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

Date: FEB 07 2001
Issue list

0501.03-11
0512.02-00

Contact Person:

Identification Number:

Telephone Number:

T:EO:B1

Employer Identification Number:

Legend:

A =
B =
C =
D =

Dear Sir or Madam:

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

FACTS:

You are recognized as exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code. You operate a community based health care system. You are not a private foundation within the meaning of section 509(a)(3) of the Code. You and your affiliates provide hospital, physician, home health, hospice, nursing home, and other health care services in your service area. Your primary business is the operation of A.

In order to better serve community needs, you and a group of local physicians have formed B, a professional limited liability company, to own and operate an ambulatory surgery center ("ASC"). You formerly owned and operated the ASC.

You contributed sufficient capital to acquire a 70 percent ownership interest in B. The individual physicians contributed sufficient capital to acquire a 30 percent ownership interest. Additional members will be admitted to B if approved by the board of directors. You will reduce your percentage interest in profits and losses by selling membership interests to approved purchasers until your percentage interest in profits and losses is 51 percent. Thereafter, the percentage interests in profits and losses of the other members will be reduced proportionately

235

by selling membership interests to approved purchasers. All profits and losses are allocated to the members based on membership percentage.

B has leased the ASC from C, pursuant to the terms of a lease. B has also leased the equipment used in the ambulatory surgery center from C under a separate lease agreement. C is your for-profit subsidiary that was formed to develop the medical complex surrounding A. You represented that each of the lease agreements was negotiated at arm's length and represents the fair market rental value of the facilities and the fair market purchase value of the equipment.

The operations of B are conducted pursuant to an Operating Agreement entered into by B's members. The Operating Agreement provides that the purpose of B is to lease and/or own and operate an ambulatory surgery center in furtherance of your tax exempt and public charity purposes by promoting health for a broad cross section of its community (which includes the people in your service area). It further provides that B and its board of directors will at all times cause B to be operated for such purposes and that this duty overrides any duty to operate B for the financial benefit of the members. You have represented that the overriding charitable purpose in B's Operating Agreement is legal, binding and enforceable under D's Limited Liability Company statutes. The Operating Agreement further states that B recognizes that charity care was previously provided at the ASC prior to the execution of the Agreement and B will continue to provide charity care. Any unresolved dispute concerning the terms and provisions of the Operating Agreement will be submitted to binding arbitration.

On all matters requiring a vote of the members, each member has a vote equal to his percentage interest in profits and losses of B at the time of the vote. The following matters require the approval of a majority vote of all members:

(A) Annual operating budget and capital budget;

(B) Purchase of assets not included in the annual budgets in excess of $50,000 as to any one item or $100,000 in the aggregate in any fiscal year;

(C) Lease of assets as lessor not included in the annual budgets with payments totaling in excess of $50,000 as to any one item or $100,000 in the aggregate in any fiscal year;

(D) Equipment leases as lessee not included in the annual budgets with payments totaling in excess of $50,000 as to any one item or $100,000 in the aggregate in any fiscal year;

(E) Contracts not related to the items in (B)-(E) inclusive not included in the annual budgets with payments totaling in excess of $50,000 as to any one item or $100,000 in the aggregate in any fiscal year;

(F) Distribute cash in an amount less than 90 percent of net income if accumulation of cash is required to allow B to further your tax exempt and public charity purposes;

(G) Distribute cash in an amount greater than 90 percent of net income;

(H) Approve or disapprove recommendations from the board of directors;

(I) Borrow money not included in the annual budget in excess of $50,000 total outstanding debt;

(J) Pledge or mortgage assets;

(K) Distribute assets other than cash;

(L) Remove a member for cause;

(M) Approve the transfer of a member interest not specifically authorized by the Operating Agreement;

(N) Engage in a business unrelated to the ambulatory surgery center business;

(O) Approve the amount of fees to be paid to the directors.

The following matters require your approval and the percentage vote of all of the other members:

(P) Dissolution of B pursuant to approval of the members – other member percentage of 75 percent;

(Q) Amend the Operating Agreement - other member percentage of 75 percent;

(R) Amend the Articles of Organization if the amendment would change any provision of the Operating Agreement – other member percentage of 75 percent;

(S) Approve an agreement with you for providing services to B – other member percentage of 75 percent.

D's Limited Liability Company statutes require the consensus vote of members in situations (P), (Q), and (R), above.

