Section 501.—Exemption From Tax on Corporations, Certain Trusts, Etc.

26 CFR 1.501(c)(3)–1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.
(Also §§ 170 and 509.)

Tax consequences of participation by hospitals described in section 501(c)(3) of the Code in joint ventures with for-profit entities. This ruling provides examples illustrating whether nonprofit hospitals that participate in joint ventures with for-profit entities continue to qualify for exemption as organizations described in section 501(c)(3) of the Code.

Rev. Rul. 98–15

ISSUE

Whether, under the facts described below, an organization that operates an acute care hospital continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code when it forms a limited liability company (LLC) with a for-profit corporation and then contributes its hospital and all of its other operating assets to the LLC, which then operates the hospital.

FACTS

Situation 1

A is a nonprofit corporation that owns and operates an acute care hospital. *A* has been recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3) and as other than a private foundation as defined in § 509(a) because it is described in § 170(b)(1)(A)(iii). B is a for-profit corporation that owns and operates a number of hospitals.

A concludes that it could better serve its community if it obtained additional funding. *B* is interested in providing financing for *A*'s hospital, provided it earns a reasonable rate of return. *A* and *B* form a limited liability company, *C*. *A* contributes all of its operating assets, including its hospital to *C*. *B* also contributes assets to *C*. In return, *A* and *B* receive ownership interests in *C* proportional and equal in value to their respective contributions.

C's Articles of Organization and Operating Agreement ("governing documents") provide that *C* is to be managed by a governing board consisting of three individuals chosen by *A* and two individuals chosen by *B*. *A* intends to appoint community leaders who have experience with hospital matters, but who are not on the hospital staff and do not otherwise engage in business transactions with the hospital.

The governing documents further provide that they may only be amended with the approval of both owners and that a majority of three board members must approve certain major decisions relating to *C*'s operation, including decisions relating to any of the following topics:

A. *C*'s annual capital and operating budgets;
B. Distributions of C's earnings;
C. Selection of key executives;
D. Acquisition or disposition of health care facilities;
E. Contracts in excess of $x per year;
F. Changes to the types of services offered by the hospital; and
G. Renewal or termination of management agreements.

The governing documents require that *C* operate any hospital it owns in a manner that furthers charitable purposes by promoting health for a broad cross section of its community. The governing documents explicitly provide that the duty of the members of the governing board to operate *C* in a manner that furthers charitable purposes by promoting health for a broad cross section of the community overrides any duty they may have to operate *C* for the financial benefit of its owners. Accordingly, in the event of a conflict between operation in accordance with the community benefit standard and any duty to maximize profits, the members of the governing board are to satisfy the community benefit standard without regard to the consequences for maximizing profitability.

The governing documents further provide that all returns of capital and distributions of earnings made to owners of *C* shall be proportional to their ownership interests in *C*. The terms of the governing documents are legal, binding, and enforceable under applicable state law.

C enters into a management agreement with a management company that is unrelated to *A* or *B* to provide day-to-day management services to *C*. The management agreement is for a five-year period, and the agreement is renewable for additional five-year periods by mutual consent. The management company will be paid a management fee for its services based on *C*'s gross revenues. The terms and conditions of the management agreement, including the fee structure and the contract term, are reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals. *C* may terminate the agreement for cause.

None of the officers, directors, or key employees of *A* who were involved in making the decision to form *C* were promised employment or any other inducement by *C* or *B* and their related entities if the transaction were approved. None of *A*'s officers, directors, or key employees have any interest, including any interest through attribution determined in accordance with the principles of § 318, in *B* or any of its related entities.

Pursuant to § 301.7701–3(b) of the Procedure and Administrative Regulations, *C* will be treated as a partnership for federal income tax purposes.

A intends to use any distributions it receives from *C* to fund grants to support activities that promote the health of *A*'s community and to help the indigent obtain health care. Substantially all of *A*'s grantmaking will be funded by distributions from *C*. *A*'s projected grantmaking program and its participation as an owner of *C* will constitute *A*'s only activities.

Situation 2

D is a nonprofit corporation that owns and operates an acute care hospital. *D* has been recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3) and as other than a private foundation as defined in

§ 509(a) because it is described in § 170(b)(1)(A)(iii). *E* is a for-profit hospital corporation that owns and operates a number of hospitals and provides management services to several hospitals that it does not own.

D concludes that it could better serve its community if it obtained additional funding. *E* is interested in providing financing for *D*'s hospital, provided it earns a reasonable rate of return. *D* and *E* form a limited liability company, *F*. *D* contributes all of its operating assets, including its hospital to *F*. *E* also contributes assets to *F*. In return, *D* and *E* receive ownership interests proportional and equal in value to their respective contributions.

