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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person:

Telephone Number:

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

Date: MAR 19 1999

Legend:

W=
M=
A=
S=
E=
H=
C=
N=
O=
F=

Dear Sir or Madam:

This is in response to your ruling request concerning the tax implications under sections 501(c)(3) and 513 of the Internal Revenue Code of a transaction.

W serves as the parent entity of a 4-state health care system sponsored by a religious order. W is exempt under section 501(c)(3) of the Code and is described in section 509(a)(3).

M serves as the parent entity of a regional health care system. M is exempt section 501(c)(3) of the Code and is described in section 509(a)(3). M is sponsored by another religious order within the same religious denomination.

A serves as a joint operating company coordinating the health care activities of two hospitals and various other health care organizations (collectively referred to as S). S includes E and H, which are both hospitals. A has two members, W and M. A serves as the managing member of E and H. A also is the sole shareholder of C, which provides physician services. A is exempt under section 501(c)(3) of the Code and is described in section 509(a)(3).

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E operates a hospital. Since 1995, E has participated in an operating arrangement pursuant to which it has two members: W, which serves as its corporate member, and A, which serves as its managing member. E serves as one of the shareholders of O. E is exempt under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(iii).

H operates a hospital. Since 1995, H has participated in an operating arrangement pursuant to which H has two members: M which serves as its corporate member, and A, which serves as its managing member. H is exempt under section 501(c)(3) of the Code and is described in sections 509(a)(1) and 170(b)(1)(A)(iii).

C provides health care services through employed physicians at various practice settings. All of the issued and outstanding stock of C is held by A. With E, C serves as one of the two shareholders of O. C is a taxable entity.

N was incorporated on December 7, 1998 as a membership corporation having A as its sole corporate member. As described below, it is contemplated that C will convert from a taxable stock entity by merger into N.

O provides occupational therapy medical services at various practice settings. The issued and outstanding stock of O is held equally by E and C. O is a taxable entity.

F was incorporated on January 21, 1999 as a membership corporation having E and C as its corporate members. As described below, it is contemplated that O will convert from a taxable stock entity by merger into F.

The Transaction

In 1994, C became indirectly affiliated with A and one of its related hospitals through the acquisition by W of an approximate 50% stock interest in C. The remaining 50% of the stock continued to be beneficially owned by C's physician-shareholders and held in a voting trust (Physician Voting Trust). Simultaneously with the acquisition of W's interest, restated corporate documents were filed to render C a stock corporation. C also owns 50% of the issued and outstanding capital stock of O, which provides occupational medical services. The other 50% of O's stock is owned by E.

On August 31, 1998, A, the Voting Trust and W entered into an Agreement of Merger providing for the acquisition by A of all the issued and outstanding stock of C. As a result of the foregoing transaction, A now holds all of the issued and outstanding shares of capital stock of C.

CONVERSION OF C TO NONSTOCK CORPORATION N

N was organized on December 7, 1998 as a nonstock, nonprofit corporation, with the purpose of assuming all of the assets, liabilities and activities of C. Moreover, M, W, A, C and N have entered into a Conversion Agreement, dated January 27, 1999, pursuant to which the parties are obligated to effect the conversion transaction, subject only to the receipt from the IRS of a determination letter for N and a related private letter ruling.

Because C is a stock corporation, various steps are necessary to convert it to a not-for-profit corporation. C's state law does not allow the conversion of a stock entity to non-stock form through either the amendment of organizational documents or a merger into a domestic nonstock corporation. State law does allow, though, (i) the merger of a domestic stock corporation and a foreign stock corporation, and (ii) the merger of a foreign stock corporation with and into a domestic nonstock corporation. Accordingly, the parties will utilize a two-step process to convert C from a stock to a nonstock, nonprofit corporation:

Following the conversion, N will continue the historic activities and operations of C and will operate as the physician component of an integrated regional health care delivery system. Concurrently with this ruling, N received prospective recognition of exemption under section 501(c)(3) of the Code.

