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

Date: MAR 2 2 2000

Contact Person:

UIL: 501.03-11
OP:E:EO:T1

ID Number:

Telephone Number:

Employer Identification Number:
Key District Office:

Q =
R =
S =
T =
U =
V =
W =

Dear Sir or Madam:

This is in response to a letter from your authorized representative regarding the tax consequences associated with the transactions described below.

Q, R, S, T, U, V and W are entities affiliated through common control in a health care system.

Q owns and operates a hospital that provides a variety of health care services and facilities within a regional area of a state. It is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

R owns and operates a hospital which is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii).

S operates a multi-specialty group medical practice which is

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exempt from federal income tax under section 501(c)(3) of the Code and has been classified as a nonprivate foundation under section 509(a)(3).

T operates a group model health maintenance organization which is exempt from federal income tax under section 501(c)(4) of the Code.

U provides management and consultative services, at cost, to members of the health care system. It is exempt from federal income tax under section 501(c)(3) and is classified as a nonprivate foundation under section 509(a)(3).

V is a for-profit corporation which is a wholly-owned subsidiary of W and provides management, consulting and medical services to health care providers both inside and outside the system.

W owns and controls the member corporations of the system and is exempt from federal income tax under section 501(c)(3) of the Code and has been classified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(vi).

S employs staff physicians at various locations in different communities within the service area of the system. It also contracts with non-employed physicians to provide physician services in certain areas. S provides physician services to T, which had previously employed its own physicians. S also conducts medical education programs and basic and clinical research programs in conjunction with Q, R and T. W exercises control over S through its power to appoint the Members of S who in turn elect the board of directors of S.

T is a federally qualified group model health maintenance organization which is exempt from federal income tax under section 501(c)(4) of the Code. It is a Medicare risk provider and it is currently negotiating to provide a Medicaid product. T is community rated and shifts the risk of excess utilization to its providers. All of T's physician services to its members are provided by or through S. Hospital services are provided through T's contractual arrangements with Q, R and other community hospitals. W is also the parent corporation of T and exercises control over T through its authority to appoint the Members of T who in turn elect its board of directors.

You have stated that in addition to providing health care to the community, Q, R and S are dedicated to the education of medical professionals. Specifically, you state that Q and R provide a

number of continuing education, residency and fellowship programs and operate a school that trains medical technologists. You also state that Q engages in significant medical education and research activities and that S was established to conduct research and educational activities along with Q. You state that S currently conducts continuing medical education programs in conjunction with Q, R and T.

Laboratory services are provided, in part, by Q, R and S for specimens sent to the laboratory by physicians who are under contract with S (but are not employed by S) in connection with physician services they provide to members of T.

You have stated that the collection of specimens from the physicians contracting with S is instrumental to the educational components of Q, R and S in the training of the medical students, interns and residents of your medical education programs. You have stated that residency and fellowship programs provided by Q and R in the areas of pathology, cytopathology, medicine, obstetrics and gynecology, dermatology and emergency medicine as well as the school of medical technologists are particularly reliant on the collection and testing of these specimens. You state that the greater the number of specimens, the greater the number of tests the students are able to perform and they are more likely to encounter a greater number of cultures that test positive which often provide the most beneficical learning experience. You also state that because the contract physicians typically treat patients who reside throughout a relatively broad geographic area, the collected specimens generally include a wider sampling of disease strains. You state that this would not be possible without the specimens provided by the contract physicians.

You have requested the following ruling:

Income to Q, R and S from the provision of laboratory services with respect to specimens referred by physicians under contract with S (but not employed by S), in connection with physician services they provide to members of T, is not unrelated business income under sections 511 through 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, acknowledges that the promotion of health is a charitable purpose within the meaning of section 501(c)(3) of the Code.

Revenue Ruling 85-109, 1985-1 C.B. 165, provides, in part, that the provision of laboratory testing on specimens needed in a hospital's medical education program, which are not obtained from patients of the hospital, may be substantially related to the exempt purposes of the hospital.

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 514(a) of the Code requires unrelated income attributable to debt-financed property to be included in the calculation of an organization's unrelated business taxable income.

Section 514(b) of the Code defines debt-financed property as any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year.

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 the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes.

Assuming that the testing of specimens referred to Q, R and S by physicians who are under contract with S (but are not employed by S) in connection with physician services they provide to members of T contributes importantly to the educational purposes of Q, R and S, because they are utilized in the education of students, residents, or interns, we rule that:

Income to Q, R and S from the provision of laboratory services with respect to specimens referred by physicians under contract with S (but are not employed by S) in connection with physician services they provide to members of T is not unrelated business income under sections 511 through 514 of the Code.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

This ruling is directed only to the organization that requested them. Section 6110(j)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling does 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 Office of this action. Please keep a copy of these rulings in your permanent records.

Sincerely,

Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1