

**Internal Revenue Service  
Appeals Office**

**Department of the Treasury**

**Employer Identification Number:**

Release Number: **201744019**

Release Date: 11/3/2017

Date: August 7, 2017

**Person to Contact:**

Employee ID Number:

Tel:

Fax:

ORG  
ADDRESS

**UIL: 0501.03-11**

**Certified Mail**

Dear :

This is a final adverse determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code (the "Code") section 501(a) as an organization described in Code section 501(c)(3).

The favorable determination letter to you dated June 15, 1989 is hereby revoked and you are no longer exempt under section 501(a) of the Code effective February 1, 2011.

The adverse determination was made for the following reason(s):

You failed the operational test because your resources were not devoted to purposes that qualify as exclusively charitable within the meaning of section 501(c)(3) of the Code and the applicable regulations.

Contributions to your organization are not deductible under section 170 of the Code.

You are required to file Federal income tax returns on Forms 1120. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit [www.irs.gov](http://www.irs.gov).

We will make this letter and the proposed adverse determination letter available for public inspection under Code section 6110 after deleting certain identifying information. We have provided to you, in a separate mailing, Notice 437, *Notice of Intention to Disclose*. Please review the Notice 437 and the documents attached that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437.

If you decide to contest this determination, you may file an action for declaratory judgment under the provisions of section 7428 of the Code in one of the following three venues: 1) United States Tax Court, 2) the United States Court of Federal Claims, or 3) the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed within 90 days from the date this determination letter was mailed to you. Please contact the clerk of the appropriate court for rules and the appropriate forms for filing petitions for declaratory judgment by referring to the enclosed Publication 892. You may write to the courts at the following addresses:

United States Tax Court  
400 Second Street, NW  
Washington, DC 20217

US Court of Federal Claims  
717 Madison Place, NW  
Washington, DC 20005

U. S. District Court for the District of Columbia  
333 Constitution Ave., N.W.  
Washington, DC 20001

Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Code.

You also have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels get prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. You may call toll-free, 1-877-777-4778, for the Taxpayer Advocate or visit [www.irs.gov/advocate](http://www.irs.gov/advocate) for more information.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely Yours,

Appeals Team Manager

cc:

Enclosure: Publication 892





Department of the Treasury  
Internal Revenue Service  
Tax Exempt and Government Entities  
Exempt Organizations Examinations

Date:  
July 14, 2016  
Taxpayer Identification Number:

Form:

Tax Year(s) Ended:  
January 31, 20xx  
Person to Contact/ID Number:

ORG  
ADDRESS

Contact Numbers:

Manager's Name/ID Number:

Manager's Contact Number:

Response due date:  
August 15, 2016

**Certified Mail - Return Receipt Requested**

Dear :

**Why you are receiving this letter**

We propose to revoke your status as an organization described in section 501(c)(3) of the Internal Revenue Code (Code). Enclosed is our report of examination explaining the proposed action.

**What you need to do if you agree**

If you agree with our proposal, please sign the enclosed Form 6018, *Consent to Proposed Action - Section 7428*, and return it to the contact person at the address listed above (unless you have already provided us a signed Form 6018). We'll issue a final revocation letter determining that you aren't an organization described in section 501(c)(3).

After we issue the final revocation letter, we'll announce that your organization is no longer eligible for contributions deductible under section 170 of the Code.

**If we don't hear from you**

If you don't respond to this proposal within 30 calendar days from the date of this letter, we'll issue a final revocation letter. Failing to respond to this proposal will adversely impact your legal standing to seek a declaratory judgment because you failed to exhaust your administrative remedies.

**Effect of revocation status**

If you receive a final revocation letter, you'll be required to file federal income tax returns for the tax year(s) shown above as well as for subsequent tax years.

**What you need to do if you disagree with the proposed revocation**



If you disagree with our proposed revocation, you may request a meeting or telephone conference with the supervisor of the IRS contact identified in the heading of this letter. You also may file a protest with the IRS Appeals office by submitting a written request to the contact person at the address listed above within 30 calendar days from the date of this letter. The Appeals office is independent of the Exempt Organizations division and resolves most disputes informally.

