

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

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E.I.N.

LEGEND

F=
C=
J=
A=
M=
S=
O=

Dear Sir/Madam:

You are requesting a ruling that the reorganization of F will not adversely affect the tax-exempt or public charity status of J, A, or C nor generate any unrelated business taxable income under section 511 of the Internal Revenue Code.

FACTS

BACKGROUND

F is exempt under section 501(c)(3) of the Code and is an organization described in section 509(a)(2) of the Code. F is the sole member of J and A. J and A are exempt under section 501(c)(3) of the Code. J is described in section 509(a)(2) of the Code and A is described in sections 509(a)(1) and 170(b)(1)(A)(iii).

F conducts programs of education in clinical medicine and medical science, medical research and comprehensive medical care. The clinical physician practice within F has always been referred to as C. F is also the sole member of two local section 501(c)(3) hospitals that provide inpatient and related services. These facilities are known as M. In addition, F is the sole member of a number of regional health care providers referred to as S.

A majority of the members of F's Board of Trustees are public trustees consisting of community and civic leaders. The balance of the Board is comprised of physician and administrative individuals from F. F has a substantive conflicts of interest policy.

Presently, both J and A are subsidiaries of F. Consequently, the education, research and medical practice activities at these sites are conducted in subsidiaries of F, while the activities conducted at C are performed directly in F.

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THE PROPOSED REORGANIZATION

With the growth of J and A operations and the need to coordinate strategic and other planning, policies, and fundraising across the entire S, F proposes to reorganize. F has adopted Restated Articles of Incorporation and Restated Bylaws, which change its name to C and creates a new parent corporation. The new parent corporation will be named F (to avoid confusion the new parent will be referred to as New F). At the same time, New F will become the sole member of J, A, and C. Because the new parent will be named New F, neither J or A will be required to amend their corporate documents because those documents now provide that F is the sole member. Consequently, the subsidiary organizations of New F--C, J and A--will become brother-sister corporations. C will continue to serve as the parent of S.

For technical state law reasons and to implement the transaction on the desired effective date (January 1, 2000), New F has been incorporated as O. An amendment, operative on the effective date, will change the name of O back to New F. Again, to avoid confusion, O will still be referred to as New F.

New F, simultaneously with this ruling, has been recognized as exempt under section 501(c)(3) of the Code and is other than a private foundation because it is an organization described in sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code.

As organized, New F will be involved in overall strategic planning, overall policy development, system-wide medical education and medical research planning, capital and operating budgeting, capital and resource allocation, system-wide fundraising, system-wide human resource planning, legal compliance, system-wide accounting and reporting, and oversight of taxable entities within the system. Each of the operating organizations that New F will be the sole member of will be responsible for implementation of system-wide policies, coordination of medical education, medical research and clinical care delivery for the region for which it has accountability.

New F will be funded primarily by assessments from the operating entities for their allocated portion of system-wide functions, cost sharing arrangements and fundraising activities. New F will also hold and/or manage portions of the investment portfolio of S.

Like A and J, C will have a Board of Directors which consists of physicians and administrators employed by C. A's and J's boards will be responsible for the day-to-day medical education, medical research and clinical operations of their respective organizations. New F as the sole member has the following important structural and financial reserved powers over A, J, and C that require its approval or action:

- approval of capital, operating, research and education budgets and capital expenditures
- compensation of employed physicians
- incurrence of debt
- sale or transfer of assets other than in the ordinary course of business

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- election of the members of the Board of Directors (through its right to amend the Bylaws, the member may also ultimately remove C Directors)
- election of the CEO
- amendment of Articles of Incorporation and Bylaws

In addition, New F has the right to approve mergers, dissolution and major corporate transactions. Finally, in connection with major policy issues, New F has the power to establish policies that must be adopted and followed by the other entities within S, including A, J and C. The policies include human resources, employee compensation and benefits, risk management, labor relations, fundraising, governmental relations and public affairs, cash management and tax-exempt financing, materials management, and information systems.

RULINGS REQUESTED

- (1) The implementation of the reorganization will not adversely affect C's, J's and A's section 501(c)(3) status.
- (2) The implementation of the reorganization will not adversely affect or change the status as other than a private foundation under section 509(a)(2) of the Code of C and J and section 509(a)(1) and 170(b)(1)(A)(iii) of A.
- (3) The flow of funds or accounting entries between New F and C, J and A reflecting assessments for administrative and other services performed by New F or other exempt affiliated entities within S, as cost allocations for administrative and other services, as distributions of cash without consideration, as a result of the reorganization or structure of the organizations, will not result in unrelated business taxable income to New F, C, J and A within the meaning of section 511 of the Code.
- (4) The transfer of assets from C to New F to permit New F to manage investment funds on behalf of the entire S will not result in unrelated business taxable income to the organization within the meaning of section 511 of the Code.

