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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200147059

Date: AUG 3 1 2001

Contact Person:

Identification Number:

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Employer Identification Number:

Legend

A =
B =
C =
D =
E =
F =
G =
H =

Dear Sir or Madam:

We have considered your request for rulings as to the consequences of several proposed transactions on your exempt status under section 501(c)(3) of the Internal Revenue Code and your classification as other than a private foundation under section 509(a) of the Code.

FACTS

A owns and operates a comprehensive, general acute care hospital facility and adjacent professional office building. A is an organization exempt from federal income tax under section 501(c)(3) of the Code and is other than a private foundation within the meaning of sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

B is a primary care group practice that was formed by A in 1994 to support its charitable, scientific and educational purposes and is currently administered for the benefit of A, its sole member. B serves as the physician services component of A's integrated health care delivery system. B has assets consisting principally of cash, accounts receivable, intangible assets, office furniture and medical equipment. A board of directors appointed by A governs B. B is, and has been at all times since its founding, an organization described in 501(c)(3) of the Code

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that is not a private foundation because it is a supporting organization described in section 509(a)(3) of the Code.

C was organized in 1984 to solicit and receive bequests to finance construction projects or activities in furtherance of A's operations, and to hold funds for the benefit of A. C also owns the buildings used by B and leases property to B and one of its subsidiaries. A is the sole member of C and elects its board of directors. C is an organization described in 501(c)(3) of the Code that is not a private foundation because it is a supporting organization described in section 509(a)(3) of the Code.

D is a Texas business corporation, all of the stock of which is owned by C. D provides management services to H and B pursuant to management agreements. In addition, as of September 1999, D provides management services to one independent physician. D intends to expand its management services to additional independent physicians in the future.

E is a Texas business corporation, all of the stock of which is owned by A, that performs functions for A that are required to be performed by a taxable entity. To this end, E owns A's Common Membership Interest in F, doing business as G; E is currently one of four Common Membership owners. In addition, E is planning to acquire durable medical equipment for resale and lease to A and B patients as well as to other customers.

A proposes to undertake a reorganization of its current corporate structure to achieve certain administrative efficiencies and more fully implement an integrated system of health care delivery. In connection with the implementation of this, A has created H. H is organized and will operate exclusively for the benefit of A. In that capacity, H will act as the sole member of A and will replace A as the sole member of certain A-related entities in the reorganized health care system. H will enter into arrangements with A-related entities for the use of facilities and space necessary for its operations. A's executives will be transferred to H and will serve as executives for both H and A . H will also replace A as the sole member of both B and C. The substitution will be reflected in the governing documents of B and C. H's activities will be limited to (i) overall strategic planning for A and the health care system, including establishing and coordinating policies that will be implemented by A-related entities that are part of the health care system, (ii) supervising, on a limited basis, the operations of A-related entities that are part of the health care system, (iii) providing management services to A and related entities, including the management of the health care system wide funds, (iv) making distributions to A and related 501(c)(3) entities that are part of the health care system, and (v) ensuring that all activities of all A-related entities are in the best interests and in support of A. H will not provide services or support to entities that are unrelated to A. Although no transfers of non-cash assets are currently planned, it is possible that certain A-related entities may transfer non-cash assets to H and all or a portion of such assets may be subsequently transferred to another A related entity.

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RULINGS REQUESTED

The following rulings are requested:

1. The reorganization and the resulting corporate structure will not result in the revocation of, or otherwise adversely affect, the continued status of A as an organization described in section 501(c)(3) of the Code nor will it adversely affect the status of B or C as organizations described in section 501(c)(3).

2. The reorganization and resulting corporate structure will not cause A to lose its nonprivate foundation status under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code nor will it cause B or C to lose their nonprivate foundation status under section 509(a)(3) of the Code.

3. Any transfers of funds, assets, services and/or personnel in connection with the reorganization will not jeopardize the continued status as an organization described in section 501(c)(3) of the Code, as applicable, of the organization providing such funds, assets, services and/or personnel.

4. Any transfers of funds, assets, services and/or personnel will not adversely affect the continued nonprivate foundation status of A, B or C under sections 509(a)(1) or 509(a)(3) of the Code, as applicable.

5. Any payments for transfers of funds, assets, services and/or personnel in connection with the reorganization will not generate unrelated business taxable income under sections 511 through 514 of the Code.

LAW AND ANALYSIS

Section 501(c)(3) of the Code exempts from taxation organizations described in subsection (c)(3), including corporations organized and operated exclusively for charitable and educational purposes. Furthermore, the aforementioned subsection requires that no part of the organization's net earnings inure to the benefit of any private shareholder or individual, that no substantial part of its activities is to influence legislation, and that it does not participate in any political campaign on behalf of or in opposition to any candidate for public office.

Rev. Rul. 69-545, 1969-1 C.B. 117, has established that an organization that engages in activities that promote health in the community may be considered to have a charitable purpose within the meaning of section 501(c)(3). In Rev. Rul. 74-132, 1974-1 C.B. 152, the Service stated that an organization whose purpose was to sponsor specific projects and programs to improve hospital services to its patients and to support and promote the hospital's education, training and research programs qualified for exemption. In Rev. Rul. 69-463, 1969-2 C.B. 131, a hospital derived income from leasing office space in an adjacent office building to a medical group. Although the medical group served on the hospital's medical staff and used the leased

facilities to provide medical services to its private patients, the Service concluded that any income received by the hospital was substantially related to the hospital's exempt purpose. *See also* Rev. Rul. 69-464, 1969-2 C.B. 132 (leases of office space by an exempt hospital to members of its medical staff who contribute importantly to the hospital's exempt functions are not considered business leases within the meaning of section 514, as then in effect).

