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Issue Letter

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

Date: NOV 1 2002

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 a request for rulings as to the federal income tax consequences of a participation in a proposed joint venture with physicians to operate a cardiac catheterization laboratory.

FACTS:

A is a nonprofit general acute care hospital that has been recognized as exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3) of the Code. It has been classified as other than a private foundation under section 509(a)(1) as a hospital described in section 170(b)(1)(A)(iii). The sole member of A is C, which is an organization that is described in section 501(c)(3).

B is a health care organization that supports A in the provision of health care services. B is a nonprofit organization that has been recognized as exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3). It has been classified as other than a private foundation as a supporting organization described in section 509(a)(3). C serves as the sole member of B.

A currently owns and operates 6 cardiac catheterization laboratories. All are located within A in contiguous rooms. The 6 cardiac catheterization laboratories share a common waiting area for patients as well as a common scrub area for physicians, nurses and other medical personnel working in the laboratories.

B is planning to develop and operate a seventh cardiac catheterization laboratory (the "Lab") to serve as a dedicated outpatient laboratory through a joint venture with cardiologists who have staff privileges at A. B and A formed D, a limited liability company.

Initially, B and A will be the only members of D because, at the time D was formed, a limited liability company formed under state law was required to have at least 2 members. Once the physicians participating in the joint venture are admitted to D, A will withdraw from D and will be paid the positive amount of its capital account.

Physicians who will be allowed to hold membership interests ("the Physician Group") will be members of the active medical staff of A with unrestricted privileges to conduct cardiac catheterization procedures. It is anticipated that as many as twenty-four physicians representing as many as five practice groups will participate in the ownership of the facility.

B will hold at least a 52 percent membership interest and the Physician Group will hold no more than a 48 percent membership interest in D. Pursuant to the Operating Agreement, B and the Physician Group will make contributions in cash to D in proportion to their membership interests.

The Physician Group's cash contributions to D will entitle the physicians to membership interests in D. Up to 24 units of membership interests (representing up to an aggregate 48 percent membership interest) are being offered to physicians within the Physician Group at a cash purchase price of $20,000 per unit as a capital contribution to D. Units not initially sold to physicians within the Physician Group will be acquired by B and may be sold by D in the future to additional physicians in the Physician Group on terms deemed acceptable to D at the time of the sale.

Ownership interests are proportional to and equal in value to their respective contributions. All financial arrangements between M and the physician members will be negotiated on an arm's-length basis and will be based on fair market value.

Capital contributions to D and allocations of income, loss, deduction and credits will be in proportion to the members' percentage interests in D. There will be no special allocations of income or loss to any particular member of D. In the event of dissolution,

following the payment of all debts and liabilities of D and the allocation of income, profits, losses and deductions, and after adjustments to the capital accounts required by applicable income tax regulations, the remaining funds will be distributed to the members to the extent of, and in proportion to, their positive capital account balances.

B will enter into a development agreement with D in which it will provide development services with respect to the Lab. The Agreement shall continue until the date the first procedure is performed at the Lab. The development fee paid will be fair market value.

Each member shall have voting rights equal to the member's percentage interest. A quorum is present at a meeting of the members if members holding more than 50 percent of the percentage interests of all the members are represented at the meeting. The board of governors and the managers may not make certain decisions without the approval of members holding more than 50 percent of the percentage interest of the members. These decisions include (a) amending the Operating Agreement and the Articles of Organization; adopt any new or changes to existing long-term or master institutional or strategic plans for D; merge D with or consolidate D into any other entity; organize or acquire any subsidiary or affiliate of D; and sell, assign or otherwise transfer all or substantially all of the assets of D.

Management of the business and affairs of D will be vested in the board of governors and its managers. The Operating Agreement provides for a board of governors of 5 members, 3 of whom are appointed by B and 2 of whom are appointed by the Physician Group. If new members are appointed, they must be added in groups of 2, 1 appointed by B and 1 appointed by the Physician Group, so that a majority of the board of governors will always be appointed by B. The presence of 3 governors at a meeting constitutes a quorum. All matters that come before the board are decided by a majority vote.

