Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Uniform Issue List:
501.03.11
512.00-00

Contact Person:

199910060

Telephone Number:

In Reference to: OP:E:EO:T:1

Date: DEC 14 1998

Employer Identification Number:
Key District Office:

Legend:

L =
M =
N =
O =
d =
e =
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Dear Sir or Madam:

This refers to your request for rulings under sections 501(c)(3) and 512(a)(1) of the Internal Revenue Code.

FACTS

L is a Massachusetts corporation that has been recognized as an organization described in section 501(c)(3) of the Code. L has adopted a substantial conflicts of interest policy.

At its main facility in e (the "Main Facility"), L engages in the following activities:

- Through a staff of over 30 physicians who are specially trained to treat diabetes and other endocrine diseases as well as other medical specialists, L provides various health care services to ambulatory patients diagnosed with diabetes and related diseases.

- L engages in both clinical and laboratory research programs involving diabetes and related diseases. L's

ambulatory patients are an essential component of L's clinical research programs.

- L participates in fellowship programs of the f School of Medicine involving diabetes-related studies such as endocrinology, nephrology and ophthalmology. In addition, L offers a variety of fellowship opportunities in its research laboratories. L also participates informally in the training of medical students and physicians in residency training programs at the f School of Medicine. L's ambulatory patients are an essential component of L's medical education activities.

M is a Massachusetts corporation that controls and oversees a health care delivery system of teaching and community hospitals, physician groups and other caregivers. The M health care system includes six hospitals. M is the parent corporation and sole corporate member of each of these hospitals. M has been recognized as an organization described in section 501(c)(3) of the Code.

M and L will enter into a formal cooperative arrangement involving the diagnosis, treatment and care of ambulatory patients with diabetes and related diseases, and the performance of related medical research and medical education.

M and L intend to operate this arrangement through N (the "Clinic"), formerly known as O, which has been recognized as an organization described in section 501(c)(3) of the Code. Under the Clinic's Restated Articles of Organization, M and L are the members of the Clinic and the Clinic will operate in conjunction with, and in support of, M and L. Under the Clinic's proposed amended Bylaws, L will elect five of the nine members of the Clinic's Board of Trustees and M will elect four.

Under this proposed arrangement, except in certain limited circumstances, the Clinic will be the exclusive provider of diabetes services for M's affiliates. The Clinic will provide an integrated, multi-disciplinary practice that will serve as an essential component of M's broad-based network of hospitals and other health care providers. As such, the Clinic will provide:

- Specialty clinical diabetes and endocrine professional services for care of ambulatory patients with diabetes and endocrine disorders;

- Specialty services related to the care of ambulatory patients with diabetic complications;

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- Specialty services related to the care of ambulatory pediatric patients with diabetes and endocrine disorders; and

- Primary care to ambulatory patients with diabetes.

The Clinic has applied for a clinic license from the d Department of Public Health. Once this license is granted, the Clinic, rather than L, will provide health care services to ambulatory patients diagnosed with diabetes and related diseases.

Except in very limited circumstances, L will no longer provide health care services to ambulatory patients. However, L will continue to engage in clinical research activities and medical education activities involving diabetes and related diseases. The Clinic's patients will continue to be an essential component of L's clinical and laboratory research programs and its medical education activities.

The Clinic's principal place of business will be at the Main Facility. L will lease to the Clinic approximately 32 percent of the Main Facility where L currently provides health care services to ambulatory patients diagnosed with diabetes and related diseases. In the leased portion of the Main Facility, the Clinic will provide health care services to ambulatory patients diagnosed with diabetes and related diseases using leased and contracted physicians and other professional staff. The Clinic will pay L rent based on a proportionate allocation of L's costs.

Initially, the Clinic will not directly employ physicians or other medical personnel. Instead, L will provide to the Clinic L's employed physicians who currently provide health care services to ambulatory patients diagnosed with diabetes and related diseases. In addition, M's affiliates may contract their employed physicians to L or directly to the Clinic.

M and L will enter into a Joint Venture Agreement with respect to the Clinic. Under the Joint Venture Agreement, pursuant to a Services Agreement between M and L, L will provide the services of L's employed physicians and provide supervision, direction and control of the day-to-day business activities, management, administration and operation of the Clinic. The Clinic will compensate L for these services based on L's costs, which include the direct and indirect fully allocated costs of the services provided.

RULINGS REQUESTED

1. The proposed arrangement between M and L with respect to the Clinic will not affect the status of L as an

organization described in section 501(c)(3) of the Code.

2. The rent L will receive from the Clinic for the lease to the Clinic of a portion of L's facilities where the Clinic will provide health care services to ambulatory patients diagnosed with diabetes and related diseases will not constitute unrelated business taxable income to L under section 512(a)(1) of the Code.

3. The payments L will receive from the Clinic under the Services Agreement for the provision of certain services to the Clinic will not constitute unrelated business taxable income to L under section 512(a)(1) of the Code.

