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

Date: JAN 30 2001

Contact Person:

Identification Number:

Telephone Number:

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Employer Identification Number:

Legend:

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J =

Dear Sir or Madam:

This is in response to your request for rulings as to the federal income tax consequences of a proposed joint venture to operate an ambulatory surgery center.

FACTS:

A was formed to develop, construct, own and operate an outpatient surgery center or other medical center, and to receive and maintain a fund to use and apply the whole or part of the income therefrom and the principal thereof exclusively for charitable, scientific, or educational purposes. A was recognized as exempt under section 501(c)(3) of the Internal Revenue Code and classified as a public charity described in sections 509(a)(1) and 170(b)(1)(A)(iii). A will accomplish its exempt purposes by participating in a joint venture with another section 501(c)(3) organization, B, to operate an ambulatory surgery center. A's sole member is C, a section 501(c)(3) organization that operates a general acute care inpatient hospital specializing in ophthalmology and otolaryngology surgery and services.

B was formed to develop, construct, own and operate an outpatient surgery center. It has been recognized as exempt under section 501(c)(3) of the Internal Revenue Code and classified as a public charity described in sections 509(a)(1) and 170(b)(1)(A)(iii). B will accomplish its exempt purposes by participating in a joint venture with A to operate an ambulatory surgery center. B's sole member is D, a section 501(c)(3) organization that was

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formed to further the exempt purposes of E, a state educational institution, and F, a teaching hospital that is a public body corporate and political subdivision of the State of G.

Due to a change in the means of providing eye, ear, nose and throat care and surgery and the need for substantial improvements to upgrade C's facilities, C determined that it was in the best interest of C and of healthcare in general that the operations carried out at C be carried on in an outpatient surgical hospital. Therefore, C formed A in order to organize and develop an outpatient facility.

A and B formed J to develop, construct, own and operate an outpatient ambulatory surgery center ("Center"). A and B each own 50 percent membership in J. A and B will each contribute cash, land, and operating assets to the Center sufficient to cover the estimated development capital contribution. After each member has contributed cash and property with a fair market value equal to 50 percent of the estimated development capital contribution, A and B shall contribute cash to J on a 50/50 basis. Equipment and land contributed by A and B to J shall be valued for capital contribution purposes at their fair market value, as determined by an independent third party appraiser.

A Certificate of Need was obtained from the State Health Commissioner authorizing J to construct the Center. Among the conditions imposed by the Commissioner and accepted by J are the following:

(1) C will delicense the six operating rooms that are currently licensed and operated at the hospital, and F will delicense two of its currently licensed and operated operating rooms.

(2) J will provide medical services to all patients referred to the Center regardless of such patients' ability to pay, and shall annually provide free surgery services to indigent patients equal to a certain percentage of the Center's gross revenue.

(3) J will provide a reasonable daily system of transportation from the downtown area to accommodate the needs of elderly and poor patients who would otherwise use C's hospital.

The assets contributed by C, through A, to J include operating rooms currently licensed to C and a broad base of experience in specialized ophthalmology and otolaryngology care and surgery. B brings the expertise of a large university hospital and a multi-specialty physician practice group.

A and B each will hold a 50 percent financial interest in J and will share equally in allocations of revenue and loss from its operations. However, A is contributing substantially all of the operating assets of its parent, C, to J. As a result, A and B have agreed that A shall control 60 percent of the voting interests in J, with B controlling the remaining 40 percent. A and B will collectively appoint all of the members of J's board of managers. The board shall consist of 10 managers. A shall appoint six managers, and B shall appoint four managers. Each member may remove managers appointed by it to the board, with or without cause, by giving

written notice to J and to the other member.

The Operating Agreement sets out several operational matters that will remain the exclusive province of the board and may not be delegated to the company manager, if any. Among these matters are the appointment of the officers, the incurrence of debt other than accounts payable incurred in the ordinary course of business; and the approval of annual budgets. All actions by the board require the vote of at least six managers. The following actions require unanimous approval of all managers of the board: (A) approve strategic and /or long range plans of J; (B) approve an annual capital budget that calls for capital expenditures to exceed $350,000 yearly; (C) approve capital expenditures in any year that exceeds $350,000 in any year; (D) incur debt in an aggregate amount that, when aggregated with all other debt, is greater than $1,000,000; (E) approve any transaction between J and one or more of its members or affiliates with the exception of any management agreement; (F) sell, lease, or otherwise dispose of J's assets (other than supplies used in the ordinary course of business) during any year having an aggregate book value in excess of $150,000; and, (G) approve the operating budget, or any amendment thereto, in the event that such annual operating budget projects profits equal to less than 2 percent of operating revenues.

