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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: DEC - 6

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No third party contact

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Dear

This is in response to your ruling request concerning a proposed hospital reorganization and its effect on the tax exempt status under section 501(c)(3) of the Internal Revenue Code, foundation classification under section 509(a) of the organizations involved, and the applicability of the unrelated trade or business income tax provisions under sections 511 through 514 of the Code.

Facts

A is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a hospital under sections 509(a)(1) and 170(b)(1)(A)(iii). A operates an acute care hospital which includes a regional neonatal intensive care unit, a children's hospital, psychiatric and rehabilitation units, and ground and air ambulances. The hospital is also a teaching facility with residency programs focusing largely on primary care. A operates residency programs in internal medicine, family practice, pediatrics, ob-gyn, surgery, and radiology. A is the parent corporation of D, a health care system that includes A, B and C.

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B is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a public charity pursuant to section 509(a)(3). B's sole member is A. B is the fundraising vehicle for A.

C was formed by A to serve as the new parent corporation of D and to support A in its health care mission. C is being granted exemption from federal income tax under section 501(c)(3) of the Code and nonprivate foundation status under section 509(a)(3) of the Code by letter of even date. C will provide administrative support and such other activities that benefit, perform the functions of or carry out the purposes of A.

A desires to change its current corporate structure for a variety of reasons relating to accreditation, compliance with governmental regulatory requirements, reimbursement, simplification of corporate structure, financial reporting, tax compliance, and lending. Also, the proposed restructuring will allow a more flexible framework within which to conduct and expand management functions. A currently has the components of an integrated delivery system (an acute care facility, outpatient services, home health, ambulance services, physician services, etc.), but it is not currently structured in a manner designed to maximize the usefulness of this integrated system for the delivery of health care services. A states that replacing the hospital corporation as the parent corporation with a not-for-profit holding company in the form of C will place appropriate emphasis on the component parts of the integrated delivery system rather than a disproportionate emphasis on the hospital. The Board of Directors of C will engage in strategic planning, oversight and guidance for the entire system.

From x to date, A has owned all stock of its affiliated stock corporations and has been the sole member of B and its other affiliated non-stock corporations. Under the proposed restructuring, C will own, directly or indirectly, 100% of the stock of all A affiliated stock corporations and will be the sole member of A, B and other A affiliated non-stock corporations.

A has represented that it will amend its Articles of Incorporation and properly file such amendment with the State authorities to provide that A is a membership corporation having C as its sole member and that it will change its Board of Directors from a self-perpetuating board to one appointed by its sole member. Presently, C's initial Board of Directors is identical in composition to that of A's current Board of Directors. Hereafter, each of A's board members shall be appointed by the sole member to serve coterminously with his or her membership on the Board of Directors of the sole member.

A has represented that the Bylaws of B will be amended to change the identification of the sole member from A to C and to provide that at least one member of B's Board of Directors will also be a member of the A board.

In addition to the restructuring described above, A desires to move outpatient clinics currently operated by second and third tier for-profit subsidiaries of A into A. As of the date of this ruling letter, A proposes to transfer certain of the outpatient physician practices to be operated directly by A. The referenced outpatient physician practices include internal medicine, family practice, pediatrics, gynecologic oncology, and neurology. With the exception of neurology, the practices referenced above have always functioned as departments of A and are regarded by A as faculty

physician practices. The physicians in those practices will continue to be employed under full-time faculty contracts with a for-profit subsidiary of the D Health System to teach physicians enrolled in A's residency programs. The neurologists will continue to be employed by the for-profit subsidiary as well. A does not operate a residency program in neurology, but residents rotate through the neurological practice as part of the core curriculum of the family practice and internal medicine residency programs. In addition, certain fourth year medical students rotate through the neurological practice.

As a result of the restructuring, A will be replaced by C as the holding company of its affiliated stock and non-stock corporations and as the sole member of B. A will engage in the same exempt hospital operations after the restructuring as it does now. A has been and will continue to be operated exclusively for the charitable purpose of promoting health. A treats patients on an inpatient and outpatient basis who can pay the cost of their hospitalization, either themselves, or through private health insurance, or with the aid of public programs such as Medicare and Medicaid. In addition, A has an indigent/charity care policy for patients based on the federal poverty guidelines. A operates a full time emergency room which provides health care services to patients without regard to ability to pay. Control of A rests with its Board of Directors and its sole member, C. The Boards of C and A are identical and are composed of prominent and independent civic leaders in the community.

As a result of the proposed restructuring, B will continue to be the fundraising vehicle to its supported organization.

Rulings Requested

1. A's proposed restructuring will not adversely affect A's tax exempt status under section 501(c)(3) of the Code and its classification as a public charity pursuant to sections 509(a)(1) and 170(b)(1)(A)(iii).

2. A's proposed restructuring will not adversely affect B's tax exempt status under section 501(c)(3) of the Code and its classification as a public charity pursuant to section 509(a)(3) of the Code.

3. The operation of the outpatient clinics regarded by A as faculty physician practices as outpatient departments of A will not constitute unrelated trade or business of A.

