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

Date: MAY 25 2000

Contact Person:

ID Number:

Contact Number:

OP:E:EO:T2

UIL: 9999.98-00

LEGEND:
A =
B =
C =
D =

Dear Sir or Madam:

This responds to your request for ruling dated December 29, 2000, from your authorized representative requesting a series of rulings on your behalf regarding the tax consequences associated with the affiliation agreement described below. You are referred to as A in the legend above.

A is a Maryland non-for-profit corporation, which has been recognized by the Internal Revenue Service as an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986 (Code). A is also described in Section 509(a)(3) of the Code.

B is a Maryland non-profit corporation, which has been recognized by the Internal Revenue Service as an organization described in Section 501(c)(3) of the Code of 1986 (Code). B is also described in Section 509(a)(2) of the Code. B's sole corporate member is A. B owns operates and maintains a continuing care retirement community.

C is a Maryland non-profit corporation, which has been recognized by the Internal Revenue Service as an organization described in Section 501(c)(3) of the Code of 1986 (Code). C is also described in Section 509(a)(2) of the Code. C's sole corporate member is A. C owns, operates and maintains a continuing care retirement community.

D is a Pennsylvania non-profit corporation which has been recognized by the Internal Revenue Service as an organization described in Section 501(c)(3) of the Code of 1986 (Code). D is also described in Section 509(a)(2) of the Code. Following the affiliation described herein, D's sole corporate member will be A. D owns, operates and maintains continuing care retirement communities and long term facilities in its service area.

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You have stated A, B, C and D have determined that it is in the best interest of their communities and constituencies, and in furtherance of their exempt purposes, for A and D to become affiliated to serve residents of Maryland, Pennsylvania and the surrounding regions, while preserving their own identities and their involvement in the delivery of geriatric healthcare, continuing care retirement communities and senior living services in their respective areas.

The Affiliation Agreement will become effective at such time that all conditions precedent thereto have been met.

You state that the affiliation creates a geriatric healthcare and senior living system ("System") consisting of A, B, C and D.

In the future the System may include additional entities as supported organizations of A. Each such additional supported organization will be exempt from federal income taxation under section 501(c)(3) of the Code.

You state that the System will enable and facilitate the delivery of geriatric healthcare, continuing care retirement communities and senior living through a system of B, C and D.

You state that the System will foster a continuum of geriatric care services to include home healthcare, senior living, adult day care, primary physician care, hospice care and geriatric services.

By its creation, the System expects to reduce operating expenses, save on capital and building projects, and lower costs of financing.

The Affiliation Agreement grants A certain reserved powers over B, C and D. These powers are proper in this context.

An action by A with regard to subsection (ii), (vi), (vii), (viii) and (xii) of 2 above requires an affirmative vote of seventy five percent (75%) of the Board of Directors of A.

You state that A will establish a budget and will be provided sufficient operating capital from the payment of management fees by B, C and D to function as an independent business. Section 6.1 of the Affiliation Agreement provides that D may withdraw from the System with the approval of sixty percent (60%) of the Board of Directors of A. In addition to the withdrawal under section 6.1, section 6.2 of the Affiliation Agreement permits D to withdraw from the System if (i) A fails to perform any material term of the Affiliation Agreement and such failure continues for 90 days after written notice thereof has been provided to A, or (ii) D discovers within 2 years after the Affiliation Agreement becomes effective, that a representation or warranty of A contained in the Affiliation Agreement was not true in any material respect or omitted to state a material fact.

You state that a condition precedent to the implementation of the Affiliation Agreement is that A, B, C and D amend and restate their respective Articles of Incorporation and Bylaws ("Governing Documents") to reflect the affiliation. You have represented that A, B, C and D have adopted their Governing Documents.

You state that the Governing Documents of A provide that it is organized and operated exclusively to carry out the charitable purposes of B, C and D. A will use, apply and distribute its income and principal and other assets, from time to time, exclusively for the benefit of B, C and D.

The Board of Directors of A consists of 15 members, fourteen of which are elected. The President of A serves as an *ex-officio* member with a vote.

A will initially designate 9 of the 14 elected Directors and the other 5 Directors will be designated by D. The initial Directors will be divided as evenly as possible into three classes and will have staggered terms of one, two and three years. After the terms of the initial Directors expire, the successor Directors will have terms of 3 years.

