200004041

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

Date: NOV 0 2 1999

Contact Person:

ID Number:

Telephone Number:

UIL 511.00-00

In reply refer to:
OP:E:EO:T:1

E.I.N.

LEGEND

H=
G=
S=
C=
V=

Dear Sir/Madam:

You requested a ruling that the reorganization of H will not adversely affect H's, G's or S's tax exempt and public charity status nor generate for H, G or S any unrelated business taxable income under sections 511-514 of the Internal Revenue Code.

FACTS

G is a not-for-profit hospital. G is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a public charity under sections 509(a)(1) and 170(b)(1)(A)(iii).

H is a non-profit corporation. On February 2, 1998 H was recognized as exempt under section 501(c)(3) of the code and received a section 509(a)(2) advanced ruling. H was formed to own and operate a therapy center. However, H now plans to own and operate medical clinics and physician practices. Thus, after the reorganization, H expects to qualify as a section 509(a)(1) and 170(b)(1)(A)(iii) public charity.

S is exempt under section 501(c)(3) of the Code and is other than private foundation under section 509(a)(3). S is the sole member of G and H. S is responsible for strategic planning, resource allocation, supervision, oversight and coordination of health care activities of the affiliated system. S has the following reserved powers and reserves the right and authority to perform the following acts with respect to each of its subsidiaries:

1. amend the Articles of Incorporation or Bylaws of the Corporation;

2. adopt any operating budget or capital budget or strategic plan of the Corporation;

3. acquire, sell, transfer or otherwise dispose of any assets of the Corporation, in any transaction or group of related transactions, excluding transactions occurring in the

ordinary course of business and transactions previously approved as part of the Corporation's budget or strategic plan;

4. adopt marketing and business strategies for, or policies governing operational functions of, the Corporation;

5. reorganize, merge or consolidate the Corporation with any other Corporation or entity, liquidate or dissolve the Corporation, or voluntarily file any petition in bankruptcy with respect to the Corporation;

6. approve the acquisition or control by the Corporation of, or the affiliation of the Corporation with, any other entity; or

7. distribute the assets of the Corporation to any entity other than S upon dissolution.

C was incorporated as a taxable corporation on October 18, 1995. C provides management services to both affiliated and unrelated physician practices. The sole shareholder of C is V, a taxable corporation. The sole shareholder of V is S.

Proposed Transaction

G created primary care clinics to provide care to the indigent and the needy in its service community. These clinics provided a lower cost alternative than having the patients come to the hospital's emergency room. However, recently, development of a primary care network was necessitated by the prevalent use of primary care physicians as gatekeepers by managed care health plans. Thus, in 1995 C was formed and the clinics owned by G were moved to C in order to facilitate managed care contracting. The formation of C as a taxable corporation also enabled it to manage physician practices that were not owned by G or C.

Currently, C owns and operates seventeen primary care clinics. Of the seventeen, eight of the practices were acquired from the local county hospital authority. Five practices were started up by C. The remaining four practices were purchased by C directly from physicians. The submission provides details on which practices were purchased, the physician(s) involved in the practice, the purchase price, the amount of goodwill purchased, and a copy of an independent fair market valuation dated before the purchase.

C now wants to transfer the medical practices to H. C will distribute the assets (both tangible and intangible) to V as a dividend distribution. V will transfer the assets to S. S will then transfer the assets to H. The management of these practices and the services provided to other nonaffiliated physicians and medical groups will continue to be conducted by C. The employment contracts with physicians will be assigned to H from S subject to a management agreement between C and H. H will enter into an agreement with C for C to manage the physician practices and medical clinics. The agreement will be structured on a cost plus fair market value markup basis.

You state that sufficient cash to provide working capital will be transferred by S to H at the consummation of the reorganization. Following the initial transfer, you anticipated that there may be further cash transfers among H, G and S. Further, these entities may share some assets, personnel and services in an effort to reduce, through economies of scale, the overall cost of providing health care services.

You state H will provide care for individuals who are unable to pay for medical services, as well as individuals covered under Medicare and Medicaid programs. All of H's clinics will provide treatment to individuals in need of immediate medical treatment regardless of the individual's ability to pay. For follow-up or continuing care, patients will continue to be treated by H physicians or they will be referred to the appropriate care provider within the S.