The board of directors manages the routine day to day business and affairs of B. The number of directors is 6. You appoint 2 of the directors, and the remaining members elect 4 of the directors, all whom must also be members. Each director elected by you will have 3 votes on all matters that come before the board. Each director elected by the members other than you will have 1 vote on all matters that come before the board. All matters that come before the board will be decided by a majority vote. You provided information indicating that the directors appointed by you to the board of directors are community leaders experienced in health care matters. The directors appointed by you are not on the medical staff of the hospital or on the medical staff of the ASC, and are not otherwise engaged in business transactions with you, A, B, or the ASC, other than as a board member or officer.

B has a charity care policy consistent with your policy. The charity care policy will be made known to potential patients. Charity care will not be included in bad debt. You represented that services provided to charity care patients and Medicaid patients will not differ from those services provided to other patients. The approximate percentage of patients that are expected to be served by B are (a) indigent - 4 percent; (b) Medicare - 36 percent; (c) Medicaid - 6 percent; (d) Non-Medicare or Medicaid Managed Care -10 percent; (e) Non-Medicare/Medicaid Fee-for-Service - 43 percent; and (f) Self-pay - 1 percent. These percentages are roughly equivalent to the percentage of patients that were served at the ASC when you owned it prior to the creation of B.

Physician privileges at B's facility are not dependent upon owning a membership interest in B. Medical staff members apply for and are granted privileges at the facility based on credentialling criteria. Approximately 40 percent of the physicians with privileges to practice at the ASC own membership interests in B. Currently, B has no employees and no future plans to have employees. You provide support services to B pursuant to a Service Operations Agreement. You lease nursing, clinical, administrative, clerical, and other staff/personnel to B. Medical staff members are independent practitioners and are not employees of you or of B. Professional services are billed separately by the independent practicing medical staff members providing the service. B bills for the technical services and use of the facility.

You have requested the following rulings:

1. Your participation in the ownership and operation of B, which will provide outpatient surgery services, will not jeopardize your status as an organization described in section 501(c)(3) of the Code.

2. Your participation in the ownership and operation of B, which will provide outpatient surgery services, will not jeopardize your status as a public charity classified under section 509(a)(3) of the Code.

3. The distributive share of profits and losses you receive with respect to your membership in B will not result in unrelated business taxable income to you, as provided in sections 511 - 513 of the Code.

APPLICABLE LAW:

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(a)(1) of the Income Tax Regulations provides that in order 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 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(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 exempt purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. See Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279, in which the Supreme Court held that the presence of a single nonexempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

Section 1.501(c)(3)-1(d)(1) of the 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).

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 serve private interests.

Rev. Rul. 78-41, 1978-1 C.B. 148, concludes that a trust created by a hospital to accumulate and hold funds to pay malpractice claims against the hospital qualified for exemption under section 501(c)(3) of the Code as an integral part of the hospital. The hospital provided the funds for the trust, and the banker-trustee was required to make payments to claimants at the direction of the hospital. The organization conducted an activity that the hospital could perform itself.

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)(3) of the Code excludes from the definition of private foundation those organizations that are (A) organized, and at all times thereafter are 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 paragraph (1) or (2); (B) operated, supervised, or controlled by or in connection with one or more organizations described in paragraph (1) or (2); and (C) not controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than one or more organizations described in paragraph (1) or (2).

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 with such gross income.

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)(1) of the regulations provides that gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of income) to the purposes for which exemption is granted. This requirement necessitates an examination of the relationship between the business activities that generate the particular income in question and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that to be substantially related to the exempt purposes of the organization, the business activity must have a causal relationship to the achievement of exempt purposes and it must contribute importantly to the accomplishments of those purposes.

ANALYSIS:

Under the regulations, an organization that is organized and operated exclusively for charitable purposes may qualify for exemption under section 501(c)(3) of the Code. The promotion of health has long been recognized as a charitable purpose.

Whether a hospital or other health care organization promotes health in a charitable manner is determined under the community benefit standard of Rev. Rul. 69-545, supra. This standard focuses on a number of factors to determine whether the hospital benefits the community as a whole rather than private interests.

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. Aggregate treatment is also consistent with the treatment of partnerships for purposes of the unrelated business income tax under section 512(c) of the Code. In light of the aggregate principle discussed in Butler v. Commissioner and 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 limited liability company treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit 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).

