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

199949038

Date:

SEP 07 1999

Contact Person:

ID Number:

Telephone Number:

OP:E:EO:T1

Employer Identification Number:
Key District Office:

Legend :

J =
K =
L =
M =
N =
Q =

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 is the sole member of K and parent of a regional health care delivery system and has been recognized as 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.

K, a subsidiary of J, provides health care services and has been recognized as 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.

L is the corporate member of M and has been recognized as 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.

M, a subsidiary of L, provides health care services and has been recognized as 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.

N, a subsidiary of K and L, provides health care services and has been recognized as 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.

Q is an operating unit of K which provides healthcare services in the same community as M.

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You have stated that M and Q propose to affiliate, which will provide for their common management through N, a joint operating company. You believe that consolidating service lines and thus patient volumes, can reduce excess capacity caused by declining inpatient utilization in the hospitals' service area.

You have stated that rather than create a new entity, the parties will amend the Articles of Incorporation and Bylaws of N and use it as the joint operating company. You have stated that the parties intend to centralize decision making powers in N, including management authority over M and Q. All corporate powers will be specifically vested in N, unless a power is specifically reserved or retained by the governing body of M and Q.

You have stated that the actions of the joint operating company, N, shall be binding on M and Q. N will have the power to consolidate the operations of M and Q and may itself become a provider of services. The powers of N include: (a) allocation or reallocation of services, programs and equipment between M and Q; (b) authorization of funding and capitalization of new services, equipment and joint ventures; (c) incurrence of capital expenditures less than or equal to $3,000,000; (d) authorization of the purchase of services, including the purchase of services or participation in the initiatives, programs and services of J or K, consistent with the provisions of the joint operating agreement; (e) establishment of quality and performance measurements; (f) establishment of compensation and benefit policies; provided that such policies shall not cause any pension plan of the parties to fail to satisfy any applicable tax qualification requirement; (g) development of an organizational structure for the hospitals; (h) development of a purchasing program and data system for the hospitals consistent with the provisions of the joint operating agreement; (i) development of common accounting systems for linkage among the hospitals, L and K; (j) initiation, defense or settlement of legal actions in accordance with policies developed by the Boards of Directors of N and approved by K in respect of Q and by L in respect of M; (k) recommendation to an individual member of the incurrence of long term debt; (l) development and recommendation to the members of the annual operating and capital budget and the strategic business plan for M and Q; (m) recommendation to the members of the sale, lease, exchange, transfer or other disposition of assets or the encumbrance of assets of the hospitals or to the respective members, of the merger, consolidation, dissolution or liquidation of a hospital; (n) approval of any certificate of need application for the joint operating company, M or Q; (o) binding the hospitals to contracts including managed care contracts, in accordance with the provisions of the affiliation agreement and executing such contracts on behalf of and in the name of each hospital; (p) establishment or setting of the fees for services to be provided by the hospitals; (r) taking or causing to be taken any or all actions necessary for M and Q to be in compliance with the terms of the affiliation agreement; (s) approval of the non-ex-officio voting members of the governing bodies of M and Q and (t) exercise of any right or power not expressly reserved, individually or collectively, to the members or expressly retained by the governing bodies of the hospitals.

You have stated that the affiliation agreement contemplates certain minimal, explicitly enumerated powers to be retained by the boards of M and Q. These powers, which are designed to allow compliance with the Joint Commission on Accreditation of Healthcare Organizations (JCAHO) and state law to maintain accreditation and licensure as an acute care facility, include the following: (a) compliance with standards of professional work in the hospital; (b) establishment of any policy providing for the investigation of unusual incidents which may occur; (c) credentialing of the medical staff of the hospital; (d) determination and implementation of standards of care of patients, including emergency care, of the hospital; (e) compliance with all JCAHO standards; (f)

establishment and compliance with a corporate compliance program for the hospital, including programs designed to detect or prevent health care fraud or improper third-party payor billing and activities regarding legal and regulatory compliance and (g) other responsibilities as may be required by state law, JCAHO or other accrediting body.

You have stated that there are also the following limited joint powers that K and L, the members of the joint operating company have reserved: (a) adoption, amendment, restatement or repeal of any provision of the Articles of Incorporation or Bylaws of any hospital which alters, modifies or otherwise affects or is inconsistent with any provision of the affiliation agreement; (b) approval of annual operating and capital budgets of any hospital, the financial and strategic plan of any hospital and any modification or change thereto which increases the total dollar amount of an approved budget or materially changes any strategic plan; (c) incurrence of capital expenditures by the hospital in excess of $3,000,000; (d) purchase of insurance coverage for the hospitals and (e) amendment, supplement or modification of the formula described in the affiliation agreement for the sharing of risks, liabilities, obligations and net revenues of the activities of the hospitals.