For your protest to be valid, it must contain certain specific information including a statement of the facts, the applicable law, and arguments in support of your position. For specific information needed for a valid protest, please refer to page one of the enclosed Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*, and page six of the enclosed Publication 3498, *The Examination Process*. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Track Mediation referred to in Publication 3498 generally doesn't apply after we issue this letter.

You also may request that we refer this matter for technical advice as explained in Publication 892. Please contact the individual identified on the first page of this letter if you are considering requesting technical advice. If we issue a determination letter to you based on a technical advice memorandum issued by the Exempt Organizations Rulings and Agreements office, no further IRS administrative appeal will be available to you.

**Contacting the Taxpayer Advocate Office is a taxpayer right**

You have the right to contact the office of the Taxpayer Advocate. Their assistance isn't a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate can't reverse a legally correct tax determination or extend the time you have (fixed by law) to file a petition in a United States court. They can, however, see that a tax matter that hasn't been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Internal Revenue Service  
Office of the Taxpayer Advocate



**For additional information**

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

for

Director, EO Examinations

**Enclosures:**

Report of Examination

Form 6018

Publication 892

Publication 3498



Form <b>886-A</b> (Rev. January 1994)	<b>EXPLANATIONS OF ITEMS</b>	Schedule number or exhibit
Name of taxpayer  ORG	Tax Identification Number	Year/Period ended  January 31, 20XX

**This supersedes the report issued September 28, 20xx and also withdraws Form 6018 signed October 27, 20xx.**

ISSUES:

Whether ORG is operated exclusively for exempt purposes described within Internal Revenue Code section 501(c)(3)?

Whether ORG is engaged primarily in activities that accomplish exempt purpose?

FACTS:

ORG ( ) is a general acute care hospital located in . It is the only hospital located within a xx mile radius of the community. The facility is licensed for xx beds and offers acute medical/surgical care, ICU, rehabilitation, geriatric psychiatric care, surgery and emergency care.

The hospital was founded in the xxs as a community hospital. Beginning in 19xx, it was operated by , an IRC 501(c)(3) hospital system. (now ORG ) filed Form 1023, *Application for Recognition of Exemption under section 501(c)(3) of the Internal Revenue Code* ("IRC"), with the Internal Revenue Service on February 27, 19xx. The Form 1023 stated that the organization was incorporated August 22, 19xx. The Restated Articles of Incorporation provided that its purpose is to acquire, establish, maintain and operate a general hospital in the vicinity of the city of , at which the corporation and its employees will administer medical care for the sick, infirm and helpless, the maimed and the afflicted of all creeds and nations, regardless of their ability to pay. The bulk of its revenue would be derived from patients. In a letter dated June 15, 19xx, the Internal Revenue Service granted ORG exemption under IRC section 501(c)(3).

By 19xx, however, the hospital was not financially viable. On November 26, 19xx, ORG submitted documentation to the Internal Revenue Service to inform them that ( ) was transferring control of ORG to the local board (for nominal consideration) and the local board would assume and be fully responsible for all operations of the hospital. All real property, fixtures, and equipment used in the operation of the general acute care hospital located in would be transferred from to ORG . The documentation also stated that ORG was considering entering into an agreement for consulting and management services with . The terms of the agreement stated shall be the contract manager and responsible for the day to day operations of the hospital beginning on the transfer date.

From 19xx until 19xx, ORG continued to operate a hospital and had a for-profit management, , conducting all of the day to day activities on their behalf. ORG still maintained control and reported patient revenues and all other revenues generated from hospital services on their Form 990, *Return of Organization Exempt from Income Tax*.

