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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

No third party contact
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Identification Number:

Telephone Number:

T:ED:B1

Legend:

A-
B-
C-

Employer Identification Number:

Dear Sir or Madam:

This is in response to your ruling request concerning a proposed transaction and its effects on the exempt status and unrelated business income tax liability of B and C under sections 511 through 514 of the Internal Revenue Code.

A is an organization described in section 501(c)(3) of the Code. A's purpose is to provide funds for the construction, equipment and operation of a free clinic and hospital for crippled, maimed or diseased children.

A created B to promote the health of the community by operating a charitable hospital specializing in pediatric services. B is an organization described in section 501(c)(3) of the Code and in sections 509(a)(1) and 170(b)(1)(A)(iii). B's sole member is A. A provides ongoing support to B. A must approve all amendments to the B's articles of incorporation and bylaws, the election and removal of B's directors, and the dissolution of B.

C is an organization described in section 501(c)(2) which was created by B, C's sole member. C's sole purpose is to own, operate, and maintain the property transferred to it as described below, and to tender the net profits of the property to B.

B 's medical campus consists of connected physical structures providing charitable medical services through a broad range of pediatric treatment facilities and related administrative services. B erected two office towers adjacent to its campus on land it owns. The towers are attached by an overhead walkway to B's campus and are used primarily by B for the treatment of patients and administrative services. However, B has leased fifteen percent of the

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total space to physicians, that only practice pediatric medicine, to carry on their private medical practices. These physicians, regularly, but are not required to, refer their patients to B for treatment and also have staff privileges at B. B, as a matter of policy, will not lease space in the office towers to physicians not practicing in the field of pediatric medicine. For example, B leases space to a tenant specializing in pediatric cardiology, a sub-specialty that might not be available to B absent the proximity of the office towers. The physicians are available for emergency and other medical services offered by B, regularly attend B's staff meetings and attend or provide medical education programs. Neither A nor B have any ownership interest in the physician practices.

Physicians are charged a fixed rental, subject to adjustments such as inflation. The physicians do not receive any personal property under the leases and personal services included within the lease are limited to elevator services, security, utilities, replacement of light bulbs, janitorial services and building maintenance. All such services are usual and customary in the leasing of real property in the area.

B has erected a multi-story parking facility. The facility is unattended and is open to the patients, visitors and family members of patients of B without charge. B does not control ingress or egress over the parking facility, because it has no toll or ticket gate. B has agreed to provide a limited number of parking spaces to the physicians who lease space in the office towers and their patients. The leases to the physicians do not contain a provision setting forth a fee for providing parking spaces. However, with one exception, no spaces are required to be reserved and the leases do not separately charge for the spaces. With regard to the one exception, B agreed to reserve one space for the medical director of the tenant specializing in pediatric cardiology to have easy access to the physician offices and B's campus at all times.

It has come to B's attention that leasing a portion of the office towers to private physicians may cause the entirety of both office towers to be subject to local property taxes. To minimize the potential impact of the property tax, B proposes to convert the office towers into condominiums in 2001 and to contribute the units leased to physicians to C, free of any mortgage and, in conjunction with that, assign B's rights and duties as landlord to C. Under the lease arrangements, B will agree with C to continue to provide parking spaces to the physicians and patients without charge to C.

Under the lease arrangements, B will agree to continue performing the services relating to elevators, security, utilities, replacement of light bulbs, janitorial and building maintenance, as when it was landlord. B will also perform management functions such as preparing and mailing monthly rental invoices without charge to C.

After B completes the process of converting the leases into condominiums, B will contribute the physician units, a total of three, to C. B will initially retain the remaining units for use in its operations as well as a share of the common areas. However, B may contribute the remaining units to C for leasing to the physicians as the need may arise. In any event, the rights and responsibilities as between the tenants and C will be the same as now exists between the tenants and B with the added benefit that only the leased units are subject to local property tax. Consequently, B should be able to achieve substantial savings by transferring the

property to C.

C does not anticipate providing any direct services to manage, maintain, or operate the condominium units transferred to it. These services, which include the collection of rents and the payment of expenses, will be provided by B without charge to C. Start up costs attributable to organizing C as well as amounts as may be needed from time to time by C in excess of its net income will be contributed by B.

