



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:
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Dear :

This letter responds to your request for rulings under sections 511-514 of the Internal Revenue Code.

Facts

B is a nonprofit corporation recognized as an organization described in section 501(c)(3) of the Code, and as a supporting organization under section 509(a)(3). B's purposes include:

- (a) Establishing or maintaining a health care system comprised of C and other health care related entities which are sponsored by or otherwise affiliated with C;
- (b) The formation of affiliate nonprofit and/or for profit corporations; and

- (c) To engage in other activities directly or indirectly related to or which may assist in the accomplishment of such purposes.

B's mission is to support C and its affiliates by providing overall planning, management, and support to those entities. B acts as sole member or shareholder of various health care entities, including C.

D, B's sole member, is also a nonprofit corporation recognized as an organization described in section 501(c)(3) of the Code, and as a supporting organization under section 509(a)(3). D's mission is to promote health care by acting as the parent of a vertically and horizontally integrated health care system and supporting the affiliates in its system, including B and C.

C is a nonprofit corporation recognized as an organization described in section 501(c)(3) of the Code and classified as a hospital under sections 509(a)(1) and 170(b)(1)(A)(iii). B is the sole member of C. C's primary activity is operation of E, a community hospital.

F is a nonprofit corporation recognized as an organization described in section 501(c)(3) of the Code and classified as a hospital under sections 509(a)(1) and 170(b)(1)(A)(iii). B is the sole member of F. F's principal activity is providing health care services through physicians in connection with C. F operates at a medical office building ("MOB") situated on land owned by B on the campus of C. All of F's physicians at the MOB are members of C's medical staff.

G is a limited partnership and is owned by H, its general partner and a taxable corporation, and C, a limited partner. G's sole activity consists of its ownership and operation of the MOB, including the renting of t square feet of space.

I is a taxable corporation that owns and operates a retail pharmacy in the MOB owned by G and leased to C, which subleases space to I.

J is a taxable corporation whose sole shareholder is B. J's sole activity is ownership of 100% of the stock of H and 100% of the stock of I.

G has entered into a k-year lease agreement (the "Ground Lease") with B, as lessor, to lease certain land (the "Land") owned by B on the campus of C. This land is adjacent to a hospital owned and operated by C. The MOB is situated on a portion of this land. G pays an annual rental to B.

G borrowed \$m from C (the "Loan"), pursuant to the terms of a promissory note (the "Note") that C has since assigned to B. G used the Loan to finance the construction, maintenance, and operation of the MOB on the Land. The Note is payable to B on demand. The unpaid principal amount of the Loan and any unpaid accrued interest thereon continue to accrue interest at the rate of n percent per annum. G makes regular interest payments to B in accordance with the terms of the Note.

G has incurred indebtedness to unrelated third party commercial lenders to finance and refinance the acquisition, construction, and improvement of the MOB. B, however, has no debts, liabilities, or obligations that relate to its acquisition or improvement of the Land.

C and B participated in the organization of G and its acquisition and construction of the MOB so that members of C's medical staff could maintain their private practices near E, in order to improve the overall quality of C's patient care.

G, as owner of the MOB, leases approximately o square feet of space in the MOB to C. C uses approximately p square feet of such space for outpatient surgical services.

C uses the remaining q square feet of the MOB as an employee pharmacy primarily for the convenience of employees. C also subleases this q square feet to I to operate a separate retail pharmacy.

G leases approximately r square feet of space in the MOB to E, which uses this space for the medical offices of its physicians.

G leases the remainder of space in the MOB (s square feet) to other physicians to carry on their private medical practices. Pursuant to the G limited partnership agreement, each such lessee must be a member of C's active medical staff. Generally, each lease is for a term of more than five years, and will be in default if the physician-lessee or lessees cease to be members in good standing on the medical staff of C.

Each tenant in the MOB arranges for janitorial and maintenance services with respect to the space each occupies in the MOB. G pays H for maintenance of common areas in the MOB, and then allocates these costs as additional rent to each of the tenants based on the amount of space they occupy in the MOB.

All of G's revenues that fund its rental and interest payments to B are derived from its MOB leases.

Rulings Requested

1. The interest received or accrued by B from G on the Loan evidenced by the Note does not generate unrelated business taxable income to B under sections 511 through 514 of the Code; and
2. The rental income received or accrued by B from G pursuant to the Ground Lease does not generate unrelated business taxable income to B under sections 511 through 514 of the Code.

