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

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Date: OCT 10 2000

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Dear Sir or Madam:

This is in response to a letter from your authorized representative requesting a series of rulings on your behalf regarding the tax consequences associated with the transactions described below.

A is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and is a nonprivate foundation under section 509(a)(3). A was organized pursuant to an affiliation agreement which resulted in the affiliation of A, B and C. A's mission is to promote health by acting as the parent of a vertically, horizontally and geographically integrated section 501(c)(3) healthcare system and otherwise supporting the system. A is controlled by a community-based Board of Trustees.

B is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). Its mission is to promote healthcare by acting, directly or indirectly, as the sole member of various section 501(c)(3) healthcare entities, including G and H, and by providing overall planning, management and support services for those entities.

C is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii).

Pursuant to an affiliation agreement, A became the sole member of D and D caused its affiliated exempt acute care hospitals, rehabilitation hospital and other entities under its ownership and control to become part of A. D is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a)(3).

Pursuant to an affiliation agreement, A became the sole member of E and E caused its exempt affiliates to become part of A. E is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a)(3). E's mission is to support its affiliates by providing overall planning, management and support services.

Pursuant to an affiliation agreement, A became the sole member of F and F caused its exempt affiliates to become part of A. F is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii).

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As a sole member, A exercises control and supervision over its affiliates, including their exempt hospitals. As the parent of an integrated healthcare system, it exercises authority through reserved powers over its direct and indirect subsidiaries which are specifically enumerated in the bylaws of the entities and the various system affiliation agreements.

Subject to certain limitations, the reserved powers of A include: (a) electing the members of the affiliates' boards of trustees or directors from candidates nominated by the respective institution. (You have stated that under the system affiliation agreements, A ultimately controls the composition of the board of each subsidiary system affiliate through its power to elect and remove such individuals. By a 75% vote of A's board then in office, A has the reserved power and authority to remove any member of a subsidiary's board.); (b) appointing the CEO of each institution upon the recommendation of its CEO and the respective institutions' boards; (c) developing annual operating budgets for the A system and approving the annual operating and capital budgets of each of the systems (which must be consistent with the system budget adopted by A); (d) designing and implementing strategic plans for the A system and approving the strategic plans for each of the systems; (e) approving the incurrence of material debt by an affiliate and requiring participation by the systems and their affiliates in system wide debt; (f) requiring the systems to make capital contributions to A; (g) approving the proposed sale or transfer of assets outside the systems; (h) approving any proposed fundamental corporate transactions involving the institutions or any affiliate; (i) intervening in the management of the affiliates, including hospitals, if financial circumstances so require; (j) requiring transfers of assets between and among systems under certain circumstances; (k) approving academic affiliations outside the A system; (l) conducting and/or directing health care services contracting for the system in order to satisfy the system wide goals and objectives of A; (m) approving proposed changes in the articles of incorporation and bylaws of any affiliate; (n) approving the addition, material revision or discontinuance of a health care service provided by an affiliate if it has system implications and requiring affiliates under certain circumstances to add, revise, relocate or discontinue a health care service (You have stated that A, as parent, has the power and authority, by a 75% vote of A's board then in office, to require system members and their related hospitals to add, revise, relocate or discontinue any health care service.); (o) approving the participation by any affiliate in any key strategic relationship outside the A system and requiring such participation in certain circumstances and (p) admitting new A system members.

You have stated that each of the affiliates has its own governing board and is responsible for its respective operations, the development of health care delivery and other related internal policy decisions, subject to the reserved powers of A. A exercises direct and indirect controls with respect to the affiliates, based in part on its power to remove members of the governing boards of the affiliates. The members of the boards of trustees or directors of the affiliates can generally be removed by a supermajority vote of A's board of trustees for cause, which includes actions not in the best interests of the A system or which undermine or impede system goals and objectives.

A provides various corporate management and support services to its affiliates on a centralized, coordinated or shared service basis. The activities carried out by A would, in the absence of A, be conducted at duplicative expense by one or more organizations in the system. A currently provides the following corporate management and support services: (a) financial services, including establishing financial goals and processes to accomplish goals and providing direction regarding capital financing, financial reporting and planning, reimbursement management, financial data analysis and monitoring of budgeting processes; (b) legal services including business, regulatory, governance, medical staff, patient care, human resources, medical legal ethics and other

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legal services through A's inside legal department and coordinating the delivery of services by outside counsel; (c) insurance and risk management services; (d) materials management services, including negotiating contracts with vendors on behalf of the affiliates and conducting centralized purchasing activities; (d) planning and marketing services, including initiating and directing strategic planning for the affiliated organizations and approving major capital expenditures pursuant to the planning and budgeting process; (e) human resources services; (f) information system services and (g) compliance services.

