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

Date: JUN - 9 2004

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

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Dear :

We have considered a ruling request regarding the federal income tax consequences of the joint venture arrangement described below.

**FACTS:**

A ("Hospital") is a nonprofit organization that has been recognized as exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). It has been classified as a hospital described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

Hospital formed B ("Company") to serve as the general partner in a limited partnership. Company is wholly-owned by Hospital. Company is formed as a limited liability company under the laws of State X. Hospital is the sole member of Company. Company will not elect to be treated as a separate entity from the Hospital for federal income tax purposes, but rather will be a disregarded entity such that assets owned or transferred to Company will be treated as assets owned or transferred to Hospital for federal income tax purposes.

C (the "Partnership") was formed as a limited partnership under the laws of State X. The partners of the Partnership currently consist of Company and Hospital. Company holds one general partnership unit representing one percent of the Partnership. Hospital holds one limited partnership unit representing ninety-nine percent of the Partnership. The Partnership intends to offer for sale limited partnership units of the Partnership to eligible physician investors and related physician groups (the "Investors"). Assuming the offering is fully subscribed, Company will continue to own one general partnership unit, Hospital will own fifty-four limited partnership units, the Investors will own forty limited partnership units, and D ("Manager"), the company engaged by the Partnership to manage the Partnership's facility, will own five limited partnership units.

Under the partnership agreement, Partnership interests will be proportional to and equal in value to their respective contributions. All financial arrangements will be negotiated on an arm's-length basis and will be based on fair market value. Partnership contributions and allocations of income, loss, deduction and credits will be in proportion to the partners' percentage interests. There will be no special allocations of income or loss to any particular partner.

The Partnership was formed to significantly expand the scope of available diagnostic imaging services in the local area by owning and operating a free-standing imaging center ("Center"). The imaging services to be provided at the Center will include MRI, x-ray, CT, ultrasound and mammography, most of which are not currently available in or around the local area.

The Partnership Agreement provides Company, as general partner, with the sole and exclusive right to manage and supervise the Partnership's business and property. Under the Partnership Agreement, the general partner, Company, has all the rights and powers which may be necessary or helpful in carrying out the Partnership's business without any management rights given to the other partners. The Board of Managers of Company is composed of individuals elected by Hospital. These individuals are community leaders with experience in health care matters, including officers and board members of Hospital.

The Partnership Agreement also provides that the Partnership and its facilities will be operated and managed in a manner that furthers the charitable purposes of the Hospital by promoting health for a broad cross-section of the community. Under the Partnership Agreement, this duty to operate and manage the Partnership in a charitable manner overrides any duty that Company, as the general partner, may have to operate the Partnership and the Center for the financial benefit of the partners or anyone else. The Partnership Agreement states that the general partner can only be removed by the

limited partners holding more than eighty percent of the sharing ratios of all partners.

The Partnership will engage Manager, an independent third party expert in managing imaging centers, to manage the Center pursuant to a management agreement. The Hospital contracted with an independent health care consultant to select a management company. The consultant screened 15 management companies, interviewed 4 of the 15 companies, and requested proposals from 2 of the 4 companies before selecting D. The Hospital does not have any other business relationship with Manager nor does Manager have any affiliation with any other potential investors.

Manager will provide all services, direction, advice, supervision, and assistance necessary to make the Center fully operational. The management agreement provides that the Manager will manage the facility in a manner that furthers the charitable purposes of the Hospital by promoting health for a broad cross section of the community and that this duty to operate and manage the Partnership in a charitable manner overrides any duty the Manager may have to operate the Center for the financial benefit of the partners or anyone else. The management agreement will provide for an initial 2-year term, which, with the consent of the Partnership and of Manager, can be renewed for one additional 2-year term. The management agreement may be terminated earlier than that for cause. The management agreement will provide for a management fee based on a percentage of funds collected in payment of Center services rendered to patients, subject to a ceiling amount.

The Partnership will also pay (a) an upfront organization fee of \$ ; (b) a development fee of percent of total costs incurred in the construction and development of the Center; and, (c) a purchasing service fee of percent of the net cost of purchases made prior to the Center being operational, limited to medical equipment and medical instruments that are not purchased directly from a center in the process of being converted from one ownership structure/organization to another. The Partnership Agreement prohibits the Partnership from paying Manager more than fair market value for services. The management agreement will provide that all fees paid will be subject to a ceiling amount that will not exceed fair market value.

