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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:

MAR 29 1999

Date:

Employer Identification Number:
Key District Office:

Legend:

P =
R =
S =
T =
U =
V =
W =
X =
Y =
Z =

Dear Sir or Madam:

This is in response to a letter from your authorized representative requesting a series of rulings on your behalf regarding the tax consequences associated with the affiliation transaction described below.

R was formed to support, benefit and operate an integrated health care services delivery network. It is being recognized as exempt from federal income tax under section 501(c)(3) of the Code and as a nonprivate foundation under section 509(a)(3) by letter of even date.

S is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(1). It operates an acute, general care hospital.

T is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). It was formed, in part, to provide planning and coordination of health care services and to support members of the S system. Prior to the proposed affiliation, T is the sole member of S, U, V and W.

U is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section

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509(a)(1). It was formed to receive, manage and dispense funds contributed and intended to support the mission of S.

V and W are exempt under section 501(c)(2) of the Code. They were created to hold and manage real property.

X, Y, Z and P are entities within another health care system.

X is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(1). It operates an acute, general care hospital.

Y is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3). Prior to the affiliation, Y is the sole corporate member of X, Z and P.

Z is exempt under section 501(c)(2) of the Code.

P is exempt from federal income tax under section 501(c)(3) of the Code and is a nonprivate foundation under section 509(a)(3).

You have stated that the respective systems have agreed to affiliate to form a regional health care network. The Affiliation Agreement provides the terms by which the hospitals and affiliates will cause R to become their sole corporate member. In addition, you have stated that as soon thereafter as possible, the parties shall cause 100% of the membership and equity interests held by T and Y in the hospitals and affiliates of the systems to be vested in R. Each hospital and affiliate will also cause its certificate of incorporation and bylaws to be amended as necessary to vest in R certain reserved powers.

You have stated that R's reserved powers over the hospitals and the affiliates will consist of two categories: (i) imposition powers, defined as powers that R can unilaterally impose or initiate and (ii) approval powers, defined as powers that R can exercise with respect to an entity only upon a recommended action by such entity, granting or withholding approval in its sole discretion.

You have stated that in accordance with the affiliation agreement, R's reserved powers will be exercised by a vote of its Board of Directors. A two-thirds vote of R's Board is required for the exercise by R of any imposition powers and its approval powers with respect to the dissolution or liquidation of a hospital or affiliate and the distribution of its assets; the merger, consolidation or corporate reorganization of a hospital

or affiliate; or the sale, lease, or exchange of all or substantially all of the assets of an entity. Except where a greater percentage is required by law or the Affiliation Agreement, all other decisions require a majority decision of R's Board.

You have stated the following imposition powers have been granted to R:

1. To remove, with or without cause, the directors or trustees of a hospital or affiliate;

2. To appoint and remove, with or without cause, the president of a hospital or affiliate;

3. To amend, alter, restate or repeal the certificates of incorporation and bylaws of a hospital or affiliate (subject to any government or judicial approvals which may be required by law);

4. Except as otherwise required by paragraph 3 and 4 of the approval powers (enumerated below), any transaction which would result in a change of ownership, membership or control of the hospital or affiliate;

5. Subject to applicable law and the terms of any debt instruments, to transfer and reallocate cash or assets between or among the hospitals and affiliates;

6. The development of new programs and affiliations with respect to or involving a hospital or affiliate:

7. To negotiate and execute managed care contracts on behalf of the hospital or affiliate; and

8. To negotiate and execute exclusive contracts and non-competition agreements on behalf of the hospital or affiliate.

Action on the following matters shall be initiated by the Board of the hospital or affiliate, but no such action shall be effective unless and until approved by R (approval powers):

1. The appointment of trustees/directors;

2. The dissolution or liquidation of a hospital or affiliate and the distribution of its assets;

3. The participation of any hospital or affiliate in any merger, consolidation or corporate reorganization involving the hospital or affiliate;

4. The sale, lease or exchange or other disposition of all, or substantially all, of the assets of the hospital or affiliate;

5. The capital and operating budgets of the affiliate;

6. Any unbudgeted capital expenditures by the hospital or affiliate;

7. The incurrence of debt in excess of one year in duration; and

8. The strategic plan of the hospital or affiliate.

You have stated that R will monitor and audit the compliance of the hospitals and the affiliates with its directives. Should the hospitals or affiliates fail to comply with the directives of R, R may exercise its powers to remove a director, trustee or president of such organization. The governing body and committees of R will meet regularly to exercise overall responsibility for operational decisions involving those day-to-day and long-range strategic management determinations that have been delegated by the hospitals and the affiliates.