ORG entered an agreement with (for-profit) on April 24, 19xx, to lease the acute care facility: ORG ADDRESS



Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number		Year/Period ended.
ORG			January 31, 20XX

ORG leased its land, property and equipment to \_\_\_\_\_ for them to operate the acute care hospital under the name ORG. ORG turned over control of all hospital operations including collecting revenues to \_\_\_\_\_. \_\_\_\_\_ is currently operated by \_\_\_\_\_ a for-profit entity which specializes in operating rural hospitals.

The initial lease was for xx years, which ended in 20xx. Rent was \$xxx,xxx per year. As a part of the lease the for-profit agreed to provide charity care in each lease year in a manner consistent with the past practices of the hospital. Charity care shall be deemed to be the care provided to patients who are determined under the hospital's charity care policy in effect at the time of execution of the agreement to pay for their care, it being the intent of the parties to provide hospital care and related services to residents of the hospital's primary service area without regard to ability to pay. \_\_\_\_\_ x-year renewals are available under the original leases at a rate of \$xxx,xxx per year. \_\_\_\_\_ gave notice in 20xx as part of a lease amendment that it was exercising its first \_\_\_\_\_ lease renewals in connection with various capital improvements, in order to guarantee xx-year availability for depreciation purposes. The current xx-year lease was executed in 20xx (with a rent of \$xxx,xxx per year).

ORG disclosed the change in their activities on all of their Forms 990 from 19xx to present. The stated mission on the Form 990 is maintenance of acute care hospital. The program service accomplishment listed is: Operation of hospital leased to a for-profit to accomplish the stated goal of providing medical care to rural central \_\_\_\_\_. The \_\_\_\_\_ Report prepared by \_\_\_\_\_ annually state that \$x.x, \$x.x, and \$x.x million in charity care was provided during 20xx, 20xx, and 20xx, respectively. ORG also separately leases facilities used as a rural health clinic and adjacent to the hospital.

#### LAW:

Section 1.501(c)(3)-1(a)(1) of the regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will not be regarded as operated exclusively for exempt purposes if more than an insubstantial part of its activities is not in furtherance of exempt purposes.

Section 1.501(c)(3)-1(d)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, it is necessary for an organization to establish that it is not organized and operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

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, and includes the relief of the poor and distressed or of the underprivileged as well as the advancement of education.



Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer  ORG	Tax Identification Number	Year/Period ended  January 31, 20XX	

Section 1.501(c)(3)-1(e)(1) of the regulations provides that an organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purposes of carrying on an unrelated trade or business.

In *Better Business Bureau of Washington D.C., Inc. v United States*, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

An organization is not operated exclusively for charitable purposes, and thus will not qualify for exemption under section 501(c)(3), if it has a single noncharitable purpose that is substantial in nature. This is true regardless of the number or importance of the organization's charitable purposes. See *Stevens Bros. Foundation, Inc. v. Commissioner*, 324 F.2d 633 (8th Cir. 1963), *aff'd*, 39 TC 93 (1962), *cert. denied*, 376 US 969 (1964). Operating for the benefit of private parties who are not members of a charitable class constitutes such a substantial nonexempt purpose.

An organization is not described in IRC 501(c)(3) if it serves a private interest more than incidentally. See Rev. Rul. 76-152, 1976-1 CB 151. If, however, the private benefit is only incidental to the exempt purposes served, and not substantial, it will not result in a loss of exempt status. See *St. Louis Union Trust Co. v. United States*, 374 F.2d 427 (8th Cir. 1967). If an activity serves both exempt and nonexempt purposes, the organization will be exempt only if the predominant motivation underlying the activity is an exempt purpose.

A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must of necessity coexist with the activity which benefits the public at large. That is, the activity can be accomplished only by benefiting certain private individuals. Compare Rev. Rul. 72-559 (an organization is exempt which provides relief of the poor and distressed by providing training and salaries to recent law graduates who agreed to provide legal services to indigents) with Rev. Rul. 80-287 (an organization is not exempt under section 501(c)(3) which provides assistance to persons in need of legal services by operating a lawyer referral service).