F's Articles of Organization and Operating Agreement ("governing documents") provide that *F* is to be managed by a governing board consisting of three individuals chosen by *D* and three individuals chosen by *E*. *D* intends to appoint community leaders who have experience with hospital matters, but who are not on the hospital staff and do not otherwise engage in business transactions with the hospital.

The governing documents further provide that they may only be amended with the approval of both owners and that a majority of board members must approve certain major decisions relating to *F*'s operation, including decisions relating to any of the following topics:

A. F's annual capital and operating budgets;
B. Distributions of *F*'s earnings over a required minimum level of distributions set forth in the Operating Agreement;
C. Unusually large contracts; and
D. Selection of key executives.

F's governing documents provide that F's purpose is to construct, develop, own, manage, operate, and take other action in connection with operating the health care facilities it owns and engage in other health care-related activities. The governing documents further provide that all returns of capital and distributions of earnings made to owners of *F* shall be proportional to their ownership interests in *F*.

F enters into a management agreement with a wholly-owned subsidiary of *E* to provide day-to-day management services to *F*. The management agreement is for a five-year period, and the agreement is renewable for additional five-year periods at the discretion of *E*'s subsidiary. *F* may terminate the agreement only for cause. *E*'s subsidiary will be paid a management fee for its services based on gross revenues. The terms and conditions of the management agreement, including the fee structure and the contract term other than the renewal terms, are reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals.

As part of the agreement to form *F*, *D* agrees to approve the selection of two individuals to serve as *F*'s chief executive officer and chief financial officer. These individuals have previously worked for *E* in hospital management and have business expertise. They will work with the management company to oversee *F*'s day-to-day management. Their compensation is comparable to what comparable executives are paid at similarly situated hospitals.

Pursuant to § 301.7701–3(b), *F* will be treated as a partnership for federal tax income purposes.

D intends to use any distributions it receives from *F* to fund grants to support activities that promote the health of *D*'s community and to help the indigent obtain health care. Substantially all of *D*'s grantmaking will be funded by distributions from *F*. *D*'s projected grantmaking program and its participation as an owner of *F* will constitute *D*'s only activities.

LAW

Section 501(c)(3) provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)–1(c)(1) of the Income Tax 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 § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. In *Better Business Bureau of Washington, D.C. v. United States,* 326 U.S. 279, 283 (1945), the Court stated that "the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Section 1.501(c)(3)–1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. It further states that "to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized and operated for the benefit of private interests . . . ."

Section 1.501(c)(3)–1(d)(2) provides that the term "charitable" is used in § 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*, §§ 368, 372 (1959); 4A Austin W. Scott and William F. Fratcher, *The Law of Trusts* §§ 368, 372 (4th ed. 1989). However, not every activity that promotes health supports tax exemption under § 501(c)(3). For example, selling prescription pharmaceuticals certainly promotes health, but pharmacies cannot qualify for recognition of exemption under § 501(c)(3) on that basis alone. *Federation Pharmacy Services, Inc. v. Commissioner,* 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980) ("*Federation Pharmacy*"). Furthermore, "an institution for the promotion of health is not a charitable institution if it is privately owned and is run for the profit of the owners." 4A Austin W. Scott and William F. Fratcher, *The Law of Trusts* § 372.1 (4th ed. 1989). *See also Restatement (Second) of Trusts*, § 376 (1959). This principle applies to hospitals and other health care organizations. As the Tax Court stated, "[w]hile the diagnosis and cure of disease are indeed purposes that may furnish the foundation for characterizing the activity as 'charitable,' something more is required." *Sonora Community Hospital v. Commissioner,* 46 T.C. 519, 525-526 (1966), aff'd 397 F.2d 814 (9th Cir. 1968) ("*Sonora*"). *See also Sound Health Association v. Commissioner,* 71 T.C. 158 (1978), acq. 1981-2 C.B. 2 ("*Sound Health*"); *Geisinger Health Plan v. Commissioner,* 985 F.2d 1210 (3rd Cir., 1993), *rev'g* 62 T.C.M. 1656 (1991) ("Geisinger").

In evaluating whether a nonprofit hospital qualifies as an organization de-

scribed in § 501(c)(3), Rev. Rul. 69–545, 1969–2 C.B. 117, compares two hospitals. The first hospital discussed is controlled by a board of trustees composed of independent civic leaders. In addition, the hospital maintains an open medical staff, with privileges available to all qualified physicians; it operates a full-time emergency room open to all regardless of ability to pay; and it otherwise admits all patients able to pay (either themselves, or through third party payers such as private health insurance or government programs such as Medicare). In contrast, the second hospital is controlled by physicians who have a substantial economic interest in the hospital. This hospital restricts the number of physicians admitted to the medical staff, enters into favorable rental agreements with the individuals who control the hospital, and limits emergency room and hospital admission substantially to the patients of the physicians who control the hospital. Rev. Rul. 69–545 notes that in considering whether a nonprofit hospital is operated to serve a private benefit, the Service will weigh all the relevant facts and circumstances in each case, including the use and control of the hospital. The revenue ruling concludes that the first hospital continues to qualify as an organization described in § 501(c)(3) and the second hospital does not because it is operated for the private benefit of the physicians who control the hospital.