CONVERSION OF O TO NONSTOCK CORPORATION F

F was organized on January 21, 1999 as a nonprofit corporation, with the purpose of assuming all of the assets, liabilities and activities of O. M, W, A, O and F have entered into a Conversion Agreement, dated January 27, 1999, pursuant to which the parties are obligated to effect the conversion transaction as described below, subject only to the receipt from the IRS of a determination letter for F and a related private letter ruling.

As in the case of the C conversion, a two-step process will be necessary to convert O to a nonstock, not-for-profit corporation. From a technical standpoint, the O conversion will be undertaken immediately following the C conversion; this will guard against the membership interest in F being held, at any point in time, by a taxable entity, C.

Following the O conversion, F will continue the historic activities and operations of O and will continue to provide occupational medical services as part of the integrated regional

health care delivery system. Concurrently with this ruling, F received prospective recognition exemption under section 501(c)(3) of the Code.

OPERATION OF N AND F AS PART OF A

A is organized and operated pursuant to an Integration Agreement between W and M. Originally entered into in January 1995, the Integration Agreement was amended and restated several times, including, most recently, as of August 31, 1998, in connection with the buyout of the C stock. The Integration Agreement provides a multi-level dispute resolution process which includes non-binding mediation and, ultimately, binding arbitration. All of these actions are prefaced by the parties explicit agreement to work in good faith to resolve dispute questions.

A is directed and controlled by its community Board of Directors which has a substantial conflicts of interest policy. Generally, the persons comprising the Board also serve as the boards of directors for all of the various S organizations. Pursuant to A's Bylaws, the Board (with the support of various active standing committees) is responsible for all of the health care activities conducted by A, including those of E, M, N, and F.

The activities of the Board are assisted through the efforts of certain standing committees, which are similarly subject to the conflicts of interest policy. These standing committees include the Finance and Operations Committee, the Strategic Planning Committee, and the Physician Governance Committee. The functions and composition of some of these committees are as follows:

Finance and Operations Committee

The responsibilities and authority of the Finance and Operations Committee are to:

- Review and recommend annual capital and operating budgets of S entities which are consistent with the long-term strategic and financial plans of S;
- Approve all managed care contracts, including global risk contracts, full professional risk contracts, PPO contracts, discounts for services and prices;
- Approve allocation of capitation;
- Approve most personnel policies of A and N;
- Monitor monthly budget performance; and
- Monitor managed care contract performance.

Strategic Planning Committee

The responsibilities and authority of the Strategic Planning Committee are to:

- Review and recommend the S strategic plan;
- Review and recommend proposals for new services and consolidation of services;
- Review analysis of physician capacity needs and recommend physician staffing;
- Review utilization of non-employed physicians on a contract basis; and
- Review and recommend affiliations and affiliation strategies.

Authority of A Over S Entities

A's Board has the power to recommend to W and M the following:

- Changes to the Articles of Incorporation and Bylaws of A and changes to the Articles of Incorporation and Bylaws of S entities;

- Action required to comply with canonical alienation requirements, including but not limited to the long-term borrowing of money and the purchase or sale of property and any other long-term borrowing of money in excess of $1,000,000;

- The dissolution, merger or consolidation of A, and the dissolution, merger, consolidation or withdrawal from S for other S entities;

- The admission of new members of A and the admission of new S entities which do not become members of A;

- The long-term strategic and financial plans of A, which incorporates plans of all S entities; and

- Indebtedness incurred by A, S entities, M or W on behalf of A.

A's Board has the sole and exclusive authority to approve all of the following:

- The role statement of the S entities, and assure that the role statement and management philosophy are lived out through A;

- The selection of the auditor for A and for S entities, who shall be the auditors of W or M;
- The establishment of subsidiary corporations and partnerships of A and S;
- All managed care contracts, contracts with physicians or physician groups, and prices/discounts;
- The exercise of all other authority over S as provided for in the Articles of Incorporation and Bylaws of A; and
- The annual capital and operational budget of A and the annual capital and operational budgets of S entities which are consistent with long-term strategic and financial plans of A and which causes the budget of each S entity to provide that each S entity will pay and perform all of its financial and other covenants contained in applicable financing documents.