G is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii). B is the sole member of G, which is the surviving entity in the merger of I and J into K. K's name was changed following the merger to G. At present, G operates I, J and K as separately licensed acute care hospital divisions.

H is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii). G is the sole member of H, which operates a medical research center.

L is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(vi). L, which has no members, engages in fundraising and provides financial support for K.

M is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). M, which has no members, engages in fundraising and provides financial support for I and H.

N is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(vi). N, which has no members, engages in fundraising and provides financial support for J.

O is being granted exemption from federal income tax under section 501(c)(3) of the Code and is being classified as a nonprivate foundation under section 509(a)(3) by letter of even date. O's exempt purpose is to support G and P by acting as an intermediate parent for certain of B's nonacute, nonprofit entities as described below.

P is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii). O is the sole member of P.

O is the sole member of R, which is being granted exemption from federal income tax under section 501(c)(3) of the Code and is being classified as a nonprivate foundation under section 509(a)(3) by letter of even date. R leases and operates a skilled nursing facility.

S is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(vi). S supports community based services that foster independent living for senior citizens.

T is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). T is the entity through which B's clinical laboratories are consolidated and operated.

U is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). U owns real property interests in support of K.

V is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). V was merged into U, which now owns and operates medical office buildings adjacent to and in support of J.

W is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). It engages in fundraising and provides financial support for P.

X, whose sole member is Q, is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(2). X provides rehabilitation services to support G and provides home care.

Y, whose sole member is Q, is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(2). It provides hospice services.

Z, whose sole member is Y, is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(2). It engages in fundraising in support of the hospice and home care programs of B and its subsidiaries.

AA, whose sole member is Q, is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). It is currently inactive.

AB is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). It owns primary and specialty care physician practices. The assets and operations of AC, which had similar activities to AB and had been granted exemption from federal income tax under section 501(c)(3) of the Code and nonprivate foundation status under section 509(a)(3), were transferred to AB.

AD was formed to act as the sole member of C and its section 501(c)(3) affiliates and to provide overall planning, management and support services to those entities. AD is being granted exemption from federal income tax under section 501(c)(3) of the Code and is being classified as a nonprivate foundation under section 509(a)(3) by letter of even date.

C is the sole member of AE, which is treated as a taxable corporation. AE negotiates and coordinates the negotiation of managed care contracts for C and its affiliated physicians.

AD is the sole member of AF, which supports C by providing planning, management and support services to certain affiliates of C. AF has been granted exemption from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). It is the sole member of various tax-exempt entities, including AX, which is exempt from federal income tax under section 501(c)(2). AX acts as a real estate holding company.

AD is the sole member of AG, which has been organized and you state will operate as a section 501(c)(3) organization, but has not filed an application for tax-exempt status as of this date. AG is the sole member and sole shareholder of various other corporations, including AH, which operates a specialized pharmacy that serves nursing homes and is treated as a taxable corporation.

AI is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii). D is the sole member of AI.

AJ is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii). AI is the sole member of AJ.

AJ is the sole member of AK, which is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(vi).

AL is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii). AI is the sole member of AL.

AM is exempt from federal income tax under section 501(c)(3) of the Code and has been classified as a nonprivate foundation under section 509(a)(3). AI is the sole member of AM.

AN is exempt from federal income tax under section 501(c)(3) of the Code and has been classified as a nonprivate foundation under section 509(a)(2). AI is the sole member of AN.

AO is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii). AP, which engages in fundraising and provides financial support to AO, is exempt from federal income tax under section 501(c)(3) of the Code and has been classified as a nonprivate foundation under section 509(a)(3).

AR is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii).

AS is exempt from federal income tax under section 501(c)(3) of the Code and has been classified as a nonprivate foundation under section 509(a)(3).

AT is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(vi).

AU and AV are exempt from federal income tax under section 501(c)(3) of the Code and have been classified as nonprivate foundations under section 509(a)(3) and support AT.

