INFO 2005-0051

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Dear [redacted]

This letter is in response to your request for information concerning the tax consequences of the involvement of a hospital described in section 501(c)(3) of the Internal Revenue Code in a joint venture operating as a limited liability company with a physician group practice and physicians that are staff physicians of the hospital. The exempt hospital's board of directors is comprised primarily of non-physician community representatives. The joint venture represents only a portion of the activities of the exempt hospital. The operation of the hospital remains the primary activity. Specific areas in which you wanted discussion concern the hospital's exempt status and the possibility of an excess benefit transaction.

Exempt Status

An organization that is organized and operated exclusively for charitable purposes may qualify for exemption from federal income tax under section 501(a) of the Code as described in 501(c)(3). The promotion of health has long been recognized as a charitable purpose.

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

For federal income tax purposes, the activities of a partnership are considered to be the activities of the partners. See Butler v. Commissioner, 36

T.C. 1097 (1961), acq., 1962-2 C.B. 4. Aggregate treatment is also consistent with the treatment of partnerships for purposes of the unrelated business income tax under section 512(c) of the Code. In light of the aggregate principle discussed in Butler v. Commissioner and reflected in section 512(c), the aggregate approach also applies for purposes of the operational test set forth in section 1.501(c)(3)-1(c) of the regulations. Thus, the activities of a limited liability company treated as a partnership for federal income tax purposes are considered to be the activities of a section 501(c)(3) organization that is a member of a limited liability company when evaluating whether the section 501(c)(3) organization is operated exclusively for exempt purposes as required in section 1.501(c)(3)-1(c) and section 501(c)(3).

Accordingly, a section 501(c)(3) organization may form and participate in a partnership, including a limited liability company treated as a partnership for federal income tax purposes, and meet the operational test, 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 the for-profit partners. See Rev. Rul. 98-15.

Based on Rev. Rul. 98-15, whether a section 501(c)(3) organization whose principal activity is the ownership of a membership interest in a limited liability company that is engaged in health care activities satisfies the community benefit standard of Rev. Rul. 69-545 depends on all the facts and circumstances. Further, based on Rev. Rul. 2004-51 2004-22 I.R.B. 974, a section 501(c)(3) organization will not jeopardize its exemption when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company with a for-profit corporation when the activities of the limited liability company were not a substantial part of the exempt organization's activities, and these activities taken alone did not jeopardize the exempt organization's exemption.

Thus, an exempt hospital that conducts a portion of its activities through a limited liability company with a for-profit corporation and continues to primarily provide health care to the community through the operation of the hospital facility in conformity with the community benefit requirements of Rev. Rul. 69-545 will continue to be operated for exempt charitable purposes when the particular activities of the LLC taken alone does not jeopardize the hospital's exemption.

Further, the activities of an exempt hospital conducted through an LLC that is operated similar to Situation 1 of Rev. Rul. 98-15 will be substantially related to the exercise and performance of the hospital's exempt purposes. See Rev. Rul. 2004-51. Where the hospital retains effective control over the limited liability company and the limited liability company serves charitable purposes, the

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manner in which the LLC conducts the activity contributes importantly to the accomplishment of the hospital's charitable purposes, and the activities of the LLC are substantially related to the hospital's charitable purpose of the promotion of health

Excess Benefit Transaction

Section 4958 of the Code imposes a tax on excess benefit transactions. An excess benefit transaction is defined in section 4958(c) as any transaction in which an economic benefit is provided by an organization described in section 501(c)(3) directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received by providing such benefit.

The term "disqualified person" includes "any person who was, at the time during the 5-year period ending on the date of such (excess benefit) transaction, in a position to exercise substantial influence over the affairs of the organization." A disqualified person also includes a corporation, partnership, or trust or estate in which persons such persons collectively own more than 35 percent of the combined voting power, more than 35 percent of the profits interest, or more than 35 percent of the beneficial interest, respectively. Section 4958(f)(1) and (f)(3) of the Code.

The payments to the physician group and physicians by the LLC involve the transfer of property. Rules for determining the value of economic benefits regarding the fair market value of property for purposes of section 4958, including the right to use property, is the fair market value, i.e., the price at which property or the right to use property, would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell, or transfer property or the right to use property, and both having reasonable knowledge of relevant facts. Section 53.4958-4(b)(1)(i) of the Foundation and Similar Excise Taxes Regulations.

A transfer of property, or the right to use property, is presumed to be at fair market value if several conditions are satisfied, including (a) the terms of the property transfer are approved in advance by an authorized body of the organization composed entirely of individuals who do not have a conflict of interest with respect to the property transfer; (b) the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and (c) the authorized body adequately documented the basis for its determination concurrently with making the determination. Section 53.4958-6 of the regulations.

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If the joint venture transaction is conducted in accordance with the intermediate sanctions Code sections and regulations, it will not be considered an excess benefit transaction

In accordance with section 3.06 of Rev. Proc. 2004-4, 2004-4 I.R.B. 125, 129, this information letter is advisory only and has no binding effect on the Internal Revenue Service.

If you have any questions about this letter, please contact [redacted] (ID # [redacted] at [redacted] (not a toll-free call).

Sincerely,

Michael Seto

Michael Seto, Manager, Exempt Organizations Technical Group 1