Upon the expiration of the terms of the initial Directors having terms of one and two years, their immediate successors will be designated by the party (A or D) that designated such initial Directors and will be elected by the Board of Directors of A.

Thereafter, Directors will be elected by a vote of at least seventy-five percent (75%) of the Board of Directors. Notwithstanding the foregoing, at least one Director of A must be a member of the board of directors of B, one Director must be a member of the board of directors of C and one Director must be a member of the board of directors of D. Section 6.16 of A's Bylaws grants A certain reserved powers over the operations of B, C and D. Such reserved powers are essentially similar to those provided in section 3.4 of the Affiliation Agreement *supra*.

The Governing Documents of C provide that A is the sole corporate member of C. Section 2.2 of C's Bylaws lists the reserved powers granted to A. Such reserved powers are essentially similar to those provided in section 3.4 of the Affiliation Agreement, *supra*. The Board of Directors of C will be elected by A from a slate of nominees selected by C.

The Governing Documents of B provide that A is the sole corporate member of B. Section 2.2 II of B's Bylaws lists the reserved powers granted to A. Such reserved powers are essentially similar to those provided in section 3.4 of the Affiliation Agreement, *supra*. The Board of Directors of B will be elected by A from a slate of nominees selected by B.

A ,B, C and D will execute a management services agreement to appoint A to manage facilities owned by B, C and D. Each management agreement will have a term of 36 months. Unless terminated by either party, the initial term will be automatically extended for additional 36 months period.

The Management Agreement will immediately terminate at such time as B, C and D is no longer an organization supported by A.

In consideration for the services provided under the Management Agreement, B, C and D will pay A a fixed monthly fee. A will also be reimbursed for all direct costs of equipment and/or supplies purchased by A for any of the facilities managed under the Management Agreements.

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

1. The execution, delivery and implementation of the Affiliation Agreement will not adversely affect the tax-exempt status of A, B and C as organizations described under section 501(c)(3) of the Code.

2. The Affiliation Agreement will not adversely affect the public charity status of A under section 509(c)(3) of the Code.

3. The Affiliation Agreement will not adversely affect the public charity status of B and C under section 509(a) of the Code.

4. The Affiliation Agreement will not result in recognition of gain or loss by, or in unrelated trade or business income to, A, B or C under sections 511 to 514 of the Code.

5. The Management Agreements will not result in unrelated trade or business income to A under sections 511 to 514 of the Code.

Section 501(c)(3) of the Internal Revenue Code provides for the exemption of federal income tax of corporations organized and operated exclusively for charitable, scientific or educational purposes, provided that no part of the net earnings of the corporation inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. Relief of the poor and distressed or the underprivileged and the promotion of health have long been recognized as charitable.

Section 509(a)(2) of the Code excludes from the definition of "private foundation" an organization which normally receives more than one-third of its support in each taxable year from any combination of gifts, grants, contributions, or membership fees, and gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities, in an activity which is not an unrelated trade or business, subject to certain exceptions, and which normally receives not more than one-third of its support in each taxable year from the sum of gross investment income and the excess of any amount of unrelated business taxable income over the amount of tax imposed by section 511.

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); and
> (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 classified 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 1.509(a)-4(i)(1) of the regulations provides that a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" and the "integral part" test.

Section 1.509(a)-4(i)(2) of the regulations provides that a supporting organization will meet the "responsiveness test" if the organization is responsive to the needs and demands of the publicly supported organizations. A supporting organization is responsive to the needs of one or more supported organizations if one or more members of the governing bodies of the publicly supported organizations are also officer, directors or trustees of, to hold other important offices in, the supporting organizations. *See,* section 1.509(a)-4(i)(2)(ii)(b) of the regulations.

Section 1.509(a)-4(i)(3)(i) of the regulations provides that a supporting organization will meet the "integral part" if it maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. A supporting organization maintains a significant involvement in the operations of the supported organizations if the activities of the supporting organizations are activities to perform the functions of, or to carry out the purposes of, the supported organizations. In addition, but for the involvement of the supporting organization, such activities would normally be engaged in by the supported organizations. *See,* 1.509(a)-4(i)(3)(ii) of the regulations.

