TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Release Date: 11/26/04

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Contact Person:

No Third Party Contact:
SIN 501.03-11
511.00-00
512.02-00

Identification Number:

Telephone Number:

Legend

LLC-A:
LLC- B:
M:
T:
V:
X:
t:
z:

Employer Identification Number:

Dear :

This is in response to your ruling request regarding the federal income tax consequences of your participation in two joint ventures with various individuals and rule as follows:

Facts:

You are an organization described in section 501(c)(3) and classified as a public charity described in sections 509(a)(1)and 170(b)(1)(A)(iii) of the Code.

You were formed to own and operate equipment known as M for treatment of patients in your community. The state agency reviewing the certificate of need determined that M should be owned by a not-for-profit corporation and jointly operated by local hospitals and local physicians. Your bylaws include a conflicts of interest policy.

Your bylaws provide that you are to provide services relating to M to all persons in need in your community without regard to their ability to pay. Furthermore you are required to budget and set aside a certain percentage of your gross revenues to be divided equally between two

medical schools in the local area for certain related medical research projects. In addition, you sponsor a fellowship program for qualified physicians. Your primary support is from the operation of M.

You have acquired the technology and machinery to perform T services to treat certain ailments. You have determined that a need exists in your community to provide additional services for the treatment of patients suffering from certain ailments and diseases. Due to the inherent difficulties in providing these services, you have decided to organize two joint ventures rather than a single joint venture to conduct these activities. Each joint venture will be identical.

LLC-A

This joint venture will provide V services to your community and will own and operate the machines and equipment to provide these services. Furthermore the machines and related equipment LLC-A will own will be made available to third parties at one or more facilities leased or owned by LLC-A or made available to LLC-A under other arrangements with hospitals, ambulatory surgery centers and other providers of outpatient health care services.

You will contribute to LLC-A, the machines and related equipment to provide V services and will assign your rights and obligations under related agreements with hospitals, ambulatory surgery centers and other providers of outpatient health care services and equipment in exchange for a membership interest. Your contribution represents less than one percent of your total assets. Your contribution was appraised as being equal to your ownership interest. Physicians participating in LLC-A will contribute cash to LLC-A in exchange for their membership interests pursuant to subscription agreements. All cash received from physician subscriptions in excess of the minimum offering proceeds will be distributed to you, reducing your capital account and percentage ownership interest. Your ownership interest will always be equal to at least t, and the physicians interest can not exceed z.

These ownership interests are proportional to and equal in value to the respective contributions. All financial arrangements between you and the physician members will be negotiated on an arm's length basis and will be based on fair market value.

The operating agreement provides that all activities and business of LLC-A shall be carried on in furtherance of your exempt purposes under section 501(c)(3). LLC-A will be operated by a board of directors consisting of three directors appointed by you and two appointed by a majority of the physician members. You may remove any of the three directors you appoint. At least two of your directors must be present at a board meeting for a quorum to exist. LLC-A's board of directors will elect all of its officers.

The operating agreement and articles of organization LLC-A may not be amended, nor may the status of LLC-A be changed from one in which management is vested in the board of directors to one in which management is vested in the members without your consent and a majority of the physician members.

Neither the Board of Directors nor the members of the LLC will be able without your consent to take any action pertaining to LLC-A's charity care policies or any action that may adversely affect your tax-exempt status under section 501(c)(3). Pursuant to the operating

agreement, you will have sole authority over the provision of charity care in LLC-A to patients with limited or no ability to pay. You will have sole authority to cause LLC-A to conduct community need assessments and respond to the unmet community needs within the scope of LLC-A's activities and services.

Capital contributions to LLC-A and allocations of income, loss, deduction and credits will be in proportion to the members' percentage interests in LLC-A. There will be no special allocations of income or loss to any member of LLC-A. In the event of dissolution, following the payment of all debts and liabilities and the allocation of income, profits, losses and deductions, and after adjustments to the capital accounts required by applicable income tax regulations, the remaining funds will be distributed to the members to the extent of, and in proportion to, their positive capital account balances.

The operating agreement includes a conflict of interests policy to protect you against the private interests of directors, officers and members.

LLC-B

This LLC satisfies your need to exist in the community to expand your ability to provide X services relating to specific ailments. This LLC will provide X services to the community and it will own and operate devices or pieces of equipment utilized to administer such services. The LLC will use and make available for use by third parties M and other related devices at one or more facilities leased or owned by LLC-B or made available to LLC-B under other arrangements with hospitals, ambulatory surgery centers and other providers of outpatient health care services.

The organization and operation of LLC-B is almost identical to the organization and operation of LLC-A . You will contribute equipment to LLC-B in exchange for your membership interest. The equipment represents less than one percent of your total assets. Your contribution of equipment was appraised as being equal to your ownership interest. Local physicians will contribute cash in exchange for membership interests in LLC-B. Cash received from the physicians in excess of LLC-B's minimum subscription offering will be distributed to you upon completion of the offering and will reduce your initial capital account and percentage ownership interest in LLC-B. Your ownership interest will always equal at least t, and the physicians interests will never exceed z. All financial arrangements between you and the physicians will be negotiated on an arm's length basis and will be based on fair market value.