Rev. Rul. 80-309, 1980-2 CB 183, January 1, 1980, a nonprofit organization was created to construct, maintain, and operate or lease a public hospital and related facilities for the benefit of a city and surrounding communities is operated exclusively for charitable purposes and qualifies for exemption under IRC section 501(c)(3).

After construction of these facilities, the organization's only activity was to lease facilities to an association exempt under IRC 501(c)(3). The lessee operates the facilities and pays as consideration an amount sufficient only to retire the organization's indebtedness incurred to finance the hospital and meet the organization's administrative expenses. The organization's income is derived from lease payments and disbursements are made for administrative expenses and retirement of indebtedness.

Rev. Rul. 73-313 provides that an organization formed and supported by residents of an isolated rural community to provide medical building and facilities at reasonable rent to attract a doctor who would provide medical services to the entire community is exempt under section 501(c)(3).



Form <b>886-A</b> (Rev. January 1994)	<b>EXPLANATIONS OF ITEMS</b>		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		January 31, 20XX	

The circumstances in this case reveal the following facts particularly relevant to the determination of whether the devotion of resources to the provision of a physical facility for medical practice in the manner described qualifies as a charitable use:

- The community was totally lacking in local medical service, and the isolation of the community was such that the lack of such services posed a real and substantial threat to the health and safety of the community.
- The lack of adequate facilities for the conduct of a medical practice in the community was shown to be a significant factor in the inability of civic leaders of the community to induce a doctor to locate in the community.
- Providing the physical facility in the manner described bears a clear relationship to lessening of the health hazards resulting from the absence of a local practitioner in the community.
- The terms of the arrangement entered to induce the doctor to locate his practice in the locality bear a reasonable relationship to promotion and protection of the health of the community. The arrangements in question were completely at arm's length, with no relationship between any person connected with the organization and operation of the organization and the medical practitioner induced to locate in the community.

Rev. Rul. 69-545 compares two hospitals. Hospital 1 is controlled by a board of trustees composed of independent *civic* leaders; maintains an open medical staff; operates a full-time emergency room open to all regardless of ability to pay; otherwise admits all patients able to pay; and uses surplus funds to improve the quality of patient care, expand facilities, and advance its medical training, education and research programs.

Hospital 2 is controlled by physicians who have a substantial economic interest in the hospital, restricts the number of physicians admitted to the medical staff, enters into favorable rental agreements with individuals who control the hospital, and limits emergency room and hospital admission substantially to the patients of the physicians who control the hospital.

Rev. Rul. 69-545 concludes that Hospital 1 is exempt, while the Hospital 2 is not, and notes that the fact that Hospital 1 operates at an annual surplus of receipts over disbursements does not preclude its exemption. By using its surplus funds to improve the quality of patient care, expand its facilities, and advance its medical training, education, and research programs, the hospital is operating in furtherance of its exempt purposes. Furthermore, Hospital 1 is operated to serve a public rather than a private interest. Control of the hospital rests with its board of trustees which is composed of independent civic leaders.

Rev. Rul. 98-15 provides examples illustrating whether nonprofit hospitals that participate in joint ventures with for-profit entities continue to qualify for exemption as organizations described in IRC 501(c)(3).

In Situation 1, A is an IRC 501(c)(3) corporation that owns and operates an acute care hospital and B is a for-profit corporation that owns and operates a number of hospitals.

A concludes that it could better serve its community if it obtained additional funding. B is interested in providing financing for A's hospital, provided it earns a reasonable rate of return. A and B form a limited liability company, C. A contributes all of its operating assets, including its hospital to C. B also contributes



Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number		Year/Period ended
ORG			January 31, 20XX

assets to C. In return, A and B receive ownership interests in C proportional and equal in value to their respective contributions.

C's Articles of Organization and Operating Agreement ("governing documents") provide that C is to be managed by a governing board consisting of three individuals chosen by A and two individuals chosen by B.

