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

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Date:

MAY 23 2002

Contact Person:

ID Number:

Telephone Number:

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Employer Identification Number:

Legend:

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Dear Sir or Madam:

This is in response to a letter from your authorized representative requesting rulings on your behalf regarding the tax consequences associated with the reorganization of the operations of a tax-exempt integrated healthcare system.

You have stated that A is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and has operated a hospital under the sponsorship of a religious congregation. A different religious congregation and its multi-tiered system, B, has recently assumed sponsorship of A. Within this structure, A's sole corporate member is a holding company, E.

You have stated that A recently entered into a joint operating agreement with C, another tax-exempt hospital located in its geographic area, which resulted in the formation of D to oversee and direct the activities of and services of A and C. D is exempt from federal income tax under section 501(c)(3) of the Code.

You have stated that for various reasons a new campus was purchased for A and a new hospital facility has been constructed on that campus and is about to open. In contemplation of this opening, D concluded that significant efficiencies would result if the activities conducted on the campuses of A and C could be conducted within a single corporate entity. D has proposed an alternative operating structure in contrast to an

alternative corporate structure.

Upon completion of the new A facility, the facility and the equipment located therein will be leased to C, which will then operate and control the business of the new A facility as well as the C facility. C will be the provider of all services at both facilities.

You have stated that from a corporate standpoint, A and C will continue to function in the same manner as they have done in the past, under the coordinated oversight and direction of D. A will continue to have its own board of directors which will be appointed by E. Whereas A's activities previously consisted of operating a hospital, you have stated that its activities will now consist of owning and leasing a hospital facility in support of the overall charitable purposes of D.

You have requested the following rulings in connection with the transaction described above: (1) The proposed alternative operating structure, including the lease by A to C of A's assets, will not adversely affect A's tax-exempt status under section 501(c)(3) of the Code; (2) Under the proposed alternative operating structure, A will continue to be classified as a nonprivate foundation, but will be reclassified as a supporting organization under section 509(a)(3) and (3) The rental income to be received by A pursuant to the lease, as well as any operating income to be allocated to A, will not result in unrelated business taxable income to A under sections 511 through 514.

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, acknowledges 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, provides, in part, that a trust operated 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 under section 501(c)(3). It was held that the trust was operating as an integral part of the hospital, performing a function that the hospital could do directly.

Section 509(a)(3) of the Code provides that a supporting organization of an organization described in section 509(a)(1) or 509(a)(2) is not a private foundation.

Section 509(a)(3)(A) of the Code requires that a supporting organization be organized and at all times thereafter 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 section 509(a)(1) or (2).

Section 509(a)(3)(B) of the Code requires that a supporting organization be operated, supervised or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2).

Section 509(a)(3)(C) of the Code requires that a supporting organization not be 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 section 509(a)(1) or (2).

Section 1.509(a)-4(f)(1) of the regulations states that section 509(a)(3)(B) of the Code sets forth three different types of relationships, one of which must be met in order to meet the requirements of the subsection. One of those requirements is operated, supervised or controlled by one or more publicly supported organizations. Section 1.509(a)-4(f)(4) of the regulations provides that in the case of supporting organizations which are supervised or controlled by one or more publicly supported organizations, the distinguishing feature is the presence of a substantial degree of direction by the publicly supported organizations over the policies, programs and activities of the supporting organization, such as the fact that a majority of the officers, directors or trustees of the supporting organization are appointed or elected by the governing body, officers acting in their official capacity or the membership of one or more publicly supported organizations.

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) defines unrelated business taxable income as the gross income derived by any 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) 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 the 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 exempt purposes.

Section 514(a) requires unrelated business income attributable to debt-financed property to be included within the calculation of an organization's unrelated business taxable income.

A will not adversely affect its tax exempt status under section 501(c)(3) of the Code by the proposed transaction as it will perform essential services for D. A qualifies for nonprivate foundation status under section 509(a)(3) of the Code as it meets the requirements of section 509(a)(3)(A), (B) and (C). The rental income to be received by A pursuant to the lease as well as operating income to be allocated to A will not result in unrelated business taxable income to A.

Accordingly, based on all the facts and circumstances described above, we rule: (1) The proposed alternative operating structure, including the lease by A to C of A's assets, will not adversely affect A's tax-exempt status under section 501(c)(3) of the Code; (2) Under the proposed alternative operating structure, A will continue to be classified as a nonprivate foundation, but will be reclassified as a supporting organization under section 509(a)(3); and (3) The rental income to be received by A pursuant to the lease, as well as any operating income to be allocated to A, will not result in unrelated business taxable income to A under sections 511 through 514.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based.

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.

Please keep a copy of these rulings in your permanent records.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1