The operating agreement provides that all activities and business carried in by LLC-B shall be in a manner that is in furtherance of and consistent with your tax-exempt purposes. You will be operated by a board of directors consisting of three directors appointed by you and two directors appointed by the physician members. Only you may remove any of the three directors you appoint. In order for there to be a quorum at Board meetings, at least two of the directors appointed by you must be present. The board of directors will elect all of LLC-B's officers.

The operating agreement and articles of organization may not be amended nor may LLC-B be changed from one in which management is vested in the board of directors to one in which management is vested in the members without your consent and a majority of the physician members.

Neither the board of directors of LLC-B nor its members, without your consent, will be able to take any action pertaining to LLC-B's charity or any action that may adversely affect your tax-exempt status. Pursuant to the operating agreement, you will have sole authority over LLC-B's provision of charity care to patients with limited or no ability to pay. In addition, you will have sole authority to cause LLC-B to conduct community need assessments and respond to the unmet needs with the scope of LLC-B's activities and services.

Capital contributions to LLC-B and allocations of income, loss, deduction and credits will be in proportion to the members' percentage interests in LLC-B. There will be no special allocations of income or loss to any particular member of LLC-B. In the event of dissolution, following the payment of all debts and liabilities of LLC-B and the allocation of income, profits, losses and deductions, and after adjustments to the capital accounts required by the applicable income tax regulations, the remaining funds will be distributed to the members to the extent of and in proportion to, their positive capital account balances.

The operating agreement includes a conflict of interests policy to protect LLC-B, and consequently you against the private interests of directors, officers and members.

Rulings requested

1. Whether your participation in LLC-A, including the acquisition and retention of a membership interest in LLC-A will not adversely affect your exempt status under section 501(c)(3) of the Code?

2. Whether your participation in LLC-A will not adversely affect your continued treatment as an organization described in sections 509(a)(1)/170(b)(1)(A)(iii) of the Code?

3. Whether the income received from your distributive share of LLC-A's profits will be income from a related trade or business and will not be subject to tax under section 511 of the Code?

4. Whether your participation in LLC-B, including the acquisition and retention of a membership interest in LLC-B will not adversely your exemption as an organization described in section 501(c)(3) of the Code?

5. Whether your participation in LLC-B will not adversely affected your continued treatment as an organization described in sections 509(a)(1)/170(b)(1)(A)(iii) of the Code?

6. Whether the income received from your distributive share of LLC-B's profits will be income from a related trade or business and will not be subject to the tax on unrelated business taxable income under section 511 of the Code?

Law

Section 501(c)(3) of the Code describes as exempt from federal income tax, as provided under section 501(a), organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations provides that to be exempt under section 501(c)(3) of the Code an organization must be organized and operated exclusively for the purposes specified therein. The purposes specified in section 501(c)(3) include charitable purposes.

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 exempt purposes specified in section 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.

Section 1.501(c)(3)-1(d)(1) of the regulations provides that an organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of designated individuals.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in 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 (1959); 4A Scott and Fratcher, The Law of Trusts, sections 368, 372 (4th ed. 1989).

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, 1998-12 I.R.B. 6, compares two situations where an exempt hospital forms a joint venture with a for-profit entity and then contributes its hospital and all of its other operating assets to the joint venture, which then operates the hospital.

In the first situation, the revenue ruling concludes that the exempt organization will continue to further charitable purposes when it participates in the joint venture. Favorable factors include the commitment of the joint venture to give charitable purposes priority over maximizing profits; the community make-up and structure of the board; the voting control held by the exempt organization's representatives on the board; the specifically enumerated powers of the board; and, that the terms and conditions of the management contract are reasonable.

In the second situation, the revenue ruling concludes that the organization will fail the operational test when it participates in the joint venture because activities of the joint venture will result in greater than incidental private benefit to the for-profit partner. Factors leading to this

conclusion include shared voting control with the for-profit partner; no binding obligation to serve the community; the joint venture's operation as a business enterprise will not necessarily give priority to the health needs of the community over maximizing profits; the chief executives of the joint venture have a prior relationship to the for-profit partner and the management company, a subsidiary of the for-profit partner; and, the management company is given broad discretion over activities and assets and may unilaterally renew the contract.

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.

Section 511 of the Code imposes a tax on the unrelated business taxable 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 from any unrelated trade or business regularly carried on, less the allowable deductions that are directly connected with the carrying on of the trade or business, both computed with certain modifications.

Section 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, this organization, in computing its unrelated business taxable income, must include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income. See also, section 1.512(c)-1 of the regulations.

Section 513(a)(1) 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 such organization of its exempt purposes.