The governing documents further provide that they may only be amended with the approval of both owners and that a majority of three board members must approve certain major decisions relating to C's operation, including, decisions relating to any of the following topics:

- A. C's annual capital and operating budgets;
- B. Distributions of C's earnings;
- C. Selection of key executives;
- D. Acquisition or disposition of health care facilities;
- E. Contracts in excess of \$x per year;
- F. Changes to the types of services offered by the hospital; and
- G. Renewal or termination of management agreements.

The governing documents require that C operate any hospital it owns in a manner that furthers charitable purposes by promoting health for a broad cross section of its community. The governing documents explicitly provide that the duty of the members of the governing board to operate C in a manner that furthers charitable purposes by promoting health for a broad cross section of the community overrides any duty they may have to operate C for the financial benefit of its owners. Accordingly, in the event of a conflict between operation in accordance with the community benefit standard and any duty to maximize profits, the members of the governing board are to satisfy the community benefit standard without regard to the consequences for maximizing profitability. (emphasis added)

C enters into a management agreement with a management company that is unrelated to A or B to provide day-to-day management services to C. The management agreement is for a five-year period, and the agreement is renewable for additional five-year periods by mutual consent. The management company will be paid a management fee for its services based on C's gross revenues. The terms and conditions of the management agreement, including the fee structure and the contract term, are reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals. C may terminate the agreement for cause.

A intends to use any distributions it receives from C to fund grants to support activities that promote the health of A's community and to help the indigent obtain health care. Substantially all of A's grantmaking will be funded by distributions from C. A's projected grantmaking program and its participation as an owner of C will constitute A's only activities.

In Situation 2, D is an IRC 501(c)(3) corporation that owns and operates an acute care hospital and E is a for-profit hospital corporation that owns and operates a number of hospitals and provides management services to several hospitals that it does not own.

D concludes that it could better serve its community if it obtained additional funding. E is interested in providing financing for D's hospital, provided it earns a reasonable rate of return. D and E form a limited



Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer  ORG	Tax Identification Number		Year/Period ended January 31, 20XX

liability company, F. D contributes all of its operating assets, including its hospital to F. E also contributes assets to F. In return, D and E receive ownership interests proportional and equal in value to their respective contributions.

F's Articles of Organization and Operating Agreement ("governing documents") provide that F is to be managed by a governing board consisting of three individuals chosen by D and three individuals chosen by E. D tends to appoint community leaders who have experience with hospital matters, but who are not on the hospital staff and do not otherwise engage in business transactions with the hospital.

The governing documents further provide that they may only be amended with the approval of both owners and that a majority of board members must approve certain major decisions relating to F's operation, including decisions relating to any of the following topics:

- A. F's annual capital and operating budgets;
- B. Distributions of F's earnings over a required minimum level of distributions set forth in the Operating Agreement;
- C. Unusually large contracts; and
- D. Selection of key executives.

F enters into a management agreement with a wholly-owned subsidiary of E to provide day-to-day management services to F. The management agreement is for a five-year period, and the agreement is renewable for additional five-year period at the discretion of E's subsidiary. F may terminate the agreement only for cause. E's subsidiary will be paid a management fee for its services based on gross revenues. The terms and conditions of the management agreement, including the fee structure and the contract term other than the renewal terms, are reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals.

As part of the agreement to form F, D agrees to approve the selection of two individuals to serve as F's chief executive officer and chief financial officer. These individuals have previously worked for E in hospital management and have business expertise. They will work with management company to oversee F's day-to-day management. Their compensation is comparable to what comparable executives are paid at similarly situated hospitals.

D intends to use any distributions it receives from F to fund grants to support activities that promote the health of D's community and to help the indigent obtain health care. Substantially all of D's grantmaking will be funded by distributions from F. D's projected grantmaking program and its participation as an owner of F will constitute D's only activities.