LAW AND RATIONALE

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 taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code defines the term unrelated business taxable income as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions, computed with the modifications listed in section 512(b).

Section 512(b)(3) of the Code provides generally that rents from real property (and its incidental related personal property) are not unrelated business income unless the property is debt-financed under section 514 of the Code. Debt-financed property does not include any property substantially related to the exercise or performance by such organization of its charitable functions.

Section 512(b)(4) of the Code requires that notwithstanding paragraphs (1), (2), (3) or (5), the net income realized with respect to debt-financed property must be included in unrelated business taxable income.

Section 512(b)(5) of the Code exempts from the definition of unrelated business taxable income all gains and losses from the sale, exchange or other disposition of non-inventory items and items not held for sale in the ordinary course of business.

Section 512(b)(13) of the Code limits the exclusion of interest, annuities, royalties, and rents provided by section 512(b)(1), (2), and (3) where such amounts are derived from a controlled organization.

Section 1.512(b)-1(1) of the regulations provides that if an exempt organization has control of another organization, the controlling organization shall include as an item of gross income in computing its unrelated business taxable income the amount of interest, annuities, royalties, and rents derived from the controlled organization, determined in accordance with the formula described in section 512(b)(13) of the Code and section 1.512(b)-1(1)(3) of the regulations.

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 income or 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 that a trade or business is related to exempt purposes, in the relevant sense, only where the conduct of business activities has a causal relationship to the achievement of exempt purposes; and it is substantially related only if the causal relationship is a substantial one. The regulation states that for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 514 of the Code provides for the taxation under section 512 of income from debt-financed property. Section 514(b)(1)(A)(i) of the Code, however, provides that the definition of debt-financed property does not

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include any property substantially all the use of which is substantially related to the exercise or performance by such organization of the charitable purposes constituting the basis for its exemption under section 501.

ANALYSIS

The purposes of J, A and C will not change as a result of the proposed reorganization and the corresponding amendments to their respective Articles of Incorporation and Bylaws. Each of these organizations will continue to operate to accomplish its respective exempt purposes under section 501(c)(3) of the Code. Therefore, neither the act of reorganization nor the resulting organizational structure will adversely affect J's, A's and C's continued exemption under section of 501(c)(3) of the Code.

Because J, A, and C will continue to receive their support from the same sources after the reorganization, the reorganization will not adversely affect their respective classification as non-private foundations.

As a parent, New F will provide guidance and direction to all of the affiliated tax-exempt organizations in S. New F will also serve as a mechanism for coordinating the activities of all of the affiliates in S in support of their charitable purposes. New F will be considered an integral part of the system within the meaning of Rev. Rul. 78-41.

The reorganization transfer and related transactions by J, A, C and New F will not adversely affect their exempt status because the transferred assets will be put to the same charitable uses. The tax on unrelated business income imposed by section 511 of the Code will not be applicable with respect to the transactions among the tax-exempt affiliated organizations of S because section 513(a) of the Code excludes from the definition of unrelated trade or business any trade or business which contributes importantly to the accomplishment of an organization's exempt purpose. The proposed asset transfers and provisions of services among the affiliated tax exempt entities within S will contribute to their mission of health care in the community. Therefore, the reorganization and transactions described above will not result in unrelated business income under sections 511 through 514 of the Code for J, A, C and New F.

CONCLUSION

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

1. The implementation of the reorganization will not adversely affect C's, J's and A's section 501(c)(3) status.
2. The implementation of the reorganization will not adversely affect or change the status as other than a private foundation under section 509(a)(2) of the Code of C and J and section 509(a)(1) and 170(b)(1)(A)(iii) of A.
3. The flow of funds or accounting entries between New F and C, J and A reflecting assessments for administrative and other services performed by New F or other exempt affiliated entities within S, as cost allocations for administrative and other services, as distributions of cash without consideration, as a result of the reorganization or structure of the organizations, will not result in unrelated business

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taxable income to New F, C, J and A within the meaning of section 511 of the Code.

4. The transfer of assets from C to New F to permit New F to manage investment funds on behalf of the entire S will not result in unrelated business taxable income to the organization within the meaning of Section 511 of the Code.

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.

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

These rulings are based on the understanding that there will be no material change in the facts upon which they are based. Any changes that may have a bearing on your tax status should be reported to the Service. We are informing your key District Director of these rulings. Please keep this ruling letter in your permanent records.

Sincerely yours,
Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1