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

200127052

Date: APR 12 2001

Contact Person:

Identification Number:

Telephone Number:

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Employer Identification Number:

Legend

A =
B =
D =
E =
X =

Dear Sir or Madam:

This is in reply to your request for rulings as to the consequences of the sale of your assets on your exempt status under section 501(c)(3) of the Internal Revenue Code and as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

FACTS

A for years operated a hospital and is recognized as an organization described in section 501(c)(3) of the Code and as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code. A sold its assets to B, an organization also recognized as an organization described in section 501(c)(3) of the Code and as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

The sale to B entailed the transfer of substantially all of the assets owned or leased by A in connection with the hospital. However, A retained certain assets, including: restricted and unrestricted cash and cash equivalents, generally including investments in marketable securities, certificates of deposit, bank accounts and promissory notes; rights to settlement and retroactive adjustments for open cost reporting periods ending on or prior to the date of closing and arising from or against the federal government under certain federal programs, from or against any state under state Medicaid programs, or from or against third-party payor programs that settle on a cost report basis; assets in pension plans maintained for employees of A and its affiliates; notes or accounts receivable and advances owing from physicians; and certain other assets identified in exhibits to the sale agreement.

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The sale was structured in a manner to accomplish, among other purposes, the following:

1. To allow A to discontinue its operation as a medical and surgical hospital and yet to continue to accomplish its exempt purposes and to maintain its exempt and public charity status;

2. To produce long-term economies of scale, general health care improvements, and community enhancements for the people and the area served by A; and

3. To generate a pool of funds that could be invested and used as a community resource to improve the lives of the people in and around the community where the hospital has operated for over three decades.

After resolving various issues relating to its past operation of the hospital and reorganizing its governance structure, A will convert to a supporting organization of D. D's Board of Directors will approve the proposed supporting organization relationship with A. D is an organization described in section 501(c)(3) of the Code and as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code. D is organized and operated to conduct charitable, educational, and similar programs and activities benefiting the residents of its service area.

After resolving post-closing issues relating to the sale, A will have roughly X in net proceeds to invest and to use for its new exempt purposes. A intends to amend its name to reflect the change in operation from a health care provider to a community support organization. A's new name likely will be E. In addition to adopting a new name, A will amend and restate its Articles of Incorporation and Bylaws to include the following provisions, among others:

1. A will operate at all times as a Code section 509(a)(3) supporting organization of D, conducting and supporting activities that carry out the exclusively charitable, scientific, educational, and other exempt purposes of D. In furtherance of this purpose, A may engage in the following activities in support of D:

   (a) Providing financial support to the medically indigent;
   (b) Providing financial support and care to hospice patients and their families;
   (c) Providing support directly to community outreach programs such as home health care;
   (d) Contributing grant monies to tax-exempt medical and health programs;
   (e) Supporting health care education through the funding of internships, research grants, forums, and health fairs; and
   (f) Making grants to health related organizations and other charities within the geographic or program scope of D.

2. D will have the power to appoint at least fifteen percent of A's Board of Directors, insuring that D at least appoints one member of A's Board.

3. Upon dissolution, A will distribute to D all assets (if any) remaining after payment of grants approved by its Board of Directors and other obligations. If D is no longer described in Code sections 170(c)(2)(B), 501(c)(3), 2055(a)(2), and 2522(a)(2), A will distribute its remaining assets to one or more alternate organizations designated by its Board that are described in Code sections 170(c)(2)(B), 501(c)(3), 2055(a)(2), and 2522(a)(2). The Articles will not empower E to support or benefit any organization other than D (other than through the activities described above).

A will rely on D's expertise in developing investment policies, grant making policies, scholarship and award programs, and gift acceptance policies. D will be available to provide continuing oversight of investment managers, prepare financial statements for A, and develop reports on investment performance by fund managers. D's officers and staff also will provide A with operating and administrative support in the areas of governance, legal and statutory compliance, grants and program management, financial oversight and record keeping, fund development, and public relations. Furthermore, A will earmark its funds for D's programs by making grants only with the approval of D. Such approval may be manifest in either of the following ways:

1. The name of the proposed grantee must appear on a list of grantees approved in advance by D; or

2. D's Executive Director must agree to any proposed grant to a grantee not on the pre-approved list.

RULINGS REQUESTED

A requested the following rulings:

1. The sale, and A's participation in the sale, is consistent with A's charitable purposes and section 501(c)(3) status;

2. That during taxable years 2000 and 2001, A will qualify as other than a private foundation under section 509(a)(2) of the Code;

3. Upon its adoption of the amended and restated Articles of Incorporation and Bylaws, A will qualify as other than a private foundation under section 509(a)(3) of the Code;

4. A will not be or become a private foundation subject to the private foundation rules set forth in sections 4940 through 4945 of the Code, including specifically the excise tax described in section 4940 of the Code; and

5. The gain realized by A from the sale does not constitute unrelated business taxable income under section 512 of the Code and, therefore, is not subject to the tax under section 511 of the Code.