The following rulings are requested:

1. The change in property ownership of the office towers from fee simple to condominium will not be considered an unrelated trade or business that would generate unrelated business taxable income under sections 511 through 514 and will not affect B's exempt status under section 501(c)(3).

2. The transfer of the condominium units and related leases by B to C will not generate unrelated business taxable income as described in sections 511 through 514 to either B or C.

3. Neither the exempt status of either B or C will be affected by the transfer of the condominium units or physician leases and the subsequent operations to be carried on by B and C as a result thereof.

4. The rental income received by C from the physicians' leases will not constitute unrelated business taxable income under sections 511 through 514.

5. The rental income received by B from C from the physician leases, after the payment of costs and expenses, will not constitute unrelated business taxable income under sections 511 through 514.

6. The receipt of income to B from C, net of costs and expenses, will not affect B's exempt status under section 501(c)(3) of the Code.

7. The providing of parking facilities by B to the physicians and their patients and B's providing of management, maintenance and operational services to C will not affect B's status as an organization described in section 501(c)(3) and will not constitute unrelated business taxable income under sections 511 through 514 of the Code.

8. The providing of start up costs, as well as amounts needed to meet C's costs and expenses in excess of income will not constitute UBIT to C and not affect B's status as an organization described in section 501(C)(3).

Section 501(c)(2) of the Code provides for the exemption from federal income tax of corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from federal income tax under section 501(a).

Section 1.501(c)(2)-1(b) of the Income Tax Regulations provides that a corporation described in section 501(c)(2) of the Code cannot accumulate income and retain its exemption but must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501(a).

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of organizations that are organized and operated exclusively for religious, charitable, scientific, or educational purposes, provided no part of their net earnings inures to the benefit of any private shareholder or individual.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions directly attributable to such business activity.

Section 512(b)(3) provides that rents from real property (and incidental related personal property) are not treated as unrelated business income unless the real property is debt-financed under section 514. Section 514(b) defines debt-financed property as any property that is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year. Debt financed property does not include any property substantially related to the exercise or performance by such organization if its exempt purposes.

Section 513(a) of the Code defines the term "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 or performance by an organization of the purpose or function constituting the basis for its exemption.

Section 1.513-1(a) of the regulations defines "unrelated business taxable income" to mean gross income from any unrelated trade or business regularly carried on. Section 1.513-1(b) states that the phrase "trade or business" includes activities carried on for the production of income and which possess the characteristics of a trade or business within the meaning of section 162 of the Code. Finally, section 1.513-1(c) explains that "regularly carried on" has reference to the frequency and continuity of the conduct of an activity and the manner in which the activity is pursued.

Section 1.513-1(d)(2) of the regulations provides 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 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 those purposes.

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Section 514 of the Code provides for the taxation under section 512 of the Code 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 include any property substantially all the use of which is substantially related to the exercise or performance by such organization of its charitable purposes constituting the basis for its exemption under section 501.

Rev. Rul. 69-269, 1969-1 C.B. 160, provides that the operation of a parking lot for patients and visitors only by a section 501(c)(3) hospital does not constitute unrelated trade or business under section 513 of the Code.

Rev. Rul. 69-463, 1969-2 C.B. 131 provides that income derived by a hospital from leasing office space in an adjacent office building to a medical group was substantially related to the hospital's exempt purpose.

Rev. Rul. 69-545, 1969-2 C.B. 117, sets forth standards under which a nonprofit hospital may qualify for recognition of exemption under section 501(c)(3) of the Code. This revenue ruling gave consideration to two separate hospitals, only one of which was determined to qualify for exempt status under section 501(c)(3). By weighing all the relevant facts and circumstances, the revenue ruling analyzed whether both the control and use of the hospitals were for the benefit of the public or for the benefit of private interests. The hospital that qualified for exemption was found to be organized and operated to further the charitable purpose of promoting health by satisfying a community benefit standard that included, among other factors, a board of directors that broadly represented the interests of the community. The hospital that did not qualify for recognition of exemption was found to be operating for the private benefit of those who controlled it rather than for the benefit of the public.

