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

Date: MAR 25 2003

Contact Person:

Identification Number:

Telephone Number:

501.03-11
512.02-00
513.00-00

T:EO: B1

Employer Identification Number:

Legend:

X -
Y -
a -
b -
c -

Dear Sir or Madam:

This is in response to your request for rulings concerning the federal tax consequences of your participation in a joint venture that will manage a neonatal intensive care unit (NICU). Details of the proposed transaction are described below.

X is an organization described in sections 501(c)(3), 509(a)(1) and 170(b)(1)(A)(iii) of the Internal Revenue Code. X owns and operates a hospital that is the only academic medical center in a five-state area devoted solely to the medical, surgical and developmental needs of children.

X 's hospital includes a NICU. Neonatal nurseries are rated at Levels I, II or III depending upon the intensity of care which they are equipped and licensed to provide, with Level III providing the most intensive level of care. X's NICU is a Level III NICU. X has developed clinical protocols and methods of training clinical personnel that enhance and support the delivery of the most sophisticated levels of neonatal care in its NICU.

Y is an organization described in sections 501(c)(3), 509(a)(1) and 170(b)(1)(A)(iii) of the Code. Y owns a general acute care hospital that includes a Level II NICU. No Level III NICU services are available in the community where Y is located. Therefore, neonatal patients that require a more intensive level of care must be transported to other communities in order to receive Level III services. Y is located in the northern portion of X's service area.

Y desires to have a neonatal nursery offering Level III intensive care services at its hospital. A new Level III neonatal nursery at Y would enhance the level of care available to infants and families in the communities served by Y. Furthermore, a Level III neonatal nursery would avoid the potential jeopardy to health and other disadvantages inherent in transferring fragile infant patients needing such services to other facilities outside the community that Y serves.

In order to obtain the necessary specialized medical expertise needed to operate a Level III NICU, Y proposes to enter into a joint venture with X . The joint venture will manage the new neonatal nursery at Y.

The objectives of the joint venture are:

1. To provide residents of the benefited communities with access to high quality children's health care services by expanding the neonatal intensive care services at Y.

2. To decrease the need for out-of-area transport of critically ill newborns and to facilitate transfers back to the community of babies requiring neonatal intensive care services at Y.

3. To decrease the physical and emotional stress on patients and families and to increase patient and family satisfaction with respect to the care of newborns requiring intensive care.

4. To increase the availability of trained neonatal surgeons, physicians and other health care professionals in the benefited communities.

5. To improve the efficiency and effectiveness of neonatal surgical techniques and therapies through a greater number of patients treated.

6. To enhance clinical research opportunities with respect to neonatal care; and

7. To enhance educational opportunities for medical professionals with respect to neonatal care through a greater number of patients treated.

The neonatal intensive care unit (NICU) will be operated pursuant to a joint operating arrangement. The arrangement will be implemented through two interdependent contractual agreements: (1) the formation of a limited liability company (LLC) with X and Y as members; and (2) a management agreement between the LLC and Y.

The LLC is organized under state law pursuant to a certificate of formation and will operate pursuant to an LLC operating agreement. X and Y will each have a 50% membership interest in the LLC. The LLC will manage the new Level III NICU unit at Y.

The NICU will be operated under Y's general acute care license. Y will provide routine administrative services and maintenance for the NICU, just as it does for its other departments. Admission to the NICU medical staff will be open to all qualified physicians consistent with the NICU's size and nature of its activities, with the exception of certain areas of neonatology and pediatrics. The NICU will provide care on a nondiscriminatory basis to persons meeting the clinical admission criteria and in accordance with Y's Medicare and Medicaid participation agreements and with its charity care policies.

The LLC will be capitalized by X in the amount of a and Y will contribute cash in the amount of b. Immediately after X's contribution is made, c of such amount will be distributed to Y. Thereafter, such amount will be restored to the LLC by Y over a period of 15 years, with an interest component. Such amount, as and when restored to the LLC, will be subject to distribution by the LLC to its members, along with all other cash available for distribution, in accordance with the usual distribution provisions of the operating agreement.

The governance of the LLC will be implemented at three levels: (1) through the members; (2) through delegation by the members of certain operating decisions to an Operations Council; and (3) through delegation by the members of certain operating decisions to the Program Manager.

Certain actions of the LLC will need unanimous approval of both members. These actions include any amendments to the certificate of formation or operating agreement and any transactions involving a merger, additional capital call, dissolution of the LLC, sale of assets or admission of a new member.