You have requested the following rulings in connection with this series of transactions:

1. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of Y and that, following the affiliation, Y will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(3) of the Code.

2. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of X and that, following the affiliation, X will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(1) of the Code.

3. The proposed affiliation will have no adverse impact on the tax exempt status of Z and that, following the affiliation, Z will continue to qualify as an exempt organization under section 501(c)(2) of the Code.

4. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of P and that, following the affiliation, P will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(3) of the Code.

5. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of S and that, following

the affiliation, S will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(1) of the Code.

6. The proposed affiliation will have no adverse impact on the tax exempt status of V and that, following the affiliation, V will continue to qualify as an exempt organization under section 501(c)(2) of the Code.

7. The proposed affiliation will have no adverse impact on the tax exempt status of W and that, following the affiliation, W will continue to qualify as an exempt organization under section 501(c)(2) of the Code.

8. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of U and that, following the affiliation, U will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(1) of the Code.

9. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of R and that, following the affiliation, R will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(3) of the Code.

10. Neither the provision of management, fiscal, administrative or other services nor any transfer of assets or resources among the parties will result in unrelated business income to any of the parties or otherwise adversely affect the tax-exempt status of any of the parties.

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, recognizes that the promotion of health is a charitable purpose within the meaning of section 501(c)(3) of the Code.

Revenue Ruling 78-41, 1978-1 C.B. 148, concludes that a trust created by an exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the hospital is operated exclusively for

charitable purposes and is exempt under section 501(c)(3) of the Code.

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

Providing management and consultants' services to other, unrelated exempt organizations for a fee sufficient to produce a small profit does not further an exclusively exempt purpose. See B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978).

An organization providing laundry services on a centralized basis to exempt hospitals does not qualify for exemption under section 501(c)(3). See HCSC-Laundry v. United States, 450 U.S.1 (1981).

Section 513(e) of the Code provides that in the case of a hospital, the term "unrelated trade or business" does not include the furnishing of one or more of the services described in section 501(e)(1)(A) to one or more hospitals if such services are furnished solely to such hospitals which have facilities to serve not more than 100 inpatients, such services, if performed on its own behalf by the recipient hospital, would constitute activities in exercising or performing the purpose or function

constituting the basis for its exemption, and such services are provided at a fee or cost which does not exceed the actual cost of providing such services.

Rev. Rul. 77-72, 1977-1 C.B. 157, provides that indebtedness owed to a labor union by its wholly owned tax-exempt subsidiary is not acquisition indebtedness within the meaning of section 514 of the Code since the parent and subsidiary relationship shows the indebtedness to be merely a matter of accounting.

In Geisinger Health Plan v. United States, 30 F.3rd 494 (3rd Cir. 1994) (Geisinger), the court recognized that an organization may qualify for exemption based on the integral part doctrine, which arises from an exception to the "feeder organization" rule set forth in section 1.502-1(b) of the regulations, which states that if a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with the parent organization. The court also noted that an entity seeking exemption as an integral part of another cannot primarily be engaged in activity which would generate more than insubstantial unrelated business income if engaged in by the other entity. In this regard, the court followed the reasoning of section 1.502-1(b), which contains an example of a subsidiary organization that is not exempt from tax because it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. The example states that if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations) it is not exempt because such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

Accordingly, the court in Geisinger determined that application of the integral part doctrine requires at a minimum that an organization be in a parent and subsidiary relationship and that it not be carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