APPLICABLE LAW

Section 501(c)(3)

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 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable, scientific or educational purposes, provided no part of the organization's net earnings 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 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 one or more 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(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.

Rev. Rul. 69-545, 1969-2 C.B. 117, established the community benefit standard as the basis for the federal income tax exemption of a hospital. This revenue ruling held that a hospital satisfies the community benefit standard if it promotes

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the health of a class of persons broad enough to benefit the community as a whole and it does not unduly benefit private individuals in achieving that objective.

Section 1.501(c)(3)-1(b)(1) of the regulations provides that an organization is organized exclusively for one or more exempt purposes only if its articles of organization (a) limit the purposes of such organization to one or more exempt purposes and (b) do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

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 of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Rev. Rul. 76-455, 1976-2 C.B. 150, held that a nonprofit organization formed to encourage and assist in establishing nonprofit regional health data systems, to conduct studies and propose improvements regarding quality, utilization and effectiveness of health care and health care agencies, and to educate those involved in furnishing, administering, and financing health care is operated exclusively for scientific and educational purposes and qualifies for exemption under section 501(c)(3) of the Code.

Section 512(a)(1)

Section 511 of the Code, in part, imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions directly connected with the carrying on of such trade or business, both computed with certain modifications.

Section 513(a) 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 the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption.

Section 513(a)(2) of the Code provides that the term "unrelated trade or business" does not include any trade or business which is carried on, in the case of an organization described in section 501(c)(3), such as a hospital, by the organization primarily for the convenience of its patients.

Section 1.513-1(a) of the regulations defines "unrelated business taxable income" to mean gross income derived by an organization from any unrelated trade or business regularly carried on by it, less directly connected deductions and subject to certain modifications. Therefore, gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from 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 (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(d)(1) of the regulations states that the presence of the substantially related requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations states that a trade or business is related to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of an exempt purpose, and is substantially related for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of a 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 those purposes.

RATIONALE

Section 501(c)(3)

Following the consummation of the proposed arrangement between L and M with respect to the Clinic, L will continue to be organized exclusively for charitable purposes. Therefore, L will continue to satisfy the organizational test under section 1.501(c)(3)-1(a)(1) of the regulations.

Following the Clinic's receipt of the clinic license from the d Department of Public Health, L will no longer provide

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health care services to ambulatory patients, except in very limited circumstances. However, L will continue to engage in clinical research activities and medical education activities involving diabetes and related diseases. These activities constitute activities that directly promote health and further scientific and educational purposes. See Rev. Rul. 76-455, supra. Therefore, L will continue to satisfy the operational test under section 1.501(c)(3)-1(a)(1) of the regulations.

Thus, following the consummation of the proposed arrangement between L and M with respect to the Clinic, L will continue to promote the health of the community under the community benefit standard established in Rev. Rul. 69-545, supra, and further its scientific and educational purposes. Therefore, L will continue to satisfy the organizational and operational tests of section 1.501(c)(3)-1(a)(1) of the regulations. As a result, the arrangement between L and M will not adversely affect the status of L as an organization described in section 501(c)(3) of the Code.

Section 512(a)(1)

Following the consummation of the proposed arrangement between L and M with respect to the Clinic, and after the Clinic obtains a clinic license from the State of Massachusetts, the Clinic, rather than L, will provide health care services to ambulatory patients diagnosed with diabetes and related diseases. However, L will continue to engage in its research and medical education programs and the Clinic's ambulatory patients will continue to be an essential component of these programs.

L will require the Clinic's ambulatory patients in order to continue to perform its tax-exempt research and medical education activities. Therefore, L's activities with respect to the Clinic, leasing to the Clinic a portion of the Main Facility, where the Clinic will provide health care services to ambulatory patients diagnosed with diabetes and related diseases; and providing the Clinic certain services related to its ability to provide these health care services, will materially benefit L's activities and will contribute importantly to the accomplishment of L's tax-exempt purposes. As a result, L's activities with respect to the Clinic will have a substantial causal relationship to the achievement of L's tax-exempt purpose under section 1.513-1(d)(2) of the regulations. Thus, L's leasing and providing certain services to the Clinic are activities that will be substantially related to L's performance of its exempt functions within the meaning of section 512(a)(1) of the Code and section 1.513-1(a) of the regulations.

RULINGS

1. The proposed arrangement between M and L with respect to the Clinic will not affect the status of L as an organization described in section 501(c)(3) of the Code.

2. The rent L will receive from the Clinic for the lease to the Clinic of a portion of L's facilities where the Clinic will provide health care services to ambulatory patients diagnosed with diabetes and related diseases will not constitute unrelated business taxable income to L under section 512(a)(1) of the Code.

3. The payments L will receive from the Clinic under the Services Agreement for the provision of certain services to the Clinic will not constitute unrelated business taxable income to L under section 512(a)(1) 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 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.

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

We are informing your key District Director of this action. Please keep a copy of this ruling in your permanent records.

Sincerely,
Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1