J's Operating Agreement includes a charitable purposes policy. This policy requires the board and company manager, if any, to operate the Center in a manner that furthers charitable purposes by promoting health for a broad cross-section of the community. The Operating Agreement also provides that the duty to promote charitable purposes overrides any duty to operate the Center for financial benefit.

The Operating Agreement also provides that J and each member has a right of first refusal to purchase a transferring member's interest in J.

When the Center commences operations, C will cease operations of the hospital and will begin winding down its operations, collecting its accounts receivable and disposing of hospital equipment and related assets that are not contributed to J. C and D have agreed that C will sell the hospital building and land to F or one of its affiliates. Thus, C will sell the hospital real estate and improvements and contribute substantially all of its remaining operating assets (primarily equipment, staff and records) to J for use in the Center.

Following the completion of the Center and sale of the hospital assets, C intends to merge with and into A by means of a statutory merger (the "Merger") and on terms and conditions set forth in the Articles and Plan of Merger. At that time, the respective Boards of Directors of A and C will approve the Merger, as required under state law to consummate a merger. As of the date of the Merger, A's Articles of Incorporation and Bylaws will be amended and restated to (a) reflect the fact that A will, from and after the date of the Merger, have no members, and (b) preserve the C Board of Directors as the A Board of Directors. The day-to-day affairs of A will be governed by an Executive Committee identical to A's pre-Merger Board of Directors. The current Board of Directors of A is made up of the same persons who currently serve as the Executive Committee of the C Board of Directors.

Following the Merger, C will no longer be a distinct entity but will instead be a part of A.

A's principal activity will continue to be the provision of hospital and medical services through its participation as a member and owner of the 50 percent interest in J.

In addition to engaging, through J, in the provision of hospital and medical services as its principal activity, A will make charitable grants to local physicians to promote and carry out medical research projects and data collection in the medical specialties of otolaryngology and ophthalmology. These grants will be made in accordance with grant application guidelines. In addition, A will provide annual support for a local center that studies and treats low vision. This center provides such treatment to patients on a comprehensive basis that is unavailable elsewhere in the area. Funds will also be made available to support the medical education of both area physicians and the local community under the grant application guidelines. Physician educational funding will primarily subsidize continuing medical education seminars. Community education will include, among others, educational presentations regarding community health issues. Substantially all of the funds received by A in the form of distributions from J, as well as the pre-Merger non-operating assets of C, will be used to make such charitable grants and to provide financial support for the Center.

You request the following rulings with regard to the proposed transaction:

1. A's participation in J as described above will not adversely affect its status as an organization described in section 501(c)(3) of the Code.

2. Following the merger of C with and into A, A will continue to be classified as a non-private foundation as described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

3. A's distributive share of the profits and losses of J will be income from a trade or business that is substantially related to its charitable purposes and will not be subject to the tax on unrelated business income under section 511 of the Code.

LAW AND ANALYSIS:

Section 501(c)(3) of the Code describes as exempt from federal income tax, as provided under section 501(a), organizations organized and operated exclusively for charitable, scientific, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(1) of the Income Tax Regulations provides that an organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of designated individuals.

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).

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Rev. Rul. 69-545, 1969-2 C.B. 117, provides that a nonprofit corporation whose purpose and activity are providing hospital care is promoting health and therefore furthers charitable purposes as provided in section 501(c)(3) of the Code if it meets the community benefit requirements. The community benefit standard focuses on a number of factors indicating the operations of a hospital benefit the community rather than serving private interests.

Rev. Rul. 98-15, 1998-1 I.R.B. 6, compares two situations where an exempt hospital forms a joint venture with a for-profit entity and then contributes its hospital and all of its other operating assets to the joint venture, which then operates the hospital. In Situation 1, the revenue ruling concludes that the exempt organization will continue to further charitable purposes when it participates in the joint venture. Favorable factors include: the commitment of the joint venture to give charitable purposes priority over maximizing profits; the community make-up and structure of the board; the voting control held by the exempt organizations' representatives on the board; the specifically enumerated powers of the board; and, the reasonable terms and conditions of the management contract. In Situation 2, the revenue ruling concludes that the organization fails the operational test when it participates in the joint venture because activities of the joint venture will result in greater than incidental private benefit to the for-profit partner.

