200036049

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

Date: JUN 13 2000

Contact Person:

ID Number:

Telephone Number:

In reply refer to:
T:EO:RA:T:1

U/L: 509.00-00
501.00-00

E.I.N.

LEGEND

G=
E=
T=
R=
W=
J=
C=
H=
S=
N=
P=
F=
O=
X=
D=

Dear Sir/Madam:

You requested rulings involving the establishment and operation of T.

259

FACTS

G

G is a health care system comprised of the following tax-exempt organizations: R, a section 501(c)(3) organization described in section 509(a)(1) of the Code; W, a section 501(c)(3) organization described in section 509(a)(1); J, a section 501(c)(3) organization described in section 509(a)(3); C, a section 501(c)(3) organization described in section 509(a)(3); and H, a section 501(c)(3) organization described in section 509(a)(3).

E

E is a health care system comprised of the following organizations: S, a section 501(c)(3) organization described in 509(a)(1); N, a section 501(c)(3) organization described in section 509(a)(1); P, a section 501(c)(2) entity; F, a section 501(c)(3) organization described in section 509(a)(1); O, a non-profit organization that is applying for section 501(c)(3) exemption; and X, a section 501(c)(3) organization described in section 509(a)(3).

S is the sole corporate member of N and P. F is the sole corporate member of O. X and F are controlled by a group of five individuals (the "Members of the Corporation"). The Members of the Corporation consist of the head of a religious group and four individuals appointed by the head of the religious group.

Description of the Transaction

Pursuant to an Agreement to Form Joint Operating Company and a Joint Operating Agreement by and between W and S, it is proposed to consolidate certain services and operations through the formation of T. T is intended to effectuate a "virtual merger" of W and S. T is simultaneously with this request for ruling submitting an application for exemption that it is exempt under section 501(c)(3) of the Code and is described in section 509(a)(3).

T intends to serve charitable purposes by enabling W and S to realize substantial cost efficiencies, develop a more coordinated continuum of care, address the health needs of the community as a whole through program development and outreach, and maintain an integrated, cost-effective medical education program.

T will be managed by a Chief Executive Officer and a Chief Operating Officer. The Chief Executive Officer shall also be the President and Chief Executive Officer of W and S. The Chief Operating Officer of T shall also be the Chief Operating Officer of

W and S. The Chief Executive Officer and the Chief Operating Officer may be removed by the affirmative vote of a majority of the Directors of T, provided that such majority includes at least one designee of each of W and S who, in each case, is not a community physician.

T will also assume the planning functions for W and S. In addition, T will assume the treasury functions of W and S, including budgeting, reimbursement matters, establishment of charge structures, and functions pertaining to general ledger, accounts payable, purchasing, payroll, cash disbursements, billing, collections, credit, financial reporting and financial planning.

T's Powers

In addition to the management, administrative, financial and operational services provided, T will facilitate the following arrangements:

1. Clinical Services. Section 3 of the Joint Operating Agreement provides that W and S shall reallocate existing clinical services. Section 4 of the Joint Operating Agreement provides that T may allocate or reallocate clinical services in addition to or in a manner different from prior allocations of clinical services.

2. Hospital Actions. Section 5 of the Joint Operating Agreement sets forth actions W and S cannot take without the approval of T. These actions include (i) initiate, implement, close or terminate any new major clinical service; (ii) expand any clinical service beyond certain levels; (iii) incur capital expenditures except as reflected in the approved capital budget; (iv) incur or assume indebtedness in excess of $1,000,000; (v) sell properties or assets in excess of $1,000,000; (vi) pledge assets for new debts; (vii) incur any expense not provided for in the approved operating budget; (viii) terminate existing affiliations for the training of physicians and surgeons or establish new affiliations; (ix) enter into any programmatic or clinical affiliation with any institution not affiliated with or approved by G; (x) merge or consolidate; (xi) contribute or transfer, without adequate consideration, funds to any organization (other than for certain permitted transfers); (xii) change the corporate membership, certificate of incorporation, by-laws or governance structure of W or S; (xiii) establish any subsidiary corporation; (xiv) enter into contracts or leases for more than one year and which require payment of more than $600,000 in any year; and (xv) divert or participate in any plan which diverts patients or programs from W or S.

3. Corporate Existence. Section 6(c) of the Agreement to Form Joint Operating company provides that W and S shall each maintain their separate corporate existence and shall each maintain title to and ownership of their respective properties and assets.