Law

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" ("UBTI") as gross income derived by an organization from an "unrelated trade or business" regularly carried on by it, less the allowable deductions which are directly connected with such trade or business.

Section 512(b)(1) of the Code excludes dividends, interest and other payments from the computation of UBTI.

Section 512(b)(3) of the Code excludes certain rents from the rental of certain real and personal property from computation of UBTI.

Section 512(b)(13) of the Code provides special rules for certain amounts that a "controlling organization" receives from a "controlled entity."

Section 512(b)(13)(A) of the Code provides that, notwithstanding sections 512(b)(1) and (3), a "controlling organization" receiving a "specified payment" from a "controlled entity" must include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the "net unrelated income" of the controlled entity (or increases any "net unrelated loss" of the controlled entity).

Section 512(b)(13)(B)(i) of the Code defines the term "net unrelated income," for the purposes of a controlled entity which is not exempt from tax under section 501(a), as the portion of the entity's taxable income which would be unrelated business taxable income if such entity were exempt under section 501(a) and had the same exempt purposes as the controlling organization.

Section 512(b)(13)(C) of the Code defines the term "specified payment" as any interest, annuity, royalty or rent.

Section 512(b)(13)(D)(i) of the Code provides, in part, that the term "control" means, in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of such corporation, and in any case other than a corporation or partnership, "control" means ownership of more than 50 percent of the beneficial interests in the entity.

Section 512(b)(13)(D)(ii) of the Code provides that Section 318 shall apply for purposes of determining ownership of stock in a corporation, for purposes of determining control under Section 512(b)(13)(D).

The Pension Protection Act of 2006, Pub.L. 109-280, Title XII, section 1205(a) (Aug. 17, 2006), added new section 512(b)(13)(E) to the Code. Section 512(b)(13)(E) generally provides that section 512(b)(13)(A) applies only to that portion of a specified payment that the controlling organization receives or accrues that exceeds the amount that would meet the requirements of section 482. Section 512(b)(13)(E) only applies to payments made pursuant to a written binding contract in effect on August 17, 2006 that are received or accrued after December 31, 2005 and on or before December 31, 2007.

Section 318(a)(2)(C) of the Code provides that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person is considered as owning the stock owned directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all of the stock in such corporation.

Section 513(a) of the Code defines the term "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 the organization of the purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the Income Tax 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 (other than through the production of income); 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 those purposes.

Section 514(a) of the Code provides that income from unrelated debt-financed property is subject to the unrelated business income tax.

Section 514(b)(1) of the Code provides that the term "debt-financed property" means any property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

Section 514(b)(1)(A) of the Code provides that the term "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 its tax-exempt purposes. Section 514(b)(1) provides that substantially all the use of a property shall be considered to be substantially related to an organization's exempt purpose or function if such property is real property subject to a lease to a medical clinic entered into primarily for purposes substantially related to the organization's exempt purpose or function.

Section 514(c)(1) of the Code provides that the term "acquisition indebtedness" means, with respect to any debt-financed property, the unpaid amount of the indebtedness incurred by the organization (a) in acquiring or improving such property; (b) before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and (c) after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Section 1.514(b)-1(b)(ii) of the regulations provides that the term "substantially all," for purposes of Section 514(b)(1)(A) of the Code, means eighty-five percent (85%).

Section 1.514(b)-1(c)(1) of the regulations provides that property is not debt-financed property if it is real property subject to a lease to a medical clinic, and the lease is entered into primarily for purposes which are substantially related to the organization's exempt purpose or function.

Rev. Rul. 69-464, 1969-2 C.B. 132, provides that leases of office space by an exempt hospital to members of its medical staff are substantially related to the performance of hospital functions, for purposes of Section 514(b)(1)(A) of the Code. The hospital leased space to doctors to carry on their private medical practices. Only members of the hospital's active or courtesy medical staff could lease space. The usual term of the leases, including options to renew, was for more than five years. However, the leases could be terminated sooner by the hospital in the event a tenant ceases to be a member of the hospital's medical staff. Only janitorial and maintenance services were provided to tenants by the hospital. The hospital established that the leasing of office space contributed importantly to the hospital's functions by increasing the hospital's efficiency, encouraging fuller utilization of its facilities, and improving the overall quality of its patient care.

