



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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No Third Party Contact:
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509.00-00
511.00-00
170.00-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

T-
W-
X-
Y-
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Dear _____ :

We have considered your ruling request regarding the tax consequences associated with the corporate reorganization described below.

W is recognized as exempt under section 501(c) (3) of the Code and classified as an organization described in section 509(a)(3) of the Code. W operates as a parent corporation to X and Y as well as other health care entities. W was established to carry out the purposes of X, which operates an acute care hospital and other ancillary health care services for the benefit of the general public.

X is recognized as exempt under section 501(c)(3) of the Code and classified as an organization described in sections 509(a)(1)/170(b)(1)(A)(iii) of the Code. X operates multi-specialty, general and surgical hospital, and a general acute care hospital.

Y is a subsidiary of W that operates T hospital. Y is recognized as exempt under section 501(c)(3) and classified as an organization described in sections 509(a)(1)/170(b)(1)(A)(iii) of the Code. T hospital is a specialty hospital in long-term care services, and it offers pain management, outpatient surgery services, ophthalmology and podiatry services.

As the number of hospitals operated by W entities has increased, W sought greater efficiency and consistency among its subsidiaries and their respective hospitals and health care services. W hired consultants to undertake a study of the corporate and management structure of the various corporations and health care facilities associated with W and to recommend a

governance and management structure that best serves and promotes the health needs of the community.

The consultants recommended retaining X and Y to operate the various hospital and ancillary health systems. The consultants recommend centralization of the planning aspect and the implementation of certain administrative function by W as opposed to redundant and duplicative performances of these functions by X and Y. Thus, W would have greater planning and administrative control over the hospitals. The functions that would be planned and implemented by W include compliance/internal audit, decisions support, finance, the Foundation, government relations, human resources, legal services, managed care, patient financial services, policy development, public relations/marketing, real estate management, revenue management, and strategic planning.

Under the restructure W would be responsible for the planning of clinical functions and non-clinical support functions; however, the implementation of clinical operations and support functions would be the responsibility of X and Y. For example, the medical staff functions remain under the control of X and Y. While each hospital's medical staff operates independently of each other, the medical staffs are unified by similar bylaws, rules and regulations approved by the respective subsidiary corporation's board of directors with respect to W. Additionally X and Y credentials its own physicians.

W is still governed by a community Board of Directors. The Chiefs of Staff of each of the hospitals operated by W's subsidiaries will hold ex officio positions on the Board with full voting privileges; however, no more than 30% of the board may be comprised of practicing physicians. Directors of W receive no compensation.

W's primary functions after the restructure are to:

- Determine the objectives and major policies of W, X and Y and related entities with relation to community needs. W will continue to review the responsibilities, programs, physical resources and funds, and allocate such resources and personnel to the various subsidiaries of W based upon health care needs of the public and resources available.
- Provide overall strategic direction and strategic planning for W, X, and Y and related entities; W is responsible for studying the health care needs of the community served by its subsidiaries, reviewing and analyzing public health statistics, and determining whether community needs are being met. W reviews the existence of additional services resulting from technological and medical advances, and evaluates whether the community needs these services and what is the most efficient way to offer these services.
- Establish and operate special activities where patients or customer needs dictate and/or where a centralized services will be more cost effective and pro-competitive.
- Facilitate capital development and long range financial planning and approve the annual budget of X, Y and related entities.

- Expand existing or assume new, managerial and operational activities with respect to the affiliated corporate entities, as sound business practices may dictate; W continually evaluates its role with respect to the management and daily operational activities of the affiliated corporate entities. In circumstances where business practice dictates, as may be evidenced by demographic shifts, technological advances and other factors, W may assume a more direct role in the management and operations of the various subsidiaries, including for example appointing the chief executive and operating officers within W and importing employed personnel at the subsidiary level to implement W's goals and strategies.

