200218037
MAR 27 2001

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

EO Examinations
Through: EO Mandatory Review Staff

501.03-11
509.02-02
512.02-00
513.00-00

Taxpayer's Name:

Taxpayer's Address:

T:EO:B1

Taxpayer's Identification Number:

Years Involved:

Conference Held: No

Legend:

A =
B =
C =
D =
E =
F =
G =
H =
J =
K =
L =

Issues:

1. Does the organization continue to qualify for exemption as an organization described in section 501(c)(3) of the Internal Revenue Code?

2. Does the management of a limited partnership whose business activity is the operation of a magnetic resonance imaging ("MRI") facility constitute a charitable activity within the meaning of section 501(c)(3) of the Code?

3. Does the organization continue to qualify as a supporting organization under section 509(a)(3) if it supports other section 509(a)(3) organizations?

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4. Are the management fees received by the organization from the limited partnership for providing administrative management services subject to unrelated business income tax under section 511 of the Code?

5. Are the income distributions that an exempt organization receives as the general partner in a limited partnership subject to unrelated business income tax under section 511 of the Code?

6. Should the organization be granted relief pursuant to section 7805(b) of the Code?

Facts:

A was recognized as an organization described in section 501(c)(3) of the Internal Revenue Code by letter dated February 2, 1991. It was classified as an organization described in section 509(a)(3).

A was incorporated as a nonprofit corporation under the nonprofit laws of the State of L. Amended articles of incorporation provide that the organization is formed to support and encourage the efficient utilization of health care services; specifically including the utilization and rendering of diagnostic magnetic resonance imaging services and to otherwise support health care organizations exempt from tax under section 501(c)(3), as listed: B, C, D, and E.

A was formed as part of a joint undertaking by exempt hospital systems. The hospitals acted collectively in establishing an MRI facility because the State of L limited the number of MRI facilities that it would authorize under a certificate of need. The four initial member organizations were B, C, D, and F. F's membership was transferred to E. B, C, and E are exempt under section 501(c)(3) of the Code and classified under section 509(a)(3). D is exempt under section 501(c)(3) of the Code and classified as a hospital under sections 509(a)(1) and 170(b)(1)(A)(iii).

The current member organizations are G, H, D, and J. G and J are exempt under section 501(c)(3) of the Code and classified under section 509(a)(3). H is exempt under section 501(c)(3) and classified as a hospital under sections 509(a)(1) and 170(b)(1)(A)(iii).

The bylaws provide that A is governed by a board of trustees. A indicated during its application process that it is governed by a board of trustees composed of the Chief Operating Officer and the Chief Financial Officer of each member. The bylaws require that all trustees be nominated and elected by the members. Under the bylaws, members expressly reserve the power to amend, alter or change the articles of incorporation and the bylaws and the right to approve all central policy decisions by a vote of 75 percent of the members.

A was formed to further the tax exempt purposes of its members by providing magnetic resonance imaging services to the general public being served by the multi-entity health care systems of which the members are integral components. A furthers its members' exempt purposes through its participation in a limited partnership. A is the general partner in K ("the Partnership"). The Partnership owns and operates a magnetic

resonance imaging ("MRI") facility. The L Department of Health issued a certificate of need, selecting the Partnership to be one of only a handful of MRI demonstration projects in the state.

EO Examinations, conducted an examination of A. It concluded that A does not qualify for exemption as an organization described in section 501(c)(3) of the Code. That office asserts that because A was formed by two or more unrelated hospitals to operate on a centralized basis, section 501(e) of the Code is controlling. It further determined that the management services performed by A for the Partnership do not come within the scope of any of the services enumerated in section 501(e). It argued that the operation of the MRI facility, which possibly could qualify as a clinical service, cannot be attributed to A, because A is an entity separate and apart from the Partnership.

The Partnership is a limited partnership with limited partnership units. The general partner, A, owns special limited partners own ; pension trusts own units; and local physicians own the remaining units. Local physicians initially held limited partnership units but the Partnership purchased units from those physicians resulting in units presently owned by local physicians. Each of the founding hospitals contributed $ to A for a total of $ A in turn made a capital contribution of $ to the Partnership. The two special limited partners made contributions: one of $ and the other of $. The special limited partners have exclusive rights to provide medical services for the MRI facility. Each regular limited partner made a capital contribution of $ to the Partnership.

The Partnership Agreement provides that net cash flows, net proceeds of capital transactions and net income or loss from the Partnership shall be distributed fifty percent to the general partner, fifteen percent to the special limited partners, and thirty-five percent to the regular limited partners.