Certain actions of the LLC will be delegated to the Operations Council. The Operations Council consists of six to eight members that will govern the LLC. Each member has the right to appoint an equal number of members to the Operations Council and has the right to remove any member it appoints. The Operations Council's delegated responsibilities include developing and approving the LLC's annual capital and operating budgets, approving the LLC's incurring any expenditure or indebtedness that was not approved as part of the capital or operating budget, monitoring and auditing the NICU's compliance with its directives, selecting the providers that will provide perinatal and/or neonatal services at the NICU, determining the specific scope and timing of the development of pediatric sub-specialty services available at the NICU, and overseeing quality assurance with respect to neonatal services provided at the NICU. The presence of a majority of the members of the Operations Council constitutes a quorum, and the unanimous consent of all members of the Operations Council present is required to take action.

X will be the Program Manager of the LLC. The Program Manager is responsible for the day-to-day operation and management of the LLC, and in turn the NICU, pursuant to the management agreement. The responsibilities of the Program Manager include recruiting and selecting the Program Administrative Manager, directing the operations of the NICU and managing the NICU's facilities and services, advising and assisting Y regarding credentialing of NICU physicians and allied health professionals, overseeing NICU staffing, selecting the Medical Director of the NICU, maintaining program quality assurance with respect to neonatal services provided at the NICU, decision making consistent with the Program Manager's clinical judgment regarding the scope and mechanism for delivery of clinically appropriate ancillary services necessary to support patient care in the NICU, and final approval of the providers who will provide perinatal and/or neonatal services at the NICU and of the specific scope and timing of the development of pediatric sub-specialty services to be provided at the NICU.

The LLC will receive a management fee for managing the NICU. The management fee is equal to the difference between revenues derived from the treatment of NICU patients and expenses associated with such treatment. The management fee may be negative; that is the difference may result in a payment by the LLC to Y, in particular in the start up phase of the NICU when revenues are less than expenses.

Y will provide a facility setting for the NICU, including equipment, space, support services, non-physician employees, supplies, medical records, maintenance, billing and collection. These services will be provided in the same manner and to the same extent as they are provided to Y's other departments.

The net profits of the LLC will first be allocated to each of the members in an amount equal to the agreed value of services performed by them in the conduct of the business of the LLC. Thereafter, all remaining net profits or losses will be allocated to X and Y as members of the LLC in accordance with their respective percentage interests in the LLC.

The term of the operating agreement is fifty years unless earlier terminated according to its terms. The term of the management agreement is also fifty years unless the agreement is earlier terminated. The term of the management agreement during which services will be provided will commence as of the date that all of the following conditions have been met:

- The members receive a favorable response from the Internal Revenue Service to the requested rulings.
- All governmental or contractual approvals for the operation of the NICU by the LLC have been received.
- The facilities at the Y Nursery are completed and in a state of general readiness to commence NICU operations.

Other than in the case of a failure to make an initial capital contribution, a termination of the joint operating arrangement of the parties under the operating agreement and management agreement will be effectuated by a termination and liquidation of X's interest in the LLC, resulting in Y becoming the sole member of the LLC with sole authority over and interest in the

LLC. Ten years after the operations commencement date, either member may elect to cause X to withdraw as a member and terminate and liquidate X's interest in the LLC. Termination events include an uncured breach of a material provision of the management agreement, an uncured breach of a material provision of the operating agreement, a member's loss of its tax-exempt status, or occurrence of any event including, without limitation, any change in the law, rules or regulations, or any order recommendation or determination of a regulating or accrediting agency or court with proper jurisdiction, which would render performance by a member illegal or jeopardize a member's license, accreditation, certification or tax-exempt status, if the members are unable after good faith negotiations to agree to modify the operating agreement to rectify the illegality or remove the jeopardy.

The LLC may be dissolved on approval of the members, or if the members fail to reach agreement after good faith negotiations to amend the operating agreement in connection with a failure to receive a favorable response from the IRS for the requested rulings.

In the event of a termination and liquidation of its interest in the LLC, X shall be entitled to receive an amount generally dependent upon the value of its interest, subject to adjustment for the period expired since the operations commencement date and the reason for the termination.

You have requested the following rulings:

(1) Your involvement in the LLC will not affect your status as an organization described in section 501(c)(3) and classified as a public charity in section 509(a)(1)/170(b)(1)(A)(iii).

(2) Payments received from the LLC for goods, property, services or personnel provided in connection with the NICU and your distributive share of the income or loss of the LLC in connection with its management of the NICU, will constitute income from a trade or business that is substantially related to your tax-exempt purposes within the meaning of section 513 and not be subject to tax on unrelated business income.

