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

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Date: AUG 03 2000

Contact Person:

ID Number:

Telephone Number:

In reply refer to:
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LEGEND

M=
U =
C=
H=

Dear Sir/Madam:

FACTS

You request rulings involving a joint venture under sections 501(c)(3), 513 and 141 of the Internal Revenue Code.

C and U

C operates general acute care hospitals and other health services and facilities on the campuses of U and C. C is staffed by the faculties, residents, interns and students of U and C medical schools as well as community-based health care providers. U is exempt from taxation under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(ii). C is exempt from taxation under section 501 (c)(3) of the Code and its income is excluded from the definition of gross income by section115 of the Code. C operates two large academic medical center-based neonatal intensive care units ("NICUs"). In connection with these operations, C has developed clinical protocols and methods of training clinical personnel that enhance the level of NICU care. In furtherance of its educational and service missions, C desires to establish and operate a regional NICU in conjunction with H operated by M and members of its medical staff.

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M

M is exempt from federal income tax under section 501(c)(3) of the Code and is an organization described in sections 509(a)(1) and 170(b)(l)(A)(iii). M is part of a religious order and large health care system. M owns and operates H, a general acute care hospital. H offers prenatal and obstetrics services, and currently operates a NICU. M's patients requiring more intensive care than H provides must be transferred to other facilities, including C's NICU. M wants to utilize a joint venture with C to operate H's existing NICU while developing a newly established NICU that would increase the types and quality of care in H's NICU to ensure adequate health coverage for residents of the community

Purpose of Transaction

Neonatal services are highly specialized and costly, necessitating certain minimum patient volumes to sustain the level of resources, including professional resources, required to maintain quality of care. Both C's and M's participation is critical to the operation of H's NICU. M's participation is essential because C does not have the resources alone to operate an enhanced NICU service of the type operated by C at its hospitals. C's participation is essential because H is unable to provide the high level of professional clinical resources as offered by C at its hospitals. The goal of the parties is to provide residents of M's community with access to high-quality children's health services, to decrease the need for out-of-area transport of critically ill newborns and to facilitate transfers back to the community of babies requiring intensive neonatal care.

Description of Transaction

C and M have formed a limited liability company ("LLC") to serve as a joint operating entity for the operation of H's existing NICU and an expanded, replacement NICU to be effectuated by the LLC on H's campus. The LLC is organized pursuant to Articles of Organization and operates pursuant to an LLC Operating Agreement (the "Operating Agreement"). The members of the LLC are C and M.

The NICU will be operated under H's general acute care license and will be subject to the general oversight of H's governing body. The Operating Agreement requires the NICU operate to further the exempt purposes of C and M. The Operating Agreement requires that any revenues generated by NICU operations be distributed to C and M. Admission to the NICU's medical staff will be open to all qualified physicians consistent with its size and the nature of its activities. The NICU will provide care to

everyone in its community in accordance with H's Medicare and Medicaid participation agreements and charity care policies.

C and M will contribute equally to the initial capital requirements of the LLC. C and M will each have a 50% membership interest in the LLC. The LLC's profits and losses will be shared equally.

C and M have certain reserved powers as members of the LLC. The unanimous approval of C and M is required for any amendment of the Operating Agreement or Articles of Organization and certain major transactions, including any merger, additional capital call, dissolution of the LLC, sale of substantially all LLC assets, admission of a member

The LLC will be governed by a seven member Board comprised of members appointed by C, 3 members appointed by M and one member who is the Medical Director of the NICU. The Operating Agreement requires the LLC Board to approve any changes in the types of services offered by the NICU as well as other matters.

The LLC will assume responsibility for the day-to-day operation of the NICU. These responsibilities will be carried out in part through its on-site nurse manager and medical director. The LLC will also effectuate facility improvements and provide equipment necessary for the NICU. The LLC will provide physician staffing and ensure regulatory compliance of the NICU. The LLC will bear the financial risk and have the corresponding financial reward resulting from the operation of the NICU.

M will provide a facility setting for the NICU, including space,

in exchange for reimbursement of its costs. C will be the managing member of the LLC responsible for the day-to-day operation of the NICU. In that capacity, it will provide the services of and, when required, for the NICU. C will also provide in the NICU, including the services of a full-time on-site

Upon the receipt of favorable ruling from the Service, M will pay to the LLC the revenues received by M with respect to the NICU, out of which the LLC will pay all expenses relating to the NICU. As a part of such expenses, in exchange for acting as the LLC's managing member, C will be entitled to reasonable compensation as determined by the parties. profits attributable to the NICU will then be

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distributed to C and M in accordance with If expenses exceed revenues, will bear such losses.