The Partnership Agreement was amended on January 30, 2001 to provide that the Partnership is formed to render care to certain individuals for which no payment is anticipated, and will provide services regardless of a patient's ability to pay. The Partnership Agreement, as amended, further provides that in the event that profit maximization of the Partnership conflicts with its charitable purposes in providing magnetic resonance imaging services to all patients, the general partner shall make decisions that support the charitable purposes.

The MRI facility has a written charity care policy that is made known to patients. It serves third-party payor, Medicare, Medicaid, and indigent patients, with no difference in the services provided to any of the types of patients. It has a broad-based community board representative of the exempt affiliate hospitals. Any physician may refer a patient to the facility.

The Partnership Agreement provides that the general partner has the exclusive right and power to manage and operate the Partnership and to do all things necessary to carry out the purpose, business and objectives of the Partnership. A provides financial and management assistance to the Partnership.

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The Partnership and A entered into an Administrative Management Agreement. The agreement provides that the Partnership pays A an annual fee of $ for all administrative services rendered. A negotiates and executes contracts, signs checks, borrows or invests funds, negotiates contracts with physicians and radiologists, hires or terminates Partnership employees, and enforces the facility's written charity care policy.

APPLICABLE LAW:

Exemption issues under section 501(c)(3) of the Code.

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

Section 501(e) of the Code provides that an organization shall be treated as an organization organized and operated exclusively for charitable purposes if (1) such organization is organized and operated solely to perform for two or more exempt hospitals on a centralized basis one or more of the following services, which if performed on its own behalf by an exempt hospital would constitute activities in exercise of the function constituting the basis for its exemption: data processing, purchasing, billing and collection, food, clinical, laboratory, record center; (2) such organization is organized and operated on a cooperative basis; and (3) all of its stock is owned by patron hospitals.

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) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sec. 368, 372; Scott on Trusts, sec. 368, 372.

Rev. Rul. 69-545, 1969-2 C.B. 117, establishes the community benefit standard, which focuses on a number of factors indicating the operation of a hospital or health care facility benefits the community rather than serving private interests. The revenue ruling requires all relevant facts and circumstances to be weighed in each case. The facts in Situation 1 indicate that a hospital serves the public rather than private interests because the hospital is controlled by a board composed of independent civic leaders, has an open medical staff, an open, accessible emergency room, and serves persons with third party payors such as Medicare.

Rev. Rul. 98-15, 1998-1 C.B. 718, compares two situations where an exempt hospital forms a joint venture with an unrelated for-profit entity and then contributes its hospital and all of its other operating assets to the joint venture, which then operates the hospital. The revenue ruling affirms that for federal income tax purposes, the activities of a partnership are considered to be the activities of the partners. Thus, the activities of a limited liability company ("LLC") 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 LLC when evaluating whether the exempt organization is operated exclusively for exempt purposes. Situation 1 concludes that the hospital organization's principal activity continues to be the provision of hospital care, even when such activities are conducted

through an LLC treated as a partnership, because the exempt hospital retains control over the LLC and the LLC serves charitable purposes.

Foundation status under section 509(a)(3) of the Code.

Section 509(a)(3) of the Code provides that an organization is a supporting organization, and not a private foundation, if the organization is organized and operated exclusively for the benefit of, to perform the functions of or to carry out the purposes of one or more organizations described in section 509(a)(1) or 509(a)(2); is operated, supervised or controlled by or in connection with one or more section 509(a)(1) or 509(a)(2) organizations; and is not controlled by disqualified persons.

Section 1.509(a)-4(a)(2) of the regulations provides that an organization described in section 509(a)(3) of the Code must be organized and at all times be 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 section 509(a)(1) or section 509(a)(2).

Section 1.509(a)-4(c)(1) of the regulations provides that an organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (i) limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A); (ii) do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to; (iii) state the specified publicly supported organizations; and (iv) do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations.

Section 1.509(a)-4(c)(2) of the regulations provides that the organizational test is not met if an organization's creating document allows it to operate, support, or benefit any organization which is not an organization described in section 509(a)(1) or 509(a)(2) specified in its creating instrument. The fact that the organization's actual operations have supported or benefited organizations that are section 509(a)(1) or 509(a)(2) organizations does not matter.

Section 1.509(a)-4(d)(2) of the regulations provides that if the supporting organization is "operated, supervised or controlled by" or "supervised or controlled in connection with" its supported organizations, it may specify the supported organizations either by name or class or purpose.