Rev. Rul. 98-15 cites a number of court cases in analyzing the Situations 1 and 2. In Broadway Theatre League of Lynchburg, Virginia, Inc. v. U.S., 293 F. Supp. 346 (W.D.Va.1968) ("Broadway Theatre League"), the court held that an organization that promoted an interest in theatrical arts did not jeopardize its exempt status when it hired a booking organization to arrange for a series of theatrical performances, promote the series and sell season tickets to the series because the contract was for a reasonable term and provided for reasonable compensation and the organization retain ultimate authority over the activities being managed.



Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer  ORG	Tax Identification Number	Year/Period ended January 31, 20XX

In est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), aff'd in unpublished opinion 647 F.2d 170 19th Cir. 1981 ("est of Hawaii"), several for-profit est organizations (Note: "est" stands for Erhard Seminars Training) exerted significant indirect control over est of Hawaii, a non-profit entity, through contractual arrangements. The Tax Court concluded that the for-profits were able to use the non-profit as an "instrument" to further their for-profit purposes. Neither the fact that the for-profits lacked structural control over the organization nor the fact that amounts paid to the for-profit organizations under the contracts were reasonable affected the court's conclusion. Consequently, est of Hawaii did not qualify as an organization described in IRC 501(c)(3).

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir 1974) ("Harding"), a non-profit hospital with an independent board of directors executed a contract with a medical partnership composed on seven physicians. The contract gave the physicians control over care of the hospital's patients and the stream of income generated by the patients while also guaranteeing the physicians thousands of dollars in payment for various supervisory activities. The court held that the benefits derived from the contract constituted sufficient private benefit to preclude exemption.

Rev. Rul. 98-15 provides that an IRC 501(c)(3) organization may enter into a management contract with a private party giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets **provided that the organization retains ultimate authority over the assets and activities being managed** (emphasis added) and the terms and conditions of the contract are reasonable, including reasonable compensation and a reasonable term. See Broadway Theatre League. However, if the private party is allowed to control or use the non-profit organization's activities and assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes. See est of Hawaii; Harding; section 1.501(c)(3)-1(c)(1); and section 1.501(c)(3)-1(d)(1)(ii).

In its analysis of Situation 1, Rev. Rul. 98-15 states that the governing documents of C commit C to providing health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits for C's owners. Furthermore, through A's appointment of members of the community familiar with the hospital to C's board, the board's structure, which gives A's appointees voting control, and the specifically enumerated powers of the board over changes in activities, disposition of assets, and renewal of the management agreement, A can ensure that the assets it owns through C and the activities it conducts through C are used primarily to further exempt purposes.

With respect to Situation 2, Rev. Rul. 98-15 concludes that in absence of a binding obligation in F's governing documents for F to serve charitable purposes or otherwise provide its services to the community as a whole, F will be able to deny care to segments of the community, such as indigent. Because D will share control of F with E, D will not be able to initiate programs within F to serve new health needs within the community without the agreement of at least one governing board member appointed by E. As a business enterprise, E will not necessarily give priority to the health needs of the community over the consequences for F's profits. The primary source of information for board members appointed by D will be its chief executives, who have a prior relationship with E and the management company, which is a subsidiary of E. The management company itself will have broad discretion over F's activities and assets that may not always be under the board's supervision. For example, the management company is permitted to enter into all but "unusually large" contracts without board approval. Thus, D will fail the operational test when it forms F, contributes its operating assets to F, and then serves as an owner to F.



Form <b>886-A</b> (Rev. January 1994)	<b>EXPLANATIONS OF ITEMS</b>	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended
ORG		January 31, 20XX

Rev. Rul. 98-15 holds that A will continue to qualify as an organization described in IRC section 501(c)(3) because it has established that it will be operating exclusively for charitable purpose and only incidentally for the purpose of benefiting the private interests of B.

Conversely, D will violate the requirements to be an organization described in IRC section 501(c)(3) when it forms F and contributes all of its operating assets to F because D has failed to establish that it will be operated exclusively for exempt purposes.

### TAXPAYER'S POSITION:

ORG provided the following timeline of the hospital during the examination:

In 19xx, the community of , raised money to build a hospital and the doors opened in January 19xx. The hospital was sold to . The hospital Board of Trustees reverted to the to manage a trust that was created after the sale of the hospital.

