Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Uniform Issue List:
501.03.11
512.00-00

Contact Person: 199910063

Telephone Number:

In Reference to: OP:E:EO:T:1

Date: DEC 14 1998

Employer Identification Number:
Key District Office:

Legend:

L =
M =
N =
O =
P =
R =
d =
e =
f =

Dear Sir or Madam:

This refers to your request for rulings under sections 501(c)(3) and 512(a)(1) of the Internal Revenue Code.

FACTS

M is a d corporation that controls and oversees a health care delivery system of teaching and community hospitals, physician groups and other caregivers. The M health care system includes six hospitals. M is the parent corporation and sole corporate member of each of these hospitals. One of these hospitals is P, an acute care teaching hospital affiliated with the f School of Medicine.

M is also the sole corporate member of R (the "Faculty Practice"), The Faculty Practice is a multi-disciplinary academic and clinical group practice that is affiliated with the f School of Medicine and employs all of the full-time faculty physicians practicing at P. The Faculty Practice employs approximately 700 physicians, all of whom enjoy medical staff

privileges at P. The activities of the Faculty Practice include the provision of clinical services, medical education and research.

M and P each have been recognized as organizations described in section 501(c)(3) of the Code. P is subject to the substantial conflicts of interest policy adopted by M.

L is a d corporation that has been recognized as an organization described in section 501(c)(3) of the Code. At L's main facility in e (the "Main Facility"), L provides health care services to ambulatory patients diagnosed with diabetes and related diseases, including P's patients; and engages in both clinical and laboratory research activities and medical education programs involving diabetes and related diseases.

M and L will enter into a formal cooperative arrangement involving the diagnosis, treatment and care of ambulatory patients with diabetes and related diseases, and the performance of related medical research and medical education.

M and L intend to operate this arrangement through N, formerly known as O, which has been recognized as an organization described in section 501(c)(3) of the Code. Under N's Restated Articles of Organization, M and L are the members of N and N will operate in conjunction with, and in support of, M and L. Under N's proposed amended Bylaws, L will elect five of the nine members of N's Board of Trustees and M will elect four.

Under this proposed arrangement, except in certain limited circumstances, N will be the exclusive provider of diabetes services for M's affiliates, including P. N will provide an integrated, multi-disciplinary practice that will serve as an essential component of M's broad-based network of hospitals and other health care providers, including P.

N has applied for a clinic license from the d Department of Public Health. Once this license is granted, N, rather than L, will provide health care services to ambulatory patients diagnosed with diabetes and related diseases, including P's patients.

N's principal place of business will be at the Main Facility. L will lease to N approximately 32 percent of the Main Facility where L currently provides health care services to ambulatory patients diagnosed with diabetes and related diseases. In the leased portion of the Main Facility, N will provide health care services to ambulatory patients diagnosed with diabetes and related diseases, including P's patients, using leased and contracted physicians and other professional staff.

Initially, N will not directly employ physicians or other medical personnel. Instead, L will lease to N L's employed physicians who currently provide health care services to ambulatory patients diagnosed with diabetes and related diseases. In addition, M's affiliates, including the Faculty Practice, may contract their employed physicians to L or directly to N.

M and L will enter into a Joint Venture Agreement with respect to N. Under the Joint Venture Agreement, pursuant to a Services Agreement between P and N, P will provide clinical and management services to N. N will compensate P for these services based on its costs, which include the direct and indirect fully allocated costs of the services provided.

RULINGS REQUESTED

1. The proposed arrangement between M and L with respect to N will not affect the status of P as an organization described in section 501(c)(3) of the Code.

2. The payments P will receive from N under the Services Agreement for the provision of clinical and management services to N will not constitute unrelated business taxable income to P under section 512(a)(1) of the Code.

APPLICABLE LAW

Section 501(c)(3)

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

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that for an organization to be exempt as one described in section 501(c)(3) of the Code, it must be both organized and operated exclusively for one or more exempt purposes. Under section 1.501(c)(3)-1(d)(1)(i)(b) of the regulations, an exempt purpose includes a charitable purpose.

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.

Rev. Rul. 69-545, 1969-2 C.B. 117, established a community benefit standard as the basis for the federal income tax exemption of a hospital. This revenue ruling held that a hospital satisfies the community benefit standard if it promotes the health of a class of persons broad enough to benefit the community as a whole and it does not unduly benefit private individuals in achieving that objective.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. 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 512(a)(1)

Section 511 of the Code, in part, 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 gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions directly connected with the carrying on of such trade or business, both computed with certain modifications.

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 such organization of the purpose or function constituting the basis for its exemption.

Section 513(a)(2) of the Code provides that the term "unrelated trade or business" does not include any trade or business which is carried on, in the case of an organization described in section 501(c)(3), such as a hospital, by the organization primarily for the convenience of its patients.

Section 1.513-1(a) of the regulations defines "unrelated business taxable income" to mean gross income derived by an

organization from any unrelated trade or business regularly carried on by it, less directly connected deductions and subject to certain modifications. Therefore, gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(d)(1) of the regulations states that the presence of the substantially related requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's 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 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.

RATIONALE

Section 501(c)(3)

Following the consummation of the proposed arrangement between L and M with respect to N, P will continue its activities of promoting the health of the community under the community benefit standard established in Rev. Rul. 69-545, supra. Thus, P will continue to be organized and operated exclusively for charitable purposes. Therefore, P will continue to satisfy the organizational and operational tests under section 1.501(c)(3)-1(a)(1) of the regulations. As a result, the arrangement between M and L will not adversely affect the status of P as an organization described in section 501(c)(3) of the Code.

Section 512(a)(1)

Following the consummation of the proposed arrangement between L and M with respect to N, and after N obtains a clinic license from the State of d, N, rather than L, will provide

health care services to ambulatory patients diagnosed with diabetes and related diseases, including P's patients. N will be the exclusive provider of diabetes services for M's affiliates, including P. Thus, in effect, N will operate as P's outpatient clinic for treating ambulatory patients diagnosed with diabetes and related diseases.

Therefore, P's clinical and management activities with respect to N will materially benefit P's activities and will contribute importantly to the accomplishment of P's tax-exempt purposes. As a result, P's activities will have a substantial causal relationship to the achievement of P's tax-exempt purpose under section 1.513-1(d)(2) of the regulations. Thus, P's clinical and management activities with respect to N are activities that will be substantially related to P's performance of its exempt functions within the meaning of section 512(a)(1) of the Code and section 1.513-1(a) of the regulations.

RULINGS

1. The proposed arrangement between M and L with respect to N will not affect the status of P as an organization described in section 501(c)(3) of the Code.

2. The payments P will receive from N under the Services Agreement for the provision of clinical and management services to N will not constitute unrelated business taxable income to P under section 512(a)(1) of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based.

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 organization that requested it. Section 6110(j)(3) of the Code provides that they may not be used or cited by others as precedent.

We are informing your key District Director of this action. Please keep a copy of this ruling in your permanent records.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representatives.

Sincerely,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1