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

Date: NOV 6 2002

Contact Person:

ID 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 a series of rulings on your behalf regarding the tax consequences associated with the integration of a hospital and a clinic.

A is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and is classified as a nonprivate foundation under section 509(a)(1). A operates a hospital.

B owns and operates a for-profit medical practice clinic across the street from A.

You have stated that A and B desire to integrate their delivery of healthcare services, enhance the quality of service provided and eliminate duplicate services by combining their operations. As part of this integration, A proposes to change its name to C, which after the integration will include the combined operations of the hospital and clinic.

To effectuate this integration, B will transfer its clinic business to C. Pursuant to an asset transfer agreement, B will transfer its non-provider workforce, equipment,

furniture, supplies, inventory, goodwill and contractual rights (collectively the "assets") to C. Since the asset transfer agreement does not transfer employment of the provider workforce to C, B and C will also enter into a professional services agreement for the delivery of professional services to the hospital emergency department and the clinic operations, which post-integration will be operated by C. C will construct a new medical office building adjacent to the hospital to house the practices of the providers and the majority of the clinic's operations.

You have stated that after the integration, C's board of directors will consist of eleven persons, including nine voting and two non-voting directors. Five of the nine will be community representatives, none of whom may be practicing physicians or employees of B. The remaining four will be physicians who are appointed by B's board of directors. The two non-voting directors will be the Chief Executive Officer and Chief Medical Officer of C. You have also stated that B's voting influence may be enhanced by providing for certain actions of C's Board to require a Special Majority vote. This refers to specified matters that do not receive the affirmative vote of at least three of the four physician directors, then that matter will require the affirmative vote of at least four of the five community directors. The specified matters include: (1) developing and approving strategic alliances; (2) developing and approving a strategic plan (including a provider recruitment plan) and (3) approving operating and capital budgets, including an annual operating plan. Certain other Board actions require a Supermajority vote of C's Board; that is the affirmative vote of at least six of the nine voting directors. Supermajority required actions include approving changes to C's Articles of Incorporation and Bylaws and approving a sale or change of purpose of C.

You have stated that B's clinic business will be transferred to C through an asset transfer agreement, a license agreement and a real estate agreement. Through the asset transfer agreement and the license agreement, B will transfer the clinic assets to C for less than their fair market value. Both parties intend this transaction to be permanent, but the professional service agreement does contain unwinding provisions that apply if the integration is terminated, including payments to B to assist in the reestablishment of a physician clinic.

The real estate agreement is between C and B's retirement plan, which owns the clinic building. The building will be purchased at fair market value to comply with applicable benefit laws. At the close of the transaction, the present lease between B and its retirement plan will terminate.

The asset transfer agreement between B, its shareholders and C sets forth the terms under which B will transfer the assets to C. C will assume operation of the clinic and pay B an amount equal to the amounts necessary to satisfy all encumbrances related to the assets. This amount is limited to D and both parties believe this amount

will be substantially less than D. Based on an independent appraisal of the assets being transferred, both parties believe the value of those assets to be approximately E.

The license agreement between B and C sets forth the terms under which B grants C a non-exclusive license to use B's name solely in connection with the naming, advertising and marketing of the clinic. Both parties view this agreement as being part of the transferred assets and included it solely to preserve ownership of the longstanding F name.

The professional services agreement sets forth the terms under which B will provide professional medical services to the hospital's emergency department and clinic, which after the integration will be operated by C. Both B and C believe that the compensation set forth in the agreement is commensurate with the fair market value of professional services being provided. This compensation is not based on referrals from the providers and C does not intend to track the level of these referrals by each provider. C's Board of Directors (excluding the physician directors) or a committee designated by the Board will review annually, in consultation with third parties chosen by the Board, the compensation terms of the professional services agreement to ensure that C's compensation to B for the provider's services is reasonable and consistent with fair market value.

You have stated that B entered into the professional services agreement in reliance on C's representations that it would construct a new medical office building and use due diligence in causing it to be completed. You state that if the new building is not under construction within six months of the commencement of the agreement or if it is not completed within two years of the commencement of the agreement, B may terminate the agreement. If the agreement is terminated for either of these reasons, B will have an option to purchase at fair market value (as determined by an independent appraisal) all of the assets that B transferred to C as well as the clinic real estate that C purchased from the retirement plan. The agreement also identifies procedures for unwinding the integration in the event the agreement is terminated.

The agreement also grants to B the exclusive right to provide professional services in the clinic. B will be the only provider of professional medical services to the clinic, and all of the provider's services will be billed by C. The agreement does permit C to recruit new physicians and other providers to provide services to the clinic as part of B in accordance with a recruitment plan adopted by C's Board of Directors. The agreement also allows C to continue accepting new physicians and other medical professionals unaffiliated with B to join the hospital's medical staff.

You have requested the following rulings in connection with the affiliations and subsequent activities and transactions described above:

1. Following the transactions described herein, C will remain an organization described in section 501(c)(3) of the Code and will be classified as a public charity pursuant to sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

2. The transactions described herein, including the operation of the clinic, will not result in the receipt by A or C of unrelated business taxable income as defined in sections 511 through 514 of the Code.

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.

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) of the Code defines unrelated business taxable income as the gross income derived by an 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) 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 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 purposes of section 513 of the Code 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.

The transactions described herein will not adversely affect C's tax exempt status under section 501(c)(3) of the Code as it will continue to promote health within the meaning of Revenue Ruling 69-545. C will continue to qualify as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code because it will continue to operate a hospital. In addition, the transactions described in this letter, including the operation of the clinic, will not result in the receipt by A or C of unrelated business taxable income because their activities will continue to be substantially related to the accomplishment of their exempt purposes.

Accordingly, based on all the facts and circumstances described above, we rule:

1. Following the transactions described herein, C will remain an organization described in section 501(c)(3) of the Code and will be classified as a public charity pursuant to sections 509(a)(1) and 170 (b)(1)(A)(iii) of the Code.

2. The transactions described herein, including the operation of the clinic, will not result in the receipt by A or C of unrelated business taxable income as defined in sections 511 through 514 of the Code.

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

These rulings are directed only to the organization that requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited by others as precedent.

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