4. Reserved Powers. Section 6(d) of the Agreement to Form Joint Operating Company provides that W and S shall reserve the following powers: (i) the power to approve any modification, amendment, alteration or restatement of the Certificate of Incorporation of T, (ii) the power to approve any modification, amendment or restatement of T's By-laws; (iii) the power to approve any plan of merger, consolidation or dissolution involving T; (iv) the power to approve any amendment to T; (v) the power to approve the hiring or election of a Chief Executive Officer or Chief Operating Officer of T, which power shall expire four years after the effective date of the Joint Operating Agreement; and (vi) the power to designate certain members of the Board of Directors of T.

5. Additional Powers. Section 6 of the Joint Operating Agreement outlines the following additional powers of T in connection with W and S: (i) establish rate schedules and charges for goods and services and use of facilities furnished by W and S; (ii) establish policies and procedures for health care services to the indigent, write-offs for uncollectible accounts, and other discounts; (iii) establish policies concerning pricing with third-party payers; (iv) execute and deliver third-party payer contracts on behalf of W and S; (v) incur indebtedness on behalf of W and S; (vi) annually establish and approve the operating and capital budgets; and (vii) to the extent practicable and feasible, own any substantial new facilities to be constructed.

6. Ethical Matters. S, as a religious institution, and its employees cannot be required by T or W to take any action in violation of their religious code.

7. Funding. Section 8 of the Joint Operating Agreement provides that W and S will initially fund T through long-term interest free loans or a capital contribution. T shall adopt an operating and capital budget and W and S shall each transfer to T one-half of such budget amounts.

8. Sharing and Allocation of Net Revenues. Section 9 of the Joint Operating Agreement provides that W and S agree to a proportional sharing in net revenues. W and S will each charge for their services and T will collect, in segregated accounts, the revenues of W and S and pay their respective expenses. T shall transfer moneys between W and S in such a manner as T's Board of Directors directs.

9. Term and Termination. Section 14 of the Joint Operating Agreement provides that W and S intend to form an integrated health care delivery system, as nearly as possible the equivalent of a full-fledged merger. The voluntary termination or modification of the Joint Operating Agreement and/or T shall not be permitted unless agreed upon by a two-thirds vote of each of the full memberships of the

262

governing boards of W and S. The Joint Operating Agreement and/or T shall not be terminated if there is an event of default. In such case, the parties shall attempt to negotiate an equitable resolution and in the event a negotiated settlement is not achieved, the non-defaulting party shall have the right to apply for the appointment of a master. The master's decision shall be binding on the parties.

MEMBERS and GOVERANCE

W and S shall each be members of T. T's By-laws contain a substantive conflicts of interest provision. There shall be no other members of T. T shall be governed by a Board of Directors. The initial Board shall consist of fifteen persons designated as follows: (i) five persons designated by W (one of whom shall be a community physician); (ii) five persons designated by S (one of whom shall be a community physician); (iii) one person designated by D, who shall not be a member of the governing board of W or S; (iv) the Dean of A, ex-officio; (v) one person, who shall be the Chairperson, selected jointly by W and S; (vi) the Chief Executive Officer, ex-officio; and (vii) the Chief Operating Officer, until four years after the effective date of the Joint Operating Agreement.

RULINGS REQUESTED

T, S and W request the following rulings:

1. The establishment and operation of the Joint Operating Agreement and arrangement through T will not adversely affect the exemption of any member of G from federal income tax under section 501(c)(3) of the Code.

2. The establishment and operation of the Joint Operating Agreement and arrangement through T will not adversely affect the exemption of any member of E from federal income tax under sections 501(c)(2) or 501(c)(3) of the Code.

3. The establishment and operation of the Joint Operating Agreement and arrangement through T will not adversely affect the non-private foundation status of any member of G under section 509(a) of the Code.

4. The establishment and operation of the Joint Operating Agreement and arrangement through T will not adversely affect the non-private foundation status of any member of E under section 509(a) of the Code.

5. Any loans, capital contributions, and/or transfers of assets, personnel and/or resources among T, any member of G participating in T and/or any member of E

participating in T will not constitute an unrelated trade or business within the meaning of section 513 of the Code.

6. The provision of management or other services among T, any member of G participating in T and/or any member of E participating in T will not constitute an unrelated trade or business within the meaning of section 513 of the Code.

LAW

Sections 501(c)(3), 509(a)(1) and 509(a)(3) 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, recognizes 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.

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 that 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 examples 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 an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

A joint operating agreement 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.

Section 501(c)(2) of the Code provides for the exemption of corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under section 501(c).

Section 509(a)(1) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) of the Code other than an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)). Organizations described in section 170(b)(1)(A)(iii) of the Code include organizations whose principal purpose is the provision of medical or hospital care. Section 1.170A-9(c)(1)(ii) of the Income Tax Regulations states that an outpatient clinic may qualify as a hospital if its principal purpose is the provision of hospital or medical care.