Rev. Rul. 78-41, 1978-1 C.B. 148, concludes that a trust created by a hospital to accumulate and hold funds to pay malpractice claims against the hospital qualified for exemption under section 501(c)(3) of the Code as an integral part of the hospital. The hospital provided the funds for the trust, and the banker-trustee was required to make payments to claimants at the direction of the hospital. The organization conducted an activity that the hospital could perform itself.

B currently operates a hospital and is described in sections 509(a)(1) and 170(b)(1)(A)(iii) and wants to restructure its real estate holdings in its office towers to minimize the impact of local property tax liability by converting its office towers to condominium ownership from fee simple. After the conversion of the office towers, C will hold title to all condominium units leased to physicians, and B will own all units relating to the operation of the hospital. Furthermore, B will continue to operate a hospital that will further section 501(c)(3) purposes.

The current leasing of office space to physicians will not generate any unrelated business income under Rev. Rul. 69-463. The change in form in ownership of the space that the physicians lease will have no impact on whether unrelated business income is generated by B or C under sections 511 through 514 since the space will still be leased to the physicians in the same manner as described in Rev. Rul 69-463.

The change in property ownership of the office towers and the subsequent transfer of the physician-leased condominiums to C will not adversely either entity's exempt status. Furthermore, the change in property ownership of the office towers is a one-time event and does not possess the characteristics of a trade or business regularly carried on.

The transfer of assets and/or funds to C will be one time transfers and therefore, will not possess the characteristics of a trade or business "regularly carried on." Furthermore, any gain on the transfers would not be subject to unrelated business income tax due to section 512(b)(5) of the Code.

Following the proposed reorganization, the sharing of services and facilities, whether or not a fee is charged, and transfers of cash and assets among the exempt organizations will be substantially related to the exercise or performance of the exempt purposes of B and will, therefore, not constitute unrelated trade or business activities subject to tax because the transfers will further the charitable purposes of B. The provision of parking spaces to the physicians leasing space from C and their patients will not generate unrelated business income as described in Rev. Rul. 69-269. Therefore, the exempt status of B and C will not be jeopardized, because the transferred assets will be used to further exempt purposes.

The rents C will receive from ownership of the condominiums will be income from a substantially related activity under section 513(a) of the Code. C's rental of the condominium space adjacent to its affiliated hospital B is similar to the nontaxable medical office building rental in Revenue Ruling 69-463, in which the rentals of the adjacent medical office building contribute importantly to the furtherance of the exempt activities of the lessor hospital. C's ownership of the condominium units will further B's exempt purposes because the rentals furthered B's exempt purposes when B owned the property and will still further its exempt purposes when the property is owned by B's controlled affiliate, C.

Based on the following we rule as follows:

1. B's conversion of the office towers to condominiums is not an unrelated trade or business and will not subject B to tax under sections 511 through 514 of the Code.

2. The transfer of the condominium units and the related leases by B to C is not an unrelated trade or business that will generate unrelated business income under section 511 through 514.

3. B's exempt status as an organization described in section 501(c)(3) and C's exempt status under section 501(c)(2) are not jeopardized by the transfer of the condominium units and physician leases and subsequent operations to be carried on by B and C as a result of the transfer.

4. The rental income received by C from the leases will not constitute unrelated business taxable income as described in sections 511 through 514 of the Code.

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5. The rental income received by B from C from the leases, after payment of costs and expenses, will not constitute unrelated business taxable income as described in sections 511 through 514.

6. B's receipt of income, net of costs and expenses, will not affect its exempt status under section 501(c)(3) of the Code.

7. The providing of parking facilities by B to C and their patients and B's providing of management, maintenance and operational services to C will not affect B's exempt status under section 501(c)(3) and will not generate unrelated business taxable income under sections 511 through 514 of the Code.

8. The providing of start up costs by B to C, as well as amounts needed by C from time to time to meet its costs and expenses in excess of income will not constitute unrelated business taxable income to C as described in sections 511 through 514 and will not affect B's exempt status as an organization described in section 501(c)(3) of the Code.

We have not been asked and we express no opinion on whether the provision of a parking space for the medical director of one of the tenants will generate unrelated business income under sections 511 through 514 of the Code.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

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.

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.

Sincerely,

(signed) Marvin Friedlander
Marvin Friedlander
Manager, EO Technical
Group 1

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