VIL 0501.03-11

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

200238051

Date JUN 28 2002

Contact Person:

ID Number:

Telephone Number:

T:EO:B1

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 transactions described below. The purpose of the transactions is to effectuate a joint operating agreement.

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) of the Code. It was created in accordance with a joint operating agreement as an entity to provide for common management of existing health care delivery operations of E and the clinical facilities of F.

B is an instrumentality of the State of G. It was created as the entity in which the management and control of the state university is vested. Its educational programs are administered through operating divisions, one of which, E, operates a medical school and other programs for the training of health care professionals and a general acute care hospital.

C, organized to support B, is being granted exemption from federal income tax under section 501(c)(3) of the Code and is being classified as a nonprivate foundation under section 509(a) by letter of even date.

D, organized to support C and I, is being granted exemption from federal income tax under section 501(c)(3) of the Code and is being classified as a nonprivate foundation under section 509(a) of the Code by letter of even date.

E is a division of B that owns and operates K and the School of Medicine of B. E is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a)(3) of the Code.

F, created for the purpose of supporting the health care mission of E, owns and operates a medical clinic located adjacent to E's hospital facilities. F is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a).

I is a provider of health care services and is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a). It operates an acute care hospital for infants and children.

J was formed to support I and is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under section 509(a).

K is a general acute care hospital owned and operated by E.

You have stated that B (and its related entities A, E, F and K) and I have a long-standing relationship of cooperating in their objectives of improving the health care of children and women in the State of G through patient care, education and research. I's facilities are in close physical proximity to the university hospital and medical school and I has been the primary teaching hospital for the pediatric residency program of the school of medicine. While most pediatric services provided by either B or I are located or provided at I, certain services are provided at K. As the scope of operations and complexity of issues involved in providing pediatric services has grown, B and I have been seeking better ways to manage the services they provide. In addition, you have noted a trend in medicine to coordinate the provision of women's healthcare services with those relating to infants. In order to continue to enhance the delivery of services, you have stated that I, B (through C) and A have determined it is advisable to provide for the delivery of all such services by any of them under the terms of a joint operating agreement.

You have stated that the purpose of the joint operating agreement is to provide for the common management of and sharing of the net income from, to the extent practical, all pediatric and women's healthcare services and the delivery of services to patients under 18 and to women by B and I. A, C and I will be the parties entering into the agreement. The agreement will include essentially all the existing health care facilities of I and certain facilities and services now owned and operated by K subject to a preexisting joint operating agreement. Each member and its related entities will maintain ownership of their facilities and operating assets in which portions of the joint operations will be conducted that were owned by it on the date of delivery of the agreement. The operation of such facilities and operating assets with respect to the joint operations shall be subject to common management through D, as provided by the agreement. The members may agree to develop or acquire additional health care facilities or enterprises that will be owned jointly, through ownership by D or by a separate entity controlled by or under the supervision of D.

You have stated that I and C and their associated operating entities will share revenue and expenses equally from the joint operations, subject to certain adjustments, while continuing to separately collect and account for revenues from the activities, operations and assets subject to the joint operating agreement.

You have stated that the joint operating agreement establishes a contractual relationship among I, A and C. D has been created to provide governance and management under the agreement. I and C are the sole members of D having equal membership interests in D. The use of C to be a party to the agreement allows the parties to segregate the agreement and the activities conducted pursuant to it from the other activities in which A and B are engaged. The Board of Directors of D will consist of an equal number of voting members designated by I and C.

You have stated that, in general, D will have full power to govern and manage the joint operations including the following powers: (1) setting overall strategic direction for the joint operations; (2) approving or modifying the portions of any operating and capital budgets that relate primarily to the joint operations, which approval or modification shall require a two-thirds vote; (3) directing the transfer of any program or services comprising a part of the joint operations from one member or operating entity to another, provided that such transfer may not be required if such transfer itself or the resulting transfer of revenues would cause or be reasonably interpreted to cause the transferring member or operating entity to violate or be unable to comply with any contractual obligation or covenant to which it or its property is subject and **(4)** reviewing and approving total compensation for all officers and executives of D.

You have stated that the following actions may not be taken by either member or by D without the consent of both members: (1) the addition of new members of D; (2) the assignment by either member of its rights under the agreement; (3) the sale lease or other disposition, other than in the ordinary course of business, of any of the material assets constituting part of the joint operations (which for purposes of this provision means operating assets having a book value of 5% or more of the book value of the operating assets comprising a part of the joint operations); (4) the amendment of the agreement or any of the charter documents of D; (5) the assignment by either member of its membership interest in D; (6) the assignment by D of its rights under the agreement; (7) the development, acquisition or expansion by either member (or by any associated operating entity or any affiliate of a member) of any joint ventures, minority investments, management relationships, health care facilities, services or insurance, HMO or similar product relating to the provision of pediatric healthcare services or women's healthcare services, unless such activity has been approved by and is under the supervision of D; (8) the application by D, any of the members or any associated operating entity to obtain a certificate of need for any service or facility which should comprise part of the joint operations; (9) the issuance or incurrence of debt for borrowed money in excess of an aggregate of $1,000,000 by D; or (10) any capital expenditure (or series of related capital expenditures) by D with its own funds in excess of $1,000,000.