The LLC can be dissolved in the following circumstances: expiration of the term of the Operating Agreement; approval by the LLC members; disposition of the LLC's assets; failure of the members to successfully renegotiate the Agreement if plans to increase the quality and level of NICU services are not implemented; the requested private letter ruling is not received; or there is a change in law that adversely affects a member with respect to its participation.

Rulings Requested

You have requested the following rulings.

1. Participation in the LLC will not adversely affect the status of C under section 501(c)(3) of the Code, or adversely its public charity status under sections 509(a)(1) and 170(b)(1)(A)(iii).

2. All payments received by C from the LLC for goods, property, services or personnel provided in connection with the operation of the NICU and C's distributive share of the income or loss of the LLC in connection with the operation of the NICU will constitute income from a trade or business that is substantially related to C's tax-exempt purposes within the meaning of section 513 and, therefore, will not be subject to the tax on unrelated business income under section 511.

3. With respect to any facilities financed by tax-exempt bonds and used by the LLC in connection with the NICU, C will be a qualified user of such facilities within the meaning of Revenue Procedure 97-13.

LAW

Sections 501(c)(3) and 509(a)(1) 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 provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

Revenue Ruling 69-545, 1969-2 C.B. 117, recognizes that the promotion of health is a charitable purpose within the meaning of section 501(c)(3) of the Code.

Revenue Ruling 78-41, 1978-1 C.B. 148, concludes that a trust created by an exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the hospital is operated exclusively for charitable purposes and is exempt under section 501(c)(3) of the Code.

Providing management and consultants' services to other, unrelated exempt organizations for a fee sufficient to produce a small profit does not further an exclusively exempt purpose. See BSW Group, Inc. v. Commissioner, 70 T.C. 352 (1978).

An organization providing laundry services on a centralized basis to exempt hospitals does not qualify for exemption under section 501(c)(3). See HCSC-Laundry v. United States, 450 U.S.1 (1981).

Section 513(e) of the Code provides that in the case of a hospital, the term "unrelated trade or business" does not include the furnishing of one or more of the services described in section 501(e)(1)(A) to one or more hospitals if such services are furnished solely to such hospitals which have facilities to serve not more than 100 inpatients, such services, if performed on its own behalf by the recipient hospital, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption, and such services are provided at a fee or cost which does not exceed the actual cost of providing such services.

Rev. Rul. 77-72, 1977-1 C.B. 157, provides that indebtedness owed to a labor union by its wholly owned tax-exempt subsidiary is not acquisition indebtedness within the meaning of section 514 of the Code since the parent and subsidiary relationship shows the indebtedness to be merely a matter of accounting.

In Geisinger Health Plan v. United States, 30 F.3rd 494 (3rd Cir. 1994) (Geisinger), the court recognized that an organization may qualify for exemption based on the integral part doctrine, which arises from an exception to the feeder organization rule set forth in section 1.502-1(b) of the regulations, which states that if a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with the parent organization. The court also noted that an entity seeking exemption as an integral part of another cannot primarily be engaged in activity that would generate more than insubstantial unrelated business income if engaged in by the other entity. In this regard, the court followed the reasoning of section 1.502-1(b),

which contains an example of a subsidiary organization that is not exempt from tax because it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. The example states that if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations) it is not exempt because such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

Accordingly, the court in Geisinger determined that application of the integral part doctrine requires at a minimum that an organization be in a parent and subsidiary relationship and that it not be carrying on an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

A joint operating agreement between previously independent hospitals to provide corporate services among the participants raises exemption qualification and unrelated trade or business issues. With respect to exemption qualification, the courts have been 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, other than through the application of section 501(e) of the Code for cooperative hospital service organizations. See BSW Group, Inc., supra, and HCSC-Laundry, supra. Furthermore, exemption under the integral part doctrine requires a parent and subsidiary relationship and the absence of unrelated trade or business. See Geisinger, supra, and Rev. Rul. 78-41, supra.

Section 509(a)(1) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) of the Code other than an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)). Organizations described in section 170(b)(1)(A)(iii) of the Code include organizations whose principal purpose is the provision of medical or hospital care. Section 1.170A-9(c)(1)(ii) of the Income Tax Regulations states that an outpatient clinic may qualify as a hospital if its principal purpose is the provision of hospital or medical care.

