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

Date: October 10, 2000

Contact Person:

ID Number:

Telephone Number:

In reply refer to:
T:EO:RA:T:1

LEGEND

Y=
S=
N=
P=
H=
O=
C=
G=

Dear Sir/Madam:

FACTS

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

Proposed Transaction

Y and S propose to form a joint venture structured as a new limited liability company (N) to oversee and operate rehabilitation services in its community.

Y

Y is exempt under section 501(c)(3) of the Code and has been classified as an organization that is not a private foundation within the meaning of section 509(a). Y is the sole member of three tax exempt entities that include H. These entities make up O.

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Although Y itself does not engage directly in the provision of health care, it provides overall coordination and direction for O, including the holding and leasing of real estate to each of its three subsidiaries, the management of O's endowment, and its fundraising and strategic planning.

C

C, a non-profit corporation that has standing similar to a religious congregation, is the sole member of Y. Y is governed by a Board of Directors elected by C, plus certain ex officio directors. In addition to electing the directors, C appoints Y's President and ratifies the election of Y's Chair of the Board. C also has additional reserved powers for Y's budget approval and asset disposition.

H

H is a rehabilitation facility exempt under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(iii). H serves principally as a regional referral center providing inpatient medical care for individuals with extended acute medical needs and for disabled individuals with acute disease. H is located on Y's campus.

S

S is exempt under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code. S is currently licensed as a rehabilitation center and is certified by Medicare as a long-term care facility. S serves as the rehabilitation arm for P's patients by providing comprehensive rehabilitative post-acute medical care. S's sole member is G. G is exempt under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(iii). G is controlled by P.

P

P is exempt under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(vi). P also controls two section 501(c)(3) teaching hospitals.

N

N will undertake a combination of Y's and S's rehabilitative programs. A formal merger is not possible because of inherent institutional barriers. Y is a part of a religious hospital system and cannot cede ultimate control of its facilities to P. Given

these circumstances, N was created to combines the strengths of Y and S and to provide an expanded and improved level of health care service in the community. Article 2.5 of N's Operating Agreement provides N shall operate in a manner consist with the charitable purposes of Y and S.

N will be operated by a Board of Managers, consisting of equal numbers of representatives from Y and S. N's Board of Managers will approve: (1) operating and capital budgets; (2) strategic plans; (3) selection and removal of the CEO; (4) agreements above a *de minimis* amount and any lender financed indebtedness; (5) any amendments to N's operating agreement; (6) quality of care standards; and (7) any material change in the services provided by N. Under the LLC Agreement, N's members will share ratably in all operating profits and losses from services it provides.

N will oversee the operation of the inpatient beds at H as well as its existing outpatient services. For regulatory purposes, the services must be provided under H's existing license. Several of S's existing services, such as outpatient primary care for disabled persons and industrial rehabilitation, will be moved to Y's campus and operated by N. In addition, N expects to arrange for the consolidation of inpatient geriatric and oncology rehabilitation programs by combining the existing S and Y programs at the Y campus under Y's license and N's direction. N also expects to arrange for expansion of Y's outpatient services.

H has the existing capacity to add additional beds. Over time, N intends to add beds at H to expand rehabilitation services available in H's service area and the communities served by P. N hopes to develop new programs to better serve its community. Quality of care standards will be established by N. Day-to-day oversight of medical services will occur primarily through N's Medical Director. N's Medical Director will have responsibility for recommending standards of quality of care for all its services, monitoring and evaluating the quality of care at N entities and reporting those issues to N's Board of Managers and N's members. N's Medical Director will also serve as the Medical Director of H and will be responsible for oversight of its medical staff.

The bulk of physician services will be provided by physicians currently on H's medical staff, who may also become members of S's medical staff. Certain of S's physicians, who become members of H's medical staff, will also provide services to N's patients. The physicians in charge of the programs moved from S to H are expected to become the chiefs of these programs at H. For administrative convenience, nursing services to N's patients will generally be provided by persons employed by H, though augmented in certain programs by employees employed by S.

S and H have overlapping patient referral sources; thus, the consolidation of some services under N will promote greater efficiency. S is in need of renovation or rebuilding. Thus, increased capacity and assured quality at H may permit the new or renovated S to be a smaller, more efficient facility focused on the more complex issues of rehabilitative care. In addition, Y and S believe that by integrating their medical staffs and expertise, N will make possible the delivery of superior medical services.

Y and S will make small capital contributions of cash for N's formation, and additional capital contributions as needed by N to develop new medical services. N will be responsible for the full amount of any profit or loss from operations at H. All distributions from N are subject to approval by its Board of Managers. N is contemplated to have a 20-year term.

Rulings Requested

You have requested the following rulings.

1. Participation in N will not adversely affect the status of Y and P under section 501(c)(3) of the Code.

2. The allocation of profits and losses made by N to S and Y will not be subject to the tax on unrelated business income under section 511.