In Rev. Rul. 78-41, 1978-1 C.B. 117, the sole purpose of a trust was to accumulate and hold funds for use in satisfying malpractice claims against a hospital. The revenue ruling determined that the trust was an integral part of the hospital because it was controlled by the hospital and was performing a function that the hospital could perform directly and, thus, was exempt under section 501(c)(3). The ruling's treatment of the trust as exempt is consistent with section 1.502-1 of the Treasury Regulations ("Regulations"), which provides that if a subsidiary organization of a tax-exempt organization would itself be exempt on the grounds that its activities are an integral part of the exempt activities of its parent, that exemption will not be adversely affected if, as a matter of accounting, the subsidiary derives a profit from its dealings with the parent organization.

Section 170(b)(1)(A)(iii) of the Code refers to an organization whose principal purpose or function is the provision of medical or hospital care.

Section 509(a)(1) of the Code provides, 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 clauses (vii) and (viii).

Section 509(a)(3) of the Code excludes from the definition of a private foundation an organization that:

(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 organizations described in section 509(a)(1) or (2);

(B) is organized, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2); and

(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 sections 509(a)(1) or 509(a)(2).

Section 1.509(a)-4(f) of the Regulations provides, in pertinent part, that in order to be classified as an organization described in section 509(a)(3)(B), an organization must stand in one of the designated relationships to its supported organization. It must be either:

(i) operated, supervised or controlled by;

(ii) supervised or controlled in connection with; or

(iii) operated in connection with one or more publicly supported organizations.

Section 1.509(a)-4(i)(1) of the Regulations provides that a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the responsiveness test and the integral part test as defined thereafter in sections 1.509(a)-4(i)(2) and (3), respectively. The responsiveness test requires that the supporting organization be responsive to the need or demands of the publicly supported organization, meaning, *inter alia,* that (a) one or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees or membership of the publicly supported organization, (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors or trustees of, or hold other important offices in, the supporting organization, or (c) the officers, directors or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors or trustees of the publicly supported organizations; and (d) by virtue of (a), (b) or (c), the officers, directors or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients of such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization. Section 1.509(a)-4(i)(2)(i) and (ii) of the Regulations.

The integral part test requires that the supporting organization maintain a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides, meaning that, *inter alia*, the activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves. Section §1.509(a)4(i)(3)(i) and (ii) of the Regulations.

Section 511(a) imposes a tax on the unrelated business income of organizations described in section 501(c). Section 512(a)(1) 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 that are directly connected with the carrying on of the trade or business, with certain modifications.

Section 512(b)(3) provides that rents from real property (and incidental related personal property) are not treated as unrelated business income unless the real property is debt-financed under section 514. Section 514(b) defines debt-financed property as any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year. Debt financed property does not include any property substantially related to the exercise or performance by such organization of its exempt purposes.

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Section 512(b)(5) exempts from the definition of "unrelated business taxable income" income from the sale, exchange, or other disposition of non-inventory items and items not held for sale in the ordinary course of business.

Section 513(a) defines an 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 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 goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes.

Following the reorganization, the activities of A and its affiliated entities will continue to further A's exempt health care purposes. A will continue to provide health care to the community by operating a licensed, acute care hospital with a full service emergency room, and by providing medical treatment, education and research. Likewise, B will continue to be organized and operated exclusively to benefit A by serving as the physician services component of A's integrated health care delivery system as reflected in its governing documents; and, C will continue to be organized and operated exclusively to benefit A by soliciting and receiving bequests to finance construction projects and to hold funds for A and to lease property to other A-related entities as reflected in its governing documents. H will oversee the activities of A-related entities, will participate in establishing and coordinating policies of A-related entities that are part of the health care system, will provide management services to A and related entities that are part of the health care system, will assist in strategic planning for the health care system, and generally will ensure that all activities of A-related entities are in furtherance of A's exempt purposes. Furthermore, as a result of the close relationship between A and H, A will continue to have a significant voice in the financial policies of B and C.

CONCLUSIONS

As a result of the activities of A and of related entities that are part of H, which will be solely in furtherance of A's exempt health care purposes, the proposed reorganization and any related transfers of assets, funds, services and/or personnel will not (i) adversely affect the tax exempt status of A, B or C (ii) adversely affect the nonprivate foundation status of A, B or C, or (iii) cause any of these entities to recognize unrelated business taxable income.

RULINGS

Therefore, we rule as follows:

1. The reorganization and the resulting corporate structure will not result in the revocation of, or otherwise adversely affect, the continued status of A as an organization described in section 501(c)(3) of the Code nor will it adversely affect the status of B or C as organizations described in section 501(c)(3).

2. The reorganization and resulting corporate structure will not cause A to lose its nonprivate foundation status under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code nor will it cause B or C to lose their nonprivate foundation status under section 509(a)(3) of the Code.

3. Any transfers of funds, assets, services and/or personnel in connection with the reorganization will not jeopardize the continued status as an organization described in section 501(c)(3) of the Code, as applicable, of the organization providing such funds, assets, services and/or personnel.

4. Any transfers of funds, assets, services and/or personnel will not adversely affect the continued nonprivate foundation status of A, B or C under sections 509(a)(1) or 509(a)(3) of the Code, as applicable.

5. Any payments for transfers of funds, assets, services and/or personnel in connection with the reorganization will not generate unrelated business taxable income under sections 511 through 514 of the Code.

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.

The rulings in this letter only apply the specifically indicated sections of the Code and regulations to the facts that you have represented. In this letter we do not rule on the applicability of any other sections of the Code and regulations to your case.

Because this letter could help resolve any future questions about your income tax responsibility, please keep a copy of this ruling in your permanent records.

A copy of this letter will be furnished to your Exempt Organizations Area Manager.

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 yours,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

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