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

Date: OCT 12 2000

Contact Person:

ID Number:

Telephone Number:

In reply refer to:
T:EO:RA:T:1

E.I.N.:

LEGEND

O =
C =
H =
M =
F =
D =

Dear Sir/Madam:

This is in reference to a letter and subsequent correspondence submitted on your behalf by your authorized representatives requesting certain rulings regarding the federal tax consequences of a corporate reorganization and proposed transactions described below.

C is exempt under section 501(a) of the Code as an organization described in section 501(c)(3) and is classified as other than a private foundation under section 509(a)(3). C was organized to plan, develop, participate in and operate various medical and health care ventures and facilities for the benefit of O. C owns and manages seven medical office buildings and two residential properties that are not debt-financed. C also owns all the stock of a medical laboratory and sponsors a physician recruitment program for the benefit of its community. The physician recruitment program brought various physician specialists into the community who had previously not been present and also recruited other physicians whose specialties were underrepresented.

O is exempt under section 501(a) of the Code as an organization described in section 501(c)(3) and is classified as other than a private foundation under sections 509(a)(1)

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and 170(b)(1)(A)(iii). O was incorporated to bring the operations of two nonprofit general acute care hospitals, M and D, under its common control. Since the merger of M and D into O, O has combined the hospitals and currently operates one hospital described in section 501(c)(3). The Board of Directors of C determined it would be in C's best interest and in furtherance of its charitable purpose to amend and restate its Articles of Incorporation and Bylaws to reflect the integration of D and O. Consistent with this determination, O's Board of Directors will amend its Articles to provide that: (1) O will be the sole member of C, and (2) C's Board of Directors will be nominated, appointed and elected by O's Board of Directors. All of the actions taken by C's Board of Directors will become effective upon receipt of a favorable private letter ruling from the Service.

As a full service hospital system, O provides rehabilitative services to its patients. In the past, O has performed these programs on its campus and in another facility. The demand for these services has overwhelmed O's facilities. O determined there was a need for a full-service preventative health care and rehabilitative service facility in the community. O initiated a plan to build a new facility, and two years later opened the facility, which is called H.

H is located on the old M campus, a few miles from O's main campus. H will consist of the following facilities and services: health resources; physical development and rehabilitation; outpatient services; physician offices; and a chapel (collectively called F). O will operate H. However, a large number of square feet of H will be leased to C to operate F. No portion of F constitutes debt-financed property. F consists of a gymnasium, track, warm water hydrotherapy pool, lap pool, natatorium, racquetball/squash courts, health resources library, physical development equipment, aerobic studio rooms, exercise areas, massage therapy area, and several areas dedicated for education classes, including a demonstration kitchen and classrooms. F has a pro shop, which carries various health and fitness items for its members, and a cafe, which is primarily for the convenience of its employees and members.

O states the primary purpose of F is to improve the health of the community by promoting healthy lifestyles and disease prevention. This is accomplished in three major ways: by providing various forms of rehabilitation to O's medical patients; by offering a medically supervised and non-medically supervised comprehensive exercise program to members; and, by administering prevention services and extensive and comprehensive educational programs to members and nonmembers in the community. C has described its various programs and activities as well as its efforts to target lower income and diverse groups.

F provides rehabilitative services to its patients, who have, for example, undergone cardiovascular or orthopedic surgery or have been identified as having cardiovascular disorders. Rehabilitative programs are typically prescribed by O's medical staff physicians

to its patients. F also offers certified athletic trainers for injury care and exercise supervision, as well as a registered dietician to answer all questions regarding diet. F performs these programs under the direction of a physician.

F provides extensive community education and prevention programs. Many of these programs can be accessed by the community without membership in F. For example, F offers: (1) post-polio and arthritis programs; (2) diabetes care programs; (3) "Golden Partners" programs; (4) obese population programs; (5) cardiac maintenance programs; (6) physical sports, occupational and speech rehabilitation programs; (7) prenatal education programs; (8) aquatic and fitness classes; (9) health fairs and community outreach programs; and, (10) free school health assessment programs that have thousands of participants. Many of these community programs are open to nonmembers and are free of charge. However, if fees are charged, they are reasonable, and scholarships are offered to the financially needy.