Section 509(a) provides that the term "private foundation" means a domestic or foreign organization described in § 501(c)(3) other than an organization described in § 509(a)(1), (2), (3), or (4). The organizations described in § 509(a)(1) include those described in § 170(b)(1)(A)(iii). An organization is described in § 170(b)(1)(A)(iii) if its principal purpose is to provide medical or hospital care.

Section 512(c) provides that an exempt organization that is a member of a partnership conducting an unrelated trade or business with respect to the exempt organization must include its share of the partnership income and deductions attributable to that business (subject to the exceptions, additions, and limitations in § 512(b)) in computing its unrelated business income. *See also* H.R. No. 2319, 81st Cong., 2d Sess. 36, 111–112 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 26, 109–110 (1950); § 1.512(c)–1.

In *Butler v. Commissioner,* 36 T.C. 1097 (1961), *acq.* 1962–2 C.B. 4 ("*Butler*"), the court examined the relationship between a partner and a partnership for purposes of determining whether the partner was entitled to a business bad debt deduction for a loan he had made to the partnership that it could not repay. In holding that the partner was entitled to the bad debt deduction, the court noted that "[b]y reason of being a partner in a business, petitioner was individually engaged in business." *Butler,* 36 T.C. at 1106 *citing Dwight A. Ward v. Commissioner,* 20 T.C. 332 (1953), *aff'd* 224 F.2d 547 (9th Cir. 1955).

In *Plumstead Theatre Society, Inc. v. Commissioner,* 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982) ("*Plumstead*"), 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 costs. In order to meet its funding obligations, the organization formed a limited partnership in which it served as general partner, and two individuals and a for-profit corporation were the limited partners. One of the significant factors supporting the Tax Court's holding was its finding that the limited partners had no control over the organization's operations.

In *Broadway Theatre League of Lynchburg, Virginia, Inc. v. U.S.,* 293 F.Supp. 346 (W.D.Va. 1968) ("*Broadway Theatre League*"), 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 provided for reasonable compensation and the organization retained ultimate authority over the activities being managed.

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) ("*Housing Pioneers*"), the Tax Court concluded that an organization did not qualify as a § 501(c)(3) organization because its activities performed as co-general partner in for-profit limited partnerships substantially furthered a non-exempt purpose, and serving that purpose caused the organization to serve private interests. 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.

In *est of Hawaii v. Commissioner,* 71 T.C. 1067 (1979), *aff'd in unpublished opinion* 647 F.2d 170 (9th Cir. 1981) ("*est of Hawaii*"), several for-profit est organizations exerted significant indirect control over est of Hawaii, a non-profit entity, through contractual arrangements. The Tax Court concluded that the for-profits were able to use the non-profit as an "instrument" to further their for-profit purposes. Neither the fact that the for-profits lacked structural control over the organization nor the fact that amounts paid to the for-profit organizations under the contracts were reasonable affected the court's conclusion. Consequently, est of Hawaii did not qualify as an organization described in § 501(c)(3).

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

ANALYSIS

For federal income tax purposes, the activities of a partnership are often considered to be the activities of the partners. *See, e.g., Butler.* Aggregate treatment is also consistent with the treatment of partnerships for purpose of the unrelated business income tax under § 512(c). See H.R. No. 2319, 81st Cong., 2d Sess. 36, 110–

112 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 26, 109–110 (1950); § 1.512(c)–1. In light of the aggregate principle discussed in *Butler* and reflected in § 512(c), the aggregate approach also applies for purposes of the operational test set forth in § 1.501(c)(3)–1(c). Thus, the activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of § 501(c)(3).

A § 501(c)(3) organization may form and participate in a partnership, including an LLC treated as a partnership for federal income 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 the for-profit partners. *See Plumstead* and *Housing Pioneers.* Similarly, a § 501(c)(3) organization may enter into a management contract with a private party giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets provided that the organization retains ultimate authority over the assets and activities being managed and the terms and conditions of the contract are reasonable, including reasonable compensation and a reasonable term. *See Broadway Theatre League*. However, if a private party is allowed to control or use the non-profit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes. *See est of Hawaii; Harding*; § 1.501(c)(3)–1(c)(1); and § 1.501(c)(3)–1(d)(1)(ii).

