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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Contact Person: 9999.9800

Telephone Number:

In Reference to: OP:E:EO:T:1

Date: NOV 30 1998

Employer Identification Number:
Key District:

Legend:

H=
I=
M=
S=
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T=
N=
O=
R=
A=
V=
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P=

Dear Sir or Madam:

This is in response to S's and H's ruling requests concerning the tax implications under section 501(c)(3) of the Internal Revenue Code of the following proposed transactions (Transactions) among H, I and M.

1. The proposed conversion (Conversion) of I from a business corporation to a nonprofit corporation pursuant to your state laws; and

2. The proposed statutory merger (Merger) pursuant to your state nonprofit corporation law of I and M with and into H.

FACTS

H

H is exempt under section 501(c)(3) of the Code and is a public charity described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code. H's sole corporate member is S, which is exempt under section 501(c)(3) of the Code and is a public charity described in section 509(a)(3) of the Code. S

operates as the parent holding company of a multi-corporate health care delivery system. H has historically owned and operated three acute care hospital facilities.

I

I is a for-profit corporation which is a wholly-owned subsidiary of S. You state that I was formed for the purpose of providing a vehicle whereby S and its exempt affiliates could enter into certain ventures which furthered S's charitable missions. However, there was some uncertainty whether the ventures' activities and/or ownership structures might be inconsistent with tax-exempt status. Certain of these ventures are wholly-owned and operated by I, while others consist of joint ventures between I and third parties. A brief description of each venture follows:

Wholly-Owned Ventures

I individually owns and manages real estate in the vicinity of one of H's hospitals and elsewhere. The real estate is leased to H or S, and to private physicians. I does business under the fictitious name T and provides home intravenous therapy services on an outpatient basis. You state these services are provided without regard to the patient's ability to pay. I also operates a private-duty nursing service known as N. You state the above activities will be continued by H subsequent to the effective date of the Transactions.

Joint Ventures with Other Health Systems

I and O, another section 501(c)(3) hospital, are the sole partners in R, an outpatient radiation therapy business. You state that R's services are provided to patients of H and O and to the community.

A I is a general partner in A, which operates a magnetic resonance imaging facility. The other investors in this venture include an affiliate of O, and a small number of physician limited partners. Together, I and O's affiliate represent a majority of general partner interests. Services at A are made available to patients of H and O and to the community.

V V is a general partnership which owns and manages a medical office facility. I and a physician/tenant are the only general partners of the facility.

D D is a general partnership which owns and manages a medical office facility. I is one general partner and the other is a private non-physician individual.

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You state that I has limited involvement in owning and managing medical office facilities; its primary revenue source is, and historically has been, the operation (either directly or in its capacity as general partner of partnerships) of medical service businesses; and these businesses have been operated in a manner consistent with S's mission, notwithstanding their corporate form of organization.

M

M is a non-stock, membership corporation whose sole member is P. P, in turn, is an affiliate of S, formed for the principal purpose of owning and operating satellite physician practices. P is exempt under section 501(c)(3) of the Code and is described in section 509(a)(3). P's sole member is S. M was incorporated as a for-profit corporation and was initially owned and operated by a private physician until M was acquired by P. M was converted to a nonprofit corporation simultaneously with its acquisition by P. M has not sought section 501(c)(3) exemption. Since its acquisition by P, you state that M has provided primary care medical services to the general public without regard to ability to pay.

Reasons for Proposed Transactions

Recently, H's exemption from real estate, sales and use taxes was challenged by local taxing authorities. These challenges resulted in protracted litigation. Because of these challenges by local taxing authorities, the state legislature recently enacted laws that encourage non-exempt subsidiaries of tax exempt organizations to merge back into their parent to avoid challenges to their exemption from real estate, sales and use taxes. Accordingly, S determined it is in its best interest to qualify together with all its subsidiaries as a single institution under the provisions of the newly enacted state laws. This necessitate S carrying on activities currently carried on by I and M.

Mechanics of the Merger

S will eliminate its for-profit subsidiary, I, by first converting it to a nonprofit corporation, and then merging it with and into H. Upon receipt of the rulings requested herein, I will file Articles of Conversion. On the effective date of the Articles of Conversion, I will become a nonprofit, non-stock membership corporation whose sole member be will S.