Analysis

Based on all the facts and circumstances, we conclude that C will not adversely affect its tax exempt status under section 501(c)(3) of the Code because of the transaction as it will continue to promote health within the meaning of Revenue Ruling 69-545. The

sharing of assets, personnel and/or resources pursuant to the joint operating agreement will not adversely affect the section 501(c)(3) status of C as this activity promotes health within the meaning of Revenue Ruling 69-545. C will continue to qualify as a non-private foundation under section 509(a)(1) of the Code.

Sections 511 Through 514 of the Code

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

Section 512(a)(l) of the Code defines the term unrelated business taxable income as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions, computed with the modifications listed in section 512(b).

Section 512(b)(3) of the Code provides generally that rents from real property (and its incidental related personal property) are not unrelated business income unless the property is debt-financed under section 514 of the Code. Debt-financed property does not include any property substantially related to the exercise or performance by such organization of its charitable functions.

Section 512(b)(4) of the Code requires that notwithstanding paragraphs (1), (2), (3) or (5), the net income realized with respect to debt-financed property must be included in unrelated business taxable income.

Section 512(b)(5) of the Code exempts from the definition of unrelated business taxable income all gains and losses from the sale, exchange or other disposition of non-inventory items and items not held for sale in the ordinary course of business.

Section 512(b)(13) of the Code limits the exclusion of interest, annuities, royalties, and rents provided by section 512(b)(1), (2), and (3) where such amounts are derived from a controlled organization.

Section 1.512(b)-1(1) of the regulations provides that if an exempt organization has control of another organization, the controlling organization shall include as an item of gross income in computing its unrelated business taxable income the amount of interest, annuities, royalties, and rents derived from the controlled organization, determined in accordance with the formula described in section 512(b)(13) of the Code and section 1.512(b)-1(1)(3) of the regulations.

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 income or funds or the use it makes of the profits derived) to the exercise of the organization's exempt purposes or functions.

Section 1.513-l(d)(2) of the regulations provides that a trade or business is related to exempt purposes, in the relevant sense, only where the conduct of business activities has a causal relationship to the achievement of exempt purposes; and it is substantially related only if the causal relationship is a substantial one. The regulation states 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 exemption is granted, the production or distribution of the goods or performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 514 of the Code provides for the taxation under section 512 of income from debt-financed property. Section 514(b)(l)(A)(i) of the Code, 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 the charitable purposes constituting the basis for its exemption under section 501.

Analysis

With respect to unrelated trade or business, section 513(e) of the Code makes clear that if a hospital provides regularly carried on corporate services to another unrelated exempt organization for a fee, then such services are unrelated trade or business unless they fall within the exception for certain hospital services provided by section 513(e). However, if the participating exempt organizations are in a parent and subsidiary relationship, then corporate services provided between them necessary to their being able to accomplish their exempt purposes are treated as other than an unrelated trade or business and the financial arrangements between them are viewed as merely a matter of accounting. See Rev. Rul. 77-72, supra.

At issue, is whether the joint operating agreement has established a parent and 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.

Based on all the facts and circumstances, we conclude that the joint operating agreement effectively binds C under the common control of the LLC so that C is within a

relationship analogous to that of a parent and subsidiary pursuant to the authority of the LLC's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating entities have ceded authority under the joint operating agreement to the LLC's governing body to establish their budgets, including major expenditures, debt, contracts, managed care agreements, and capital expenditures; to direct their provision of health care services; to provide for dispute resolution and arbitration; and to monitor and audit their compliance with its directives. In addition, the governing body 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. Therefore, services provided between the previously unrelated organizations through the joint operating agreement are treated as other than an unrelated trade or business.

CONCLUSION

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

1. Participation in the LLC will not adversely affect the status of C under section 501(c)(3) of the Code, or adversely its public charity status under sections 509(a)(1) and 170(b)(1)(A)(iii).

2. All payments received by C from the LLC for goods, property, services or personnel provided in connection with the operation of the NICU and C's distributive share of the income or loss of the LLC in connection with the operation of the NICU will constitute income from a trade or business that is substantially related to C's tax-exempt purposes within the meaning of section 513 and, therefore, will not be subject to the tax on unrelated business income under section 511.

3. With respect to whether C will be a qualified user of the facilities within the meaning of Revenue Procedure 97-13, this ruling request will be answered in a separate communication from the Service.

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 only to the organizations that requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited as precedent.

These rulings are based on the understanding that there will be no material change in the facts upon which they are based. Any changes that may have a bearing on your tax status should be reported to the Service. We are informing your key District Director of these rulings. Please keep this ruling letter in your permanent records.

Sincerely yours,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, EO Technical
Group 1

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