All members of F are required to complete a "Health Risk Appraisal" before using the facility. If it is determined by the Health Risk Appraisal that an individual has a high risk of disease, that person will be referred to a physician to obtain approval prior to entry into F. F's staff members develop individual programs as a result of the Health Risk Appraisal that may include referral to a physician, registered dietitian, exercise physiologists, or registered nurse.

F offers stated discounted membership fees for its various types of memberships, including therapeutic, Golden Partners, employees, Chamber of Commerce and Board of Education. F submitted information showing the persons who benefit from the discounts come from a wide variety of socioeconomic levels. More than one-half of all members benefit from some form of discount. If, after receiving these discounted rates, individuals still cannot afford the fees, they are eligible to apply for membership pursuant to F's charity care policy, which mirrors the charity care policy of O. To be eligible, a person should have a referral (preference is given to a physician's referral but it is not necessary), special circumstances (emotional, spiritual, physical, or mental) as determined by the management team, and proof of financial need. C stated that up to 18% of all memberships would be funded by scholarships available under F's charity care policy. The charity care policy as well as the availability of F and its services are advertised in local newspaper articles, newsletters, guest appearances by F's employees on local television, and through public speaking engagements.

F's membership demand and pricing was determined based on a feasibility and demographic survey and analysis performed by two consultant groups. Initial memberships were first estimated using age as well as specific economic data from a consultant who had experience working with several hospital based fitness centers. There is no other fitness center that is hospital based and clinically integrated within a 50-mile

radius of F. F states its services are priced to be affordable to the average household of the surrounding area, most particularly those within a 10-mile radius. F is located in a low-to-moderate income area.

F charges an initiation fee for individuals, couples and families, which is a one-time charge covering the cost of the following:(1) the "Initial Health Risk Appraisal; (2) "MicroFit Health Assessment, " consisting of a sub-maximal cardiovascular test, body fat composition test, flexibility test and strength test; (3) the initial exercise prescription; (4) orientation to F and its equipment; and (5) the cost of setting up a new member. In addition, F charges monthly dues. These fees may be waived or discounted if a person meets F's charity care policy. F also conducted a survey of its membership. The survey data indicated use of F comes from three segments: the general community, O's and C's employees and O's patients. All economic segments of the community are significantly represented in F's survey of its members' annual income. F will periodically repeat this survey and use the information to adjust its fees to assure that individuals within all income levels use its facility.

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of organizations 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. In the law of charity, the promotion of health is considered to be a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372; IV Scott on Trusts, sections 368, 372 (3rd ed. 1967).

Rev. Rul. 69-545, 1969-2 C.B. 117, provides that a nonprofit organization whose purpose and activity are providing hospital care is promoting health and it may, therefore, qualify as organized and operated in furtherance of a charitable purpose if it meets the other requirements of section 501(c)(3) of the Code.

Rev. Rul. 59-310, l959-2 C.B. 146, holds that a nonprofit corporation organized for the purpose of establishing, maintaining and operating a public swimming pool, playground and other recreational facilities for the children and other residents of a community is exempt from federal income tax under section 50l(c)(3) of the Code. The organization operates in a community consisting principally of low-income groups who are unable to pay the cost of privately sponsored recreation facilities. The income derived from charges for admission to the pool was minor in amount.

Rev. Rul. 59-310 also discussed the case of Isabel Peters v. Commissioner, 21 T.C. 55 (1953), nonacq., l955-1 C.B. 8, withdrawn and acq. substituted therefor, 1959-2 C.B. 6.

