UIL 501.03-11

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

199943049

Date: AUG - 2 1999

Contact Person:

ID Number:

Telephone Number:

Refer Reply To:
OP:E:EO:T:1

Employer Identification Number:
Key District Office:

Legend:

J =
K =
L =
M =

Dear Sir or Madam:

This is in response to a letter from your authorized representative requesting a series of rulings on your behalf regarding the tax consequences associated with the transaction described below.

J was created to coordinate the management of various health care institutions. It is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and is classified as a nonprivate foundation under section 509(a) of the Code. J currently operates L as a division of J.

K was formed to develop and operate an integrated health care services delivery network and is being recognized as exempt from federal income tax under section 501(c)(3) of the Code and is being classified as a nonprivate foundation under section 509(a) by letter of even date. K has two members, J and the incumbent members of the Executive Committee of the Board of Trustees of M, each having a membership interest of fifty percent (50%). Each member of K will appoint one-half of its board of directors. You have stated that K's board of directors has the power to manage, direct, control and exercise the affairs of the system and its business and property, subject to the reserved powers of the members.

L was formed to provide health care services and is being recognized as exempt from federal income tax under section 501(c)(3) of the Code and is being classified as a nonprivate foundation under section 509(a) of the Code by letter of even date. You have stated that as part of the transaction, L will lease substantially all the assets owned by J and used exclusively for the operation of L. Currently, the sole corporate member of L is J. After the transaction, you have stated that L will have two classes of membership, J and K.

263

M operates a general acute care hospital and is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a) of the Code.

You have stated that under the terms of a joint operating agreement, J, K, L and M have agreed to restructure their operations to develop and operate as an integrated health care services delivery network, specifically as a joint operating company providing certain operational and management services to L and M, the hospitals.

You have stated that the powers of the joint operating company, K, include: (a) determining the services provided and facilities offered by the hospitals, including the authority to direct the opening, closing, expansion, reduction and consolidation of facilities and patient care and administrative services or other major changes in operation of the hospitals; (b) monitoring and auditing hospital compliance with the directives of K issued in accordance with its direct and approval reserved powers and taking any action reasonably necessary in order to implement the above powers; (c) establishing the annual operating and capital budgets of the hospital and such interim budgets as the system member deems necessary or appropriate, other than the Hospital Directed Funds Budgets, which is defined in the joint operating agreement as the interim and annual operating and capital budgets approved from time to time by the governing body of a network participant that provides for the expenditure of hospital directed funds outside of those approved in a budget by the joint operating company, K, and establishing borrowing limits and terms for the borrowing of funds; (d) to direct the use of the system directed funds of the hospital, as defined in the joint operating agreement, including the making of capital contributions to the system, gifts, donations, and other transfers of system directed funds, which you have stated means that K will have direct control of up to 80% of the free cash flow of each hospital in any given fiscal year and indirect control over the remaining funds (hospital directed funds) of each hospital; (e) to initiate, waive, contest, settle or compromise any legal proceeding, suit, claim or action if the amount in controversy is five hundred thousand dollars ($500,000) or more; (f) to institute any judicial action or administrative appeal against any tax or other regulatory or governmental authority; (g) to acquire any real or personal property, tangible or intangible, other than those included in the annual budgets, other than an expenditure pursuant to the Hospital Directed Funds Budget; (h) to enter into, on behalf of a hospital, any managed care contract under which the hospital or any other health care facility owned or operated by the hospital will provide services, whether as a managed care contract applicable to one or more individual hospitals or to the hospitals as a group, consistent with the provisions of the joint operating agreement; (i) to adopt and modify general guiding principles regarding hospital operations (including contracting policies and parameters for managed care contracts and contracts for professional or other services with physicians) and an annual strategic plan for the hospital consistent with the mission of the hospital; (j) to execute agreements to affiliate with other hospitals, health care facilities, health systems or other persons; (k) to execute physician recruitment agreements; provided however, K may delegate to officers of the hospital the authority to execute, without the prior approval of K, physician recruitment agreements whose terms fall within such contracting parameters as may from time to time be established by K; (l) to make any capital expenditure in excess of one million dollars other than an expenditure pursuant to a hospital directed funds budget; (m) to initiate any maintenance or construction program in excess of one million dollars other than one under which the expenditures will be made pursuant to a hospital directed funds budget and (n) to contract with a third party to provide or to directly manage and direct the administrative, finance/accounting, cash management, information systems, human resources, business development/marketing, communications/public relations, governmental affairs,

purchasing, laundry and dietary functions of the hospitals, including without limitation, the adoption and modification of policies governing such functions.

You have stated that pursuant to the restructuring, the Articles of Incorporation and Bylaws of of K will designate J and the M Executive Committee as members of K. As such, J and the M Executive Committee have certain direct and approval reserved powers. The direct reserved powers of J consist of the sole and exclusive power to elect and remove, with or without cause, any or all of the J representative directors of K. The direct reserved powers of the M Executive Committee consist of the sole and exclusive power to elect and remove, with or without cause, any or all of the M representative directors of K. The approval reserved powers of J and the M Executive Committee consist of the power to approve or disapprove the following matters, after such matters have been recommended by the Board of Directors of K: (a) to amend, alter, restate, or repeal the Articles of Incorporation or the Bylaws of K; (b) to adopt a plan of merger, consolidation, dissolution or corporate reorganization involving K; (c) to approve the admission of a new network participant or other affiliation by a health care system or facility or other person with K; (d) to alter, amend, restate or repeal the mission statement of K; and (e) to approve amendments to the joint operating agreement. You have stated that action on any approval reserved power requires the approval of both J and the M Executive Committee.

