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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Dear Sir or Madam:

This is in response to your request for a ruling regarding a proposed reorganization and its effect under sections 501(c)(3) and 511-514 of the Internal Revenue Code.

A is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a public charity pursuant to section 509(a)(1) and 170(b)(1)(A)(iii). A owns and operates a hospital and, prior to the restructuring, owned or controlled several other health care related entities. A provides comprehensive health care services to the X community.

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B is being granted exemption from federal income tax under section 501(c)(3) of the Code and is being classified as a public charity pursuant to section 509(a)(3) by letter of even date. B was created to serve as the parent organization of the restructured health system and to support A and C.

C is being granted exemption from federal income tax under section 501(c)(3) of the Code and is being classified as a public charity pursuant to sections 509(a)(1) and 170(b)(1)(A)(iii) by letter of even date. C was created to operate the clinics and facilities of the health care system, to employ physicians and staff medical clinics and facilities and provide medical services to the communities served by B.

In 1998, A's Board of Trustees approved the establishment and funding of a separate division, C, operating as a division of A, dedicated to the operation of physician medical practices. A owned all accounts receivable attributable to the physicians it employed through C. A provided a set number of support services to the employed physicians of C. C employed primary care and specialty physicians and all respective mid-level providers, such as physician assistants and nurse practitioners, as well as all other related clinical and administrative personnel. Prior to the funding of this separate division, an unrelated physician practice was managed by an unrelated publicly traded physicians practice management company.

A was the sole member of a managed care entity, D. D is a limited liability company treated as a disregarded entity for federal income tax purposes. D provides payor contracting services to A and the employed physicians of C operating as a division of A. C, the division, contracted directly with D and provided access to those covered lives for its employed physicians.

Proposed Restructuring

Pursuant to the restructuring transaction, B was formed to serve as the common parent of A and other entities as described below. B was formed as a supporting organization to A and the newly formed C. In this role, B will undertake certain supervision, oversight, and coordination activities that were previously the responsibility of A and will ensure that the activities of the hospital and related organizations are planned, managed, and coordinated to maximize opportunities to deliver cost effective quality medical care to the X community. B will also increase the ability to ensure that clinical "best practices" can effectively and efficiently be shared between the members of the integrated health care delivery system.

A and D have been repositioned as subsidiaries of B and have amended their articles of incorporation and bylaws to reflect this relationship. A has provided a copy of A's proposed amended Articles of Incorporation and has represented that such Articles of Incorporation and Bylaws will be finalized upon receipt of a favorable ruling from the Internal Revenue Service. Such a representation indicates that the Articles of Incorporation will be filed with the proper State authorities. In addition, C has been formed as a newly incorporated subsidiary of B to employ certain physicians, previously employed by C operating as a division of A and all respective mid-level providers for those employed physicians, such as physician assistants and nurse practitioners. B also formed E, a management services organization. E is organized as a limited liability corporation and its sole member is B. E is treated as a disregarded entity for federal income tax purposes.

In most instances, physicians currently employed by C operating as a division of A have been offered continued employment with C upon expiration of their current employment contract. C will operate from the same offices from which C, the operating division of A, conducted operations. These offices are located in close proximity to A. The offices that A intends to lease the non-employee physicians, as well as E, are part of these offices. In other instances, these physicians have been offered either affiliated or independent physician status and will become non-employee physicians (collectively, the affiliated and independent physicians are referred to as non-employee physicians.) All non-employee physicians have medical staff privileges at A. Affiliated physicians, at their discretion, will practice as solo practitioners or in a group practice setting with other current or former physician employees of C operating as a division of A. Affiliates will have exclusive payor contracting accessed through D and receive certain other management services from B or its subsidiary organizations. In addition, affiliated physicians will be given the opportunity to lease office space from A and buy the equipment related to their on-site ancillary service lines. A states that affiliated physicians will not be given the opportunity to purchase any medical office space. Affiliated physicians will be given the opportunity to purchase equipment determined on a case-by-case basis depending on A's need for the equipment at the time. The sale price will be based on the appraised fair market value of the equipment. A third party independent appraiser will determine the fair market value of the equipment at the time of the sale. In order to avoid duplication of services provided by A, affiliated physicians will be asked to sign a non-compete/duplicative services agreement as part of the overall management services/affiliation agreement with B or its subsidiary organizations.

Independent physicians include those former C operating as a division of A physicians that will transition into independent, private practice with only limited contact with C. Payor contracting through D will be available to independent physicians. If restrictive covenants currently exist with A, then payor contracting through D will be exclusive for a term tied to the length of existing covenants with A. If no restrictive covenants exist then contracting may be non-exclusive. independent physicians may lease office space, buy equipment, purchase management services (excluding billing and collections), or lease non-physician employees from E or A. A states that independent physicians will not have the option to buy medical office space. B and its subsidiaries will actively enforce any restrictive covenants with respect to independent physicians in current employment contracts, as well as those employment contracts purchased from the unrelated physician practice management company.

