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

Date: JUL 05 1999

Contact Person:

ID Number:

Telephone Number:

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512.00-00
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Employer Identification Number:

Legend:

A =
B =

Dear Sir or Madam:

This is in response to your request for a ruling concerning your proposed reorganization.

The information presented discloses that A owns and operates a nonprofit acute care hospital that is exempt as an organization described in section 501(c)(3) of the Internal Revenue Code. Prior to the recent Bylaw amendment described in more detail below, it was governed by a self-perpetuating Board of Directors. In accordance with the amended Bylaws, its Board of Directors now consists of fourteen members, twelve of whom are elected by B as the sole member, and two of whom, the President of the Medical Staff and the President of the Hospital Auxiliary, are ex officio.

B is a nonstock, nonprofit corporation recognized as exempt from federal income tax as an organization described in section 501(c)(3) of the Code. It is classified under section 509(a) as a supporting organization described in section 509(a)(3). B's Articles of Incorporation state that it has been organized in order to support A and other section 501(c)(3) organizations related to A that are other than private foundations as described

in sections 509(a)(1) or 509(a)(2). In accordance with its Articles of Incorporation and Bylaws, B is governed by a self-perpetuating Board of Directors of up to fifteen members. B's Bylaws require that at all times a majority of its Board be members of A's Board.

You stated that A wanted a corporate structure that preserves the acute care community hospital as a vital part, but not the sole focus, of a diversified system of health care. Therefore, the Board of Directors of A approved the reorganization that will result in A becoming a subsidiary of a parent corporation and in other health care ventures being concentrated in the parent. It is hoped that by reorganizing, the resulting system will be able to promote the delivery of health care for A's service area more efficiently. The specific purposes of the reorganization are: (1) to assure A's continued leadership role in the community and continued capacity to provide patient care at a lower cost; (2) to facilitate compliance with governmental reporting requirements; (3) to segregate hospital assets from non-hospital assets in order to limit third party liability; (4) to separate regulated and non-regulated activities; (5) to separate the management of non-hospital activities and assets from the management of A; (6) to increase investment opportunities and enhance the development of new revenue sources; (7) to increase flexibility in undertaking capital projects; (8) to increase innovation and diversification and eliminate unnecessary duplication of resources and initiatives; and (9) to facilitate long-range planning.

B was formed by A to function as the parent corporation of the reorganized system. A has amended its Bylaws to make B its sole member. In addition to the power to elect the Board of Directors of A and any future entities within the system, A's amended Bylaws reserve to B the power to approve its annual capital and operating budgets, the sale of substantial assets, the incurrence of debt and substantial unbudgeted contractual commitments, amendments to its Bylaws and the appointment, removal and compensation of officers and senior management.

As the parent entity, B will formulate overall policy and planning for the constituents of the organization. A will retain its existing assets and will continue its hospital operations, subject to the direction and approval of B's Board of Directors. If other tax exempt entities are added to the system, it is anticipated that there may be a sharing of funds, assets, services and personnel among A and those other tax exempt members, some of which will be paid for and some of which may be gratuitous. A intends to transfer its ownership interest in any entity in which it holds an interest to B.

You request the following rulings:

(1) The proposed reorganization will not adversely affect the tax exempt status of A as an organization described in section 501(c)(3) of the Code; nor will it affect the status of A as an organization classified under sections 509(a)(1) and 170(b)(1)(A)(iii) or give rise to unrelated business taxable income to A under sections 511-514.

(2) The proposed reorganization will not adversely affect the tax exempt status of B under section 501(c)(3) of the Code; nor will it affect B's classification under section 509(a)(3) of the Code or give rise to unrelated business taxable income to B under sections 511-514.

(3) The sharing of personnel, services, facilities and expenses by A and B will not jeopardize the continued tax exempt or nonprivate foundation status of A or B under sections 501(c)(3) and 509(a) of the Code or give rise to unrelated business taxable income under sections 511-514 to A or B.

Section 501(c)(3) of the Code describes as exempt from federal income tax, as provided under IRC 501(a), organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(1) of the Income Tax Regulations provides that an organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of designated individuals.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in IRC 501(c)(3) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372 (1959); 4A Scott and Fratcher, The Law of Trusts, sections 368, 372 (4th ed. 1989).

Rev. Rul. 69-545, 1969-2 C.B. 117, provides that a nonprofit organization whose purpose and activity are providing hospital care is promoting health and may, therefore, qualify as organized and operated in furtherance of a charitable purpose under section 501(c)(3) of the Code if it meets the community benefit requirements.

Rev. Rul. 78-41, 1978-1 C.B. 148, describes a trust whose sole purpose was to accumulate and hold funds for use in satisfying malpractice claims against a hospital. The trust was determined to be an integral part of the hospital because it was controlled

by the hospital directly. The organization was ruled to be exempt under section 501(c)(3) of the Code.

Section 509(a)(1) of the Code defines the term "private foundation" as a domestic or foreign organization described in section 501(c)(3) other than an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 170(b)(1)(A)(iii) of the Code refers to an organization whose principal purpose or function is the provision of medical or hospital care.