Section 1.509(a)-4(d)(4)(i) of the regulations provides that if the supporting organization is "operated in connection with" its supported organizations, its creating instrument must specify the supported organizations by name.

Section 1.509(a)-4(e)(1) of the regulations provides that a supporting organization will be regarded as operated exclusively to support one or more specified publicly supported organizations if it supports or benefits an organization other than a private foundation which is described in section 501(c)(3) of the Code and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations.

Unrelated business income tax.

Section 511 of the Code imposes a tax on the unrelated business income of an exempt organization.

Section 512 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) 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 connected with such gross income.

Section 513(a) of the Code provides that the term "unrelated trade or business" includes any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501(a).

Section 1.513-1(d)(1) of the regulations provides that gross income derives from unrelated trade or business within the meaning of section 513(a) of the Code if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

DISCUSSION:

Exemption issues under section 501(c)(3) of the Code.

A was created by unrelated members, which were either exempt hospitals or exempt, wholly-owned hospital subsidiaries. The members joined to operate a magnetic resonance imaging facility for the local area. The service is a health care service provided to the general public, not to the member hospitals as contemplated in section 501(e) of the Code. Therefore, section 501(e) of the Code, dealing with hospital cooperative service organizations that perform certain administrative and other services for other hospitals, is not controlling.

The question is whether A is organized and operated exclusively for charitable purposes. For federal income tax purposes, the activities of a partnership are considered to be the activities of the partners. See Butler v. Commissioner, 36 T.C. 1097 (1961), acq., 1962-2 C.B. 4. Such aggregate treatment is consistent with the treatment of partnerships for the purpose of unrelated business income tax under section 512(c) of the Code. Rev. Rul. 98-15, supra, notes that in light of the aggregate principle reflected in section 512(c), the aggregate approach also applies for purposes of

the operational test set forth in section 1.501(c)(3)-1(c) of the regulations. Thus, the activities of a partnership or other joint venture are considered to be the activities of an exempt organization that is a partner in the partnership when evaluating whether the exempt organization is operated exclusively for exempt purposes.

An organization exempt under section 501(c)(3) of the Code may form and participate in a partnership and meet the operational test 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 purpose and only incidentally for the benefit of any for-profit partners. Rev. Rul. 98-15. See also Plumstead Theatre Society v. Commissioner, 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982); Housing Pioneers v. Commissioner, 65 T.C.M. (CCH) 2191 (1993), aff'd, 49 F.3d 1395 (9th Cir. 1995), amended, 58 F.3d 401 (9th Cir. 1995).

In evaluating whether A is operated exclusively for charitable purposes, the activities of the Partnership are considered the activities of A. Thus, A's primary activities consist of the health care services it provides through the Partnership. The first question then is whether the Partnership furthers the charitable purpose of promoting health for a broad cross section of the community. Any physician or hospital may refer a patient to the MRI facility. The facility has a written charity care policy that is advertised to the public. The facility serves Medicare, Medicaid, and indigent patients with the same service that are provided to any patient. No patient is turned away for lack of ability to pay. It has broad-based community board representation by the member hospitals. As such, for the years under examination, the Partnership of which A is a partner satisfied the community benefit standard of Rev. Rul. 69-545, supra.

The next question is whether the Partnership arrangement permits A to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of the physicians and other non-exempt partners. A received an interest in the Partnership equal in value to its contribution to the Partnership, and its returns are in proportion to its investment in the Partnership. A has control over the policies of the Partnership as well as the day to day activities of the MRI facility. A can ensure that the assets it owns through the Partnership and the activities conducted by the Partnership are used primarily to further exempt purposes. Thus, for the years under examination, A could ensure that the benefit to the for-profit limited partners was incidental to the accomplishment of charitable purposes. Although the Partnership Agreement did not specifically provide that charitable interests will have priority over profit interests during the examination years, it has since been amended to include the proper language. Regardless, the facts show that K was operationally consistent with Situation 1 of Rev. Rul. 98-15 during the years under examination.

Accordingly, A qualifies for exemption under section 501(c)(3) of the Code. A's participation in the Partnership is its primary activity. A primarily furthers exempt charitable purposes through its participation in the Partnership and the operation by the Partnership of the MRI facility.

Foundation status under section 509(a)(3) of the Code.

EO Examinations, , questions whether A qualifies as a supporting organization under section 509(a)(3) of the Code. That office asserts that A

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is not organized or operated exclusively for the benefit of section 509(a)(1) or section 509(a)(2) organizations because it also supports organizations described in section 509(a)(3).

