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

200314031

Date:
JAN 8 2003

Contact Person:

Identification Number:

Telephone Number:

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Employer Identification Number:

Legend:

C=
H=
B=
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Dear Sir or Madam:

You requested rulings under sections 513 and 514 of the Internal Revenue Code. This letter responds to your request.

Facts

C

C is a hospital exempt under section 501(c)(3) of the Code. C serves as the primary pediatric teaching hospital for H. H is a medical school exempt under section 501(c)(3) of the Code. Substantially all of the members of C's active medical staff hold faculty appointments at H. In addition, C supports a large program of research devoted primarily to pediatric medicine. C has a long history of discoveries and clinical advances from this program.

C's Articles of Incorporation state, in part, it is organized to provide medical and surgical care; instruct, supervise and train physicians, nurses, technicians and others in the care, treatment and prevention of disease; and to operate and conduct research laboratories to determine new and improved methods for the treatment and prevention of diseases.

B

B is a tertiary acute care hospital. B is exempt under section 501(c)(3) of the Code. Like C, B is a principal teaching affiliate of H. B's Articles of Incorporation state it was established to maintain a hospital, carry on educational activities, and perform scientific research.

While C and B are not affiliated corporate groups, they share a direct physical connection and enjoy a close professional affiliation. For approximately a decade, C and B have been linked by a connector built to support the continued free flow of patients and medical staff between the two hospitals, which have longstanding patient transfer, physician coverage, research and teaching relationships. The physical connection between C and B is further demonstrated by the fact they share an emergency arrival transportation area, which means all trauma cases arriving for either hospital are brought in to this central location. All patients arriving in this manner destined for C are therefore brought across the connector from B to C's emergency department, operating room, or intensive care unit. Further, C and B have a long-standing relationship as partners in training the next generation of doctors and researchers through a shared affiliation with H. In addition, C and B researchers collaborate actively on a number of ongoing research and academic projects. For example, C and B researchers work together by co-editing textbooks, serving on advisory boards for research projects, collaborating on research studies, and working as co-authors to publish articles stemming from their joint research efforts. Lastly, the collaborative efforts of C and B doctors extend beyond education and research to frequent diagnostic collaborations, groundbreaking surgical innovations, and repeated interventions in high-risk pregnancies.

C's Lease to B

C is constructing a new research building (Research Building) consisting of a biomedical research and laboratory building and related facilities. C states the Research Building will add an important resource to support its research programs and many existing programs are expected to expand. New initiatives in stem cell biology and developmental biology as well as an expanded program in vascular biology will be located in the new Research Building.
C states it plans to use excess space in the Research Building to further its charitable purposes of advancing medical research by entering into a 10 year lease of two floors in the building to B to provide laboratory facilities for B scientists. The Lease specifically provides B will use the space solely for research and laboratory use. C states the selection of B scientists to occupy laboratory space was made based on shared research interests with C's scientists and existing and potential collaborations. All of C and B scientists who will work in the Research Building are faculty members at H.

X scientists from C and B will occupy the Research Building, including Y from C and Z from B. C states these X scientists interact on very similar aspects of research, predominantly in the fields of hematology and oncology. C states more than half of B scientists are already involved in collaborations with C scientists and the number of collaborative projects between and among these scientists is projected to grow to over 50 new initiatives as a result of the physical proximity afforded by the lease of space in the Research Building to B.

Pursuant to the Lease, C and B also agreed to negotiate in good faith to finalize an Animal Facilities Agreement (Agreement) to allow B researchers use of a portion of the animal facilities located in the Research Building. The animal facilities are designed as a virus antibody-free barrier for rodents requiring isolation. Use of the animal facilities is incident to and for the

benefit of research being undertaken in the Research Building. According to the proposed business terms, the Agreement will provide B use of a portion of the animal facilities. The proposed business terms provide B will be entitled to the use of a certain number of small animal cages and it will be required to pay an annual base fee per cage. In addition, B will be required to pay a variable fee that may be increased annually. The term of the Agreement coincides with the term of the Lease.

C states the financial terms of the Lease were negotiated on an arm's-length basis and represent commercially reasonable terms. The Research Building in which the leased premises are located is expected to be financed by acquisition indebtedness within the meaning of section 514(c) of the Code. The acquisition indebtedness is anticipated to be in the form of qualified 501(c)(3) bonds described in section 145 of the Code.

Rulings Requested

Whether the leasing of a portion of C's research building to a tax -exempt entity not a member of its corporate group nor the provision of shared animal facilities incident to that Lease will constitute an unrelated trade or business under section 513(a) of the Code and will not result in debt-financed income under section 514 of the Code.

Law

Section 509(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 Federal Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

In the general law of charity, the promotion of health is considered to be a charitable purpose. Restatement (2nd), Trusts, sections 368 and 372, IV Scott on Trusts (3rd ed. 1967), sections 368 and 372.

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

Section 512(b)(3)(A)(i) and (ii) of the Code, in referencing unrelated business taxable income, indicate that in the case of rent, except as provided in subparagraph (B), there shall be excluded (i) all rents from real property (including property described in section 1245(a)(3)(c)), and (ii) all rents from personal property (including for purposes of this paragraph as personal property any property described in section 1245(a)(3)(B)) leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

Section 512(b)(4) of the Code provides that notwithstanding paragraph (1), (2), (3), or (5), in the case of debt- financed property (as defined in section 514) there shall be included as an item of gross income derived from an unrelated trade or business, the amount ascertained under

section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

Section 513(a) of the Code defines an unrelated trade or business as any trade or business the conduct of which is not substantially related to the exercise of the organization's exempt purposes or function.

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 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 exempt purposes.
Section 1.513-1(d)(4)(iii) of the regulation which references dual use of assets or facilities provides that, in certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such case, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes.

Section 514(b)(1)(A)(i) and (ii) of the Code in defining debt-financed property excludes any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) 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, or (ii) any purpose to which clause (i) does not apply, to the extent that its use is so substantially related.

Rationale

You represent C and B are not affiliated corporate entities, but they do share a direct physical connection and enjoy a close professional affiliation. For approximately a decade, C and B have been linked by a connector built to support the continued free flow of patients and medical staff between the two hospitals, which have a longstanding patient transfer, physician coverage, research and teaching relationships. C and B also have a longstanding relationship as partners in training the next generation of doctors and researchers through a shared affiliation with H. In addition to the formal joint programs, C and B researchers collaborate actively on a number of ongoing research and academic projects. Lastly, the collaborative efforts of C and B doctors extend beyond education and research to frequent diagnostic collaborations, groundbreaking surgical innovations, and repeated interventions in high-risk pregnancies.

You also represent the Research Building under construction will have excess space on two of its floors. As a result, C has decided to use this excess capacity in a manner to further its collaborative relationship with B by entering into the Lease with B for the excess space. Thus,

the Lease to B of space in the Research Building will substantially further C's own exempt health care and research purposes by facilitating continued collaborative research, training, and other joint undertakings that promote health. Similarly, allowing B to share its animal facilities advances C's own exempt purpose because C engages in joint research efforts with B.

Conclusion

The leasing of a portion of C's Research Building and the provision of shared animal facilities to B will not constitute an unrelated trade or business under section 513(a) of the Code and will not result in debt-financed income under section 514 of the Code.

These rulings are based on the understanding there will be no material changes in the facts upon which they are based. These rulings are directed only to the organization that requested them. Section 6110(j)(3) of the Code provides they may not be used or cited as precedent.

Please keep a copy of this ruling letter in your permanent records.

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

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1