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

Date: MAY 08 2000

Contact Person:

ID Number:

Telephone Number:

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S.I.N. #501.03-11

Employer Identification Number:

Legend:

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Dear Sir or Madam:

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

M is a nonprofit corporation formerly known as N. M 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)(3) of the Code. M is classified as other than a private foundation under section 509(a)(1) of the Code because it is a hospital within the meaning of section 170(b)(1)(A)(iii). M provides a full range of healthcare services, including emergency room services, on a nondiscriminatory basis to all members of its community regardless of any individual's ability to pay for services rendered. You further indicate that M's Board of Trustees is broadly representative of the community which it serves and that M maintains an open medical staff.

A newly formed organization took the name N and it filed Form 1023, Application for Recognition of Exemption under section 501(c)(3) of the Code and requested to be classified as a supporting organization within the meaning of section 509(a)(3). Concurrently with the issuance of this ruling, N is being issued a letter recognizing it as exempt from federal income tax under section 501(c)(3) and

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classifying it as an organization described in section 509(a)(3).

The members of N will be those persons serving as its Trustees. You state that the Board of Trustees of N will consist of thirty-one (31) voting trustees. Trustees shall include "Elected Lay Trustees," "Physician Trustees," and "Special Voting Trustees." The Elected Lay Trustees are individuals who are broadly representative of the community served by N and M and otherwise unrelated to those organizations. The Physician Trustees shall be individual physicians who hold important administrative positions at M or affiliated entities and several "at large" physician representatives. The Special Voting Trustees shall be the President and Chief Executive Officer and Executive Vice-President of N , the Chairperson of P and one representative selected by members of the women's auxiliary organizations associated with M. Sixteen (16) of the thirty-one (31) voting trustees serving on the N Board will be representatives of M , N 's supported organization. You represent that physician representation on the N Board shall at all times be limited to less that 50% and further state that your Code of Regulations will be amended accordingly.

N will coordinate, oversee, and govern the hospital system as a parent corporation. N will replace M as the sole member, sole shareholder or controlling entity with respect to four affiliated organizations. In addition, N will become the sole corporate member of M , replacing M 's trustees, who currently serve as the members of M . The organizations other than M of which N will become the sole member, sole shareholder or controlling entity are referred to as the Subsidiaries and are further described as follows:

(A) Q is a professional corporation which is recognized as exempt under section 501(c)(3) and is classified as other than a private foundation since it is a supporting organization under section 509(a)(3) of the Code. Q provides inpatient coverage services for certain of M 's patients and a 24-hour obstetric and gynecology residency training preceptor program operated at M . M will control Q pursuant to a Share Control Agreement between the Corporation and the sole shareholder of Q . The share control agreement is necessitated by ambiguities in T law as to the corporate practice of medicine. Although recent changes in T statutes support an argument that either a T corporate entity or a T limited liability company could directly employ physicians, Q follows the more traditional pattern of having a hospital-affiliated corporation which renders professional services incorporated as a professional corporation which is then controlled through an appropriate mechanism.

(B) R is a nonprofit corporation and is recognized as exempt from federal income tax under section 501(c)(3) of the Code and is classified as other than a private foundation by virtue of it being classified as an educational organization within the meaning of section 170(b)(1(A)(ii). R provides a program of education and learning for young children. Many participants in the program are children of employees of M . However, the program is open to all members of the community at an affordable cost. N will be the sole member of R .

(C) S is another professional corporation which will be affiliated with N . S employs 15 primary care physicians rendering services at eight physician office sites in two counties within M 's s service area. N will control S pursuant to a Share Control Agreement between N and the sole shareholder of S .

(D) U is a for-profit corporation which leases buildings and equipment to physicians and M . N will be the sole shareholder of U .