The board of governors cannot approve or engage in certain activities without prior approval of B or those exempt entities that control B. These activities include approval of debt or the expenditure of funds in excess of limits specified by C. The Operating Agreement provides that the decision of the board of governors or the managers to forego any activity or action which fails to gain the requisite approval from B shall not be a breach of the duty of loyalty of the board of governors or the managers to D or D's members.

B's board representatives will be persons from the community with experience in health care matters, including officers and board members of A or B. They will not be on the medical staff of D or of A. None of the officers, board members, or key employees of B or A that were involved in the negotiations or decision-making process

to form D were promised employment or other inducement, including monetary, in regard to the formation of D.

The managers are the executive officers. The board of governors elects the managers. The board of governors may remove any manager with or without cause and such removal shall be without prejudice to the contract rights, if any, of the manager so removed.

A will provide services and staff to D, pursuant to a services agreement. These services and staff will include personnel necessary to operate the Lab, equipment maintenance, certain administrative services, and billing services.

The Operating Agreement provides that the purpose of D is to develop, own and operate an outpatient catheterization center, to promote health and to provide services to individuals referred to the Lab without regard to race, creed, national origin, gender, payor source or the ability to pay for services, and to provide health care services in a manner that furthers charitable purposes by promoting health for a broad cross section of the community. It further provides that these charitable purposes take precedence over any profit-making motive. The members acknowledged and agreed that placing charitable purposes over profit-making motives is not a breach of duty of loyalty of the board of governors or its members. These overriding charitable purposes are legal, binding and enforceable under the state limited liability law.

D has applied for and received a certificate of need from the state. The Lab is to be designed and is intended to serve relatively low risk patients on an outpatient basis exclusively. The determination of whether a patient is a candidate for cardiac catheterization at the Lab as opposed to the existing cardiac catheterization laboratories currently operated by A will be based on criteria developed by the American College of Cardiology. The criteria applied will generally insure that the patients will not require hospitalization associated with the diagnostic procedures. The procedures to be performed will be those which are typical and appropriate for low risk outpatient diagnostic studies.

The primary purpose of developing the Lab is to expand existing cardiac catheterization services offered at A by providing improved patient care and service by segregating the low risk outpatient modalities from the current inpatient facilities, thereby greatly increasing the convenience to the patients who undergo testing in the Lab, as well as the patients' families. As compared to the existing cardiac catheterization laboratories, which currently perform testing for both low risk and higher risk patients, the Lab will be able to more reliably schedule procedures and more reliably maintain such schedules. Patients who will undergo testing in the Lab will not be subject to the risk of being "bumped" by emergency or higher risk patients or patients

who while undergoing testing may require supplemental interventional and therapeutic procedures which are longer in duration and more difficult to predict and schedule.

The Lab will provide services to all patients, including Medicare, Medicaid and indigent patients. There will be no difference in the provision of services to Medicaid or indigent patients from those provided to other patients. The indication of the percentage of indigent patients expected to be served by the Lab is based on the percentage of indigent patients historically provided with the outpatient cardiac catheterization services at A. The population served by providers of outpatient cardiac catheterization services tends to be older and therefore more likely to be covered by Medicare. In addition, health care providers in the state where D is located tend to provide a lower percentage of indigent care than providers in other states due to the state system of managed care which extends health coverage not only to the traditional Medicaid population, but also to people who might otherwise have been considered indigents. D's charity care policy will be made known to patients.

The Lab will be located on the second floor of A's diagnostic and treatment wing on the main campus near the emergency room entrance. Patients will have easy access to the Lab, which will be at grade level adjacent to surface parking. The Lab will consist of the laboratory proper, a registration and waiting area for patients and their companions, and an area for patient staging. The laboratory proper will contain a catheterization procedure room, a control room, an equipment room, 7 pre- and post-procedures recovery rooms, a nursing station, a scrub area, storage, and staff and patient rest room facilities.

D will lease the space from A at a competitive fair rental value. The lease will be for an initial term of 10 years, with an option to renew the lease for an additional term of 10 years.