Situation 1

After *A* and *B* form *C*, and *A* contributes all of its operating assets to *C, A*'s activities will consist of the health care services it provides through *C* and any grantmaking activities it can conduct using income distributed by *C*. *A* will receive an interest in *C* equal in value to the assets it contributes to *C*, and *A*'s and *B*'s returns from *C* will be proportional to their respective investments in *C*. The governing documents of *C* commit *C* to providing health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits for *C*'s owners. Furthermore, through *A*'s appointment of members of the community familiar with the hospital to *C*'s board, the board's structure, which gives *A*'s appointees voting control, and the specifically enumerated powers of the board over changes in activities, disposition of assets, and renewal of the management agreement, *A* can ensure that the assets it owns through *C* and the activities it conducts through *C* are used primarily to further exempt purposes. Thus, *A* can ensure that the benefit to *B* and other private parties, like the management company, will be incidental to the accomplishment of charitable purposes. Additionally, the terms and conditions of the management contract, including the terms for renewal and termination, are reasonable. Finally, *A*'s grants are intended to support education and research and give resources to help provide health care to the indigent. All of these facts and circumstances establish that, when *A* participates in forming *C* and contributes all of its operating assets to *C*, and *C* operates in accordance with its governing documents, *A* will be furthering charitable purposes and continue to be operated exclusively for exempt purposes.

Because *A*'s grantmaking activity will be contingent upon receiving distributions from *C, A*'s principal activity will continue to be the provision of hospital care. As long as *A*'s principal activity remains the provision of hospital care, *A* will not be classified as a private foundation in accordance with § 509(a)(1) as an organization described in § 170(b)(1)(A)(iii).

Situation 2

When *D* and *E* form *F*, and *D* contributes its assets to *F, D* will be engaged in activities that consist of the health care services it provides through *F* and any grantmaking activities it can conduct using income distributed by *F*. However, unlike *A, D* will not be engaging primarily in activities that further an exempt purpose. "While the diagnosis and cure of disease are indeed purposes that may furnish the foundation for characterizing the activity as 'charitable,' something more is required." *Sonora,* 46 T.C. at 525–526. *See also Federation Pharmacy; Sound Health;* and *Geisinger*. In the absence of a binding obligation in *F*'s governing documents for *F* to serve charitable purposes or otherwise provide its services to the community as a whole, *F* will be able to deny care to segments of the community, such as the indigent. Because *D* will share control of *F* with *E*, *D* will not be able to initiate programs within *F* to serve new health needs within the community without the agreement of at least one governing board member appointed by *E*. As a business enterprise, *E* will not necessarily give priority to the health needs of the community over the consequences for *F*'s profits. The primary source of information for board members appointed by *D* will be the chief executives, who have a prior relationship with *E* and the management company, which is a subsidiary of *E*. The management company itself will have broad discretion over *F*'s activities and assets that may not always be under the board's supervision. For example, the management company is permitted to enter into all but "unusually large" contracts without board approval. The management company may also unilaterally renew the management agreement. Based on all these facts and circumstances, *D* cannot establish that the activities it conducts through *F* further exempt purposes. "[I]n order for an organization to qualify for exemption under § 501(c)(3) the organization must 'establish' that it is neither organized nor operated for the 'benefit of private interests.'" *Federation Pharmacy,* 625 F.2d at 809. Consequently, the benefit to *E* resulting from the activities *D* conducts through *F* will not be incidental to the furtherance of an exempt purpose. Thus, *D* will fail the operational test when it forms *F*, contributes its operating assets to *F*, and then serves as an owner of *F*.

HOLDING

A will continue to qualify as an organization described in § 501(c)(3) when it forms *C* and contributes all of its operating assets to *C* because *A* has established that *A* will be operating exclusively for a charitable purpose and only incidentally for the purpose of benefiting the private interests of *B*. Furthermore, *A*'s principal activity will continue to be the provision

of hospital care when *C* begins operations. Thus, *A* will be an organization described in § 170(b)(1)(A)(iii) and thus, will not be classified as a private foundation in accordance with § 509(a)(1), as long as hospital care remains its principal activity.

D will violate the requirements to be an organization described in § 501(c)(3) when it forms *F* and contributes all of its operating assets to *F* because *D* has failed to establish that it will be operated exclusively for exempt purposes.

DRAFTING INFORMATION

The principal author of this revenue ruling is Judith E. Kindell of the Exempt Organizations Division. For further information regarding this revenue ruling contact Judith E. Kindell on (202) 622-6494 (not a toll-free call).

Section 509.—Private Foundation Defined

Whether an organization that operates an acute care hospital constitutes an organization whose principal purpose is providing hospital care within the meaning of § 170(b)(1)(A)(iii) of the Internal Revenue Code for purposes of § 509(a)(1) when it forms a limited liability company (LLC) with a for-profit corporation and then contributes its hospital and all of its related operating assets to the LLC, which then operates the hospital. See Rev. Rul. 98–15, page 6.