In that case the Tax Court held that an organization operating a public beach, playground and bathing facility was charitable within the meaning of section 501(c)(3) of the Code. The revenue ruling acquiesced in the court case but only under the limited facts presented, which included the fact that no fees were charged to use the facilities. However, it emphasized that every organization dedicated solely to the promotion of social welfare should not be classified as charitable.

Rev. Rul. 67-325, 1967-2 C.B. 113, holds that an organization which provides recreational facilities without charge to the residents of a township is not organized and operated exclusively for charitable purposes, where the basis for charitable qualification is dedication of the facilities involved to community use and the use of the facilities is restricted to less than the entire community on the basis of race. This revenue ruling indicated that the basis for recognizing organizations that provided recreational facilities to the community as exempt under section 501(c)(3) was that they tend to lessen the burdens of government.

Rev. Rul. 79-360, 1979-2 C.B. 237, holds that the operation of health club facilities in a commercial manner by an organization exempt from tax under section 501(c)(3) of the Code constitutes unrelated trade or business under section 513. In this revenue ruling, the organization had recreational facilities that were used in its general physical fitness programs. These facilities included a track, gymnasium, swimming pool, and courts for racquetball, handball and squash. Members used these facilities as often as they wished and at a nominal fee. However, the organization also organized a health club program that its members could join for an advance annual fee that was sufficiently high that it restricted participation to a limited number of the members of the community. The annual fee was comparable to fees charged by similar local commercial health clubs. The advance annual fee was in addition to the nominal annual dues for membership in the organization. In addition, those who were not health club members paid admission fees comparable to fees charged by similar local commercial health club facilities.

Section 511(a) 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 the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions, computed with the modifications listed in section 512(b).

Section 513 of the Code defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related to the exercise or performance by an organization of the charitable purpose constituting the basis for its exemption under section 501(c)(3).

Section 513(a)(2) of the Code provides, in part, 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), by the organization primarily for the convenience of its employees.

Section 1.5l3-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, 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 the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Rev. Ruls. 69-267 and 69-268, 1969-1 C.B. 160, hold that a hospital gift shop, and cafeteria and coffee shop contributed importantly to the hospital's exempt purposes by contributing to the physical well-being of the patients, in the case of the gift shop, and by keeping the employees and staff on the premises throughout the workday, thereby increasing the hospital's efficiency, in the case of the cafeteria and coffee shop.

Section 509(a) of the Code provides that the term "private foundation" means an organization described in section 501(c)(3) other than one described in section 509(a)(1), (2), (3), or (4).

Section 509(a)(3) of the Code excludes from the definition of a private foundation an organization that is organized and 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 sections 509(a)(1) or (2). The supporting organization must also be operated, supervised or controlled by the supported organization; supervised or controlled in connection with the supported organization; or operated in connection with the supported organization.

Section 1.509(a)-4(a) of the regulations describes in general terms the various tests that a supporting organization must meet in order to be classified as an organization described in section 509(a)(3) of the Code.

Section 1.509(a)-4(c)(1) of the regulations specifies the requirements for the supporting organization's articles of incorporation. The articles must: (1) limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A) of the Code; (2) not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in section 509(a)(3)(A); (3) state the specified

publicly supported organizations on whose behalf such organization is operated; and (4) not expressly empower the organization to operate to support or benefit other than the specified publicly supported organizations.

Section 1.509(a)-4(e)(1) of the regulations requires the supporting organization to engage solely in activities that support or benefit the specified publicly supported organization; the furthering of any purpose other than supporting or benefiting the specified organization will prevent qualification. However, the supporting organization is not required to pay over its income to the supported organizations to meet the operational test. Section 1.509(a)-4(e)(2) provides that a supporting organization may satisfy the test by using the income to carry on an independent activity or program that benefits the supported organizations.

Section 509(a)(3)(C) of the Code prohibits direct or indirect control by one or more disqualified persons (as defined in section 4946 of the Code), other than foundation managers or section 509(a)(1) or (2) organizations.