You state that in addition to its interests in the subsidiaries, N may assume M 's joint venture interests in V and W . V is a nonprofit corporation which has two classes of members --Class A members who are physicians and a Class B member which is M . You indicate that V might best be described as a "physician hospital organization" which contracts or arranges contracts with health maintenance organizations, preferred provider organizations, third party administrators, employers and others to provide or arrange for the services of physicians, hospitals and other healthcare providers. W is an arrangement among M and 25 other area hospitals or social service agencies/bureaus, both private and governmental. W is recognized as exempt from federal income tax under section 501(c)(3) of the Code and is classified as a supporting organization under section 509(a)(3) of the Code. You state that W exists to arrange, promote, facilitate and encourage health and social service initiatives in Northeast T .

X is an HMO wholly-owned by V . It provides comprehensive healthcare services to an enrolled population for a predetermined, prepaid monthly fee. X enrollees are eligible to receive healthcare services from multiple providers, including M .

You indicate that another M affiliate is Y . Y is a for-profit corporation which is a domestic stock property and casualty company. The company offers preferred provider products through which enrolled members elect to receive care from a network preferred provider or a non-network provider at the member's option. You further indicate that it is likely that M will remain the sole shareholder of Y immediately following the restructuring. This is because M is currently considering a restructuring of certain of its insurance-related activities which involve Y , X and V . You indicate that implementation of that restructuring will not go forward until favorable rulings concerning this ruling request are received. You state that it is likely that the result of the reorganization will be that V as it is currently structured will cease to exist and either N or H will be joint owners of Y with M affiliated physicians. It is anticipated that N or M will retain a controlling interest in Y subsequent to the reorganization of the insurance activities. You represent that the proposed reorganization involving Y and V is a transaction entirely separate and apart from the proposed restructuring.

Based on the foregoing you have requested the following rulings:

As to N :

(1) That (a) implementation of the restructuring and (b) N 's carrying out of the transactions contemplated by the restructuring will not, either alone or collectively, adversely affect the status of N as exempt from federal income tax pursuant to section 501(a) of the Code as an entity organized and operated as described in section 501(c)(3) of the Code.

(2) That (a) implementation of the restructuring and (b) N 's carrying out of the transactions contemplated by the restructuring will not, either alone or collectively, adversely affect the status of N as other than a private foundation as an entity organized and operated as described in section 509(a)(3) of the Code.

(3) That any transfers of assets, personnel and/or resources (a) to N from M or any subsidiary or (b) from N to M or any subsidiary, which transfers are in furtherance of the exempt purposes of N and will not constitute an unrelated trade or business within the meaning of section 513 of the Code with respect to N and will not result in N being subject to the tax on unrelated business taxable income pursuant to section 511 of the Code.

As to M :

(1) That (a) implementation of the restructuring , (b) M 's carrying out of the transactions contemplated by the restructuring, and (c) M 's participation in the hospital system, will not, either alone or collectively, adversely affect M 's status as exempt from federal income tax pursuant to section 501(a) of the Code as an entity organized and operated as described in section 501(c)(3) of the Code.

(2) That (a) implementation of the restructuring (b) M 's carrying out of the transactions contemplated by the restructuring , and (c) M 's participation in the hospital system, will not, either alone or collectively, adversely affect M 's status as other than a private foundation as an entity organized and operated as described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

(3) That any transfers of assets, personnel and/or resources (a) to M from N and/or any subsidiary (b) from M to N and/or any subsidiary, which transfers are in furtherance of the exempt purposes of N , will not constitute an unrelated trade or business within the meaning of section 513 of the Code with respect to M and will not result in M being subject to the tax on unrelated business taxable income pursuant to section 511 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 (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.

Rev. Rul. 69-545, 1969-2 C.B. 117, establishes that a nonprofit organization whose purpose and activity include providing hospital care is promoting health and may, therefore, qualify as organized and operated in furtherance of a charitable purpose, provided other requirements of section 501(c)(3) are met.

Section 511(a) of the Code imposes a tax on the unrelated business income tax 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 512(b)(5) of the Code defines the term "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on by the organization, less allowable business expenses directly connected with the carrying on of such trade or business. This section excludes all gains and losses from the sale, exchange, or other disposition of property other than (1) stock in trade or other property which would be property includable in inventory if on hand at the end of the year, and (2) property held primarily for sale to customers in the ordinary course of the

organization's trade or business.

