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

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Date: JAN 28 2004

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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 certain changes in the system affiliation agreements to which A and its affiliates are a party.

In a letter dated October 10, 2000, the Internal Revenue Service ruled that: (1) certain affiliation and reorganization transactions described in a request for rulings dated May 5, 2000, did not adversely affect the status of A and its direct and indirect section 501(c)(3) affiliates as tax-exempt organizations under section 501(c)(3) of the Code, (2) the transactions did not adversely affect the status of A and its section 501(c)(3) affiliates as public charities described in section 509(a) of the Code and (3) there had been no unrelated trade or business under section 513 of the Code and no unrelated trade or business income under sections 511 through 514 of the Code resulting from the transactions or any transfers of assets or sharing or provision of services between and among the tax-exempt section 501(c)(3) organizations in the system.

In your ruling request dated May 5, 2000, you stated that 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). A acts as the parent of an integrated healthcare delivery system and is the sole member of various tax-exempt organizations pursuant to certain system affiliation agreements under which it exercises control and supervision over these organizations. This control and supervision is exercised by A through certain reserved powers granted to it under the system agreements, the

governing instruments of the organizations and the provisions of state law. As parent of the system, A supports, benefits and carries out the purposes of the organizations, coordinates their activities and plays an active supervisory and long-range planning role in their affairs. It also provides management services to these organizations.

You have stated that recently A and the organizations agreed to certain changes in the system affiliation agreements. The reserved powers of A have been amended and restated to further clarify and strengthen A's powers and responsibilities with respect to its financial oversight of the system. Subject to certain exceptions and limitations, the reserved powers of A now include, in part,: (1) electing all non ex-officio members of the organizations' Boards; (2) removing by a % Board vote any member of an organization's Board for cause, which includes, in part, (a) failure to adhere to any written policy established by A; (b) neglect of duties as a board member; (c) misappropriation of funds or property and (d) breach of fiduciary duty; (3) removing by a % Board vote members of an organization's Board and electing new board members in exceptional circumstances including, in part,

(4) appointing the CEO of each organization; (5) evaluating, determining the compensation of, and removing, with or without cause, the CEO's of the organizations; (6) developing business plans for the system; (7) developing and adopting capital expenditure and operating budgets for the system; (8) approving the incurrence of debt in excess of $ in any month period by an organization; (9) subject to supermajority voting requirements, incurring system debt and requiring participation by the system member in such debt; (10) subject to a % Board vote, requiring all institutions to make additional capital contributions to A to fund various initiatives; (11) approving, subject to a % Board vote, asset transfers outside the system and (12) collecting and reviewing the financial records, reports and any other documents of an organization in order to determine whether that organization has failed to comply with specified minimum financial standards and taking action where a failure has occurred.

You have stated that additionally A is empowered to identify new opportunities and initiatives intended to strengthen the system's ability to function effectively by (1) ensuring that system debt is maintained and paid in accordance with the terms thereof and that each organization's financial condition is sufficient to meet its allocated portion of system debt and its own requirements on a timely basis; (2) enhancing the value of the system to managed care and other payors through exclusive system wide contracting and by permitting each organization to strengthen its ability to serve the community; (3) developing system expertise and resources in the area of payor contracting, malpractice and other insurance requirements, compliance and purchasing and information system opportunities; and (4) collecting and facilitating the sharing of clinical information between and among the organizations and their respective staffs.

You have stated that A provides various management and support services to the organizations on a centralized, coordinated or shared service basis including financial services, insurance and risk management, payor contracting and materials management, planning, human resources services and compliance and internal audit services.

You have requested the following rulings in connection with the restated system affiliation agreement described, in part, above:

1. The restated system affiliation agreement does not adversely affect the tax-exempt status and the public charity status of A and the tax-exempt affiliates under sections 501(c) and 509(a) of the Code.

2. There will be no unrelated trade or business under section 513 of the Code or unrelated business taxable income under section 511 through 514 of the Code resulting from any transfers of assets or sharing or provision of services between and among the tax-exempt affiliates in the system resulting from the implementation of the restated system affiliation agreement.

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 states 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 relationships 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 consultant's services to other, unrelated exempt organizations for a fee sufficient to produce a small profit does not further an exclusively exempt purpose. See B.S.W. 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 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 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. 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 an affiliated system of organizations with common control, then corporate 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 restated system affiliation agreement establishes the affiliated system with sufficient common control such that corporate 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 restated system affiliation agreement effectively binds the participating affiliates under the common control of A so that the participating entities 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 affiliates have ceded authority to A's governing body as sole member under state nonprofit corporation law and under the affiliation agreement. A exercises control with respect to strategic plans, operating budgets, and capital budgets. In addition, A'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 is 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 reason of the affiliation and subsequent activities 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 restated system affiliation agreement does not adversely affect the tax-exempt status and the public charity status of A and the tax-exempt affiliates under sections 501(c) and 509(a) of the Code.

2. There will be no unrelated trade or business under section 513 of the Code or unrelated business taxable income under section 511 through 514 of the Code resulting from any transfers of assets or sharing or provision of services between and among the tax-exempt affiliates in the system resulting from the implementation of the restated system affiliation agreement.

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.

We are informing your Area Office of this action. Please keep a copy of these rulings in your permanent records.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1