bonds that would cause that series of the Q Bonds to be private activity bonds under § 141.

11. The execution and implementation of the Agreement will not result in a change of use of the proceeds of any series of the I Bonds that would cause that series of the I Bonds to be other than qualified 501(c)(3) bonds under § 145(a).

Except as specifically stated above, no opinion is expressed regarding the consequences of this transaction under any provision of the Internal Revenue Code, the Income Tax Regulations, or the Temporary Income Tax Regulations. Specifically, no opinion is expressed regarding whether the provision of physician services by L and Z to any qualified user, as that term is defined in section 3.07 of Rev. Proc. 97-13, 1997-5 I.R.B. 18, with respect to a facility results in private business use of that facility. In addition, no opinion is expressed regarding whether or not the implementation and execution of the Agreement will result in a violation of the $150,000,000 limitation contained in § 145(b).

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be cited as precedent.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: _____
Timothy L. Jones
Assistant to the Chief
Branch 5

Enclosure:
copy for § 6110 purposes

223