Law

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of organizations that are organized and operated exclusively for religious, charitable, scientific, or educational purposes, provided no part of the 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; IV Scott on Trusts, section 368, 372 (3rd ed. 1967); and Rev. Rul. 69-545, 1969-2 C.B. 117.

Section 509(a) of the Code provides that all organizations described in section 501(c)(3) are private foundations except those described in sections 509(a)(1), (2), (3) or (4).

Section 509(a)(1) of the Code excludes from the term "private foundation" an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 509(a)(3) of the Code excludes from the definition of a 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 specified organizations described in paragraph (1) or (2),
>
> (B) is operated, supervised, or controlled by or in connection with one or more organizations described in paragraph (1) or (2), and
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> (C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in paragraph (1) or (2).

Section 170(b)(1)(A)(iii) of the Code describes an organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of an organization described in section 501(c)(3) of the Code.

Section 512(a)(1) of the Code defines unrelated business taxable income as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly attributable to such business activity.

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 or performance by the organization of the purpose or function constituting the basis for its exemption.

Section 1.513-1(a) of the regulations defines unrelated business taxable income to include the gross income of an exempt organization if, and to the extent that: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is related to exempt purposes only where the conduct of the business activity has a causal relationship to the

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achievement of an exempt purpose, and is substantially related for purposes of section 513 only if the causal relationship is a substantial one. Thus, for the conduct of a 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 the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Revenue Ruling 78-41, 1978-1 C.B. 148, describes a trust whose sole purpose was to accumulate and hold funds for use in satisfying malpractice claims against a hospital. The trust was determined to be an integral part of the hospital because it was controlled by the hospital directly and was performing a function that the hospital could do directly. The organization was ruled to be exempt under section 501(c)(3) of the Code.

Revenue Ruling 69-545, 1969-2 C.B. 117, provides that a non-profit organization whose purpose and activity is providing hospital care is promoting health and may, therefore, qualify as organized and operated in furtherance of a charitable purpose if it meets the other requirements of section 501(c)(3) of the Code.

A proposes to undertake a reorganization of its current corporate structure to achieve certain administrative efficiencies and implement an integrated system of health care delivery through its structurally affiliated exempt entities. In connection with the implementation of this system, A has created C as a non-profit corporation.

C has been established for the sole purpose of providing an organization that will operate for the exclusive benefit of A. C will act as the parent organization of the reorganized health care system and will provide overall planning, coordination and management. C's activities will include, among others, (i) establishing and coordinating policies that will be implemented by the system, (ii) supervising, on a limited basis, the operations of entities related to A, (iii) ensuring that all activities of all entities related to A are in the best interests and in support of A. C will not provide services or support to entities that are unrelated to A.

Following the reorganization, the activities of C and its affiliated entities will continue to further A's exempt health care purposes. A will continue to provide health care services to the community by operating an acute care hospital and by providing medical education and research. B will continue to be organized and operated solely to benefit C and A by coordinating fundraising activities and providing financial support to C as needed. C will oversee the activities of all affiliates, will participate in establishing and coordinating policies, will assist in strategic planning for the system, and generally will ensure that all activities of its affiliates are in furtherance of A's exempt purposes.

Since A will continue to provide hospital and health education services to its service area and B will continue to engage in fundraising activities for the benefit of the system, their current tax-exempt status under section 501(c)(3) of the Code and their classification as not private foundations under sections 509(a)(1) and 170(b)(1)(a)(iii) and 509(a)(3), respectively, will not be affected by the proposed reorganization.

The creation of C furthers A's charitable purposes. By establishing and coordinating policies, supervising operations, and performing other management functions exclusively for the health care system, C is providing services which support A's exempt purposes and activities and which could be performed by A if C had not been created.

The outpatient clinics regarded by A as faculty physician practices conduct the medical education programs of A and also provide health care services to the community it serves. The physicians are employed by a for-profit subsidiary within the health care system as teaching physicians and as such they hold faculty appointments at a medical school and provide clinical instruction to medical students. The conduct of such activities, as described, is substantially related to A's performance of its exempt activities. Such activity contributes importantly to the accomplishment of A's purpose of providing quality heatlh care to the community.

Based on all the facts and circumstances described above we rule as follows:

1. A's proposed restructuring will not adversely affect A's tax exempt status under section 501(c)(3) of the Code and its classification as a public charity pursuant to sections 509(a)(1) and 170(b)(1)(A)(iii).

2. A's proposed restructuring will not adversely affect B's tax exempt status under section 501(c)(3) of the Code and its classification as a public charity pursuant to section 509(a)(3) of the Code.

3. The operation of the outpatient clinics regarded by A as faculty physician practices as outpatient departments of A will not constitute unrelated trade or business of A pursuant to section 1.513-1(d)(2) of the regulations.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling does not address the applicability of any section of the Code or regulations to facts submitted other than with respect to the sections described.

We are informing your Area Office of this action. Please keep a copy of this ruling in your permanent records.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

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