Section 509(a)(3) of the Code excludes from the definition of private foundation an organization which:

(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations described in sections 509(a)(1) or 509(a)(2),

(B) is organized, supervised, or controlled by or in connection with one or more organizations described in sections 509(a)(1) or 509(a)(2), and

(C) is not controlled directly or indirectly by one or more disqualified persons defined in section 4946 other than foundation managers and other than one or more organizations described in sections 509(a)(1) or 509(a)(2).

Section 511 of the Code imposes a tax on the unrelated business taxable income (as defined in section 512) 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 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 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member, is an unrelated trade or business with respect to such organization, this organization, in computing its unrelated business taxable income, must include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(a)(1) 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 its exempt 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), 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 its charitable purposes constituting the basis for its exemption under section 501.

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 IRC 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.

After the reorganization, A will continue to provide health care to the community by operating a licensed general hospital, the same charitable activity that originally qualified it for exemption under section 501(c)(3) of the Code. A will be engaged directly in the promotion of health of the community as described in Rev. Rul. 69-545, supra. Therefore, A will continue to be exempt as an organization described in section 501(c)(3).

In addition, the corporate reorganization will not change A's status as an organization providing medical or hospital care within the meaning of section 170(b)(1)(A)(iii) of the Code. As such, it is and will continue to be organized and operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Code and section 1.501(c)(3)-1(d)(2) of the regulations.

No assets are being transferred from A to B except for A's interest in C and cash that may be transferred from time to time. A will receive no consideration from B for these transfers. Therefore, these transactions will not give rise to unrelated taxable business income to A within the meaning of section 512(a) of the Code.

221

After the reorganization, B will conduct policy making and planning activities and the other supporting functions that A would otherwise have to provide. No part of its earnings inure to the benefit of any private person, and it serves exclusively charitable interests similar to the organization discussed in Rev. Rul. 78-41, supra. Therefore, B will continue to qualify for exemption as an organization described in section 501(c)(3) of the Code.

B will also continue to qualify as a nonprivate foundation under section 509(a)(3) of the Code. It satisfies the organizational test because its Articles of Incorporation limit its purposes to those set out in section 509(a)(3)(A) for the benefit and support of A, an organization described in section 509(a)(1). It satisfies the operational test because it engages solely in activities that support or benefit A. The organizational documents of B require that a majority of its directors be members of A's Board. This satisfies the requirements of common supervision or control by the persons supervising or controlling both the supporting organization and the supported organization, since the control or management of the supporting organization, B, is vested in the same persons that control or manage the publicly supported organization, A. This common control assures that B will remain responsive to A's needs and requirements. B is, therefore, "supervised or controlled in connection with" A within the meaning of section 1.509(a)-4(f)(4) and section 1.509(a)-4(h)(1) of the regulations.

The transfers to B, including B's becoming the sole member of A, are being made as part of the reorganization to consolidate all the system's holdings, directly or indirectly, in the system parent. Contributions to an exempt organization do not produce taxable income to the recipient. Further, the assets being transferred are excluded from the unrelated business income tax under section 512(b)(5) of the Code. Since the intention of the reorganization is to make the system's overall operations more efficient, the transfer is substantially related to A's and B's charitable purpose of providing health care to the community. The transaction will, therefore, not give rise to unrelated taxable business income to B within the meaning of section 512(a).

Any sharing of resources between B and A will constitute activities between related exempt organizations in furtherance of their exempt purposes. Such activities, therefore, will not jeopardize the exempt status of either A or B.

Any trade or business which contributes importantly to the accomplishment of an organization's exempt purposes is excluded from the definition of unrelated trade or business under section 512 of the Code. Since any sharing of resources among the section 501(c)(3) organizations in the system will be substantially related to the exempt purposes of A and B in providing health care for the benefit of the community, any

payments in connection with the sharing of such resources will not give rise to unrelated business taxable income to any exempt entity. In addition, income received from property, the use of which is substantially related to the furtherance of an exempt purpose constituting the basis for the organization's exemption, is not included in unrelated debt-financed income under section 514.

Accordingly, we rule as follows:

(1) The proposed reorganization will not adversely affect the status of A as an organization described in section 501(c)(3) of the Code and will not adversely affect A's classification under section 509(a) as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) or give rise to unrelated business taxable income to A under sections 511-514.

(2) The proposed reorganization will not adversely affect the status of B as an organization described in section 501(c)(3) of the Code and will not adversely affect B's classification under section 509(a) as other than a private foundation under section 509(a)(3) or give rise to unrelated business taxable income to B under sections 511-514.

(3) The sharing of personnel, services, facilities and expenses by A and B will not jeopardize the continued tax exempt or nonprivate foundation status of A or B or give rise to unrelated business taxable income under sections 511-514 of the Code to A or to B.

This ruling is based on the understanding that there will be no material change in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service. 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.

We are informing your key District Director of this ruling. Because this letter could help resolve future questions about your income tax responsibility, please keep a copy of this ruling in your permanent records.

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.

We have sent a copy of this letter to your representative as indicated in your power of attorney.

Sincerely,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1