You have requested the following rulings in connection with the affiliations and reorganization described above:

1. The transactions including, without limitation, the D, E and F affiliations and the B and C reorganizations, do not adversely affect the status of A and its direct and indirect section 501(c)(3) affiliates as tax-exempt organizations under sections 501(a) and 501(c)(3) of the Code and of AX as a section 501(c)(2) organization.

2. The transactions do not adversely affect the status of A and its section 501(c)(3) affiliates as public charities described in section 509(a) of the Code.

3. The transactions and the transfer or sharing or provision of assets or services between and among the tax-exempt organizations in the system, including the transfers of stock or membership

interests will not result in unrelated business taxable income to any tax-exempt affiliate within the meaning of sections 511 through 514 of the Code.

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.

Revenue Ruling 69-545, 1969-2 C.B. 117, acknowledges that the promotion of health is a charitable purpose within the meaning of section 501(c)(3) of the Code.

Revenue Ruling 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 1.509(a)-4(f)(1) of the regulations provides that section 509(a)(3)(B) of the Code sets forth three different types of relationships, one of which must be met in order to meet the requirements of the subsection. One of those requirements is operated, supervised or controlled in connection with. Section 1.509(a)-4(f)(4) of the regulations provides that in the case of supporting organizations which are supervised or controlled in connection with one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors.

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 the 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).

Section 513(e) of the Code provides that in the case of a hospital, the term "unrelated trade or business" does not include the furnishing of one or more of the services described in section 501(e)(1)(A) to one or more hospitals if such services are furnished solely to such hospitals which have facilities to serve not more than 100 inpatients, such services, if performed on its own behalf by the recipient hospital, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption, and such services are provided at a fee or cost which does not exceed the actual cost of providing such services.

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), 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.

An affiliation between previously independent hospitals to provide corporate services among the participants raises exemption qualification and unrelated trade or business issues. With respect

to exemption qualification, the courts have been clear that 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. With respect to unrelated trade or business, section 513(e) of the Code makes clear that if a hospital provides regularly carried on corporate services to another unrelated exempt organization for a fee, then such services are unrelated trade or business unless they fall within the exception for certain hospital services provided by section 513(e). However, if the participating exempt organizations are in an affiliated system of organizations with common control, 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 affiliation established an affiliated system with sufficient common control such that corporate services and payments provided between the participating affiliates will not be treated as unrelated trade or business income.

Based on all the facts and circumstances, we conclude that the affiliation effectively binds the participating affiliates under the common control of A so that the participating entities are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of A's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating affiliates have ceded authority to A's governing body to elect the members of their board's of trustees and to appoint the CEO of each institution upon the recommendation of A's CEO and the respective institution's boards, to develop annual operating and capital budgets for the system and to approve the annual operating and capital budgets of each former system, design and implement strategic plans for the system and approve the strategic plans of each of the former systems, approve the incurrence of debt by any former system affiliate and require participation by the former systems and their affiliates in system-wide debt, require the affiliates to make capital contributions to A and approve the proposed sale or transfer of assets. In addition, A's board of trustees meets regularly to exercise overall responsibility for operational decisions and to monitor the affiliates compliance with A's decisions. Therefore, the transfer or sharing or provision of assets or services between and among the tax-exempt organizations in the system, including the transfers of stock or membership interests are treated as other than an unrelated trade or business.

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

The participating affiliates will not adversely affect their tax exempt status under section 501(c)(3) of the Code by the proposed transactions as they will continue to promote health within the meaning of Revenue Ruling 69-545. The participating entities will continue to qualify as nonprivate foundations under section 509(a) of the Code because they will continue to maintain the relationships and/or activities serving as the basis for their nonprivate foundation status.

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

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1. The transactions including, without limitation, the D, E and F affiliations and the B and C reorganizations, do not adversely affect the status of A and its direct and indirect section 501(c)(3) affiliates as tax-exempt organizations under sections 501(a) and 501(c)(3) of the Code and of AX as a section 501(c)(2) organization.

2. The transactions do not adversely affect the status of A and its section 501(c)(3) affiliates as public charities described in section 509(a) of the Code.

3. The transactions and the transfer or sharing or provision of assets or services between and among the tax-exempt organizations in the system, including the transfers of stock or membership interests will not result in unrelated business taxable income to any tax-exempt affiliate within the meaning of sections 511 through 514 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 are directed only to the organizations that requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited by others 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.

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

Sincerely,

Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

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