Section 509(a) of the Code provides 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)(3) of the Code excludes from the definition of a private foundation an organization which is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or 509(a)(2).

Section 509(a)(3) of the Code describes an organization which is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in sections 509(a)(1) or 509(a)(2). The supporting organization must also be operated, supervised or controlled by the supported organization; supervised or controlled in connection with the supported organization; or operated in connection with the supported organization in order to be classified as a public charity under section 509(a)(3).

Section 1.509(a)-4(a) of the regulations describes in general terms the various tests that a supporting organization must meet in order to be classified as an organization described in section 509(a)(3) of the Code.

Analysis

Based on all the facts and circumstances, we conclude that the entities comprising G and E will not adversely affect their tax exempt status under section 501(c)(3) of the Code by the transactions as they will continue to promote health within the meaning of Revenue Ruling 69-545. Further, P will continue to promote exempt purposes under section 501(c)(2)

of the Code. The sharing of assets, personnel and/or resources pursuant to the joint operating agreement will not adversely affect the section 501(c)(3) status of any exempt participating entity member as this activity promotes health within the meaning of Revenue Ruling 69-545. The entities comprising G and E will continue to qualify as non-private foundations under sections 509(a)(1) and 509(a)(3) of the Code.

Sections 511 Through 514 of the Code

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)(3) of the Code provides generally that rents from real property (and its incidental related personal property) are not unrelated business income unless the property is debt-financed under section 514 of the Code. Debt-financed property does not include any property substantially related to the exercise or performance by such organization of its charitable functions.

Section 512(b)(4) of the Code requires that notwithstanding paragraphs (1), (2), (3) or (5), the net income realized with respect to debt-financed property must be included in unrelated business taxable income.

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 512(b)(13) of the Code limits the exclusion of interest, annuities, royalties, and rents provided by section 512(b)(1), (2), and (3) where such amounts are derived from a controlled organization.

Section 1.512(b)-1(l) of the regulations provides that if an exempt organization has control of another organization, the controlling organization shall include as an item of gross income in computing its unrelated business taxable income the amount of interest, annuities, royalties, and rents derived from the controlled organization, determined in accordance with the formula described in section 512(b)(13) of the Code and section 1.512(b)-1(l)(3) of the regulations.

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 the 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.

Analysis

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 a parent and subsidiary relationship, 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 joint operating agreement has established a parent and subsidiary relationship such that corporate services and payments provided between the participating entities will not be treated as unrelated trade or business income because the activities are essential to the accomplishment of exempt purposes, could be conducted by a participating entity for itself without giving rise to unrelated trade or business income, and occur in the context of a close relationship among them.

Based on all the facts and circumstances, we conclude that the joint operating agreement effectively binds W and S under the common control of T so that the participating organizations are within a relationship analogous to that of a parent and subsidiary pursuant

to the authority of T's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating entities have ceded authority under the joint operating agreement to T's governing body to establish their budgets, including major expenditures, debt, contracts, managed care agreements, and capital expenditures; to direct their provision of health care services; to provide for dispute resolution and arbitration; and to monitor and audit their compliance with its directives. In addition, the governing body and its committees meet regularly to exercise overall responsibility for operational decisions involving the day-to-day and long range strategic management decisions that have been delegated by the participating entities. Therefore, services provided between the previously unrelated organizations through the joint operating agreement 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.

CONCLUSION

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

1. The establishment and operation of the Joint Operating Agreement and arrangement through T will not adversely affect the exemption of any member of G from federal income tax under section 501(c)(3) of the Code.

2. The establishment and operation of the Joint Operating Agreement and arrangement through T will not adversely affect the exemption of any member of E from federal income tax under sections 501(c)(2) or 501(c)(3) of the Code.

3. The establishment and operation of the Joint Operating Agreement and arrangement through T will not adversely affect the non-private foundation status of any member of G under section 509(a) of the Code.

4. The establishment and operation of the Joint Operating Agreement and arrangement through T will not adversely affect the non-private foundation status of any member of E under section 509(a) of the Code.

5. Any loans, capital contributions, and/or transfers of assets, personnel and/or resources among T, any member of G participating in T and/or any member of E participating in T will not constitute an unrelated trade or business within the meaning of section 513 of the Code.

6. The provision of management or other services among T, any member of G participating in T and/or any member of E participating in T will not constitute an unrelated trade or business within the meaning of section 513 of the Code.

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

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

Sincerely yours,

Marvin Friedlander

Marvin Friedlander
Manager, EO Technical
Group 1

270