LAW

501(c)(3) Status

Section 501(a) of the Internal Revenue Code exempts from taxation organizations described in subsection (c)(3), including corporations organized and operated exclusively for charitable and educational purposes. Furthermore, the aforementioned subsection requires that no part of the organization's net earnings inure to the benefit of any private shareholder or individual, that no substantial part of its activities is to influence legislation, and that it does not participate in any political campaign on behalf of or in opposition to any candidate for public office.

Unrelated Trade or Business

Section 511 of the Code provides for the imposition of a tax on all unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code provides that the term "unrelated trade or business income" means the gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it.

Section 513 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 such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 1.512(b)-1(d)(1) of the regulations excludes from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (1) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (2) property held primarily for sale to customers in the ordinary course of the trade or business.

Section 512(b)(4) of the Code in part, provides that capital gains generally excluded from unrelated business taxable income will be included and taxed to the extent derived from "debt-financed property."

Section 1.513-1(a) of the regulations provides that the income of the trade or business must be included in the computation of unrelated business taxable income if: (1) it is income from a 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 to the organization's performance of its exempt function.

Section 1.513-1(c) of the regulations provides that to determine whether a trade or business is "regularly carried on," within the meaning of section 512 of the Code, regard must be

had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 514(b)(1)(A) of the Code and section 1.514(b)-1(b)(1) of the regulations provide that property, the use of which is "substantially" related to an organization's exempt function is not debt financed property. Section 1.514(b)-1(b)(1)(ii) of the regulations provides that substantial is defined as 85 percent or more of the use of the property.

Private Foundation Status

Sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code provide that a hospital, a cooperative hospital service organization, or a medical research organization operated in conjunction with a hospital is other than a private foundation. Section 1.170A-9(c)(1)(ii) of the regulations provides that the term "hospital" includes a rehabilitation institution, outpatient clinic, or community mental health or drug treatment center if its principal purpose or function is providing hospital or medical care.

Section 509(a)(2) of the Code provides that an organization that receives less than one third of its financial support from investments and more than one third from a combination of contributions, membership fees, and gross receipts from activities related to its exempt functions, is other than a private foundation.

Section 1.509(a)-3(c)(1) of the regulations provides that the support tests set forth in section 509(a)(2) are to be computed on the basis of the nature of the organization's 'normal' sources of support. An organization will be considered as "normally" receiving one-third of its support from any combination of gifts, grants, contributions, membership fees, and gross receipts from permitted sources (subject to the limitations described in paragraph (b) of this section) and not more than one-third of its support from items described in section 509(a)(2)(B) for its current taxable year and the taxable year immediately succeeding its current year, if, for the 4 taxable years immediately preceding the current taxable year, the aggregate amount of the support received during the applicable period from gifts, grants, contributions, membership fees, and gross receipts from permitted sources (subject to the limitations described in paragraph (b) of this section) is more than one-third, and the aggregate amount of the support received from items described in section 509(a)(2)(B) is not more than one-third of the total support of the organization for such 4-year period.

Section 509(a)(3) of the Code provides that an organization that meets the following requirements is other than private foundation:

1. It is organized, and at all times thereafter is operated 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)(2) or 509(a)(1) and 170(b)(1)(A) of the Code other than in clauses (vii) and (viii);

2. It is operated, supervised, or controlled by or in connection with one or more organizations described in sections 509(a)(1) and 170(b)(1)(A) other than in clauses (vii) and (viii), as well as in section 509(a)(2); and

3. It is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in sections 509(a)(2) or 509(a)(1) and 170(b)(1)(A), other than in clauses (vii) or (viii).

Section 1.509(a)-4(c)(1) of the regulations provides that in order for an organization to be organized exclusively for one or more of the purposes specified in section 509(a)(3) of the Code its articles of organization:

(i) Must limit the purposes to one or more of the purposes set forth in section 509(a)(3)(A);

(ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this paragraph;

(iii) State the specified publicly supported organizations on whose behalf such organization is to be operated;

(iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

Section 1.509(a)(3)-4(e) of the regulations provides that a supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations only if it is engages in activities which support or benefit the specified publicly supported organizations. An organization may satisfy this test by using its income to carry on an independent activity or program that supports or benefits the specified publicly supported organizations.