You have stated that J has the following approval powers: (a) to alter, amend, restate or repeal the Articles of Incorporation or Bylaws of L; (b) to adopt a plan of merger, consolidation, dissolution or corporate reorganization involving L; and (c) to sell, transfer or otherwise dispose of any health care facility or other assets owned by L. You have stated that such actions are initiated by K.

You have stated that the Board of Trustees of M has the power to initiate action on the following matters: (a) to alter, amend, restate or repeal the Articles of Incorporation or Bylaws of M; (b) to adopt a plan of merger, consolidation, dissolution or corporate reorganization involving M; and (c) to sell, transfer or otherwise dispose of any health care facility or other assets owned by M. You have stated that such actions are initiated by the Board of Trustees of M and approved by K.

You have stated that action on the following matters with respect to M is initiated by the incumbent members of the executive committee of the Board of Trustees of M but no action shall be effective unless and until approved by K: (a) electing the Board of Trustees of the hospital from the nominees submitted by the incumbent members of the Executive Committee of the Board of Trustees of M (or a nominating committee thereof) and to remove trustees, with or without the requirement of cause therefor, whenever, in the judgement of the incumbent members of the Board of Trustees of M and K, the best interests of the hospital would be served; (b) to elect and remove the president/chief executive officer of the hospital, with or without the requirement of cause therefor, whenever the best interests of the hospital would be served and (c) to approve any amendment or other modification of the L lease.

You have stated that action on the following matters with respect to L shall be initiated by J, but no such action shall be effective unless and until approved by K: (a) electing the Board of Directors of the hospital from the nominees selected by J (or nominating committee thereof) in consultation with the Board of Directors of the hospital and to remove directors, with or without the requirement of cause therefor, whenever, in the judgement of J and K, the best interests of the hospital would be served thereby; (b) to elect, from nominees submitted by J in consultation with the Board of Directors of the hospital, and remove, with or without the requirement of cause

therefor, whenever, in the judgement of J and K, the best interests of the hospital would be served thereby, the president/chief executive officer of the hospital, and (c) to approve any amendment or other modification to the lease by L of the assets of J and used exclusively for the operation of L.

You have stated that in the event of a dispute, the joint operating agreement requires that the parties first conduct negotiations, then, if a dispute is still unresolved, engage in mediation and finally, if necessary, mandatory final and binding arbitration.

You have stated that the joint operating agreement contains a provision governing an approved withdrawal by a member; however, such a withdrawal may only occur after five years subsequent to the execution of the joint operating agreement, upon approval of the Board of Directors of K. Penalties for such an approved withdrawal include a 10% reduction in the proportionate share value to which the withdrawing network participant is entitled. In the event the withdrawal is not approved by K, the withdrawing member is subject to a 20% reduction in its proportionate value share of the assets of the system and bears the reasonable and necessary costs incurred by the system and other member(s) in connection with such withdrawal.

You have requested the following rulings in connection with this transaction:

(1) That the proposed restructuring will have no adverse impact on the tax-exempt and public charity status of J and that, following the restructuring, J will continue to qualify as an exempt organization under section 501(c)(3) of the Internal Revenue Code and as a public charity under section 509(a)(3) of the Code.

(2) That the proposed restructuring will have no adverse impact on the tax-exempt and public charity status of M and that, following the restructuring, M will continue to qualify as an exempt organization under section 501(c)(3) of the Internal Revenue Code and as a public charity under section 509(a)(1) of the Code.

(3) That neither the provision of management or other services nor any loans, capital contributions, and/or transfers of assets, personnel or resources among the parties will result in unrelated business income to any of the parties or otherwise adversely affect the tax-exempt status of any of the parties.

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.

Section 511(a) of the Code imposes a tax on the unrelated business income of organizations described in section 501(c).

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

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 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, in part, that a trade or business is related to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes; 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 goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes.

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 which 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 a trade or business which would be 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. 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 L and M under the common control of K so that the participating organizations are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of K'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

K'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; 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, the transfer of resources, goods, services and the payment of fees 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.

J and M will not adversely affect their tax exempt status under section 501(c)(3) of the Code by the proposed transactions as they will continue to promote health within the meaning of Revenue Ruling 69-545. 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 member as this activity promotes health within the meaning of Revenue Ruling 69-545. J and M will continue to qualify as nonprivate foundations under section 509(a) of the Code because the basis for their nonprivate foundation status will not change as a result of the proposed transaction.

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

(1) That the proposed restructuring will have no adverse impact on the tax-exempt and public charity status of J and that, following the restructuring, J will continue to qualify as an exempt organization under section 501(c)(3) of the Internal Revenue Code and as a public charity under section 509(a)(3) of the Code.

(2) That the proposed restructuring will have no adverse impact on the tax-exempt and public charity status of M and that, following the restructuring, M will continue to qualify as an exempt organization under section 501(c)(3) of the Internal Revenue Code and as a public charity under section 509(a)(1) of the Code.

(3) That neither the provision of management or other services nor any loans, capital contributions, and/or transfers of assets, personnel or resources among the parties will result in unrelated business income to any of the parties or otherwise adversely affect the tax-exempt status of any of the parties.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based.

These rulings are directed only to the organization that requested them. Section 6110(j)(3) of the Code provides that they may not be used or cited by others as precedent.

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.

We are informing your key District Director of this action. Please keep a copy of these rulings in your permanent records.

Sincerely,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1