All non-employee physicians will pay B or its subsidiaries an amount equal to fair market value for any management services or other services or equipment sold or otherwise provided by B or its subsidiaries. Total gross income derived by B from services provided to the non-employee physicians is not expected to exceed y percent of its gross income from all sources. Gross income derived by A from leases (including leased employees) to non-employee physicians is not expected to exceed z percent of its consolidated gross income from all sources.

C will lease from A the land and building space attributable to the employed physicians, while furniture and equipment will be transferred to C or leased to C via an internal charge at fair market value. No more than z percent of the building will be available for lease of office space by the non-employee physicians. Employee benefits provided by C will remain unchanged from those previously provided by C operating as a division of A. In addition, C will contract directly with D to provide medical services on a fee for service or a capitated basis for the covered lives contracted by D with payors (HMOs, PPOs, POS, self-insured employer groups, and indemnity insurance). C will also own all accounts receivable attributable to the physicians employed by C. B will fund any C operating deficits. The annual level of funding will be prospectively determined based on operating budgets at the beginning of each fiscal year.

E will provide administrative and management services, including certain patient billing and collection services, to the C employed physicians and the non-employee physicians. Pursuant to this arrangement, E will purchase a portion of these services from A pursuant to a formal purchased services agreement. These purchased services will represent a portion of the total cost within the total management services package which will be offered and provided to the C employed physicians and the non-employee physicians and are independent of any anticipated management services which will be developed internally by E or those which are purchased from an outside vendor. In accordance with the formal purchased services agreement, A will receive from E consideration in an amount equal to the fair market value for these purchased services. In addition, E will employ all non-physician employees (clinical and administrative only, but no physician extenders) associated with the C employed physicians and the (if applicable) non-employee physicians and lease them to either C or the non-employed physician as appropriate. E will provide billing and collection services and other management services to the affiliated physicians.

Subsequent to the reorganization, A no longer employs physicians. A will lease land and buildings to C and E at fair market value for the C employed physician's office space and the E administrative space, respectively. The non-employee physicians will have the option to lease their office space from A. All clinical assets and physician office furniture will be transferred from A to C. All administrative assets (not covered under purchased service arrangements) will be transferred from A to C. Non-employee physicians will have the option of purchasing their clinical assets and office furniture from C at fair market value. Non-employee physicians will not have the option to buy medical office space.

All transactions undertaken between A, D, C, B, E, and/or the non-employee physicians pursuant to and subsequent to the reorganization will be based on fair market value for such goods and services exchanged.

The ultimate governance of A, C, and E will vest in B's community based Board of Trustees. B's Board of Trustees is comprised of the eight (8) physicians serving on C's and E's Board of Trustees plus all members of A's Board of Directors. B's Board of Trustees elects and removes A's, C's, and E's trustees or directors. Furthermore, B, A, C, and E operate through interlocking directorates. A's Board of Directors consists of three (3) physician members and fifteen (15) non-physician members. C's Board of Directors consists of eight (8) physicians employed by C and three (3) non-physician members of A's Board of Trustees. The physician directors serving on C's Board of Directors are different from those physicians serving on A's Board of Directors. The persons serving on C's Board of Directors also serve on E's Board of Directors.

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Rulings Requested

1. The reorganization, as described, will not adversely impact A's exemption from tax under section 501(c)(3) of the Code and its classification as a public charity under sections 509(a)(1) and 170(b)(1)(A)(iii).

2. The reorganization, as described, and the subsequent business arrangements between A, B, and C relating to the provision of administrative/management services and the lease of land and buildings will not give rise to unrelated business income to the three entities.

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 charitable, educational or scientific purposes, provided no part of their net earnings inures to the benefit of any private shareholder or individual.

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. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372; IV Scott on Trusts, section 368, 372 (3rd ed. 1967); and Revenue Ruling 69-545, 1969-2 C.B. 117.

Section 509(a) of the Code provides that all organizations described in section 501(c)(3) are private foundations except those described in sections 509(a)(1), (2), (3), or (4).

Section 509(a)(1) of the Code excludes from the term private foundation an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 170(b)(1)(A)(iii) of the Code describes an organization whose principal purpose or functions include providing medical or hospital care or medical education or medical research.

Section 511(a) of the Code imposes a tax on the unrelated business income of organizations described in section 501(c)(3).

Section 512(a)(1) of the Code defines unrelated trade or business taxable income as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions directly attributable to such business activity, with certain modifications.

Section 512(b)(3) of the Code provides that rents from real property (and its incidental related personal property) are not treated as unrelated business income unless the real property is debt-financed under section 514. Debt-financed property does not include any property substantially related to the exercise or performance by such organization of its charitable functions.

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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(a) of the regulations defines unrelated business taxable income to include the gross income of an exempt organization if, and to the extent that: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the productions of funds) to the organization's performance of its exempt 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 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 exempt purposes.

Section 514 of the Code provides for the taxation under section 512 of income from debt-financed property. Section 514(b)(1)(A)(i), however, provides that the definition of debt-financed property does not include any property substantially all the use of which is substantially related to the exercise or performance by such organization of its charitable purposes constituting the basis for its exemption under section 501.