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 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.

You represent that M will act exclusively for exempt purposes by promoting health in a charitable manner for the benefit of the community. In addition, you indicate that M will promote the furtherance of education and scientific purposes through support of the teaching, research and other educational activities of M. M has been created and its activities are intended to (a) maintain and improve the quality of healthcare services, (b) ensure and enhance the continued access of all members of the community to a full range of high quality healthcare services rendered on a nondiscriminatory basis without regard to race, creed, color, national origin, economic status or participation in government sponsored programs such as Medicare or Medicaid and (c) support medical education and health related research programs. M will accomplish these objectives by (i) serving as an entity focused specifically on expansion of healthcare services and complementary activities through relationships, alliances and other strategic steps that position the hospital system to better serve and/or address the healthcare needs of the community, (ii) establishing a more efficient governance structure which allows the Board of M to focus on system-wide matters while the Board of M focuses on patient activities, (iii) monitoring, directing and guiding the operation and development of the hospital system, particularly the development of M and (iv) permitting the shifting of certain administrative/planning activities from M and other subsidiaries as necessary to obtain the benefits of focused management and strategic planning so as to improve the efficiency of the delivery of healthcare services.

You indicate that M's tax-exempt and charitable purposes will be unchanged by the restructuring. M will continue to operate hospital facilities for the benefit of all persons without regard to their ability to pay. M will make its services available on a nondiscriminatory basis and will continue to operate an emergency room open to and for the benefit of the community it serves. You state that M will be governed by a Board of Trustees composed of persons broadly representative of all members of the community it serves and will continue to promote scientific and educational purposes by participating in graduate medical education programs for physicians and allied health care professionals and conducting and supporting scientific research.

Accordingly, based on the facts and representations set forth, we rule as follows:

As to N :

N, at the time this ruling is issued is being recognized as exempt from federal income tax under section 501(c)(3) of the Code and is being classified as a supporting organization within the meaning of section 509(a)(3) of the Code.

(1) That (a) implementation of the restructuring and (b) N' s carrying out of the transactions contemplated by the restructuring will not, either alone or collectively, adversely affect the status of N as exempt from federal income tax pursuant section 501(a) of the Code as an entity organized and operated as described in section 501(c)(3) of the Code.

(2) That (a) implementation of the restructuring and (b) N 's carrying out of the transactions contemplated by the restructuring will not, either alone or collectively, adversely affect the status of N as other than a private foundation as an entity organized and operated as described in section 509(a)(3) of the Code.

(3) That any transfers of assets, personnel, and/or resources (a) to N from M or any subsidiary or (b) from N to M or any subsidiary, which transfers are in furtherance of the exempt purposes of N, will not constitute an unrelated trade or business within the meaning of section 513 of the Code with respect to the tax on unrelated business taxable income pursuant to section 511 of the Code.

As to M :

(1) That (a) implementation of the restructuring, (b) M's carrying out of the transactions contemplated by the restructuring and (c) M's participation in the hospital system, will not , either alone or collectively adversely affect M's status as exempt from federal income tax pursuant to section 501(a) of the Code as an entity organized and operated as described in section 501(c)(3) of the Code.

(2) That (a) implementation of the restructuring, (b) M's carrying out of the transactions contemplated by the restructuring, and (c) M's participation in the hospital system, will not, either alone or collectively, adversely affect M's status as other than a private foundation as an entity organized and operated as described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

(3) That any transfers of assets, personnel and/or resources (a) to M from N and/or any subsidiary (b) from M to N and/or any subsidiary, which transfers are in furtherance of the exempt purposes of M and the hospital system, will not constitute an unrelated trade or business within the meaning of section 513 of the Code with respect to hospital and will not result in Hospital being subject to the tax on unrelated business taxable income pursuant to section 511 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 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.

These rulings are directed to the organization that requested them. Section 6110(j)(3) of the Code provides that they may not be used of 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,

(signed) Marvin Friedlander

Manager Exempt Organizations
Technical Group 1