Section 1.513-1(a) of the regulations defines unrelated business taxable income to mean gross income derived by an organization from any unrelated trade or business regularly carried on by it, less directly connected deductions and subject to certain modifications. Therefore, gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if (1) it is income from 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 production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations states that the phrase "trade or business" includes activities carried on for the production of income which possess the characteristics of a trade or business within the meaning of section 162 of the Code. Section 1.513-1(c) of the regulations explains that regularly carried on has reference to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(d)(1) of the regulations states that the presence of the substantially related requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations states 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 an 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.

Analysis

Under the regulations, an organization that is organized and operated exclusively for charitable purposes may qualify for exemption under section 501(c)(3) of the Code. The promotion of health has long been recognized as a charitable purpose. Whether a hospital or other health care organization promotes health in a charitable manner is determined under the community benefit standard of Rev. Rul. 69-545, supra. This standard focuses on a number of factors to determine whether the hospital benefits the community as a whole rather than private interests.

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 a member of the limited liability company when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code. A section 501(c)(3) organization may form and participate in a partnership, including a limited liability company treated as a partnership for federal income tax purposes, and meet the operational test of section 1.501(c)(3)-1(c) of the regulations, if participation in the partnership furthers a charitable purpose, and the partnership agreement permits the exempt organization to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of any for-profit partners. See Rev. Rul. 98-15 supra.

After the creation and operation of the joint ventures, LLC-A and LLC-B, your charitable and exempt purposes will continue to be the same as prior to the creation of the joint ventures. You will provide health care to the community through providing treatment services according to the community benefit requirements of Rev. Rul. 69-545, supra.

Your participation in both joint ventures will further your exempt purposes. Your participation in LLC-A and LLC-B will promote health for the community in a manner that satisfies the requirements of Rev. Rul. 69-545, supra. The structure of each joint venture will allow you to act exclusively in furtherance of your exempt purposes with no undue private benefit to the physician members as provided in Rev. Rul. 98-15, supra.

As in Situation 1 of Rev. Rul. 98-15, supra, your ownership interests in LLC-A and LLC-B are proportionate to and equal in value to what your contributed to each joint venture. The returns to you and the physicians from each joint ventures will be proportionate to the respective investments in LLC-A and LLC-B.

Furthermore you will effectively control the activities of LLC-A and LLC-B. The governing documents of each LLC commit each LLC to provide health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits. Each LLC has adopted a conflict of interest policy. Through your appointment of members of the community to each board of LLC-A and LLC-B, you can ensure that the assets you own through LLC-A and LLC-B and the services provided will further your exempt purposes.

After the formation of LLC-A and LLC-B, you will continue to promote the health of the community and otherwise accomplish your exempt purposes through the operation of each of these LLCs, which is consistent with situation 1 in Rev. Rul 98-15, supra. After the formation of the LLCs, you will continue to operate or promote health care services, consistent with the community benefit factors for exempt health care organizations as described in Rev. Rul. 69-545, supra. You will continue your charity care policies through the operations of LLC-A and LLC-B, and will control both the assessment of, and response to, unmet community needs within the scope of activities of LLC-A and LLC-B.

Your exempt purposes will be furthered by the participation in each joint venture. Your participation enables you to provide expanded and improved health care services to the community. The purposes of each LLC specifically include enhancing the quality of health care and promoting the general health and well being of the community. These purposes override any duty to the members to maximize profits. Accordingly, such participation will not constitute an unrelated trade or business to you within the meaning of section 513 of the Code. Consequently, pursuant to section 512(c) of the Code, and distributive share of LLC-A and LLC-B profits to you will not be considered unrelated trade or business income.

Conclusions:

Accordingly, we rule as follows:

1. Your participation in LLC-A, including the acquisition and retention of a membership interest in LLC-A will not adversely affect your exempt status under section 501(c)(3) of the Code.

2. Your participation in LLC-A will not adversely affect your continued treatment as an organization described in sections 509(a)(1)/170(b)(1)(A)(iii) of the Code.

3. The income received from your distributive share of LLC-A's profits will be income from a

related trade or business and will not be subject to tax under section 511 of the Code.

4. Your participation in LLC-B, including the acquisition and retention of a membership interest in LLC-B will not adversely your exemption as an organization described in section 501(c)(3) of the Code.

5. Your participation in LLC-B will not adversely affected your continued treatment as an organization described in sections 509(a)(1)/170(b)(1)(A)(iii) of the Code.

6. The income received from your distributive share of LLC-B's profits will be income from a related trade or business and will not be subject to the tax on unrelated business taxable income under section 511 of the Code

These rulings are based on the understanding that there will be no material change in the facts upon which they are based. Any changes that may have a bearing on your tax status should be reported to the Service. This ruling letter does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

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. Because this letter could help resolve future questions about your income tax responsibility, please keep a copy of this ruling in your permanent records.

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.

Sincerely,

Michael Seto
Manager,
EO Technical
Group 1