RULINGS REQUESTED

1. The conversions and the subsequent activities and operations of N and F as part of A and S will not adversely impact the continued tax-exempt status of W, E, H, A, and M.

2. Subsequent to the conversions, transactions and arrangements between N, F, W, E, S, A, M and H will not result in unrelated business taxable income under sections 511-514 of the Code to any of these organizations.

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 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, recognizes 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, concludes that a trust created 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 and is exempt under section 501(c)(3) of the Code.

Providing management and consultants' services to other, unrelated exempt organizations for a fee sufficient to produce a small profit does not further an exclusively exempt purpose. See BSW Group, Inc. v. Commissioner, 70 T.C. 352 (1978).

An organization providing laundry services on a centralized basis to exempt hospitals does not qualify for exemption under section 501(c)(3). See HCSC-Laundry v. United States, 450 U.S.1 (1981).

Section 513(e) of the Code provides that in the case of a hospital, the term "unrelated trade or business" does not include the furnishing of one or more of the services described in section 501(e)(1)(A) to one or more hospitals if such services are furnished solely to such hospitals which have facilities to serve not more than 100 inpatients, such services, if performed on its own behalf by the recipient hospital, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption, and such services are provided at a fee or cost which does not exceed the actual cost of providing such services.

Rev. Rul. 77-72, 1977-1 C.B. 157, provides that indebtedness owed to a labor union by its wholly-owned tax-exempt subsidiary is not acquisition indebtedness within the meaning of section 514 of the Code since the parent and subsidiary relationship shows the indebtedness to be merely a matter of accounting.

In Geisinger Health Plan v. United States, 30 F.3rd 494 (3rd Cir. 1994) (Geisinger), the court recognized that an organization may qualify for exemption based on the integral part doctrine, which arises from an exception to the feeder organization rule set forth in section 1.502-1(b) of the regulations, which states that if a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with the parent organization.

The court also noted that an entity seeking exemption as an integral part of another cannot primarily be engaged in activity which would generate more than insubstantial unrelated business income if engaged in by the other entity. In this regard, the court followed the reasoning of section 1.502-1(b), which contains an example of a subsidiary organization that is not exempt from tax because it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. The examples states that if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations) it is not exempt because such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

Accordingly, the court in Geisinger determined that application of the integral part doctrine requires at a minimum that an organization be in a parent and subsidiary relationship and that it not be carrying on an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

A joint operating agreement between previously independent hospitals to provide corporate services among the participants raises exemption qualification and unrelated trade or business issues. With respect to exemption qualification, the courts have been clear that exemption under section 501(c)(3) of the Code is not generally available where an organization is established to provide corporate services to unrelated exempt organizations, other than through the application of section 501(e) of the Code for cooperative hospital service organizations. See BSW Group, Inc., supra, and HCSC-Laundry, supra. Furthermore, exemption under the integral part doctrine requires a parent and subsidiary relationship and the absence of unrelated trade or business. See Geisinger, supra, and Rev. Rul. 78-41, supra.

Sections 511 Through 514 of the Code

Section 511(a) of the Code 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 the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions, computed with the modifications listed in section 512(b).

Section 512(b)(3) of the Code provides generally that rents from real property (and its incidental related personal property) are not unrelated business income unless the property is debt-financed under section 514 of the Code. Debt-financed property does not include any property substantially related to the exercise or performance by such organization of its charitable functions.

Section 512(b)(4) of the Code requires that notwithstanding paragraphs (1), (2), (3) or (5), the net income realized with respect to debt-financed property must be included in unrelated business taxable income.

