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

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Date: MAY 15 2001

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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 combination of two health care systems.

A is the sole corporate member of B and E with broad authority to operate and manage B, E, C, F, and I as a fully integrated, economic entity subject only to certain limited powers retained by the local boards of directors. It is being granted exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code and nonprivate foundation status under section 509(a)(3) of the Code by letter of even date.

B was formed to serve as the parent corporation for the other entities in the J system and to support C and its health care mission. B is being granted exemption

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from federal income tax under section 501(c)(3) of the Code and nonprivate foundation status under section 509(a)(3) of the Code by letter of even date.

C, a hospital, is exempt from federal income tax under section 501 (c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(l) and 170(b)(1)(A)(iii) of the Code.

D, which supports C, 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.

E was formed to serve as the parent corporation of the other entities in the K system and to support F and H and their respective health care missions. 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, a hospital, is exempt from federal income tax under section 501 (c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(l) and 170(b)(1)(A)(iii) of the Code.

G, which supports 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)(3) of the Code.

ii, which provides outpatient mental health services and a free health and dental clinic to indigents, is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a nonprivate foundation under sections 509(a)(l) and 170(b)(1)(A)(iii) of the Code.

You have stated that B, C, E and F entered into an agreement to combine their respective health systems by creating A as the sole corporate member of B and E with broad authority to operate and manage the entities comprising both systems as a fully integrated, economic entity subject to only certain limited powers retained by the local boards of directors.

In order to implement the change in authority resulting from the combination, you have stated that B, C, E, F and H amended their respective articles of incorporation and bylaws. The President and Chief Executive Officer of A will be an ex-officio member of the board of directors of B, C, E and F.

You have stated that the parties recognized the benefit of retaining, at the operational level, some significant level of autonomy for the J and K systems over

community specific related operations. For this reason the combination provides for A to be the overall parent corporation of the systems, with significant control over major decisions of the entities involved, but also retains B and E as the parent corporations over their respective systems, with certain limited powers.

A has authority and responsibility over the following major activities of the entities: developing strategic and financial plans; approving, developing or revising capital and operating budgets; borrowing or loaning funds; incurring debt; guaranteeing loans or entering into similar debt obligations in excess of levels specified in the combination agreement; approving new affiliations, mergers, etc.; negotiating, executing, and implementing managed care contracts; retaining investment advisors and managing investments; engaging in consolidated cash management operations; appointing auditors and legal counsel; managing and directing compliance programs; approving proposed physicians recruitment and retention arrangements and other activities intended to centralize management of the system.

Band E retain the following authority and responsibilities: appointing four of the directors of A and assigning such directors initial staggered terms and nominating and selecting directors for their boards and for the boards of their affiliated hospitals and, in the case of E, H and I, subject to ratification by A; the right to approve their affiliated hospitals' specific strategic plans and capital and operating budgets, subject further to approval by A; and the right to oppose, approve or reject any amendment to the articles of incorporation and bylaws of their affiliated hospital.

You have stated that D and G will continue to support such parties named in their respective articles of incorporation and bylaws.

You have stated that as a result of the combination, A has the authority to require that cash and other assets of the system entities be transferred to it or another member of the system for financial and cash management, strategic, operational or other purposes. You have stated that in each case where assets are moved between members of the system, if the assets are moved between tax-exempt and taxable entities, the transactions with the taxable entities will be conducted at fair market value . and in an arms-length manner.

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

1. Subsequent to: (a) the implementation of the combination; (b) the amendment of the articles of incorporation and bylaws of B, C, D, E, F, G and ii; (c) these entities carrying out the transactions contemplated by the combination and (d) participating in the system will be or continue to be exempt from federal income tax under section

501 (a) of the Code and will continue to be classified as nonprivate foundations under section 509(a) of the Code.

2. Subsequent to: (a) the implementation of the combination; (b) the carrying out of the transactions contemplated by the combination: the transfer of cash or other assets, the sharing of assets and services, the allocation of expenses for shared services and the provision of services for a fee by, between and among the above entities will not constitiute an unrelated trade or business within the meaning of section 513 of the Code because such activities are substantially related to the exercise or performance of such organization's charitable purposes.'

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 1501(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)(l) 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-l (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-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)(l)(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 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 parents 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 Geisinaer 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, exemption under the integral part doctrine requires a parent and subsidiary relationship and the absence of unrelated trade or business. See Geisinaer, 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 combination establishes a 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 combination effectively binds the participating entities 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 entities have ceded authority to A's governing body for developing strategic and financial plans; approving, developing or revising capital and operating budgets; borrowing or loaning funds; incurring debt; guaranteeing loans or entering into similar debt obligations in excess of levels specified in the combination agreement; approving new affiliations, mergers, etc.; negotiating, executing, and implementing managed care contracts; retaining investment advisors and managing investments; engaging in consolidated cash management operations; appointing auditors and legal counsel; managing and directing compliance programs; approving proposed physicians recruitment and retention arrangements and other activities intended to centralize management of the system. 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 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. Subsequent to: (a) the implementation of the combination; (b) the amendment of the articles of incorporation and bylaws of B, C, D, E, F, G and i-l; (c)these entities carrying out the transactions contemplated by the combination and (d) participating in the system these entities will be or continue to be exempt from federal income tax under section 501(a) of the Code and will continue to be classified as nonprivate foundations under section 509(a) of the Code.

2. Subsequent to: (a) the implementation of the combination; (b) the carrying out of the transactions contemplated by the combination: the transfer of cash or other assets, the sharing of assets and services, the allocation of expenses for shared services and the provision of services for a fee by, between and among the above entities will not constitiute an unrelated trade or business within the meaning of section 513 of the Code because such activities are substantially related to the exercise or performance of such organization's charitable purposes.

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,

/S/

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

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