A section 501(c)(3) organization may form and participate in a partnership, including a limited liability company treated as a partnership for federal income tax purposes, 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 purposes and only incidentally for the benefit of the for-profit partners. See Rev. Rul. 98-15, supra.

Based on Rev. Rul. 98-15, supra, whether a nonprofit organization whose principal activity is the ownership of a membership interest in a limited liability company that is engaged in health care activities satisfies the community benefit standard depends on all the facts and circumstances.

Following the formation and operation of B, you will continue to be primarily involved in furthering the needs of the exempt hospital system and its exempt entities, similar to that described in Rev. Rul. 78-41, supra. In addition, your participation in B will further your exempt purposes. Your participation in B and operation of the ASC will promote health for the community in a manner that satisfies the requirements of Rev. Rul. 69-545, supra. The structure of B and operation of the ASC will allow you to act exclusively in furtherance of charitable purposes with no undue private benefit to the physician members.

Currently, you own a 70 percent membership interest in B. Pursuant to the Operating Agreement, you will always own at least 51 percent of B. You will have voting control over major decisions. You will also have 6 of the 10 total votes of B's board of directors, which manages the day to day operations of the ASC. A majority of votes is needed to approve decisions. Thus, you will exercise effective control over the major decisions of B and over the operations and activities of the ASC. This control will ensure that the assets you will own through B and the activities you will conduct through B at the ASC will be used primarily to further exempt purposes. Similarly, in Situation 1 of Rev. Rul. 98-15, the LLC is majority owned by the section 501(c)(3) hospital. A governing board consisting of 3 individuals chosen by the section

501(c)(3) hospital and 2 individuals chosen by the for-profit organization manages the LLC. A majority of the board must approve certain major decisions. Through the hospital's effective control over the LLC's governing board and decision-making structure, the hospital could ensure that the assets it owned through the LLC and the activities it conducted through the LLC would be used primarily to further exempt purposes.

Contributions to B and allocations of profits, losses, and distributions from it will be in proportion to the interests of the members of B. With respect to termination, following the payment of all debts and liabilities of B and the allocation of income, profits, losses and deductions, remaining funds will be distributed to the members in payment of the amount of their capital accounts. As a limited liability company, no owner of B will be personally liable for the debts and obligations of B. Similarly, in Situation 1 of Rev. Rul. 98-15, profits and losses were allocated in proportion to the interests of the members.

The Operating Agreement specifically provides that the duty of the members and the board of directors is to operate B in a manner that furthers charitable purposes by promoting the health of a broad cross section of the community and that this duty overrides any duty to operate B for the financial benefit of its members. Similarly, in Situation 1 of Rev. Rul. 98-15. the LLC's governing documents committed the LLC to provide health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits for the LLC's owners.

Your participation in the formation of B and B's operation of the ASC consistent with its governing documents will further your charitable purposes and allow you to continue to be operated exclusively for exempt purposes. B will have a charity care policy that is made known to patients. The ASC will serve all members of the community needing medical care, including Medicare, Medicaid and indigent patients. Similarly, in Situation 1 of Rev. Rul. 98-15, all the facts and circumstances established that when the hospital participates in the formation of the LLC and when the LLC operates in accordance with its governing documents, the hospital will be furthering charitable purposes and will continue to be operated exclusively for exempt purposes.

Formation and operation of B will further your exempt purposes. The control you will exercise will ensure that an exempt organization will retain control of the ASC's operations and will ensure that medical services will be provided in a charitable manner in order to promote health for a broad cross section of the community regardless of ability to pay, including Medicare, Medicaid, and indigent patients. Your ownership in B will enable you to continue to promote health in a charitable manner. Because your involvement in B furthers your charitable purposes, your participation is substantially related to your exempt purposes, and does not result in unrelated business taxable income to you under sections 511 through 513 of the Code.

CONCLUSION:

Based on the facts and discussion above, we rule as follows:

1. Your participation in the ownership and operation of B, which will provide outpatient surgery services, will not jeopardize your status as an organization described in section 501(c)(3) of the Code.

2. Your participation in the ownership and operation of B, which will provide outpatient surgery services, will not jeopardize your status as a public charity classified under section 509(a)(3) of the Code.

3. The distributive share of profits and losses you receive with respect to your membership in B will not result in unrelated business taxable income to you under sections 511 - 513 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.

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

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

Sincerely,

Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1