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

Uniform Issue List:
501.03-11
509.01-00
512.00-00

Date:
11/29/2000

Contact Person:

Identification Number:
T:EO:B1
Telephone Number:

Employer Identification Number:

Legend:

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Dear Sir or Madam:

We have considered your ruling request relating to the effect a proposed restructuring will have on your organization under section 501(c)(3) of the Internal Revenue Code and whether certain activities will result in unrelated business income under section 512.

FACTS

L was incorporated on b as a non-membership nonprofit corporation under the laws of the State of a. Pursuant to a group ruling issued on c covering all members of the M, L is

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considered exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3) and as a public charity under section 509(a)(1) by virtue of being described as a hospital in section 170(b)(1)(A)(iii). L operates three licensed hospitals as unincorporated divisions.

N was incorporated on d as a nonprofit membership corporation under the laws of the State of a. The members of N consist of certain religious institutes of the O. Pursuant to a group ruling issued on e with respect to agencies and instrumentalities and all educational, charitable and religious institutions operated, supervised or controlled by or in connection with the O in the United States, its territories and possessions, appearing in P, N is considered exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3) and as a public charity described in section 509(a)(3).

R, formerly known as S, which was formerly known as T, was incorporated on f, as a nonprofit membership corporation under the laws of the State of a. The sole member of R is N. Pursuant to a group ruling issued on e with respect to agencies and instrumentalities and all educational, charitable and religious institutions operated, supervised or controlled by or in connection with the O in the United States, its territories and possessions, appearing in P, R is considered exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3) and as a public charity under section 509(a)(1) by virtue of being described as a hospital in section 170(b)(1)(A)(iii). R operates eight licensed hospitals as unincorporated divisions.

U was incorporated as a nonprofit membership corporation under the laws of the State of a on g. U was recognized as exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3) and as a public charity as described in section 509(a)(3). The members of U are L and N. U's Bylaws provide that its Board of Trustees consists of 11 persons. L appoints five trustees, N appoints five trustees, and U's President and N's President and Chief Executive Officer also serves as a voting member of the Board. U's Bylaws provide that if an Executive Committee is established, it will consist of six persons: U's Chair of the Board of Trustees, U's President and Chief Executive Officer, two members of the Board selected by L and two members of the Board selected by N.

L, N, R and U are collectively referred to as the "Parties." A majority of the voting members of the Boards of Trustees of each of the Parties and of each the Parties' Executive Committees is comprised of independent community members. A majority of the individuals comprising a quorum of each of the Parties' Boards of Trustees and each of the Parties' Executive Committees are independent community members. Each of the Parties has adopted a substantial conflicts of interest policy.

In December 1995, L and R entered into an Affiliation and Management Agreement (the "Original Agreement") which provided for the formation of U to operate and manage the operations of the health care facilities of L and R. This arrangement permitted L and R, and their respective health care facilities, to retain their distinct religious identities, while working together to satisfy common goals. In 1998, N replaced R as a party to the Original Agreement.

The Parties concluded that the arrangement established by the Original Agreement needed to be restructured if the Parties were to continue to jointly pursue their common goal of

promoting the health of the communities they serve. To accomplish this restructuring, the Parties executed an Amended and Restated Affiliation Agreement, dated April 1, 2000 (the "Amended Agreement"). Under the Amended Agreement, N has a 70 percent interest in U and L has a 30 percent interest.

Under the Amended Agreement, L and N have ceded to U significant financial, managerial and operational authority over their affairs, including exclusive authority over capital and operating budgets, strategic plans, managed care contracting, the ability to allocate or reallocate services among the health care facilities L and N manage, and the ability to monitor and audit compliance with directives.

The Amended Agreement provides that U will serve as the exclusive operator and manager of the business and healthcare activities of L and R and will have the general authority to operate and manage the health care facilities L and N manage, subject only to the terms and conditions of the Amended Agreement and the powers reserved to L and N under the U Bylaws. The U Bylaws provide that the authority over the business and healthcare activities of L and R has been granted to the Board of Trustees of U and includes certain significant actions described therein.

The U Bylaws provide that action on certain significant matters described therein must be initiated and approved by the Board of Trustees of U, but also must be approved by both of U's members, N and L.