Section 1.509(a)(3)-4(f)(2) of the regulations provides that section 509(a)(3)(B) of the Code may be satisfied by three different types of relationships that will justify classification of an organization as a supporting organization:

(i) Operated, supervised, or controlled by,

(ii) Supervised or controlled in connection with, or

(iii) Operated in connection with, one or more publicly supported organizations.

Section 1.509(a)(3)-4(f)(3) requires that any of the above relationships insure that the supporting organization will be responsive to the needs or demands of one or more publicly supported organizations; and the supporting organization will constitute an integral part of, or

maintain a significant involvement in, the operations of one or more publicly supported organizations.

RATIONALE

A was recognized as an organization described in section 501(c)(3) of the Code and as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code. Its assets were sold to B, also an organization described in section 501(c)(3). A valuation was obtained as to the fair market value of A's assets. In selecting the purchaser, A has represented that it was not only concerned with the sale price but also with the purchaser's ability to continue providing to the community the services of an acute care hospital. A has represented that the sale of A's operating assets and partnership interest to B is the result of arm's-length negotiations and that the negotiated price represents fair market value for the assets sold.

Although A converted its operating hospital assets to generate a pool of funds, such amounts remain dedicated to further exclusively charitable purposes. Therefore, the sale and A's participation in the sale is consistent with its exempt purpose under section 501(c)(3) of the Code.

The proposed amendment to A's Articles of Incorporation will change its name to E. The sale proceed and the remaining assets of A and its affiliates will be used by E to support D in activities that promote accessibility of health care services for persons in the community. Therefore, the grant funds that E provides will be used to further charitable purposes under section 501(c)(3) of the Code.

A will require some time to wind up its activities with respect to the hospital. This period conceivably could last until late 2000 or early 2001. During its 1998 taxable year (the most recent year for which it has filed Form 990), A received less than one percent of its financial support from gross investment income. The remainder - over 99 percent - was derived from gross receipts directly related to A's exempt purpose (i.e., operating a hospital), gifts, grants, contributions, and other gross receipts from its exempt activities. A's support information from 1998 is reflective of its past years' experience, and the hospital should have similar support percentages for 1999.

After the sale, A will continue to qualify as an organization excepted from private foundation classification by reason of being described in section 509(a)(2) of the Code if it continues normally to meet the public support requirements in section 1.509(a)-3(c) of the regulations.

After the sale, A will be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of D. A will specify in its Amended Articles of Incorporation that it is organized and operated exclusively to support D. Its activities will include making grants to support health related programs within the geographic or program scope of D. A will earmark its funds for D's programs. A will only make grants with the approval of D, either by D providing a list of approved grantees, or by D's Executive Director agreeing to any proposed grant for grantees not in the pre-approved list. D will appoint at least 15 percent of the members of A 's Board of Directors or at least one member of A's Board and in the event of A's dissolution all

remaining assets will be distributed to D. Thus, A will meet the requirements for classification as a supporting organization under section 509(a)(3) of the Code and will not be a private foundation subject to the private foundation rules set forth in sections 4940 through 4945 of the Code.

To the extent that A's assets qualify as property the use of which is substantially related to A's exempt function under the provisions of sections 512(a), 513(a), and 514(b)(1)(A) of the Code. Therefore, the income derived from the sale of A's operating assets and the partnership interests will not constitute unrelated business taxable income under section 512 and 513 of the Code.

RULINGS

Therefore, we rule as follows:

1. The sale, and A's participation in the sale, is consistent with A's charitable purposes and section 501(c)(3) status;

2. For taxable years after the sale, A will continue to qualify as other than a private foundation under section 509(a)(2) of the Code if it normally meets the public support requirements as provided in section 1.509(a)-3(c) of the regulations.

3. Upon its adoption of the amended and restated Articles of Incorporation and Bylaws, A will qualify as other than a private foundation under section 509(a)(3) of the Code;

4. A will not be or become a private foundation subject to the private foundation rules set forth in sections 4940 through 4945 of the Code, including specifically the excise tax described in section 4940 of the Code as long as it continues to be described either in sections 509(a)(2) or 509(a)(3) of the Code; and

5. To the extent that A's assets are substantially related to its exempt function, the gain realized by A from the sale does not constitute unrelated business taxable income under section 512 of the Code and, therefore, is not subject to the tax under section 511 of the Code.

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.

The rulings in this letter only apply the specifically indicated sections of the Code and regulations to the facts that you have represented. In this letter we do not rule on the applicability of any other sections of the Code and regulations to your case.

Because this letter could help resolve any 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.

Sincerely yours,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1