In 19xx, was going to close the hospital. The hospital had been reduced to a shell and there was no money in the bank. The community purchased the hospital for \$x.xx.

In 19xx took over the management of the hospital.

In 19xx the hospital was renamed ORG .

In 19xx leased the hospital.<sup>1</sup>

In 20xx merged with and they continue to lease the hospital today.<sup>2</sup>

The mission of ORG is to have enough funds to keep the hospital operational in case of default until new management could be located. The hospital administration reports to the ORG board at least annually. They present statistics, surveys, and areas of concern from the previous year and address plans and concerns for the upcoming year. serves on both the ORG and hospital operating board. He reports back to ORG board on any topics of concern to our board. At the requests of hospital administration, ORG reinvests into the physical plant.

ORG intends to reapply for exemption, possibly under another Code section (i.e. 501(c)(2)) after the revocation is final.

### GOVERNMENT'S POSITION:

The 501(c)(3) tax exempt status of ORG should be revoked because it is not operated exclusively for tax exempt purposes. An organization described in IRC section 501(c)(3) must establish no more than an

<sup>1</sup> & <sup>2</sup> ORG has not provided any information regarding and . They believe these entities are subsidiaries of .



Form <b>886-A</b> (Rev. January 1994)	<b>EXPLANATIONS OF ITEMS</b>		Schedule number or exhibit
Name of taxpayer	Tax Identification Number		Year/Period ended
ORG			January 31, 20XX

insubstantial part of its activities is not in furtherance of an exempt purpose. Treas. Regs. 1.501(c)(3)-1(c)(1).

ORG did not omit or misstate a material fact, but operated in a manner materially different from that was originally represented in its Application of Exemption. Following financial difficulties, the prior 501(c)(3) operator, who had applied for exemption, returned control of the hospital to the community. Then, between 19xx and 19xx, ORG, governed by a community board, first transferred management and then operational control over the hospitals operations to (now ), a for-profit entity. Although it attempted to ensure that exempt purposes were being met by inserting a requirement that provide charity care, ORG ceded complete control over the hospitals operation to a for-profit entity and only maintained an advisory role.

ORG notified the Service of a proposed change in activities in documentation submitted to the Service in 19xx. disclosed the current nature of its operations in Forms 990 they filed from 19xx to present, following the lease arrangement with ; the returns were regularly and timely filed by the all- volunteer community board. However, ORG did not formally notify the Service of the change in activities, nor did it seek an affirmation letter or private letter ruling to confirm that it continued to qualify for exemption.

There is some argument that ORG's arrangement with served exempt purposes by maintaining land, building and equipment of a hospital to ensure it would continue to be available to the public in a rural community. Maintaining and leasing medical facilities via a lease to an individual or entity to provide medical care in a rural community under certain circumstances can be considered to constitute exempt purposes, i.e. Revenue Rulings 70-313 and 80-309. The facilities at issue are located in a rural area which promotes the welfare of the community.

However, ORG has not provided sufficient information to demonstrate that its arrangement is sufficiently analogous to these authorities, including whether the devotion of resources to the provision of a physical facility for medical practice in the manner described qualifies as a charitable use as in Revenue Ruling 70-313: for example, very little information has been provided to show that the terms of the lease, such as the amount of rent the for-profits ability to induce the taxpayer to make certain capital improvements for their use, bear a reasonable relationship to the promotion and protection of the health of the community, or that .Further, unlike the hospital situation in Revenue Ruling 80-309, ORG is leasing the facilities to a for-profit corporation rather than to another non-profit corporation.

An overriding factor in the revenue rulings and court decisions cited above for determining whether a hospital functions in an exempt manner is control over the operation for exempt purposes. The taxpayer has demonstrated no control over the operations or within its lease arrangement with . Although not exactly like either of the two hospitals discussed in Rev. Rul. 69-545, ORG is much more like the (non-exempt) hospital in Situation 2, which is controlled by physicians who have a substantial economic interest in the hospital. The exempt hospital in 69-545 is controlled by a board of trustees composed of independent civic leaders.