C's purposes will not change as a result of the reorganization and amendments to its Articles of Incorporation and By-laws. C will continue to operate to accomplish its respective exempt purposes under section 501(c)(3) of the Code. Therefore, the proposed amendments will not adversely affect C's continued exemption. After the reorganization described above, C will support O and continue to qualify as an organization other than a private foundation under section 509(a)(3).

An exempt organization operating a fitness center may be charitable on the grounds it promotes health. The charitable purpose of promoting the health of a community is a basis for tax-exempt status under section 501(c)(3) of the Code. See Rev. Rul. 69-545, supra. Also, providing recreational facilities to the general public can be an exempt purpose under section 501(c)(3), as long as the facilities are available to a broad segment of the community. Similarly, in order to be exempt from unrelated business income tax under section 511, a fitness center that is conducted as an activity of an exempt organization must benefit a significant segment of the population.

F's provision of rehabilitative services to O's patients, who have, for example, undergone cardiovascular or orthopedic surgery or have been identified as having cardiovascular disorders is an exempt activity. By rehabilitating patients in accordance with treatment plans prescribed by physicians and hospital personnel, O's exempt purpose of providing for the health care needs of the community is served through F.

F's provision of facilities for health improvement and recreation of its members can be related to F's charitable purpose of providing community recreational facilities only if the fees charged are affordable to the community served. See Rev. Rul. 79-360, supra.

F's charitable purpose is demonstrated by the fact that the fees charged for memberships are affordable to a broad cross-section of the residents of the community. F conducted a survey to determine if its fees allow for all segments of its community to participate. F's fee structure was based on the survey. In addition, the survey will be updated with any new information used to adjust F's fees to assure all income levels in the community use the facility. Further, F has a charity care policy which provides for scholarships to pay all or part of a member's fees. As noted previously, up to 18% of all memberships will be funded by scholarships available under a charity care policy, and more than one-half of all members benefit from some form of discount. The charity care policy as well as the availability of F and its services is advertised in local newspapers with wide circulation in the total community. Under these circumstances, the operation of the fitness center furthers an exempt purpose under section 501(c)(3) of the Code.

Another significant activity of F is the provision of extensive community education and prevention programs, including an array of free programs conducted by F that benefit the community. Many of these programs can be accessed by the community without membership in F and are free of charge. However, if fees are charged they are reasonable, and scholarships are offered for the financially needy. Thus, by conducting these programs, F is furthering an exempt purpose under section 501(c)(3) of the Code.

The facts submitted indicate that O's and C's employees are members of F. The use of an exempt fitness center by its own employees or employees of an affiliated entity is excepted from unrelated trade or business under the "convenience exception" contained in section 513(a)(2) of the Code.

The pro shop and cafe are primarily used for the convenience of F's members and employees. The pro shop contributes to F's exempt purpose by providing fitness-related items that are used at its fitness center by its members. The cafe is used by F's members, as well as employees and staff throughout the workday, thereby increasing F's efficiency. Thus, under these circumstances, amounts derived from the pro shop and cafe would not be subject to tax under section 511. See Rev. Ruls. 69-267 and 69-268, supra. However, amounts attributable to sales of items by the pro shop that are not used at the fitness center, or amounts derived by the cafe from members of the general public would be subject to tax.

Accordingly, we rule as follows:

1. After the reorganization described above, C will continue to qualify for recognition of exemption as an organization described in section 501(c)(3) of the Code, and will continue to be classified as other than a private foundation under section 509(a)(3).

2. The operation of F in the manner described contributes importantly and is substantially related to the accomplishment of C's exempt purpose under section 501(c)(3) of the Code. Under the circumstances described, except as noted above, the operation of F by C is not an unrelated trade or business of C under section 513, and income derived from the operation of F will not be subject to the tax on unrelated business income under section 511.

This ruling is based on the understanding that there will be no material change in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service. We are informing your Exempt Organizations Area Manager of this ruling. Please keep this letter in your permanent records.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited by others 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 yours,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1