The Center will follow the charity care policy of the Hospital, which will be advertised to patients. The Center will not limit its charity care patients to only those of the Hospital. The approximate percentages of patients that will be served by the Center are as follows: Medicare - percent; Medicaid - percent; Indigent - percent; self-pay - percent; and third-party payor - percent.

The staff of the Center is expected to include technicians, a small office staff, an administrator who will supervise the day-to-day activities of the Center, and a Medical Director. The Center will receive its revenues from Medicare, Medicaid, commercial

health plans, managed care organizations, employers, private insurance, self-pay and other miscellaneous public or private payment programs.

The Center's radiologists will have a requirement to treat all members of the community, including Medicare, Medicaid and indigent patients. Physician privileges will not be dependent on owning a partnership interest. It is anticipated that there will be physician partners and approximately non-partner physicians on the Center's medical staff.

The Center will occupy a building (the "Building") located on the campus of the Hospital. The Building will be constructed and owned by the Hospital. Hospital intends to provide percent of the total anticipated costs of completing the building with the remainder of the costs being paid by the Partnership. The Partnership is expecting to obtain financing to complete the development of the Facility.

The Partnership will lease the Building from the Hospital. The initial term of the lease will be years, with a renewal option of one additional year term. There will be an additional renewal option for a -year term which may be exercised after any renewal term. The rental amount will be a fixed amount per square foot, and will reflect fair market value for the leased space. After the first years, the rent will be adjusted annually in accordance with the applicable consumer price index. The Partnership will be responsible for all real estate and sales taxes, insurance, utilities and maintenance expenses related to the lease of the Center.

You request the following rulings:

1. That the proposed transactions described will not adversely affect the status of the Hospital and the Hospital will continue to qualify as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3).
2. That any income received from the distributive share of the Partnership's profits will not result in unrelated business taxable income as defined in section 512 of the Code, taxable to the Hospital under section 511(a).
3. That any rents received from the Partnership will not result in unrelated business taxable income as defined in section 512 of the Code, taxable to the Hospital under section 511(a).

**APPLICABLE LAW:**

Section 501(c)(3) of the Code describes as exempt from federal income tax, as

provided under section 501(a), organizations organized and operated exclusively for charitable, scientific, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1) of the regulations provides that an organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of designated individuals.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372 (1959); 4A Scott and Fratcher, The Law of Trusts, sections 368, 372 (4<sup>th</sup> ed. 1989).

Rev. Rul. 69-545, 1969-2 C.B. 117, provides that a nonprofit corporation whose purpose and activity are providing hospital care is promoting health and therefore furthers charitable purposes as provided in section 501(c)(3) of the Code if it meets the community benefit requirements. The community benefit standard focuses on a number of factors indicating the operations of a hospital benefit the community rather than serving private interests.

Rev. Rul. 98-15, 1998-1 C.B. 718, compares two situations where an exempt hospital forms a joint venture with a for-profit entity and then contributes its hospital and all of its other operating assets to the joint venture, which then operates the hospital. In Situation 1, the revenue ruling concludes that the exempt organization will continue to further charitable purposes when it participates in the joint venture. Favorable factors include: the commitment of the joint venture to give charitable purposes priority over maximizing profits; the community make-up and structure of the board; the voting control held by the exempt organization's representatives on the board; the specifically enumerated powers of the board; and, the reasonable terms and conditions of the management contract. In Situation 2, the revenue ruling concludes that the organization fails the operational test when it participates in the joint venture because activities of the joint venture will result in greater than incidental private benefit to the for-profit partner.

Section 511 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 unrelated business taxable income as the gross income derived from any unrelated trade or business regularly carried on, less the allowable deductions that are directly connected with the carrying on of the trade or business, computed with the modifications described in subsection (b).

Section 512(b)(3) of the Code provides that there shall be excluded from unrelated business taxable income all rents from real property and all rents from personal property leased with such real property (if the rents attributable to such personal property are an incidental amount of the total rents received under the lease), unless the determination of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage of receipts or sales).

Section 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(a)(1) 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 or performance by such organization of its exempt purposes.

Section 1.513-1(d)(2) of the regulations states that a trade or business is related to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of an exempt purpose, and is substantially related for purposes of section 513 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 the purposes for which exemption is granted, the production or distribution of the goods or the performance of services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

#### **ANALYSIS:**

Under the regulations, an organization that is organized and operated exclusively for charitable purposes may qualify for exemption under section 501(c)(3) of the Code.