You have stated that each member of the joint operating company has certain reserved powers over the hospital of which it is also a member so that for certain actions to be binding on the hospital, the vote of K with respect to Q and L with respect to M will be required and include: (a) approval of any development or change to the philosophy or mission statement of the hospital; (b) approval or adoption of any amendment, restatement or repeal of the Articles of Incorporation or Bylaws of the hospital which is consistent with and does not nullify the powers granted to the joint operating company or the provisions of the affiliation agreement; (c) approval of the incurrence of indebtedness and guaranteeing of indebtedness by the hospital or the encumbering of any assets of the hospital, including the granting of any mortgages, security interests or other liens; (d) approval of the sale, lease, exchange transfer or other disposition of any assets that are not managed or controlled by the joint operating company; (e) approval of the merger, consolidation, dissolution or liquidation of the hospital and (f) in the case of L, appointment and removal, with or without cause, of members of the board of M or in the case of K, appointment and removal, with or without cause, of the members of the board of Q, subject in both cases, with respect to appointments, to the prior approval of the joint operating company.

You have stated that the affiliation agreement includes certain other provisions which grant the members the following powers: (a) electing the at-large directors of the joint operating company from candidates nominated by the nominating committee of the joint operating company; (b) removing at-large directors in limited situations; (c) adopting, amending, modifying, restating, or repealing the Articles of Incorporation and Bylaws of the joint operating company; (d) appointing the joint operating company's chief executive officer after recommendation of the board of the joint operating company; (e) approval of budgets and strategic plans of the joint operating company; (f) approval of the joint operating company's long-term debt; (g) approval of the incurrence of capital expenditures in excess of $3,000,000; (h) approval of any encumbrance, lease, sale, exchange, transfer or other disposition of any of the joint operating company assets in excess of $3,000,000 or within such other limits to be established by the members; (i) approval of the sale, lease, transfer, exchange or other disposition of all or substantially all the asserts of the joint operating company; (j) approval of the merger, consolidation, or dissolution of the joint operating company and the distribution of assets upon any such disposition or dissolution; (k) approval of the purchase of insurance for the joint operating company and (l) approval of any policy developed by the joint operating company for initiating, defending, or settling actions involving the joint operating company or both hospitals.

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

(1) That the affiliation of the parties as contemplated by the affiliation agreement through the joint operating company and the amendments to the parties' governing documents, will not jeopardize or otherwise be inconsistent with the continuing exempt status of N (the joint operating company), J, K, L, and M under section 501(c)(3) of the Internal Revenue Code.

(2) That the status of N (the joint operating company), J, K, L and M as other than private foundations under section 509(a) of the Code will not be jeopardized by the proposed affiliation.

(3) That the transfer of resources, the sharing or provision of goods, facilities and services and the payment of fees among N, J, K, L and M as contemplated by the affiliation agreement through the joint operating company will not produce unrelated business income under section 511, 512, 513 or 514 of the Code.

Section 501(a) of the Code provides an exemption from federal income tax for organizations described in section 501(c)(3), including organizations that are organized and operated exclusively for charitable, educational or scientific purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

Revenue Ruling 69-545, 1969-2 C.B. 117, recognizes that the promotion of health is a charitable purpose within the meaning of section 501(c)(3) of the Code.

Revenue Ruling 78-41, 1978-1 C.B. 148, concludes that a trust created by an exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the hospital is operated exclusively for charitable purposes and is exempt under section 501(c)(3) of the Code.

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) of the regulations, 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 example 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 M and Q under the common control of N so that the participating organizations are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of N'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 N's governing body to develop and recommend to the members the annual operating and capital budget and the strategic business plan for M and Q; to direct their provision of health care services, bind the hospitals to contracts including managed care contracts, approve capital expenditures within set limits 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, K, L, M, N and Q 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 entity member as this activity promotes health within the meaning of Revenue Ruling 69-545. J, K, L, M, N and O will continue to qualify as nonprivate foundations under section 509(a) of the Code.

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

(1) That the affiliation of the parties as contemplated by the affiliation agreement through the joint operating company and the amendments to the parties governing documents, will not jeopardize or otherwise be inconsistent with the continuing exempt status of N (the joint operating company), J, K, L, and M under section 501(c)(3) of the Internal Revenue Code.

(2) That the status of N (the joint operating company), J, K, L and M as other than private foundations under section 509(a) of the Code will not be jeopardized by the proposed affiliation.

(3) That the transfer of resources, the sharing or provision of goods, facilities and services and the payment of fees among N, J, K, L and M as contemplated by the affiliation agreement through the joint operating company will not produce unrelated business income under section 511, 512, 513 or 514 of the Code.
As to L:

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