Analysis

Interest and rental income received by a tax exempt organization are normally *excluded* from UBTI under sections 512(b)(1) and 512(b)(3) of the Code. However, payments of interest and

rents by a controlled entity to a tax-exempt organization are normally *included* in UBTI to the extent such payment reduces the "net unrelated income" of the controlled entity (or increases any "net unrelated loss" of the controlled entity) under section 512(b)(13)(A). "Net unrelated income" is defined as the portion of the entity's income which would be UBTI if the entity were exempt under section 501(a) and had the same exempt purposes as the controlling organization. See section 512(b)(13)(B)(i).

G's sole partners are H, the general partner, and C, a limited partner. B is the sole owner of J, which is the sole owner of H. Thus, G is a controlled entity of B under the constructive ownership rules of sections 318(a)(2)(C) and 512(b)(13)(D) of the Code.

If G were exempt under section 501(a) of the Code, and if G's income from its MOB leases were unrelated business income, then G's payments of interest and rent to B would constitute UBTI to B, to the extent that such payments reduced G's net unrelated income. See sections 512(b)(13)(B)(i)(I) and 512(b)(13)(C).

If G were exempt under section 501(a) of the Code, the income it would derive from its leases of MOB space to C and F normally would not be subject to UBTI under section 512(a)(1) of the Code, because such income would be passive rental income under section 512(b)(3).

Because G has incurred acquisition indebtedness to finance its construction and maintenance of the MOB, the MOB would normally be deemed debt-financed property under sections 514(a), 514(b)(1), and 514(c)(1) of the Code. However, if substantially all (*i.e.*, more than 85%) of the use of the MOB is substantially related to the tax exempt purposes of B (G's controlling organization for purposes of section 512(b)(13)), then the MOB will not be considered "debt-financed property."

G leases approximately o square feet of space in the MOB to C, a tax-exempt organization whose sole member is B. C uses p square feet of this space for outpatient surgical services. G also leases r square feet in the MOB to F, a tax exempt organization whose sole member is B. F uses its premises in the MOB to provide health care services through physicians in connection with C. All of F's physicians at the MOB are members of C's medical staff. G leases the remaining space in the MOB (s square feet) to private physicians. G only leases space to private physicians who are on C's medical staff.

Therefore, G's leasing of the MOB increases C's efficiency, encourages fuller utilization of C's facilities, and improves the overall quality of C's patient care. See Rev. Rul. 69-464, 1969-2 C.B. 132. Accordingly, this leasing activity is substantially related to B's exempt purposes under sections 513 and 514(b)(1)(A) of the Code and sections 1.513-1(d)(2) and 1.514(b)-1(c)(1) of the regulations.

Because substantially all (*i.e.*, more than 85%) of the total rented space in the MOB is used for purposes substantially related to the tax exempt purposes of B, the MOB is not treated as "debt-financed property" for purposes of sections 514(b)(1) and 514(b)(1)(A) of the Code and section 1.514(b)-1(b)(ii) of the regulations. Accordingly, the rental income received by G from C, B, and C staff physicians would not be UBTI if G were exempt under section 501(a). Because all of G's revenues that fund its rental and interest payments to B are derived from its MOB leases, those revenues do not constitute "net unrelated income" under section 512(b)(13)(B)(i) of the Code. Accordingly, these rental and interest payments do not reduce G's "net unrelated income" for purposes of section 512(b)(13)(A) of the Code. Thus, the rental and interest payments G makes to B do not constitute UBTI.

We are not ruling on the applicability of new section 512(b)(13)(E) of Code, as you did not request that we do so or submit facts to support such a ruling.

Rulings

1. The interest received or accrued by B from G on the Loan evidenced by the Note does not generate unrelated business taxable income to B under sections 511 through 514 of the Code; and
2. The rental income received or accrued by B from G pursuant to the Ground Lease does not generate unrelated business taxable income to B under sections 511 through 514 of the Code.

This ruling letter is based on the understanding that there will be no material changes in the facts upon which it is based.

This ruling letter 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 letter is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides it may not be used or cited by others as precedent.

This ruling letter will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Steven Grodnitzky
Manager, Exempt Organizations
Technical Group 1

Enclosure: Notice 437