LAW

Sections 501(c)(3)

Section 501(c)(3) of the Code provides for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific or educational purposes, provided that no part of the corporation's net earnings 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. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372; Scott on Trusts, sections 368, 372; Rev. Rul. 69-545, 1969-2 C.B. 117.

Rev. Rul. 69-545 establishes the community benefit standard, which focuses on a number of factors indicating the operation of a hospital benefits the community rather than serving private interests. The revenue ruling requires all relevant facts and

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circumstances to be weighed in each case. The facts in Situation 1 of the revenue ruling indicate that a hospital serves the public rather than private interests if the hospital is controlled by a board composed of independent civic leaders, has an open medical staff, and an active, open, and accessible emergency room.

Rev. Rul. 98-15, 98-1 C.B. 718, Situation 1, explicitly approves formation of a limited liability company (which is a partnership for federal tax purposes) by an exempt hospital organization, although in that ruling, the other limited liability company member is an unrelated for-profit entity. Situation 1 of the ruling concludes that the hospital organization's principal activity continues to be the provision of hospital care, even when such activities are conducted through a limited liability company, because, inter alia, the tax-exempt hospital retains control over, the limited liability company and the limited liability company serves charitable purposes. According to Rev. Rul. 98-15, for federal tax purposes, the activities of a partnership are often considered to be the activities of the partners. Aggregate treatment is also consistent with the treatment of partnerships for the purposes of the unrelated business income tax under section 512(c) of the Code. The ruling notes that in light of the aggregation principle reflected in section 512(c), the aggregate approach also applies for purposes of the operational test set forth in section 1.501(c)(3)-1(c) of the regulations. Thus, the activities of a limited liability company treated as a partnership for federal tax purposes are considered to be the activities of an exempt organization. Accordingly, an organization exempt under section 501(c)(3) of the Code may form and participate in a partnership, including a limited liability company treated as a partnership for federal tax purposes, and meet the operational test if participation in the partnership furthers its charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of any for-profit partners.

Section 1.501(c)(3)-1(e) of the regulations provides, in part, that an organization may meet the requirements of section 501(c)(3) of the Code although it operates a trade or business as a substantial part of its activities if the operation of such trade or business is in furtherance of the organization's exempt purposes and if the organization is not organized or operated for the primary purposes of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.

Sections 511 Through 513 of the Code

Section 511 of the Code imposes a tax on the unrelated business income of organizations described in section 501(c) and exempt under 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 on of the trade or business, both computed with certain modifications.

Section 512(c)(1) of the Code provides, in relevant part, 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, such organization in computing its unrelated business taxable income shall 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 connected with such gross income.

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 organization of its charitable, educational or other purpose 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-i(d)(1) of the regulations provides that gross income derives from unrelated trade or business, within the meaning of section 513(a) of the Code, 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 generate the particular income in question and the accomplishment of the organization's exempt purposes.

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 that they purport to serve. If such activities are in part related to exempt functions but are conducted on a larger scale than 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.

Analysis

The charitable and exempt purposes of Y and S after the creation of N will be the same as prior to the creation of N. As provided in Rev. Rul. 98-15, supra, the activities of a limited liability company treated as a partnership for federal income tax purposes are considered to be the activities of an exempt organization that is an owner of the limited liability company when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3). A section 501(c)(3) organization may form and participate in a partnership, including a limited liability company that has not elected to be treated as a corporation for federal tax purposes, and meet the operational test if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of any for-profit partners.

In contrast to *Rev. Rul. 98-15,* both members of N are section 501(c)(3) entities, so N's activities remain entirely in the control of Y and S, and will benefit only exempt entities. Accordingly, after the formation of N, Y and S each will continue to promote the health of the community and otherwise accomplish their respective exempt purposes through the operation of N, which is consistent with Situation 1 in Rev. Rul 98-15. After the formation of N, Y and S will continue to operate or promote the operation of hospitals and provide hospital care consistent with the community benefit factors for exempt health care organizations as described in Rev. Rul. 69-545. Furthermore, because Y and S are exempt organizations and because any income or cash of N will be allocated as distributions only to Y or S in accordance with the Operating Agreement, the creation and operation of N will not result in any private inurement or private benefit.

The exempt purposes of Y and S will be furthered by their participation in N because their participation enables them to provide expanded and improved health care services to the community. Accordingly, such participation will not constitute an unrelated trade or business to either Y or S within the meaning of section 513 Accordingly, pursuant to section 512(c), any distribution received by Y and S from N will not be considered unrelated business taxable income.

CONCLUSION

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

1. Participation in N will not adversely affect the status of Y and S under section 501(c)(3) of the Code.

2. The allocation of profits and losses made by N to S and Y will not be subject to the tax on unrelated business income under section 511.

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 Exempt Organizations Area Manager these rulings. Please keep this ruling letter in your permanent records.

Sincerely yours,

Marvin Friedlander

Marvin Friedlander
Manager, EO Technical
Group 1