Physician privileges at D are not dependent on owning a membership interest in D. Medical staff members apply for and are granted privileges at the facility based on credentialling criteria.

The following rulings have been requested:

1. Whether the creation of D, B's execution of the Operating Agreement and related agreements, the carrying out of the transaction as contemplated by such agreements, and B's participation in the ownership and operation of D will, either alone or collectively, adversely affect the status of B as exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3) or its classification as other than a private foundation as described in section 509(a)(3).

2. Whether the creation of D, A's execution of the Operating Agreement and related agreements, the carrying out of the transactions by A as contemplated by such agreements, A's participation in the ownership and operation of D until the admission of the Physician Group into D, will, either alone or collectively, adversely affect the status of A as exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3) or its classification as other than a private foundation as described in section 509(a)(1) and 170(b)(1)(A)(iii).

3. Whether the transfer of assets and resources by B to D, the distributive share of profits and losses received by B with respect to its membership interest in D, or the payments received by A pursuant to the lease agreement will result in unrelated business taxable income pursuant to section 511 of the Code to B or to A.

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 inure 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)(l)(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 C.B. 718, 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 excludes from the definition of private foundation those organizations described in, among others, section 170(b)(1)(A)(iii). Section 170(b)(1)(A)(iii) described an organization whose principal purpose or function is to provide medical or hospital care.

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 D, B will continue to be primarily involved in serving the needs of A in a manner similar to that described in Rev. Rul. 78-41, supra. In addition, B's participation in D will further its exempt purposes. B's participation in and operation of the cardiac facility will promote health for the community in a manner that satisfies the requirements of Rev. Rul. 69-545, supra. The structure of D and operation of the cardiac facility will allow B to act exclusively in furtherance of charitable purposes with no undue private benefit to the physician members.

B will always own at least a 52 percent membership interest in D, so B will have voting control over decisions made by the members. B will always have a voting control over major decisions of the board of governors under the Operating Agreement. B will

have 3 of the 5 total votes of B's board of governors, and a majority of votes is needed to approve decisions. The board of governors oversees the management of the business and affairs of D and elects the managers. Thus, B will exercise effective control over the major decisions of D and over the operations and activities of the Lab. This control will ensure that the assets that A and B own through D and the activities conducted through D 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 D and allocations of profits, losses, and distributions from it will be in proportion to the interests of the members of D. With respect to termination, following the payment of all debts and liabilities of D 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 D will be personally liable for the debts and obligations of D. 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 D 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 D 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.

A's and B's participation in the formation of D and D's operation of the Lab consistent with its governing documents will further A's and B's charitable purposes and allow A and B to continue to be operated exclusively for exempt purposes. D will have a charity care policy that is made known to patients. The Lab 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 D will further A's and B's exempt purposes. The control B will exercise will ensure that an exempt organization retains control of the Lab'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. B's ownership in D and A's ownership until the physician group is admitted, will enable A and B to continue to promote health in a charitable manner. Because A's and B's involvement in D furthers their charitable purposes, their participation is substantially related to each of A's and B's exempt purposes, and does not result in unrelated business taxable income to either A or B under sections 511 through 513 of the Code.

CONCLUSION:

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

1. The creation of D, B's execution of the Operating Agreement and related agreements, the carrying out of the transaction as contemplated by such agreements, and B's participation in the ownership and operation of D will not, either alone or collectively, adversely affect the status of B as exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3) or its classification as other than a private foundation as described in section 509(a)(3).

2. The creation of D, A's execution of the Operating Agreement and related agreements, the carrying out of the transactions by A as contemplated by such agreements, and A's participation in the ownership and operation of D until the admission of the Physician Group into D, will not, either alone or collectively, adversely affect the status of A as exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3) or its classification as other than a private foundation as described in section 509(a)(1) and 170(b)(1)(A)(iii).

3. The transfer of assets and resources by B to D, the distributive share of profits and losses received by B with respect to its membership interest in D, or the payments received by A pursuant to the lease agreement will not result in unrelated business taxable income pursuant to section 511 of the Code to B or to A.

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,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1