You have stated that in order to maintain and comply with existing facility licenses and accreditation requirements, the governing body of each member or operating entity through which any portion of the joint operations are conducted shall retain sole authority and shall remain responsible for the following activities: (1) maintaining appropriate accreditation and licensure of such facilities: (2) establishing and maintaining compliance with standards of professional practice in such facilities; (3) credentialing of health care practitioners; (4) determining and implementing of standards of care of patients, including emergency care; and (5) complying with the standards of all applicable accrediting agencies, including JCAHO.

You have stated that the joint operating agreement provides that no action shall be taken by D which would require a party or operating entity, without its prior consent, to (1) change its public or charitable mission; (2) sell, lease, exchange, transfer, encumber or otherwise dispose of its assets or (3) merge or consolidate with another entity or liquidate or dissolve itself.

You have stated that capital expenditures with respect to the joint operations are generally subject to approval by the board of directors of D pursuant to its general powers to review and approve capital and operating budgets which relate primarily to the joint operations. Capital expenditures made with respect to facilities separately owned by a member or associated operating entity but comprising a part of the joint operations are made by such member or operating entity from its own funds. All capital expenditures made by I are deemed made with respect to the joint operations. Because not all capital expenditures made by K or other operating entities affiliated with or part of B may relate to the joint operations, the agreement provides mechanisms for determining whether and when such capital expenditures are to be deemed made with respect to the joint operations.

The joint operating agreement will have an initial term of five fiscal years from commencement of the joint operations and will be renewable for successive five-year terms unless notice of intent to terminate the agreement is given by a member not less than one year prior to the expiration of the then current term. Upon termination and dissolution *of* D, any assets of D will be distributed to the members.

You have requested the following rulings in connection with the affiliations and reorganization described above:

1. The status of A as exempt from federal income tax under section 501(a) of the Code by reason of being an organization described in section 501(c)(3) will not be adversely affected as a result of entering into the joint operating agreement and the consummation of the transactions contemplated thereby.

2. Any assets, revenues or resources derived by A and C under the joint operating agreement will constitute income from a related trade or business under section 513 and therefore will not be subject to the tax on unrelated business income under section 511.

3. The status of C as exempt from federal income tax under section 501(a) by reason of being an organization described in section 501(c)(3) will not be adversely affected as a result of it being subject to the provisions of the joint operating agreement and the consummation of the transaction contemplated thereby.

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, 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.

Section 1.509(a)-4(f)(1) of the regulations provides 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 in connection with. Section 1.509(a)-4(f)(4) of the regulations provides that in the case of supporting organizations which are supervised or controlled in connection with one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors.

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.

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-Laundw v. United States, 450 U.S.I (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 Geisinqer Health Plan v. United States, 30 F.3rd 494 (3rd Cir. 1994) (Geisinqer), 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 I.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 purposes) if regularly carried on by the parent organization. The example 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 a trade or business which would be an unrelated trade or business (that is, unrelated to exempt purposes) if regularly carried on by the parent.

An affiliation 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 administrative or dther non-patient care 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. With respect to unrelated trade or business, section 513(e) of the Code makes clear that if a hospital provides regularly carried on administrative or other non-patient care 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 an affiliated system of organizations with common control, then administrative or other non-patient care services provided between them necessary to their being able 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 system with sufficient common control such that administrative or other non-patient care services and payments provided between the participating affiliates will not be treated as unrelated trade or business income.

Based on all the facts and circumstances, we conclude that the joint operating agreement effectively binds the participating entities under the common control of D so that the participating entities are within a relationship analogous to that of a parent and subsidiary pursuant to the authority of D's governing board. Although all of the facts and circumstances are relevant to this conclusion, importantly, the participating entities will share revenue and expenses equally from the joint operations and have ceded authority to D's governing body to manage the joint operations including developing strategic and financial plans; approving, developing or revising capital and operating budgets and directing the transfer of programs and services from one member or operating entity to another under certain circumstances. In addition, D's board of directors meets regularly to exercise overall responsibility for operational decisions and to monitor the affiliates' compliance with its decisions. Therefore, the transfer or sharing or provision of assets or services between and among the tax-exempt organizations in the system are treated as other than an unrelated trade or business.

Contributions to organizations exempt from federal income tax under section 501(c)(3) of the Code do not fall within the definition of unrelated business income under section 512, nor create taxable gain or loss to the transferor or transferee.

The participating affiliates will not adversely affect their tax exempt status under section 501(c)(3) of the Code by the proposed transactions as they will continue to promote health within the meaning of Revenue Ruling 69-545. The participating entities will continue to qualify as nonprivate foundations under section 509(a) of the Code because they will continue to maintain the relationships and/or activities serving as the basis for their nonprivate foundation status.

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

1. The status of A as exempt from federal income tax under section 501(a) of the Code by reason of being an organization described in section 501(c)(3) will not be adversely affected as a result of entering into the joint operating agreement and the consummation of the transactions contemplated thereby,

2. Any assets, revenues or resources derived by A and C under the joint operating agreement will constitute income from a related trade or business under section 513 and therefore will not be subject to the tax on unrelated business income under section 511.

3. The status of C as exempt from federal income tax under section 501(a) by reason of being an organization described in section 501(c)(3) will not be adversely affected as a result of it being subject to the provisions of the joint operating agreement and the consummation of the transaction contemplated thereby.

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 organizations 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