Although there is some language in the lease agreement designed to enhance public benefit, as agreed to provide charity care in each lease year in a manner consistent with the past practice of the hospital, it does not appear that the ORG has any ability to enforce this provision. These provisions notwithstanding, the control of the hospital by a for-profit entity guarantees a focus on the



Form <b>886-A</b> (Rev. January 1994)	<b>EXPLANATIONS OF ITEMS</b>		Schedule number or exhibit
Name of taxpayer	Tax Identification Number		Year/Period ended
ORG			January 31, 20XX

bottom line, not the welfare of the general public, and in the event of a conflict between operation in accordance with the community benefit standard and the duty to maximize profits; would be free to give deference to the latter.

Rev. Rul. 98-15, which discusses when a joint venture between a for-profit and a non-profit can constitute exempt function, makes it clear that the arrangement between ORG and comes nowhere close to qualifying under this standard. In order to protect its exempt status (and/or avoid unrelated business income tax), the tax-exempt organization must maintain control of the joint venture. In situation A (i.e., the hospital ruled to qualify for 501(c)(3) status), the governing documents of the limited liability company formed to run the hospital provide that it is to be managed by a governing board consisting of three individuals chosen by the hospital and two chosen by the for-profit partner. This guarantees that the 501(c)(3) entity will maintain ultimate control over the hospital. As previously stated, there is language in the governing documents which effectively prevents the for-profit partner from amending the governing documents. The governing documents require that the limited liability company operate the hospital in a manner that furthers charitable purposes by promoting health for the broad cross section of its community. Furthermore, in the event of a conflict between operation in accordance with the community benefit standard and any duty to maximize profits, the members of the governing board are to satisfy the community benefit standard without regard to the consequences for maximizing profitability.

These types of safeguards insure that the hospital will be operated in accordance with IRC 501(c)(3) requirements. ORG's lease, conversely, gives total operational control over to the for-profit entity which insures that profit maximization will be the guiding principle under which the hospital operates, with the only restrictions being the maintenance of an acute care hospital and charity care policy. This is not nearly enough for a hospital to qualify under IRC 501(c)(3). An exempt hospital's entire focus must be on community welfare. This would involve determining the health needs of the community and enacting educational and other programs designed to both prevent and address community health problems. These are typically the types of activities that for-profit healthcare providers do not involve themselves in because they are a drain on the entity's financial resources. ORG has even less control over operations than the entity in Revenue Ruling 98-15, Situation 2, which discusses an arrangement in which the exempt entity lacked sufficient control for the joint venture in order for the arrangement to qualify as an exempt activity.

Rev. Rul. 98-15 concludes that an IRC 501(c)(3) organization may enter into a management contract with a private party giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets provided that the organization retains ultimate authority over the assets and activities being managed. However, ORG does not retain ultimate control over the activities of the hospital; it concedes total operational control to the for-profit entity. Although the lease agreement states that the for-profit must provide hospital care and related services to residents of the hospital's primary service area without regard to ability to pay, there is no way for ORG to guarantee this occurs because they do not have access to the books and records of the for-profit.

ORG's lease with gave all of the income generated by operation of the hospital, over which had complete control. As in Harding, the benefits derived and continue to derive from the contract constitute sufficient private benefit to preclude exemption.

#### CONCLUSION:



Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer  ORG	Tax Identification Number		Year/Period ended  January 31, 20XX

ORG is not operated exclusively for 501(c)(3) purposes. You fail the operational test because you allowed an outsider for-profit entity to have complete control over your hospital operations. You did not exercise adequate discretion and control as required by IRC 501(c)(3).

It is recommended that ORG's tax-exempt status be revoked effective February 1, 20xx.

If the revocation is sustained, ORG is required to file Forms 1120 for all tax periods after February 1, 20xx.