Section 509(a)(1) of the Code defines the term "private foundation" as an organization described in section 501(c)(3) other than an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 170(b)(1)(A)(iii) of the Code refers to an organization whose principal purpose or function is the provision of medical or hospital care.

Section 1.170A-9 of the regulations provides that the term "section 170(b)(1)(A) organization" means any organization described in paragraphs (a) through (i) of section 1.170A-9 effective with respect to taxable years beginning after December 31, 1969.

Section 511 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 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)(1) 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 directly connected with such gross income.

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Section 513(a)(1) 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 income or funds or the use its makes of the profits derived) to the exercise or performance by such organization of its 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 the purposes for which exemption is granted, the production or distribution of the goods or the performance of services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

After the creation and operation of the joint venture, A and B will provide health care to the community through the operation of the ambulatory surgery center, according to the community benefit requirements of Rev. Rul. 69-545, supra. As provided in Rev. Rul. 98-15, supra, the activities of a limited liability company 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 limited liability company when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code. A section 501(c)(3) organization may form and participate in a partnership, including a limited liability company which has not elected to be treated as a corporation for federal tax purposes, and meet the operational test of section 1.501(c)(3)-1(c) of the regulations 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 purposes and only incidentally for the benefit of any for-profit partners.

In contrast to Rev. Rul. 98-15, both members of J will be entities that are exempt from tax under section 501(c)(3) of the Code, so that the activities of J remain entirely in the control of these tax exempt charities, and J will benefit only exempt entities. Thus, after the formation of J, A and B each will continue to promote the health of the community and otherwise accomplish their respective exempt purposes through the operation of J, consistent with Situation 1 of Rev. Rul. 98-15. Because any income or cash of J will be allocated as distributions only to A or B in accordance with the Operating Agreement, the creation and operation of J will not result in any private inurement or private benefit. A and B will continue to qualify for exemption as organizations described in section 501(c)(3) of the Code.

Until the date on which the construction of the Center has been completed, C will continue to own and operate the hospital, a general acute care inpatient hospital specializing in ophthalmology and otolaryngology surgery and services. So long as it owns and operates the hospital in pursuit of its exempt purposes, C will continue to qualify as exempt under section 501(c)(3) of the Code. C will also continue to qualify as a non-private foundation because, as a hospital, it is a public charity described in sections 509(a)(1) and 170(b)(1)(A)(iii). C's initial participation, as a sole member of A, in forming J and constructing the Center will not affect its exempt status nor its non-private foundation status.

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Because the Service treats each taxable year separately, C will continue to retain its status as a hospital under section 170(b)(1)(A)(iii) of the Code until the taxable year following the year in which it ceases operation of the hospital.

Following the Merger, A's principal activity will be the provision of hospital and medical services as described in sections 509(a)(1) and 170(b)(1)(A)(iii) through its participation as a member and owner of an interest in J, which will own and operate the ambulatory surgery center.

The exempt purposes of A and B will be furthered by A's and B's participation in J because their participation enables them to provide expanded and improved health care services to the community. The purposes of J specifically include furthering the tax-exempt purposes of its members and enhancing the quality of health care and promoting the general health and wellbeing of the community. Accordingly, such participation will not constitute an unrelated trade or business of either A or B within the meaning of section 513 of the Code.

CONCLUSION:

Accordingly, we rule as follows:

1. A's participation in J as described above will not adversely affect its status as an organization described in section 501(c)(3) of the Code.

2. Following the merger of C with and into A, A will continue to be classified as a non-private foundation as described in sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

3. A's distributive share of the profits and losses of J will be income from a trade or business that is substantially related to its charitable purposes and will not be subject to the tax on unrelated business income under section 511 of the Code.

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. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

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. Because this letter could help resolve future questions about your income tax responsibility, please keep a copy of this ruling in your permanent records.

We have sent a copy of this letter to your authorized representative as indicated in your power of attorney.

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Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

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