Section 512(b)(5) of the Code exempts from the definition of unrelated business taxable income all gains and losses from the sale, exchange or other disposition of non-inventory items and items not held for sale in the ordinary course of business.

Section 512(b)(13) of the Code limits the exclusion of interest, annuities, royalties, and rents provided by section 512(b)(1), (2), and (3) where such amounts are derived from a controlled organization.

Section 1.512(b)-1(1) of the regulations provides that if an exempt organization has control of another organization, the controlling organization shall include as an item of gross income in computing its unrelated business taxable income the amount of interest, annuities, royalties, and rents derived from the controlled organization, determined in accordance with the formula described in section 512(b)(13) of the Code and section 1.512(b)-1(1)(3) of the regulations.

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 income or 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 that a trade or business is related to exempt purposes, in the relevant sense, only where the conduct of business activities has a causal relationship to the achievement of exempt purposes; and it is substantially related only if the causal relationship is a

substantial one. The regulation states that 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 performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 514 of the Code provides for the taxation under section 512 of income from debt-financed property. Section 514(b)(1)(A)(i) of the Code, however, provides that the definition of debt-financed property does not include any property substantially all the use of which is substantially related to the exercise or performance by such organization of the charitable purposes constituting the basis for its exemption under section 501.

Analysis

Based on all the facts and circumstances, we conclude that W, E, H, A, and M will not adversely affect their tax exempt status under section 501(c)(3) of the Code because of the transactions as they will continue to promote health within the meaning of Revenue Ruling 69-545, supra. The sharing of assets, personnel and/or resources pursuant to the joint operating agreement will not adversely affect the section 501(c)(3) status of any exempt participating entity member as this activity promotes health within the meaning of Revenue Ruling 69-545, supra.

With respect to unrelated trade or business, section 513(e) of the Code makes clear that if a hospital provides regularly carried on corporate services to another unrelated exempt organization for a fee, then such services are unrelated trade or business unless they fall within the exception for certain hospital services provided by section 513(e). However, if the participating exempt organizations are in a parent and subsidiary relationship, then necessary corporate services provided between them to accomplish their exempt purposes are treated as other than an unrelated trade or business and the financial arrangements between them are viewed as merely a matter of accounting. See Rev. Rul. 77-72, supra.

At issue, then, is whether the joint operating agreement establishes a parent and subsidiary relationship where corporate services and payments between the participating entities will not be treated as unrelated trade or business income because the activities are essential to their exempt purposes, could be conducted by the participating entity for itself without giving rise to unrelated trade or business income,

and occur in the context of a close relationship among the entities.

Based on all the facts and circumstances, we conclude that the joint operating agreement effectively binds W and M under the common control of A so the participating organizations are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of A's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating entities have ceded authority under the joint operating agreement to A's governing body to establish their budgets, including major expenditures, debt, contracts, managed care agreements, and capital expenditures; to direct their provision of health care services; to provide for dispute resolution and arbitration; and to monitor and audit their compliance with its directives. In addition, the governing body and its committees meet regularly to exercise overall responsibility for operational decisions involving the day-to-day and long range strategic management decisions that have been delegated by the participating entities. Therefore, services provided between the previously unrelated organizations through the joint operating agreement are treated as other than an unrelated trade or business.

Rulings

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

1. The conversions and the subsequent activities and operations of N and F as part of A and S will not adversely impact the continued tax-exempt status of W, E, H, A, and M.

2. Subsequent to the conversions, transactions and arrangements between N, F, W, E, S, H, A, and M will not result in unrelated business taxable income under sections 511-514 of the Code to any of these organizations.

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 organizations that requested them. Section 6110(j)(3) of the Code provides that they may not be used or cited as precedent.

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

Any changes that may have a bearing on your tax status should be reported to the Service. We are informing your key District Director of these rulings. Please keep this ruling letter in your permanent records.

The contact person's identification number is 50-380400.

Sincerely yours,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1