The promotion of health has long been recognized as a charitable purpose.

Whether a hospital or other health care organization promotes health in a charitable manner is determined under the community benefit standard of Rev. Rul. 69-545, supra. This standard focuses on a number of factors to determine whether the hospital benefits the community as a whole rather than private interests.

After the creation of the Partnership and operation of the Center, the charitable and exempt purposes of Hospital will continue to be the same as prior to the creation of the Partnership. Hospital will provide health care to the community through the operation of its hospital facility in conformity with the community benefit requirements of Rev. Rul. 69-545, supra.

As provided in Rev. Rul. 98-15, supra, the activities of a partnership are considered to be the activities of an exempt organization that owns a partnership interest when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code. A section 501(c)(3) organization may form and participate in a partnership and meet the operational test of section 1.501(c)(3)-1(c) of the regulations if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of any for-profit partners.

Based on Rev. Rul. 98-15, supra, whether a section 501(c)(3) organization whose principal activity is the participation in a partnership that is engaged in health care activities satisfies the community benefit standard depends on all the facts and circumstances.

Company, a wholly-owned disregarded entity of Hospital, will be the general partner of the Partnership. As general partner, Company will have effective control over major decisions under the Partnership Agreement.

The Partnership Agreement will specifically provide that the duty of the Partnership is to operate the Partnership in a manner that furthers charitable purposes by promoting the health of a broad cross section of the community and that this duty overrides any duty to operate the Partnership for the financial benefit of its members. Company's control of major decisions ensures that the Center will be operated in a charitable manner in order to promote health for a broad cross section of the community regardless of ability to pay, including Medicare, Medicaid, and indigent patients. The Center will utilize the charity care policy of Hospital, and make it known to patients.

Company's Board of Managers will be representative of the community. The

Center will have an open medical staff. Contributions to the Partnership and allocations of profits, losses, and distributions from it will be in proportion to the interests of the partners.

The Manager will have a duty under the management agreement to operate the Center for charitable purposes, with charitable purposes taking precedence over any profit motive. Although the management fee is based on a percentage, a ceiling amount will be stated to reflect and not exceed fair market value.

Accordingly, the facts and circumstances establish that Hospital's participation in the Partnership will further its exempt purposes. Hospital's participation in and operation of the Center will promote health for the community in a manner that satisfies the requirements of Rev. Rul. 69-545, supra. In addition, the structure of the Partnership and operation of the Center will allow Hospital to act exclusively in furtherance of charitable purposes with no undue private benefit to the physician partners.

To determine whether an exempt organization's distributive share of ordinary income from a partnership is treated as unrelated business taxable income, it is necessary to look through the partnership to determine whether the partnership's trade or business is substantially related to the exempt organization's exempt purposes under section 501(c)(3) of the Code. Section 512(c). To be substantially related, the partnership's trade or business must further the organization's exempt purpose. The charitable purposes of Hospital will be furthered by the participation of Company, Hospital's wholly-owned disregarded entity, in the Partnership. Company's participation in the Partnership enables Hospital to provide expanded and improved health care services to the community. The purposes of Partnership specifically include enhancing the quality of health care and promoting the general health and well being of the community. These purposes override any duty to the members to maximize profits. Accordingly, such participation will not constitute an unrelated trade or business to Hospital within the meaning of section 513 of the Code. Consequently, pursuant to section 512(c) of the Code, any distributive share of Partnership's profits to Hospital, through Company, will not be considered unrelated business taxable income.\

The Partnership will lease the space for the Center from the Hospital on a fixed per square footage amount and not on the basis of profits of the Center. Accordingly, the rent received by the Hospital from the Partnership for the Center will be excluded from unrelated business taxable income pursuant to section 512(b)(3) of the Code.

#### CONCLUSIONS:

Accordingly, we rule as follows:



1. The proposed transactions described will not adversely affect the status of the Hospital and the Hospital will continue to qualify as an organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3).
2. The income received from the distributive share of the Partnership's profits will not result in unrelated business taxable income as defined in section 512 of the Code, taxable to the Hospital under section 511(a).
3. Rents received from the Partnership will not result in unrelated business taxable income as defined in section 512 of the Code, taxable to the Hospital under section 511(a).

This ruling is based on the understanding that there will be no material change in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

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.

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

We have sent a copy of this letter to your representative as indicated in your power of attorney.

Sincerely,

/s/

Michael Seto  
Manager, Exempt Organizations  
Technical Group 1