You state H's board of directors will be representative of the community. The board of S will have the authority to appoint H's board. No physician having a financial interest in H or any of its affiliates will be a member of the board.

RULINGS REQUESTED

1. After the amendment of H's Articles of Incorporation and Bylaws and the proposed change in activities, H will continue to be exempt from income tax under section 501(c)(3) of the Code.

2. After the proposed reorganization, H will qualify as an organization described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

3. The proposed transfers of cash and other assets and the sharing of personnel, services, facilities and expenses by and among H, G, and S, will not (a) jeopardize the continued tax-exempt status of H, G, and S; (b) adversely affect H's, G's, or S's status as public charities under section 509(a)(1) and 509(a)(3); or (c) give rise to unrelated business taxable income under sections 511-514 to H, G, or S.

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 509(a)(1) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) of the Code other than an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)). Organizations described in section 170(b)(1)(A)(iii) of the Code include organizations whose principal purpose is the provision of medical or hospital care. Section 1.170A-9(c)(1)(ii) of the Income Tax Regulations states that an outpatient clinic may qualify as a hospital if its principal purpose is the provision of hospital or medical care.

Section 509(a) of the Code provides that the term "private foundation" means an organization described in section 501(c)(3) other than one described in section 509(a)(1), (2), (3), or (4).

Section 509(a)(3) of the Code excludes from the definition of a private foundation an organization which is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or 509(a)(2).

Section 509(a)(3) of the Code describes an organization which is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in sections 509(a)(1) or 509(a)(2). The supporting organization must also be operated, supervised or controlled by the supported organization; supervised or controlled in connection with the supported organization; or operated in connection with the supported organization in order to be classified as a public charity under section 509(a)(3).

Section 1.509(a)-4(a) of the regulations describes in general terms the various tests which a supporting organization must meet in order to be classified as an organization described in section 509(a)(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 noninventory 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 sections 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.

777

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-l(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)(l)(A)(i) of the Code, however, provides that the definition of debt-financed property does not include any property substantially all the use of which is substantially related to the exercise or performance by such organization of the charitable purposes constituting the basis for its exemption under section 501.

ANALYSIS

The purpose of H will not change as a result of the proposed reorganization and the corresponding amendments to its Articles of Incorporation and Bylaws. Although H was intended to accomplish charitable purposes by operating a therapeutic center, it now proposes to operate outpatient medical services in a charitable manner. Since the proposed activities will accomplish charitable purposes, H continues to be exempt under section of 501(c)(3) of the Code. Further, the reorganization, transfer and related transactions will not adversely affect G's or S's exempt status because the transferred assets will be put to a charitable use.

Because G will continue to receive support from the same sources after the reorganization, the reorganization will not adversely affect its classification as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code. However, the nature of H's support will change as a result of the reorganization. H will now receive its support from the provision of outpatient medical services; thus, it will be reclassified as an organization described in sections 501(a)(1) and 170(b)(1)(A)(iii) of the Code. Based on its relationship with G and H, S will continue to qualify as a supporting organization described in section 509(a)(3) of the Code.

As a parent, S will provide guidance and direction to H and G, its affiliated tax-exempt organizations. S will also serve as a mechanism for coordinating the activities of H and G in support of their charitable purposes. S will be considered an integral part of H and G within the meaning of Rev. Rul. 78-41. Therefore, the section 511 tax on unrelated business income will not be applicable to the transactions among H, G and 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 H, G and 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 H, G, or S.

CONCLUSION

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

1. After the amendment of H's Articles of Incorporation and Bylaws and the proposed change in activities, H will continue to be exempt from income tax under section 501(c)(3) of the Code.

2. After the proposed reorganization, H will qualify as an organization described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

3. The proposed transfers of cash and other assets and the sharing of personnel, services, facilities and expenses by and among H, G, and S, will not (a) jeopardize the continued tax-exempt status of H, G, or S; (b) adversely affect H's, G's, and S's status as public charities under section 509(a)(1) and 509(a)(3); or (c) give rise to unrelated business taxable income under sections 511-514 to H, G or S.

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

775