The local boards of the health care facilities L and N manage are comprised of individuals elected by U pursuant to the U Bylaws and, therefore, are subject to U's control.

Under a Management and Option Agreement dated April 1, 2000 between L and V ("M&O Agreement"), V, a section 501(c)(3) organization, has paid L $10 million for (a) a five-year option to become L's sole member, and (b) L's delegation to V of L's authority to approve certain U matters described in U's Bylaws. As of the date of this ruling, V not has exercised this option. Under the M&O Agreement, a representative of V serves as the principal liaison and duly-authorized representative of V and has various responsibilities described in this document. In addition, this representative is required to deliver to the L Board of Trustees a quarterly report regarding the financial condition and operations of U and the health care facilities managed by N and L. In return for these services, L pays U a management fee of 0.15 percent of L's operating expenses.

Under the Amended Agreement, L and N are required to make annual contributions to U equal to each member's interest in U multiplied by the lesser of 50 percent of certain cash flow or $10 million.

RULINGS REQUESTED

1. Following the restructuring described above, N continues to qualify as exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3).

2. Following the restructuring described above, N continues to qualify as a public charity under section 509(a)(3) of the Code.

3. L's provision of management services, loans, capital contributions, and/or transfer of assets, personnel or resources to any of the other Parties does not result in unrelated business income to N under section 512 of the Code.

APPLICABLE LAW

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.

Rev. Rul. 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.

Rev. Rul. 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.

Section 511(a) of the Code imposes a tax on the unrelated business income 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 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 of the Code 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.

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).

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 which 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) of the regulations, 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 a trade or business which would be an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

RATIONALE

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.

However, if the exempt organizations who participate in a joint operating agreement 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, then, is whether the joint operating agreement has established a parent and subsidiary relationship between the participating organizations. If it has, the corporate services and payments provided between the participating organizations are not treated as unrelated trade or business income because these activities are essential to the accomplishment of their exempt purposes, the activities could be conducted by a participating entity for itself without giving rise to unrelated trade or business income, and they occur in the context of a close relationship between the participating organizations.

Based on all the facts and circumstances, we conclude that under the Amended Agreement and the M&O Agreement, L and N are effectively under the common control of U. As a result, these organizations are within a relationship analogous to that of a parent and subsidiary. Although all of the facts and circumstances are relevant to this conclusion, it is significant that under the Amended Agreement, L and N have ceded authority to U significant financial, managerial and operational authority over their affairs, including exclusive authority over capital and operating budgets, strategic plans, managed care contracting, the ability to allocate or reallocate services among the health care facilities L and N manage, and the ability to monitor and audit compliance with directives.

Contributions to organizations exempt from federal income tax under section 501(c)(3) of the Code or the performance of services by related section 501(c)(3) organizations do not fall within the definition of unrelated business income under section 512, nor create taxable gain or loss to the transferor or transferee.

L's, N's and R's entering into the Amended Agreement and M&O Agreement with U, will not adversely affect their status as organizations described in section 501(c)(3) because they will continue to be organized and operated exclusively for the promotion of health within the meaning of Rev. Rul. 69-545, supra. The provision of management services, loans, capital contributions, and the transfer of assets, personnel or resources between these organizations pursuant to the Amended Agreement and the M&O Agreement will not adversely affect their tax-exempt status under section 501(c)(3) because these activities will facilitate their charitable purposes of promoting health for the benefit of the community within the meaning of Rev. Rul. 69-545.

In addition, L and R will each continue to qualify as a hospital under section 170(b)(1)(A)(iii) of the Code and as a public charity under section 509(a)(1), and N will continue to qualify as a supporting organization under section 509(a)(3).

RULINGS

1. Following the restructuring described above, N continues to qualify as exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3).

2. Following the restructuring described above, N continues to qualify as a public charity under section 509(a)(3) of the Code.

3. N's provision of management services, loans, capital contributions, and/or transfer of assets, personnel or resources to any of the other Parties does not result in unrelated business income to L under section 512 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 only to the organization that requested them and may not be used or cited by others as precedent.

We are informing your Exempt Organizations Area Manager of this action. Please keep a copy of this letter in your permanent records.

If you have any questions about these rulings, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

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