200016023

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

Date: JAN 21 2000

Contact Person:

ID Number:

Telephone Number:

S.I.N. # 501.03-00

OP:E:EO:T1

Employer Identification Number:

Legend:

M=
T=
N=
P=
R=
S=
U=
v=
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x=

Dear Sir or Madam:

This is in response to your letter requesting rulings, as amended, regarding the federal tax consequences associated with the transactions described below.

M is a T nonprofit corporation and is recognized as exempt from federal income tax under section 501(a) of the Internal Revenue Code (the Code) as an organization described in section 501(c) of the Code. M specializes in the treatment of, and teaching and research related to, disorders of the eye, ear, nose, throat, head and neck. M has been a teaching affiliate of N for many years. M's chiefs of Ophthalmology and Otolaryngology hold appointments as chairs of the respective departments at N and are consequently responsible for all eye and ear, nose, throat, head and neck teaching activities at each of the P teaching hospitals. All N students undertaking ophthalmic clerkships route through M.

You represent that while emphasizing its particular specialties, M's charter contemplates a broad range of activities in support of the health care of the community. You indicate that unlike most of the other major teaching hospitals in the area, M and it affiliates are not part of a larger health care system, which includes other hospitals and medical centers. You state that the longstanding relationship between M and R, described below, as close and interdependent affiliates not subject to common corporate control, has been extremely successful, without the need for a more formal corporate affiliation. You

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further indicate that it is also generally believed that M would not be a candidate for inclusion in one of the other larger medical systems, at least in part because of this affiliation with R.

R is a T nonprofit corporation and is recognized as exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3) of the Code. R is an acute care and teaching hospital located immediately adjacent to M. You state that R enjoys world renown as a leading medical center and teaching facility. R is one of the principal teaching hospitals of N. You state that R and M are organizationally separate members of unrelated corporate groups. However, as described more particularly below, R and M have long shared a close professional affiliation.

U is also a T nonprofit corporation and is recognized as exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3) of the Code. U is a rehabilitation hospital located in S and is affiliated with R. U is organized as a sister charitable corporation of R, sharing with R the R parent as its sole corporate member. U maintains fifteen specialized programs in every field of rehabilitation. Like R and M, U is a teaching hospital affiliated with N. Due largely to an enhanced ability to provide its health care services on an outpatient basis as a principal result of advances in medical technology, you indicate that M has developed a current excess capacity of space in its main facility in which to provide inpatient care. Accordingly, M has sought to make use of this excess capacity in a manner to further its charitable purpose of providing health care to the community, consistent with its position as a member of the P teaching hospital system and with its close affiliation with R described below.

Pursuant to a lease dated v between M and U (the "Lease"), M agreed to lease to U space in the facility consisting of approximately w square feet on a single floor of the facility, plus an additional x square feet of storage space. The Lease provides, among other things, that the space be used by U solely as an inpatient unit of up to 15 beds of a rehabilitation or long term care hospital providing post acute medical care or rehabilitation services (the "Unit). In this regard, you state that it is intended by the parties that the space in question be operated as a separate unit of U, and not as a unit of M. The Unit will be operated under U's hospital license and the patients will be admitted to the Unit as patients of U. While it is anticipated that M patients who are discharged to U would, in the first instance, be admitted to the Unit, the parties have not agreed to set aside beds or otherwise give M patients preference in this regard.

Because the Unit will be located within M, it is believed that the number of patients discharged from M to U may increase since this proximity and accompanying convenience for M physicians will facilitate continuity of care. Patients of M who would otherwise have remained at M for longer periods may instead be discharged to the Unit at U. You indicate that such transfer from the "sick bed" environment of an inpatient unit to a continuing care, rehabilitation unit is viewed as desirable for patient care and is increasingly encouraged by health care insurers. Patients discharged from R directly to the Unit will enjoy these benefits. You state that, in essence, the facility will serve in part as the rehabilitation facility for M, and relieves M of the need for funding and operating its own rehabilitation facility.