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

Section 512 of the Code defines unrelated business taxable income as the gross income derived from any unrelated trade or business regularly carried on, less the allowable deductions that are directly connected with the carrying of the trade or business, both computed with certain modifications.

Section 513(a) of the Code provides that the term "unrelated trade or business" includes any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organizations of its charitable, educational and other purposes or function constituting the basis for its exemption under section 501. The term, however, does not include any trade or business carried on by the organization primarily for the convenience of its members, students, patients, officers, or employees.

Section 1.513-1(d)(1) of the regulations provides that gross income derives from "unrelated trade or business" within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. This requirement necessitates an examination of the relationship between the business activities which generates the particular income in question and the accomplishment of the organization's exempt purpose.

Section 1.513-1(d)(2) of the regulations provides in pertinent part that 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 the 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. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Section 1.513-1(d)(3) of the regulations provides that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function, which they purport to serve. If such activities are in part related to exempt functions but are

conducted on a larger scale that is reasonably necessary for the performance of such functions, the activities in excess of the needs of the exempt functions will not be considered to contribute importantly to the accomplishment of any exempt purpose of the organization.

Rev. Rul 69-545, 1978-1 C.B. 117, recognizes that the promotion of health is a charitable purpose within the meaning of section 501(c)(3) of the Code in its generally accepted legal sense.

Rev. Rul 72-124, 1972-1 C.B. 145, provides that a corporation that devotes its resources to the operation of a home for the aged will qualify for charitable status if it operates in a manner designed to satisfy the three primary needs of aged persons. These are the need for housing, the need for healthcare, and the need for financial security.

Rev. Rul. 79-18, 1979-1 C.B. 194, provides that an organization that provides specially designed housing to elderly persons at the lowest feasible cost and maintains in residence those tenants who subsequently become unable to pay the monthly fees, is an organization operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Code.

In Hospital Bureau of Standards & Supplies, Inc. v. United States, 141 Ct. Cl. 91; 158 F. Supp. 560, 562 (1958), it was stated that the "integral part" doctrine is no a codified rule, bus is a judicial doctrine. It was held that where an organization (1) bears a "close and intimate relationship" to the operation of one or more tax-exempt organizations, and (2) provides a "necessary and indispensable" service solely to those tax-exempt organizations, it will take on the exempt status of those organizations.

The Affiliation Agreement will not affect B and C's purposes to own, operate and maintain continuing care retirement communities and long-term care facilities.

The Affiliation Agreement will not change the relationship between A, B and C. A was, and will remain, the sole corporate member of B and C.

As a result of the Affiliation Agreement, A has also become the sole corporate member of D.

A, as the sole corporate member of B, C and D, will perform functions for B, C and D that they could perform directly. *See,* Rev. Rul. 78-41, *supra.*

As a direct result of A's involvement with the operations B, C and D, they will perform their exempt purposes in a more cost-effective manner and therefore enhance their activities in the communities in which they are located.

The execution, delivery and implementation of the Affiliation Agreement will not adversely affect the tax-exempt status of A, B and C as organizations described under section 501(c)(3) of the Code.

B and C are classified as public charities under section 509(a)(2) of the Code.

Under the Affiliation Agreement, B and C will continue to own and operate the continuing care retirement communities and the sources of their income will not change.

B and C will continue to receive a substantial portion of their income from the performance of exempt activities and from direct and indirect contributions from the general public.

As a result, B and C will continue to be classified as public charities under Section 501(c)(3) of the Code.

A's Bylaws, Section 6.3.3 provides that at least one Director of A must be a member of the board of B, at least one Director must be a member of the board of C, and at least one Director must be a member of the board of D. A will also elect the board of directors of B, C and D.

A, as the sole corporate member of B, C and D, A will meet the "responsiveness test" under section 1.509(a)-4(i)(2) of the regulations.

A, under the reserved powers granted to it under section 3.4 of the Affiliated Agreement, will provide supervision and coordination of B, C and D.

B, C and D will not make significant financial and operational decisions without the approval of the Board of Directors of A. A will assist with and perform planning, financial, legal, management, quality improvement, and other functions for B, C and D.

But for the involvement of A; B, C and D would normally be engaged in the above mentioned activities on their own behalf.