Pursuant to the restructuring, X and Y have virtually identical bylaws. According to their bylaws, X and Y need to obtain approval from W before taking such action as selling, mortgaging, encumbering or disposing of all or substantially all of its assets. In addition, W must approve the assignment or subleasing of property of X and Y. W must also approve any plan of merger, consolidation, dissolution, or liquidation as well as any amendment of X and Y's Articles of Incorporation or Bylaws.

X and Y are both governed by a Board of Directors that includes as ex-officio members, the chiefs of staff that are part of X and Y. X and Y's bylaws provide that W shall approve each organization's board of directors.

A for-profit corporation was formed to hold and manage various real estate ventures of W. While the for-profit corporation is a wholly owned subsidiary of W, the activities of the for-profit corporation are not substantially related to the exempt purposes of W. Thus the for-profit corporation will be operated separately from W and W's other subsidiary corporations, maintaining all corporate formalities through its own policies, procedures and daily operations.

While W will initially provide capitalization to the for-profit corporation to carry out its activities, any funds and assets of the for-profit corporation will not be combined and commingled with funds or assets of W's other subsidiaries. Likewise the for-profit corporation will pay for all administrative services provide by W, X and Y.

The for-profit's governing board is appointed by W as the sole shareholder; however the majority of the board is not comprised of persons who are current officers or directors of W. The for-profit corporation has the authority and discretion to conduct its day-to-day business pursuant to the judgment of its governing board and its officers.

You are requesting the following rulings:

1. The transactions described above will not adversely affect the section 501(c) (3) status of W, X, and Y.
2. The transactions described above will not result in W, X, and Y being treated as a private foundation under section 509 and the such organizations will continue to be treated as publicly supported charities and other than private foundations
3. Contributions to W, X, and Y will be deductible to the donor under section 170(b) (1) or (2) of the Code, subject to the percentage limitation specified therein.

4. The net revenues of W, X and Y may be directly contributed to or loaned to the other exempt organizations in the structure without giving rise to unrelated business taxable income under sections 511 through 514 of the Code.
5. The operation and organization of the for-profit corporation, ownership of the capital stock of the corporation by the system, and the receipt of dividends on such stock by W, will not affect the tax-exempt status of the W, X and Y under section 501(c) (3) of the Code and will not give rise to unrelated business taxable income under sections 511 through 514 of the Code.

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 religious, charitable, scientific, or educational 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 Code 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; IV Scott on Trusts, sections 368, 372 (3rd ed. 1967); and Revenue Ruling 69-545, 1969-2 C.B. 117.

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. 67-149, 1967-1 C.B. 131, holds that an organization providing only financial assistance to organizations exempt under section 501(c)(3) of the Code may qualify for exemption under section 501(c)(3).

Revenue Ruling 69-463, 1969-2 C.B. 131, holds 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 unrelated trade or business income under section 513 of the Code where the medical group performs important health services for the hospital.

Rev. Rul. 78-41, 1978-1 C.B. 148, concludes that a trust created by a hospital to accumulate and hold funds to pay malpractice claims against the hospital qualified for exemption under section 501(c)(3) of the Code as an integral part of the hospital. The hospital provided the funds for the trust, and the banker-trustee was required to make payments to claimants at the direction of the hospital. The organization conducted an activity that the hospital could perform itself.

Section 509(a)(1) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 509(a)(2) of the Code generally excludes from the definition of private foundation an organization that normally receives more than one-third of its support in each taxable year from any combination of (i) gifts, grants, contributions or membership fees; and (ii) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business (within the meaning of section 513), and normally receives not more than one-third of its support in each taxable year from the sum of (i) gross investment income and (ii) the excess of the amount of the unrelated business taxable income over the amount of the tax imposed by section 511 of the Code.

Section 509(a)(3) of the Code generally excludes from the definition of private foundation an organizations which is organized and, at all times thereafter, is operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations classified under section 509(a)(1) or (a)(2); (b) is operated, supervised or controlled by, or in connection with one or more organizations described in section 509(a)(1) or (a)(2); and (c) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more section 509(a)(1) or (a)(2) organizations.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(c).

