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Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
September 30, 1999

LEGEND:

Hospital Authority =

Entity A =

Entity B =

Entity C =

Entity D =

Hospital =

Act =

State X =

County Y =

Year 1 =

Year 2 =

Year 3 =

Dear :

This is in response to a March 31, 1999, letter and subsequent correspondence submitted on behalf of Hospital Authority and Entities A, B, C, and D (the Entities) requesting a ruling that the income of Hospital Authority

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and the Entities is excludible from gross income for federal income tax purposes under section 115(1) of the Internal Revenue Code. Hospital Authority has also asked for a ruling that charitable contributions to Hospital Authority are deductible by the donors to the extent provided by § 170(a) of the Code.

FACTS

State X's General Assembly passed the Act in recognition of its determination that the provision of adequate hospital facilities, medical services, and health care by counties and cities is necessary to protect the public health, safety, and welfare. The Act empowers a city council or county board of commissioners to create a hospital authority as an alternative method for providing hospital, medical, and health care within its territorial boundaries and ten miles beyond, upon the adoption of a resolution finding that it is in the interest of the public health and welfare to do so.

The Act provides a hospital authority with power to carry out the purposes of the Act, including the power to acquire any existing hospital facilities, to accept donations of money, personal property, or real estate, and to lease any hospital facilities. The Act provides that a hospital authority may exercise any or all the powers granted to it by or through a designated agent, including any corporations formed under the laws of State X. Additionally, the Act authorizes a city council or county board of commissioners to make an appropriation each year, for an amount not to exceed five percent of the city or county's general fund, for the improvement, maintenance, or operation of a hospital authority's hospital facilities. Each year, the Act requires a hospital authority to file an audited report of its activities for the preceding year with the chairman of the county board of commissioners.

Hospital Authority was formed by the five-member Board of Commissioners of County Y (the County Board) in Year 1 for the purpose of providing hospital and medical services to the people of County Y and the surrounding area. The federal government has officially designated County Y as a Medically Underserved Area and has granted County Y status as a Health Professional Shortage Area.

Hospital Authority is governed by a board of commissioners (the Hospital Authority Board) consisting of 21 individuals appointed and subject to removal by the Chairman of the County Board. Members of the Hospital

Authority Board receive no compensation for their services, but are entitled to reimbursement for necessary expenses, including travel, incurred in the discharge of their duties.

Hospital Authority is self-sufficient and does not rely on the County Board for financial support. However, the County Board does have the statutory authority to appropriate funds to Hospital Authority if needed. County Y also demonstrates its financial commitment to Hospital Authority by leasing the Hospital facility and land to Hospital Authority.

In the interests of creating an integrated healthcare delivery system to better serve the needs of the residents of County Y and surrounding area, The Hospital Authority formed four nonprofit corporations, the Entities, between Year 2 and Year 3 to which it has delegated certain of its powers. The reorganization was undertaken and accomplished pursuant to a determination by the Hospital Authority Board that Hospital Authority's purposes would be accomplished more efficiently by clarifying lines of authority and responsibility for Hospital Authority's many functions. The Hospital Authority Board acted on the belief that the delegation of certain functions to corporations controlled by Hospital Authority would improve the quality and reduce the cost of providing healthcare services.

From its establishment in Year 1 until Year 3, Hospital Authority directly operated Hospital and provided other medical services to the residents of County Y and surrounding areas. Hospital Authority leased the buildings and grounds of Hospital from County Y. In Year 3, Hospital Authority transferred operation and management of Hospital to Entity A. Entity B provides outpatient surgical services to the residents of County Y and the surrounding area, through a cost-effective freestanding ambulatory surgery center. Entity C provides medical support services to ensure that the health needs of citizens and residents of Hospital Authority's service area are met. Acting for Hospital Authority pursuant to a delegation of powers from Hospital Authority, Entity D was formed for the purposes of employing hospital-based physicians (e.g., radiologists, anesthesiologists, pathologists, etc.) and arranging for specialty medical interpretation services (e.g., cardiology, pulmonology and neurology). Hospital Authority is the sole member of Entity A and Entity D, and controls Entity B and Entity C, by its authority to appoint each corporation's board of directors.

Revenue of Hospital Authority and the Entities is applied solely towards offsetting the expenses of healthcare operations. No part of the net earnings of Hospital Authority or the Entities inures to the benefit of, or is distributable to, any private corporation, association or individual, other than reasonable compensation for services rendered, and to make other payments and distributions as needed to further the purposes of Hospital Authority. According to the Articles of Incorporation of Entity A and Entity D, and the amended Articles of Incorporation of Entity B and Entity C, upon dissolution, all of the net assets of each of the Entities will be distributed to Hospital Authority. According to the amended by-laws of Hospital Authority, upon dissolution of Hospital Authority, all of its net assets will be distributed to County Y.

LAW AND ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a state or political subdivision of a state.

When determining if § 115(1) applies, the Service considers all the facts and circumstances relating to the organization to determine whether the organization performs an essential governmental function and whether the income of the organization accrues to a state or a political subdivision of the state.