A will also meet the "integral part test" under section 1.509(a)-4(i)(3)(i) of the regulations because A will maintain a significant involvement in the operations of B, C and D. Consequently, A will be organized and operated exclusively for the benefit of, and in connection with, B, C and D under section 1.509(a)-4(i)(1) of the regulations.

An Affiliation Agreement between previously independent organizations to provide corporate services among the participants raises exemption qualification and unrelated trade or business issues. With respect to exemption qualification, it is clear that exemption under Section 501(c)(3) of the Code is not generally available where an organization is established to provide corporate services to unrelated exempt organizations.

A, B, C and D will not adversely affect their tax exempt status under Section 501(c)(3) of the Code by the above transactions as they will continue to promote housing for the aged within the meaning of Rev. Rul. 72-124, *supra,* and Rev. Rul. 79-18, *supra.* The parties will not adversely affect their public charity status because the basis for their respective classifications as public charities will remain the same.

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

The Affiliation Agreement and the Governing Documents of A, B, C and D will effectively bind B, C and D under the common control of A and create a parent subsidiary relationship between the participating entities.

A's activities with regard to B, C and D are substantially related to A's exempt purposes. Under the Affiliation Agreement and the Governing Documents, B, C and D will authorize A's Board of Directors to

establish and approve budgets; approve its directors, officers and committee chairs; approve its indebtedness; and approve expansion of its facilities.

Under each Management Agreement, A, an entity experienced in owning, operating and managing long term care and continuing care retirement facilities for the elderly will provide management services to B, C and D.

Based on all the facts and circumstances, we conclude that the Affiliation Agreement effectively binds the parties under the common control of A so that the participating organizations are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of A's Board of Directors. A is an entity experienced in owning, operating and managing long term care and continuing care facilities for the elderly will provide management services to B, C and D. Although all the facts and circumstances are relevant to this conclusion, importantly, the participating entities have ceded authority under the Affiliation Agreement to A's Board of Directors to establish and approve budgets, approve its directors, officers and committee chairs, approve its indebtedness; approve expansion of its facilities. In addition, the Board of Directors and its committees meet regularly to exercise overall responsibility for operational decisions involving the day-to-day and long range strategic management decisions that have been delegated by the participating entities. Any services provided by A under the Affiliation Agreement will be substantially related to its exempt purposes and contribute to the accomplishment of those purposes. Therefore, services provided between the previously unrelated section 501 (c)(3) tax exempt organizations through the Affiliation Agreement are treated as other than an unrelated trade or business. Any gross income derived by A from such services will not result in unrelated business income to A.

The parties will not adversely affect their tax-exempt status under section 501 (c)(3) of the Code by the proposed transactions, as they will continue to promote health within the meaning of Rev. Rul. 69-545, supra. Under each management agreement, A, an entity experienced in owing, operating and managing long term care and continuing care retirement facilities for the elderly will provide management services to B, C and D. The parties will not adversely affect their public charity status because the basis for their respective classifications as public charities will remain the same.

The management fees paid by B, C and D to A will not result in unrelated trade or business income under sections 511 through 514 of the Code because the above organizations are financially and structurally related as part of a System to promote the health of the community and to provide geriatric healthcare, continuing care retirement communities, and senior living services to the residents of their respective communities.

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

1. The execution, delivery and implementation of the Affiliation Agreement will have no adverse impact on the tax-exempt status of A, B and C as an organization described in section 501 (c)(3) of the Code.

2. The Affiliation Agreement will have no adverse affect on the public charity status of A as an organization described in section 509(a)(3) of the Code.

3. The Affiliation Agreement will have no adverse affect on the public charity status of B and C as an organization described in section 509(a) of the Code.

4. The Affiliation Agreement will nor result in recognition of gain or loss by, in unrelated trade or business income to, A, B or C under sections 511 to 514 of the Code.

5. The Management Agreements will not result in unrelated trade or business income to A under section 511 to 514 of the Code.

These rulings are directed only to the organization that requested them. Section 61 10(k)(3) of the Code provides that they may not be used or cited by others as precedent.

These rulings do not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

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

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

Sincerely,

Garland A. Carter
Chief, Exempt Organizations
Technical Branch 2

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