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

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Contact Person:

Identification Number:

Telephone Number:
(202) 283-9453

T:EO:B1

Employer Identification Number:

Legend:

M =
L =
A =
B =

Dear Sir or Madam:

We have considered your ruling request regarding the federal income tax consequences of your participation in a joint venture with individuals and for-profit entities.

FACTS:

M is a not-for-profit organization that has been recognized as exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). It has been classified as a public charity described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

M was formed to own and operate A for treatment of patients in the community. The state agency reviewing the certificate of need determined that A should be owned by a not-for-profit corporation and jointly operated by local hospitals and local physicians. M's bylaws include a conflict of interest policy.

Pursuant to its bylaws, M provides such health care services to all persons in need

without regard to their ability to pay. Further, in accordance with its bylaws, M is required to budget and set aside a certain percentage of its gross revenues to be divided equally between two medical schools in the local area for certain related medical research projects. In addition, M sponsors a fellowship program for qualified physicians. M's primary financial support is from the operation of A.

Several years ago, M purchased B and participated in Federal Drug Administration ("FDA") trials regarding the use of B to treat certain ailments. B is a modified version of, and based on the same technology as, A. The FDA subsequently approved the use of B to treat certain ailments.

M determined that a need existed in its service area to provide B services to patients in the community. In order to increase the availability of B services, M entered into a joint venture with local physicians in order to obtain the necessary capital and expertise. Accordingly, M formed L, a limited liability company, to provide B treatment services to the community and to own and operate B.

Pursuant to L's Operating Agreement (the "Operating Agreement"), M will contribute B to L in exchange for its membership interest. B represents in value approximately 3 percent of M's total assets. B is only manufactured by one company, who sold B to M, and is the only such device of that kind approved by the FDA. Accordingly, a third party appraisal is difficult to attain. Therefore, the value of B utilized for purposes of determining the initial value of M's membership interest in L represents the purchase price of B to M.

Local physicians will contribute cash to L in exchange for membership interests in L. M will have at least a 60 percent interest in both the capital and profits of L. The physician members' aggregate interests in both capital and profits will not exceed 40 percent. M anticipates marketing interests to at least 40 physicians, so each physician will likely own no more than 1 percent of L.

These ownership interests are proportional to and equal in value to their respective contributions. All financial arrangements between M and the physician members will be negotiated on an arm's-length basis and will be based on fair market value.

Capital contributions to L and allocations of income, loss, deduction and credits will be in proportion to the members' percentage interests in L. There will be no special allocations of income or loss to any particular member of L. In the event of dissolution, following the payment of all debts and liabilities of L and the allocation of income, profits, losses and deductions, and after adjustments to the capital accounts required by applicable income tax regulations, the remaining funds will be distributed to the members to the extent of, and in proportion to, their positive capital account balances.

L will be operated by a Board of Directors, consisting of 3 directors appointed by M and 2 directors appointed by a majority of the physician members. Only M may remove any of the 3 directors its appoints. In order for there to be a quorum at Board meetings, at least 2 of the directors appointed by M must be present. L's Board of Directors elects all of L's officers.

M's Board representatives will be community leaders with experience in health care matters. They will not be on the medical staff of L or any affiliated hospitals, and will not otherwise engage in business transactions with M or L other than as an L Board member. In addition, L's Operating Agreement sets forth a Conflict of Interest Policy to address any transactions or arrangements between L Board members and L. None of the officers, directors, or key employees of M or those of the affiliate hospitals that were involved in the decision to form L were promised employment or other inducement, including monetary, by L or any of the physicians in regard to the formation of L.

The Operating Agreement will provide that L is formed to further charitable purposes by promoting the health of a broad cross section of the community. It will further provide that the duty of the members of the L's Board of Directors to operate in such a manner overrides any duty that such Board members may have to operate L for the financial benefits of L's members. The provisions of the Operating Agreement concerning L's charitable purposes and precedence of such purposes over the financial benefit of L's members are legal, binding, and enforceable under the state's limited liability company law.

M will be the manager of L, conducting the day-to-day affairs of L and the operations of B. M will provide qualified and trained personnel to L, including a trained technician to operate B. The manager will be subject to the overall authority of L's Board of Directors.

The Operating Agreement and Articles of Organization of L may not be amended, nor may the status of L be changed from one in which management is vested in the Board of Directors to one in which management is vested in the members without the consent of M and a majority of the physician members.

Neither the Board of Directors nor members of L will be able, without the consent of M, to take any action pertaining to L's charity care policies or any action that may adversely affect M's tax-exempt status under section 501(c)(3) of the Code. Pursuant to the Operating Agreement, M will have sole authority over L's provision of charity care to patients with limited or no ability to pay. In addition, M will have sole authority to cause L to conduct community needs assessments and respond to unmet community needs within the scope of L's activities and services.

Physician privileges at L are not dependent on owning a membership interest in L. Medical staff members apply for and are granted privileges at the facility based on credentialling criteria.

RULINGS REQUESTED:

1. The participation of M in the joint venture, including the acquisition and retention of a membership interest in L, will not adversely affect M's exemption under section 501(a) of the Code as an organization described in section 501(c)(3).

2. The income received by M from its distributive share of the joint venture's profits will be income from a related trade or business and will not be subject to the tax on unrelated business taxable income under section 511 of the Code.

APPLICABLE LAW:

Section 501(c)(3) of the Code describes as exempt from federal income tax, as provided under section 501(a), organizations organized and operated exclusively for charitable, scientific, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1) of the regulations provides that an organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of designated individuals.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372 (1959); 4A Scott and Fratcher, The Law of Trusts, sections 368, 372 (4th ed. 1989).