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, describes a trust whose sole purpose was to accumulate and hold funds for use in satisfying malpractice claims against a hospital. The trust was determined to be an integral part of the hospital because it was controlled by the hospital directly and was performing a function that the hospital could do directly. The organization was ruled to be exempt under section 501(c)(3) of the Code.

For federal income tax purposes, a parent corporation and its subsidiary are separate taxable entities so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities (see Britt v. United States, 431 F.2d 227, 233 (5th Cir. 1970)) and the corporation was not created to contravene directly or indirectly the policies of the Internal Revenue Code. See Gregory v. Helvering, 293 U.S. 465, (1935). See also National Carbide Corporation v. Commissioner, 336 U.S. 422 (1949). That is, where a corporation is organized with the bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. See Britt, supra at 234. However, where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. See Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1111 (5th Cir. 1973).

Revenue Ruling 69-463, 1969-2 C.B. 131, provides that the leasing of its adjacent office building, and the furnishing of certain office services by an exempt hospital to a hospital based medical group is not an unrelated trade or business under section 513 of the Code where the medical group performs important health services for the hospital.

Revenue Ruling 74-132, 1974-1 C.B. 152, provides that an exempt foundation that fosters and supports the activities and purposes of an exempt hospital and advances the hospital's objectives, including the sponsorship of specific projects and programs to improve the hospital's services to its patients and to support and provide the hospital's education, training and research programs, is exempt within the meaning of section 501(c)(3) of the Code.

In Announcement 99-102, 1999-2 C.B. 545, the Internal Revenue Service expressed its intention to modify the instructions to 1999 Forms 990, 990-EZ, and 990-PF to clarify the reporting requirements of tax-exempt owners of entities disregarded for federal tax purposes under section 301.7701-1 *et seq.* of the regulations. According to this announcement, when an entity wholly-owned by an organization exempt from tax under section 501(a) is disregarded, its operations are treated as a branch or division of its owner.

A will continue to own and operate a hospital. It will continue to provide hospital health care services to the X community. A's tax exempt status under section 501(c)(3) of the Code and its classification as not a private foundation pursuant to sections 509(a)(1) and 170(b)(1)(A)(iii) will not be affected by the reorganization.

The creation of B and C furthers A's charitable purposes. B is exempt under section 501(c)(3) of the Code and classified as a supporting organization pursuant to section 509(a)(3). B will be the parent corporation of the restructured health care system. By establishing and coordinating policies, supervising operations, providing centralized management and allocating resources exclusively for the reorganized structure, B is providing services which support A's and C's exempt purposes and activities. Such services could be performed by A if B or C had not been created. C is exempt under section 501(c)(3) of the Code and is classified as not a private foundation pursuant to sections 509(a)(1) and 170(b)(1)(A)(iii). C was created to operate the clinics and facilities of the health care system, to employ physicians, staff facilities and provide medical services to the communities served by A. C's activities are of the same nature as those engaged in by A prior to the restructuring. By providing the clinical services to the community, C is furthering A's charitable purposes. Consequently, A's tax-exempt status under section 501(c)(3) of the Code and public charity status under sections 509(a)(1) and 170(b)(1)(A)(iii) will not be affected by the proposed reorganization.

C will continue to provide the physician services previously provided by A's division. A transferred all clinical assets and physician office furniture to C. The transferred assets will be used in the manner they were being used by A prior to the restructuring.

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A represents that D is a disregarded entity for federal tax purposes, which was previously an asset of A. D was transferred by A to B. B will utilize D in the same manner it was utilized by A, the expansion of access by the community to its hospital and employed physicians.

A represents that E is a disregarded entity for federal tax purposes. E's sole member is B. A transferred certain administrative assets to E. B will use the transferred assets, through E, in a manner analogous to A's use of such assets. Therefore, the assets will continue to be used to further charitable purposes.

A has represented that D and E are disregarded entities for federal tax purposes. Therefore, the activities of D and E will be treated as activities of a branch or division of B.

The contractual relationships between A, B, and C will not posses the characteristics of a trade or business regularly carried on. Following the restructuring, the sharing of services, facilities, personnel and/or resources, whether or not a fee is charged, and the transfer of cash and assets among the exempt organizations will be substantially related to the exercise or performance of the exempt purposes of the involved corporations and will, therefore, not constitute unrelated trade or business activities subject to tax. Each corporation will be merely supplying a related charitable organization with a service or facility necessary for, and in the furtherance of, the performance of exempt functions under section 501(c)(3).

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

1. The reorganization, as described, will not adversely impact A's exemption from tax under section 501(c)(3) of the Code and its classification as a public charity under sections 509(a)(1) and 170(b)(1)(A)(iii).

2. The reorganization, as described, and the subsequent business arrangements between A, B, and C relating to the provision of administrative/management services and the lease of land and buildings will not give rise to unrelated business income to the three entities.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Furthermore, we are not ruling as to the consequences of the provision of office space and administrative services to the non-employee physicians.

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.

This ruling does not address the applicability of any section of the Code or regulations to facts submitted other than with respect to the sections described.

We are informing the Tax Exempt and Government Entities (TE/GE) Office of this action. Please keep a copy of this ruling in your permanent records.

Sincerely,

(signed) Marvin Friedlander
Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

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