As indicated above, M has already converted to nonprofit status in the same manner as described above for I. I, M, and H have entered into an Agreement and Plan of Merger (Plan of Merger). Procedurally, the Plan of Merger will be accomplished pursuant to state law. You state that at the effective time of the Merger

(which will be consummated conditioned upon receipt of the favorable rulings requested herein and completion of the I conversion), H, I and M will file articles of merger in substantially the form you have submitted with the ruling request; H will be the surviving corporation, and H's Articles of Incorporation and Bylaws will be the Articles of Incorporation and Bylaws of the surviving corporation; H will succeed to all of the assets and liabilities of I and M, and thereafter, will conduct all of the operations currently conducted by I and M; and the merger will eliminate S's ownership of any for-profit or non-exempt, nonprofit entity.

RULINGS REQUESTED

1. The Merger of I and M with and into H and the resulting transfer of their respective assets and operations to H by operation of state law will not result in the recognition of any gain or loss under sections 511 through 514 of the Code by either the H or S.

2. The Merger of I and M with and into H, and H's subsequent conduct of the activities theretofore conducted by I and M, including without limitation: (a) H's direct ownership and management of real estate in the vicinity of one of H's hospital facilities and elsewhere and leasing of office space to hospital based private physicians; (b) H's direct ownership and operation of the assets employed in T's and N's businesses; (c) H's ownership of, and conduct of activities relating to, its general partnership interest in R; (d) H's ownership of, and conduct of activities relating to, its general partnership interest in A; (e) H's ownership of, and conduct of activities relating to its general partnership interests in D and V; and (f) H's direct ownership and operation of the assets formerly owned and operated by M will not have an adverse effect on H's continuing status as a charitable organization under section 501(c)(3) of the Code and as an organization described in section 170(b)(1)(A)(iii).

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)(1)(ii) of the Income Tax Regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an

organization to establish that it is not organized or operated for the benefit of private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations states 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.

Section 509(a) of the Code states that the term "private foundation" means an organization described in section 501(c)(3) other than one described in section 509(a)(1), (2), (3), or (4).

Section 509(a)(1) of the Code states, in pertinent part, that an organization will not be considered to be a private foundation if it is an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii).

Section 170 of the Code provides, in part, for the allowance of charitable contribution deductions to organizations described in section 170(c)(2), which includes hospitals described in section 170(b)(1)(A)(iii).

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)(1) 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)(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 1.512-1(d)(1) of the regulations excludes from unrelated business income tax gains and losses from the sale of property. This section provides that there shall be excluded from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (i) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of the trade or business.

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 1.513-1(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)(1)(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.

Rationale

The facts submitted state that I and M, the non-exempt affiliates of S, are to be merged into H. As a result of this merger, H will also acquire I's business interests. The facts in your submission indicate that although the merger and subsequent operation of these activities by H may result in some level of unrelated trade or business, they will not change H's primary exempt purpose of promoting health. In addition, assumption of these activities will not change H's primary function of operating a hospital.

Accordingly, we conclude that H's tax exempt status under section 501(c)(3) of the Code will not be adversely affected by the merger of I and M with and into H. Further, H will continue to qualify as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code based on its hospital operations.

The tax on unrelated business income imposed by section 511 of the Code will not be applicable with respect to the proposed Transactions among H, I, and M because any deemed gain on the contributions of M, T, N, R, A, I, D, and V will be excluded from

H's and S's computation of unrelated business taxable income under section 512(b)(5) of the Code. Therefore, the Transactions described in this paragraph will not result in unrelated business income under sections 511 through 514 of the Code for S or H.

Conclusion

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

1. The Merger of I and M with and into H and the resulting transfer of their respective assets and operations to H by operation of state law will not result in the recognition of any gain or loss under sections 511 through 514 of the Code by either the H or S.

2. The Merger of I and M with and into H, and H's subsequent conduct of the activities theretofore conducted by I and M, including without limitation: (a) H's direct ownership and management of real estate in the vicinity of one of H's hospital facilities and elsewhere and leasing of office space to hospital based private physicians; (b) H's direct ownership and operation of the assets employed in T's and N's businesses; (c) H's ownership of, and conduct of activities relating to, its general partnership interest in R; (d) H's ownership of, and conduct of activities relating to, its general partnership interest in A; (e) H's ownership of, and conduct of activities relating to its general partnership interests in D and V; and (f) H's direct ownership and operation of the assets formerly owned and operated by M will not have an adverse effect on H's continuing status as a charitable organization under section 501(c)(3) of the Code and as an organization described in section 170(b)(1)(A)(iii).

These rulings do not address the question of whether income from M's, T's, N's, R's, A's, I's, D's, and V's activities is unrelated business income under sections 511 through 514 of the Code.

These rulings are directed only to the organization that requested them. Section 6110(j)(3) of the Code provides that they may not be used or cited as precedent.

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 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 this ruling. Please keep this ruling letter in your permanent records.

Sincerely yours,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1

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