A joint operating or affiliation agreement between previously independent hospitals to provide corporate services among the participants raises exemption qualification and unrelated trade or business issues. With respect to exemption qualification, the courts have been clear that exemption under section 501(c)(3) of the Code is not generally available where an organization is established to provide corporate services to unrelated exempt organizations, other than through the application of section 501(e) of the Code for cooperative hospital service organizations. See B.S.W. Group, Inc., supra, and HCSC-Laundry, supra. Furthermore, exemption under the integral part doctrine requires a parent and subsidiary relationship and the absence of unrelated trade or business. See Geisinger, supra, and Rev. Rul. 78-41, supra. With respect to unrelated trade or business, section 513(e) of the Code makes clear that if a hospital provides regularly carried on corporate services to another unrelated exempt organization for a fee, then such services are unrelated trade or business unless they fall within the exception for certain hospital services provided by section 513(e). However, if the participating exempt organizations are in a parent and subsidiary relationship, then corporate services provided between them necessary to their being able to accomplish their exempt purposes are treated as other than an unrelated trade or business and the financial arrangements between them are viewed as merely a matter of accounting. See Rev. Rul. 77-72, supra.

At issue, then, is whether the joint operating or affiliation agreement has established a parent and subsidiary relationship such that corporate services and payments provided between the participating entities will not be treated as unrelated trade or business income because the activities are essential to the accomplishment of exempt purposes, could be conducted by a participating entity for itself without giving rise to unrelated trade or business income, and occur in the context of a close relationship among them.

Based on all the facts and circumstances, we conclude that the affiliation agreement effectively binds the parties under the common control of R so that the participating organizations are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of R's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating entities have ceded authority under the affiliation agreement to R's governing body to establish their budgets, including major expenditures, debt, contracts, managed care agreements, and capital expenditures; and to monitor and audit their compliance with its directives. In addition, the governing body and its committees meet regularly to exercise overall responsibility for operational decisions

involving the day-to-day and long range strategic management decisions that have been delegated by the participating entities. Therefore, services provided between the previously unrelated section 501(c)(3) tax exempt organizations through the affiliation agreement are treated as other than an unrelated trade or business.

Contributions to organizations exempt from federal income tax under section 501(c)(3) of the Code do not fall within the definition of unrelated business income under section 512, nor create taxable gain or loss to the transferor or transferee.

The parties will not adversely affect their tax exempt status under section 501(c)(3) of the Code by the proposed transactions as they will continue to promote health within the meaning of Revenue Ruling 69-545. The parties will not adversely affect their public charity status because the basis for their respective classifications as public charities will remain the same.

The transfer of resources and the sharing or provision of goods, facilities, and services among the section 501(c)(3) entities will not produce unrelated business income under sections 511 through 514 of the Code because the above organizations are financially and structurally related as part of an alliance to promote the health of the community.

Accordingly, based on all the facts and circumstances described above, we rule as follows:

1. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of Y and that, following the affiliation, Y will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(3) of the Code.

2. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of X and that, following the affiliation, X will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(1) of the Code.

3. The proposed affiliation will have no adverse impact on the tax exempt status of Z and that, following the affiliation, Z will continue to qualify as an exempt organization under section 501(c)(2) of the Code.

4. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of P and that, following the affiliation, P will continue to qualify as an exempt

organization under section 501(c)(3) and as a public charity under section 509(a)(3) of the Code.

5. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of S and that, following the affiliation, S will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(1) of the Code.

6. The proposed affiliation will have no adverse impact on the tax exempt status of V and that, following the affiliation, V will continue to qualify as an exempt organization under section 501(c)(2) of the Code.

7. The proposed affiliation will have no adverse impact on the tax exempt status of W and that, following the affiliation, W will continue to qualify as an exempt organization under section 501(c)(2) of the Code.

8. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of U and that, following the affiliation, U will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(1) of the Code.

9. The proposed affiliation will have no adverse impact on the tax exempt and public charity status of R and that, following the affiliation, R will continue to qualify as an exempt organization under section 501(c)(3) and as a public charity under section 509(a)(3) 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 are directed only to the organization that requested them. Section 6110(j)(3) of the Code provides that they may not be used or cited by others as precedent.

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.

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

Sincerely,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1