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

Section 513(a) 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 an organization of the purpose or function constituting the basis for its exemption.

Section 1.513-1 (a) of the regulations defines "unrelated business taxable income" to mean gross income from any unrelated trade or business regularly carried on. Section 1.513-1(b) states that the phrase "trade or business" includes activities carried on for the production of income and which possess the characteristics of a trade or business within the meaning of section 162 of the Code. Finally, section 1.513-1(c) explains that "regularly carried on" has reference to the frequency and continuity of the conduct of an activity and the manner in which the activity is pursued.

Section 1.513-1(d)(2) of the regulations provides 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 any 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.

Section 514 of the Code provides for the taxation under section 512 of the Code of income from debt-financed property. Section 514(b)(1)(A)(i) of the Code, 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.

After the reorganization occurs, W will assume the managing and performing functions that X and Y individually performed. See Rev. Rul. 78-41, 1978-1 C.B. 148. Therefore W will continue to qualify for exemption as an organization described in section 501(c)(3), because the assumption of these functions further the exempt purposes of X and Y. The exempt status of X and Y will not change because both organizations will continue to carry on its charitable activities and exempt purposes of providing hospital care and promoting health within the meaning of section 501(c)(3).

W has been previously recognized as a supporting organization. After the reorganization, it will continue to meet the organizational and operational requirements for classification as supporting organization under section 509(a) (3). Furthermore the transferring of administrative services to W will not change the functions of X and Y as health care providers as described in section 509(a)(1)/170(b)(1)(A)(iii) of the Code.

The deductibility of contributions to donors to W, X and Y under section 170 of the Code will not be affected by the restructuring since W, X and Y remain exempt from federal income tax under section 501(c) (3) of the Code.

The contribution and loaning of funds between W, X, and Y for the purpose of accomplishing their exempt purposes will not give rise to the receipt of unrelated business income under sections 511 through 514 of the Code.

You have stated that the for-profit corporation is expected to operate certain activities that would be taxable in nature. Its after-tax profits will be accumulated for future use in its activities or will be distributed as a dividend to W, its sole owner. Since section 512(b) (1) excludes dividends from the computation of unrelated business taxable income, such distributions to W will not result in recognition of unrelated business taxable income.

The for-profit corporation will be operated separately from W, X and Y, and it will maintain all corporate formalities through its own policies, procedures, and daily operations. W will appoint all directors of the for-profit corporation, and be its sole shareholder; however, W will not control the day-to-day operations of the for-profit corporation. This authority does not make the for-profit corporation an arm, agent, or integral part of W.

Employees of the for-profit corporation will be employees of the for-profit corporation and not of W, X or Y. A majority of the for-profit corporation's board consists of persons who are not currently an officer or director of W, X or Y. Therefore the ownership of the stock by W will not jeopardize its exempt status or adversely affect the exempt status of W, X, and Y and will not

give rise to unrelated business taxable income under sections 511 through 514 of the Code.

Accordingly we rule as follows:

1. The transactions described above will not adversely affect the section 501(c)(3) tax-exempt status of W, X, and Y.
2. The transactions described above will not result in W, X, and Y being treated as a private foundation under section 509 and the such organizations will continue to be treated as publicly supported charities and other than private foundations
3. Contributions to W, X, and Y will be deductible to the donor under section 170(b) (1) or (2) of the Code, subject to the percentage limitation specified therein.
4. The net revenues of W, X and Y may be directly contributed to or loaned to the other exempt organizations in the structure without giving rise to unrelated business taxable income under sections 511 through 514 of the Code.
5. The operation and organization of the for-profit corporation, ownership of the capital stock of the corporation by the system, and the receipt of dividends on such stock by W, will not affect the tax-exempt status of the W, X and Y under section 501(c) (3) of the Code and will not give rise to unrelated business taxable income under sections 511 through 514 of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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 by others as precedent.

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.

Sincerely,

Steven B. Grodnitzky
Acting Manager, Exempt Organizations
Technical Group 1

Enclosure
Notice 437