Rev. Rul. 69-545, 1969-2 C.B. 117, provides that a nonprofit corporation whose purpose and activity are providing hospital care is promoting health and therefore furthers charitable purposes as provided in section 501(c)(3) of the Code if it meets the

community benefit requirements. The community benefit standard focuses on a number of factors indicating the operations of a hospital benefit the community rather than serving private interests.

Rev. Rul. 98-15, 1998-1 C.B. 718, compares two situations where an exempt hospital forms a joint venture with a for-profit entity and then contributes its hospital and all of its other operating assets to the joint venture, which then operates the hospital. In *Situation 1*, the revenue ruling concludes that the exempt organization will continue to further charitable purposes when it participates in the joint venture. Favorable factors include: the commitment of the joint venture to give charitable purposes priority over maximizing profits; the community make-up and structure of the board; the voting control held by the exempt organization's representatives on the board; the specifically enumerated powers of the board; and, the reasonable terms and conditions of the management contract. In *Situation 2*, the revenue ruling concludes that the organization fails the operational test when it participates in the joint venture because activities of the joint venture will result in greater than incidental private benefit to the for-profit partner.

Section 511 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 unrelated business taxable income as the gross income derived from any unrelated trade or business regularly carried on, less the allowable deductions that are directly connected with the carrying on of the trade or business, both computed with certain modifications.

Section 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(a)(1) 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 its makes of the profits derived) to the exercise or performance by such organization of its exempt purposes.

Section 1.513-1(d)(2) of the regulations states that a trade or business is related to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of an exempt purpose, and is substantially related for purposes of section 513 only if the causal relationship is a substantial one. Thus, for

the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to the purposes for which exemption is granted, the production or distribution of the goods or the performance of services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

ANALYSIS:

Under the regulations, an organization that is organized and operated exclusively for charitable purposes may qualify for exemption under section 501(c)(3) of the Code. The promotion of health has long been recognized as a charitable purpose. Whether a hospital or other health care organization promotes health in a charitable manner is determined under the community benefit standard of Rev. Rul. 69-545, supra. This standard focuses on a number of factors to determine whether the hospital benefits the community as a whole rather than private interests.

The activities of a limited liability company treated as a partnership for federal income tax purposes are considered to be the activities of an exempt organization that is a member of the limited liability company when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code. A section 501(c)(3) organization may form and participate in a partnership, including a limited liability company treated as a partnership for federal income tax purposes, and meet the operational test of section 1.501(c)(3)-1(c) of the regulations, if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of any for-profit partners. See Rev. Rul. 98-15, supra.

After the creation and operation of the joint venture, the charitable and exempt purposes of M will continue to be the same as prior to the creation of L. M will provide health care to the community through providing A treatment services according to the community benefit requirements of Rev. Rul. 69-545, supra.

In addition, M's participation in L will further its exempt purposes. M's participation in L and provision of B treatment services will promote health for the community in a manner that satisfies the requirements of Rev. Rul. 69-545, supra. The structure of L and operation of B will allow M to act exclusively in furtherance of charitable purposes with no undue private benefit to the physician members, as provided in Rev. Rul. 98-15, supra.

As in *Situation 1* of Rev. Rul. 98-15, supra, M's ownership interests in L are proportionate to and equal in value to what M contributed to L. M's and the physician-

members' returns from L will be proportional to their respective investments in L.

Further, L's activities will be effectively controlled by M. L's governing documents commit L to provide health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits. L has adopted a conflict of interest policy. Through M's appointment of members of the community familiar with the hospital to L's board and the voting structure of the board, M can ensure that the assets it owns through L and the B treatment services conducted through L are used primarily to further exempt purposes.

L will allow for an open medical staff. L will have a charity care policy as adopted and enforced by M. M has the sole authority to cause L to provide care for all patients regardless of ability to pay, including Medicare, Medicaid, and patients not covered by Medicare or Medicaid. Services provided to patients not covered by third party insurance will not differ from those covered by insurance. Also, M has the authority to cause L to conduct community needs assessments and meet such community needs.

Accordingly, after the formation of L, M will continue to promote the health of the community and otherwise accomplish its exempt purposes through the operation of L, which is consistent with *Situation 1* in Rev. Rul. 98-15, supra. After the formation of L, M will continue to operate or promote health care services, namely B treatment services, consistent with the community benefit factors for exempt health care organizations as described in Rev. Rul. 69-545, supra. M will continue its charity care policies through the operation of L, and will control both the assessment of, and response to, unmet community needs within L's scope of activities or services.

The exempt purposes of M will be furthered by its participation in L. M's participation enables it to provide expanded and improved health care services to the community. The purposes of L specifically include enhancing the quality of health care and promoting the general health and well-being of the community. These purposes override any duty to the members to maximize profits. Accordingly, such participation will not constitute an unrelated trade or business to M within the meaning of section 513 of the Code. Consequently, pursuant to section 512(c) of the Code, any distributive share of L's profits to M will not be considered unrelated business taxable income.

CONCLUSIONS:

Accordingly, we rule as follows:

1. The participation of M in the joint venture, including the acquisition and retention of a membership interest in L, will not adversely affect M's exemption under section 501(a) of the Code as an organization described in section 501(c)(3).

2. The income received by M from its distributive share of the joint venture's profits will be income from a related trade or business and will not be subject to the tax on unrelated business taxable income under section 511 of the Code.

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. This ruling letter 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.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter. Because this letter could help resolve future questions about your income tax responsibility, please keep a copy of this ruling in your permanent records.

A copy of this letter will be furnished to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office.

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

We have sent a copy of this letter to your representative as indicated in your power of attorney.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1