You state that the term of the Lease is for five years from the date of U's receipt of a certificate of occupancy for the space, subject to extension upon good faith negotiation by the parties at the end of that term. Under the Lease, in addition to the space, you state that M is also responsible for providing utilities to the Unit, including utility requirements specific to a hospital setting, such as compressed air, control air vacum, carbon dioxide medical gases and chemical waste lines. The Lease gives U the right to make alterations and improvements to the leased premises at its own expense, with such alterations or improvements to become the property of M on termination of the Lease. The Lease also gives U the

right to expand into any additional space on the floor where the Unit is located, should M decide to make space available for rental anytime during the term of the lease agreement. The Lease requires M to give U a right of first refusal, if M proposes to enter into a lease of space.

The Lease provides for payment of two principal categories of rent by U and M. Basic rent is payable monthly in advance for the first year, subject to adjustment in subsequent years based on charges in the Consumer Price Index. Rent for repairs, maintenance, utilities and other services, or "RMUS rent" , is payable in the first year. So called "additional rent" is payable from time to time under the terms of the Lease, and consists of miscellaneous charges and fees associated with defaults by U. You state that M believes that the terms of the Lease represents reasonable commercial terms. You further state that the M building in which the leased premises are located is subject to "acquisition indebtedness" within the meaning of section 514(c) of the Code. You state that the acquisition indebtedness is in the form of qualified 501(c)(3) bonds described in section 145.

Based on the above, you have requested a ruling that the leasing of space to U in accordance with the terms of the Lease dated v will not constitute the operation of an unrelated trade or business pursuant to section 513(a) of the Internal Revenue Code.

Section 509(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 Federal Income Tax Regulations (Regulations) provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

In the general law of charity, the promotion of health is considered to be a charitable purpose. Restatement (2nd), Trusts, Sections 368 and 372, IV Scott on Trusts (3rd ed. 1967), Sections 368 and 372.

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

Section 512(b)(3)(A)(i) and (ii) of the Code, in referencing unrelated business taxable income, indicates that in the case of rent, except as provided in subparagraph (B), there shall be excluded (i) all rents from real property (including property described in section 1245(a)(3)(c)), and (ii) all rents from personal property (including for purposes of this paragraph as personal property any property described in section 1245(a)(3)(B)) leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

Section 512 (b)(4) of the Code provides that notwithstanding paragraph (1), (2), (3), or (5), in the case of debt-financed property (as defined in section 514) there shall be included as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

Section 513(a) of the Code defines an unrelated trade or business as any trade or business the conduct of which is not substantially related to the exercise of the organization's exempt purposes or function.

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 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 exempt purposes.

Section 1.513-1(d)(4)(iii) of the Regulation which references dual use of assets or facilities, provides that, in certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such case, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contributes importantly to the accomplishment of exempt purposes.

Section 514(b)(1)(A)(i) and (ii) of the Code in defining debt-financed property excludes any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance of such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, or (ii) any purpose to which clause (i) does not apply, to the extent that its use is so substantially related.

You represent that due largely to an enhanced ability to provide its health care services on an outpatient basis as a principal result of advances in medical technology, M has developed a current excess capacity of space in its main facility in which to provide inpatient care. As a result, M has sought to make use of this excess capacity in a manner to further its charitable purpose of providing health care to the community by entering into the Lease with U for the excess space. You further represent that it is intended by the parties that the space in question be operated as a separate unit of U, and not as a unit of M. The Unit will be operated under U's hospital license and the patients will be admitted to the Unit as patients of U. Nevertheless, you indicate that the Lease has been entered into in large part to further M's own purpose of providing an adjacent and convenient rehabilitation facility to which M's own patients may be transferred as needed. This Lease relieves M of the need to fund and operate its own rehabilitation facility on the premises.

Accordingly, based on the facts and representations set forth, we rule that the lease of the space to U outlined in your lease dated v will not constitute an unrelated trade or business within the meaning of section 513(a) of the Code, and will not result in debt-financed income within the meaning of section 514.

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

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

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

We are informing your key District Director of this action. Please keep a copy of this ruling in your permanent records.

Sincerely,

Marvin Friedlander

Manager, Exempt Organizations
Technical Group 1