Rev. Rul. 90-74, 1990-2 C.B. 34, concerns an organization formed, operated, and funded by political subdivisions to pool their casualty risks and other risks arising from their obligations concerning public liability, workers' compensation, or employees' health obligations. The ruling states that the income of such an organization is excluded from gross income under § 115(1) so long as private interests do not participate in the organization or benefit more than incidentally from the organization. The benefit to the employees of the insurance coverage obtained by the member political subdivisions was deemed incidental to the public benefit.

Rev. Rul. 77-261, 1977-2 C.B. 45, holds that income from a fund, established under a written declaration of trust by a state, for the temporary investment of positive cash balances of a state and its political subdivisions, is excludable from gross income under § 115(1) of the Code.

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The ruling reasons that the investment of positive cash balances by a state or political subdivision in order to receive some yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and raise revenue.

Hospital Authority was created by County Y pursuant to legislation passed by the State X General Assembly to provide hospital and medical care to the residents of County Y and the surrounding area. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Hospital Authority performs an essential governmental function within the meaning of § 115(1) of the Code.

In addition to the performance of an essential governmental function, for Hospital Authority and the Entities to qualify to exclude its income from gross income under § 115(1) of the Code, income of Hospital Authority and the Entities must accrue to State X or a political subdivision of State X.

No part of the net earnings of Hospital Authority or the Entities inures to the benefit of, or is distributable to, any private entity or individual. Upon dissolution, all of the net assets of each of the Entities will be distributed to Hospital Authority. Upon dissolution of Hospital Authority, all of its net assets will be distributed to County Y, a political subdivision of State X. Thus, the income of Hospital Authority and the Entities accrues to a political subdivisions of a state. Accordingly, the income of Hospital Authority and the Entities is excludible from gross income under § 115(1) of the Code.

Section 170(a)(1) of the Code provides, subject to certain limitations, a deduction for contributions and gifts to or for the use of organizations described in § 170(c), payment of which is made within the taxable year.

Section 170(c)(1) of the Code states that the term "charitable contribution" includes a contribution or gift to or for the use of a state, a possession of the United States, any political subdivision of a state or any possession of the United States, the United States, or the District of Columbia, but only if the contribution is made for exclusively public purposes.

The term political subdivision is not defined in the Code. However, § 1.103-1(b) of the Income Tax Regulations provides that "political subdivision" means any division of any state or local government unit that is a municipal

corporation or that has been delegated the right to exercise part of the sovereign power of the unit.

An entity that is not a governmental unit described in § 170(c)(1) of the Code may nevertheless qualify to receive deductible charitable contributions if it is an instrumentality of a state or an instrumentality of a political subdivision of a state. See Rev. Rul. 75-359, 1975-2 C.B. 79. Although § 170(c)(1) of the Code does not refer to instrumentalities of a state or instrumentalities of a political subdivision of a state, it is a long-standing position of the Service that contributions or gifts to a state or a political subdivision, or an organization acting on behalf of such entity, that are made for exclusively public purposes are deductible under § 170(c)(1). See Rev. Rul. 79-323, 1979-2 C.B. 106.

Revenue Ruling 57-128, 1957-1 C.B. 311, provides that the following factors are taken into consideration in determining whether an organization is an instrumentality of one or more states or political subdivisions: (1) whether it is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses.

These factors have been applied in arriving at a determination that an organization is an instrumentality for purposes of § 170(c)(1) of the Code such that contributions, if made exclusively for public purposes, may be deductible. In the present case, we find that Hospital Authority is an instrumentality of State X, which has the powers and interests of an owner. Hospital Authority was created by County Y pursuant to legislation passed by the State X General Assembly. The purpose of Hospital Authority is to provide hospital and medical care. There are substantial governmental checks on the autonomy of Hospital Authority. Hospital Authority is governed by the Hospital Authority Board, all of whose members are appointed and subject to removal by the Chairman of the County Board. Hospital Authority and the Entities report their combined financial activity to County Y on an annual basis as required by the Act. Revenue is applied solely towards offsetting the

expenses of healthcare operations. No part of the net earnings of Hospital Authority inures to the benefit of, or is distributable to any private corporation, association, or individual, other than reasonable compensation for services rendered and to make payments and distributions as needed to further the purposes of Hospital Authority. Members of the Hospital Authority Board receive no compensation other than reimbursement of necessary expenses. Upon dissolution of Hospital Authority, all of its net assets will be distributed to County Y.

Hospital Authority was formed by the County Board. The Act declares the provision of adequate hospital, medical, and healthcare to the public to be a necessary public purpose. Such a purpose is "an exclusively public purpose" as required by § 170(c)(1) for contributions to a State to be deductible. See Rev. Rul. 55-453, 1955-2 C.B. 54. Accordingly, charitable contributions to Hospital Authority are deductible by the donors to the extent provided by § 170(a) of the Code.

HOLDINGS

Based on the information and representations submitted by Hospital Authority and the Entities, we hold that the income of Hospital Authority and Entities A, B, C, and D is excludible from gross income under § 115(1) of the Code.

We also hold that charitable contributions to Hospital Authority are deductible by the donors to the extent provided by § 170(a) of the Code. No ruling has been requested on the deductibility of any specific contribution to Hospital Authority. Therefore, we are not ruling on the deductibility of any specific contribution to Hospital Authority.

Except as specifically ruled upon above, no opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Internal Revenue Code.

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

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions
and Products)

By: Alice M. Bennett
Alice M. Bennett
Chief, Branch 3

Enclosures:
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