LAW

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of organizations that are organized and operated exclusively for religious, charitable, scientific, or educational purposes, provided no part of their net earnings inures to the benefit of any private shareholder or individual.

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 are not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in Code section 501(c)(3) 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; IV Scott on Trusts, sections 368, 372 (3rd ed. 1967); and Rev. Rul. 69-545, 1969-2 C.B. 117.

Section 1.501(c)(3)-1(e)(1) of the regulations states that an organization exempt under section 501(c)(3) of the Code may operate a trade or business as a substantial part of its activities if the operation of such trade or business is in furtherance of the organization's exempt purposes. Exemption will be denied to an organization which is organized or operated for the primary purpose of carrying on an unrelated trade or business.

Section 509(a)(1) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under 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 attributable to such business activity.

Section 512(c) of the Code provides that if an exempt organization is a partner in a partnership and it generates unrelated business income, then the organization shall include in computing its unrelated business income its share of gross income from the partnership and share of partnership deductions directly connected with such gross income.

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 an organization of the purpose or function constituting the basis for its exemption.

Section 1.513-1(a) of the regulations defines "unrelated business taxable income" to mean gross income from any unrelated trade or business regularly carried on. Section 1.513-1(b) states that the phrase "trade or business" includes activities carried on for the production of income and which possess the characteristics of a trade or business within the meaning of section 162 of the Code. Finally, section 1.513-1(c) explains that "regularly carried on" has reference to the frequency and continuity of the conduct of an activity and the manner in which the activity is pursued.

Section 1.513-1(d)(2) of the regulations provides 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 any 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.

Section 1.513-1(d)(4) provides that gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of an unrelated trade or business.

Rev. Rul. 69-545, 1969-2 C.B. 117, sets forth standards under which a nonprofit hospital may qualify for recognition of exemption under section 501(c)(3) of the Code. This revenue ruling gave consideration to two separate hospitals, only one of which was determined to qualify for exempt status under section 501(c)(3). By weighing all the relevant facts and circumstances, the revenue ruling analyzed whether both the control and use of the hospitals were for the benefit of the public or for the benefit of private interests. The hospital that qualified for exemption was found to be organized and operated to further the charitable purpose of promoting health by satisfying a community benefit standard that included, among other factors, a board of directors that broadly represented the interests of the community. The hospital that did not qualify for recognition of exemption was found to be operating for the private benefit of those who controlled it rather than for the benefit of the public.

Rev. Rul. 98-15, 1998-1 C.B. 718, Situation 1, explicitly approves formation of a limited liability company by an exempt hospital organization, although in that ruling, the other member is an unrelated for-profit entity. Situation 1 of the revenue ruling concludes that the hospital organization's principal activity continues to be the provision of hospital care, even when such activities are conducted through a limited liability company, because, inter alia, the tax-exempt hospital retains control over the limited liability company and the limited liability company serves charitable purposes. According to Rev . Rul. 98-15, for federal tax purposes, the activities of a partnership are often considered to be activities of the partners. Aggregate treatment is also consistent with the treatment of partnerships for the purposes of the unrelated business income tax under section 512(c) of the Code. The revenue ruling notes that in light of the aggregation principle 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 tax purposes are considered to be the activities of an exempt organization that is an owner of the limited liability company when evaluating whether the exempt organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code. Accordingly, an organization that is exempt under section 501(c)(3) may form and participate in a partnership, including a limited liability company treated as a partnership for federal tax purposes, and meet the operational test if participation in the partnership furthers its charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of any for-profit partners.

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), a nonprofit hospital with an independent board of directors executed a contract with a medical partnership composed of seven physicians. The contract gave the physicians a virtual monopoly over the care of the hospital's patients and the stream of income they represented while also guaranteeing the physicians thousands of dollars in payments for various supervisory activities. The court held that the benefits derived from the contract constituted sufficient private benefit to preclude exemption.

In Broadway Theatre League of Lynchburg, Virginia, Inc. v. United States, 293 F.Supp. 346 (W.D.Va. 1968), the court held that an organization that promoted an interest in theatrical arts did not jeopardize its exempt status when it hired a booking organization to arrange for a series of theatrical performances, promote the series and sell season tickets to the series because the contract was for a reasonable term and the organization retained ultimate authority over the activities being managed.

In Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982), the Tax Court held that a charitable organization's participation as a general partner in a limited partnership did not jeopardize its exempt status. The organization co-produced a play as one of its charitable activities. Prior to the opening of the play, the organization encountered financial difficulties in raising its share of the costs. In order to meet its funding obligations, the organization formed a limited partnership in which it served as a general partner and two individuals and a for-profit corporation were the limited partners. Significant factors in the Tax Court's finding included that the limited partners played a passive role as investors only, that the organization remained in control of all aspects of the play, that none of the limited partners were directors or officers of the organization, and that the investors' interests in the particular play were not intrusive or indicative of serving private interests.

In Housing Pioneers v. Commissioner, 65 T.C.M. (CCH) 2191 (1993), aff'd, 49 F.3d 1395 (9th Cir. 1995), amended, 58 F.3d 401 (9th Cir. 1995), the Tax Court concluded that the organization did not qualify as an organization described in section 501(c)(3) of the Code because its activities performed as co-general partner in limited partnerships substantially furthered nonexempt purposes and private interests were served by its activities. The organization entered into partnerships as a one percent co-general partner of existing limited partnerships for the purpose of splitting the tax benefits with the for-profit partners. Under the management agreement, the organization's authority as co-general partner was narrowly circumscribed. It had no management responsibilities and could describe only a vague charitable function of surveying tenant needs.

For federal income tax purposes, the activities of a partnership are generally considered to be the activities of its partners. See, e.g., Butler v. Commissioner, 36 T.C. 1097 (1961), acq., 1962-2 C.B. 4. This is also consistent with the treatment of partnerships for purposes of the unrelated business income tax under section 512(c) of the Code.

As provided in Rev. Rul. 98-15, supra, the activities of a limited liability company treated as a partnership for federal income tax purposes are considered to be the activities of an exempt organization that is an owner of a 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 which has not elected to be treated as a corporation for federal 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 purpose and only incidentally for the benefit of any for-profit partner.

In the present case, in contrast to Rev. Rul. 98-15, both members of the LLC are entities exempt from tax pursuant to section 501(c)(3), so that the activities of the LLC remain entirely in the control of these tax-exempt charities, and the LLC will only benefit exempt entities. Thus, after the LLC's formation, its members will each continue to promote the health of the community and otherwise accomplish their respective exempt purposes through the operation of the LLC consistent with Situation 1 in Rev. Rul. 98-15. Therefore, their exempt status under section 501(c)(3) will not be adversely affected by their participation in the LLC.

After the LLC becomes operational, each of its members will continue to operate a hospital and provide hospital care and so will continue to be described in section 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

The exempt purposes of both X and Y will be furthered by establishing the LLC to manage the Level III neonatal intensive care unit at Y. Y' s participation will permit it to improve and expand the level of hospital care offered to its infant patients. X's participation will permit it to use the sophisticated skills of its neonatal specialists to reach more patients, improve neonatal techniques and therapies, provide additional clinical research opportunities, and create an additional venue for clinical education programs. Accordingly, because the joint venture enables the parties to continue to promote health in a charitable manner and contributes importantly to the accomplishment of each organization's exempt purposes, any income received by X or Y as members of the LLC will not constitute income from an unrelated trade or business within the meaning of section 513.

All patients in the NICU are patients of Y. Y provides equipment, space, support services, the services of non-physician employees, supplies, medical records, maintenance, billing and collection in relation to the NICU patients in the same manner and to the same extent as for its other patients. None of these services constitutes the provision of administrative services to the LLC. For example, the billing and collection activity relates solely to billing NICU patients, not to the provision of financial or accounting services to the LLC. Similarly, any payment to Y for the services of its specialized medical and nursing personnel to effectuate the clinical operations of the NICU will not be income from the conduct of an unrelated trade or business because such income will be derived from activities that constitute the provision of patient care rather than ordinary administrative services.

Therefore, we rule as follows:

(1) Your exempt status under section 501(c)(3) of the Code and your non-private foundation status under sections 509(a)(1) and 170(b)(1)(A)(iii) will not be adversely affected by your involvement in the LLC.

(2) Your receipt of payments from the LLC for goods, property, services or personnel provided in connection with the management of the NICU, and your distributive shares of income or loss of the LLC in connection with the operation of the NICU, will not constitute income from an unrelated trade or business under section 513 and not be subject to the tax on unrelated business income under section 511.

You also requested a ruling under section 141 of the Code. This ruling request will be the subject of a separate communication.

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.

The rulings in this letter only apply the specifically indicated sections of the Code and regulations to the facts that you have represented. In this letter we do not rule on the applicability of any other sections of the Code and regulations to your case.

Because this letter could help resolve any 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.

Sincerely,

For/Robert Fontenrose

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1