A's Articles of Incorporation provide that it is organized for the benefit of specific section 501(c)(3) organizations listed by name. However, not all the organizations listed are section 509(a)(1) or section 509(a)(2) organizations. Therefore, A does not satisfy the organizational test of section 509(a)(3)(A) of the Code. See section 1.509(a)-4(c)(1) of the regulations.

A's Bylaws provide that its members shall elect the board of trustees of A. However, some of the members are classified as supporting organizations described in section 509(a)(3) of the Code rather than as public charities described in section 509(a)(1) or section 509(a)(2). Therefore, A cannot qualify for the "operated, supervised or controlled by" relationship test. Also, there is no requirement in A's Bylaws or Articles of Incorporation that the positions of control of A, such as the officers or board of trustees, be vested in the same persons that control or manage the member organizations or other listed supported organizations. Therefore, A cannot qualify for the "supervised or controlled in connection with" relationship test.

In addition, A cannot qualify for the "operated in connection with" relationship test. The "operated in connection with" relationship requires that the section 509(a)(1) or section 509(a)(2) supported organizations be specified by name in the organizing document. A's articles of incorporation specifically list two of the exempt hospitals it supports; however, it does not specifically list the other two exempt hospitals it supports. Instead, the section 509(a)(3) supporting organizations of those exempt hospitals are listed, which does not satisfy the "operated in connection with" relationship test. The section 501(c)(3) organizations listed in A's articles of incorporation include some section 509(a)(3) organizations.

However, as noted in Rev. Rul. 98-15, because of the pass through characteristics of partnerships, the activities of the Partnership become the activities of the partners, including A. Therefore, the provision of medical services by the Partnership can be attributed to A. Accordingly, A could qualify as other than a private foundation under section 509(a) by virtue of classification under either section 509(a)(1) and section 170(b)(1)(A)(iii) as a medical care facility; or possibly under section 509(a)(2).

Unrelated business income tax.

Section 512(c) of the Code provides that those distributions to an exempt organization from a partnership in which the organization is a partner that come from an unrelated trade or business conducted by the partnership result in unrelated business taxable income to the organization. Thus, partnership arrangements were contemplated under section 512. So long as the activities of the Partnership are substantially related to the exempt purposes of A, such Partnership activities are not unrelated trade or business. The Partnership activity of providing radiology services, overseen by a physician, furthers charitable purposes of providing health care for a broad cross-section of the community. Since the MRI facility is not an activity that is an unrelated trade or

business with respect to A, the Partnership distributions to A are not subject to unrelated business income tax under section 511 of the Code.

However, A also receives fees from its administrative and management services provided for the Partnership pursuant to the Management Agreement. These services are outside the scope of its duties as general partner of the Partnership. Providing administrative and managerial services on a regular basis for a fee is a trade or business ordinarily carried on for profit. See Rev. Rul. 72-369, 1972-2 C.B. 245 (organization formed to provide managerial and consulting services at cost to unrelated exempt organizations does not qualify for exemption under section 501(c)(3) of the Code). A was formed for the benefit of and to perform the functions of exempt hospitals by providing MRI services to the public. Accordingly, fees received for the provision of administrative and management services for the Partnership result in unrelated business taxable income to A.

This technical advice memorandum does not address how to calculate the amount of unrelated business taxable income to A. Therefore, we are not considering whether the taxable income should be calculated based on an allocation of A's ownership interest or whether it should be taxed based on one hundred percent of income.

CONCLUSIONS:

1. A continues to qualify for exemption as an organization described in section 501(c)(3) of the Code.

2. A's participation as a general partner in the Partnership, which operates an MRI facility in accordance with the community benefit standards outlined in Rev. Rul. 69-545, furthers charitable purposes under section 501(c)(3) of the Code.

3. A does not qualify as an organization classified under section 509(a)(3) of the Code because it does not satisfy the organizational test or any of the relationship tests of section 509(a)(3). However, it does qualify as other than a private foundation under section 509(a) as being described in sections 509(a)(1) and 170(b)(1)(A)(iii) or section 509(a)(2).

4. A's receipt of fees for administrative and management services to the Partnership results in unrelated business taxable income to A.

5. A's receipt of distributions from the Partnership does not result in unrelated business taxable income because the Partnership's activities are substantially related to the furtherance of the exempt purposes of A.

6. There is no need to grant relief under section 7805(b) of the Code because we have concluded that A continues to qualify for exemption under section 501(c)(3) of the Code.

Although the organization had initially requested a conference if an adverse was proposed, it subsequently declined its conference of right with respect to the issue of unrelated business taxable income.

This technical advice memorandum 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.

END