Dear Applicant:

This is in reply to your request of August 22, 1990, and subsequent correspondence for rulings concerning a proposed reorganization.

H is a nonstock not-for-profit hospital. H has been recognized as exempt from federal income taxes under section 501(c)(3) of the Code and classified as a public charity under sections 509(a)(1) and 170(b)(1)(A)(iii).

P is a nonstock not-for-profit corporation. P's Certificate of Incorporation provides that its principal purpose is to benefit, perform the functions of, carry out the purposes of and uphold, promote and further the welfare, programs and activities of H. It has been recognized as exempt from federal income taxes under section 501(c)(3) of the Code and a supporting organization within the meaning of section 509(a)(3).

S is a stock corporation with P as its sole shareholder. S is a for-profit corporation and will be subject to federal income taxes. It is not anticipated that P or H will provide services to S, although some personnel and facilities may be shared in the beginning in an effort to reduce costs. If services are provided, an arms-length fee will be charged. The primary purpose of S is to perform real estate development and management functions for P and H.

In addition to its operation of a hospital, H has significant operational and administrative responsibilities in areas not directly related to the providing of medical care to hospital patients. The complexities of operating H's general acute care hospital and H's associated activities have become increasingly burdensome in recent years. At the same time, the demands on the time of persons on the Board of Trustees and Executive Committee of H have also increased. Furthermore, H's commitment to make its services available to all who may need them requires that some of these services be performed at
locations other than H's own facilities, such as at nursing homes and private homes. The combination of these factors has resulted in H studying alternatives to its present organizational structure. The alternative chosen by H is a plan of reorganization with P and S which will result in H transferring some of its activities to either P or S.

In order to implement this reorganization H will, upon approval by the Internal Revenue Service of the transactions described in this letter, amend its Charter and Bylaws as described to designate P as its sole member. After the reorganization, H, P and S will, as a group, conduct the activities formerly conducted by H alone. H will continue to operate the general acute care hospital and provide medical and hospital care. In addition, S will engage in activities which H has avoided since they may constitute an unrelated business activity subject to taxation under sections 511-514 of the Code. P will function as the parent corporation in the structure and will provide overall direction and control to H and S.

This reorganization will permit the three corporations in the system to promote more efficient delivery of health care for H's community and the conduct of certain non-patient care activities without a commitment or demand on H's Board of Trustees and Executive Committee or other resources. In addition, the burden and responsibility of direction will be spread among the Boards of P and S so that those having particular training and experience may devote their attention to particular activities in which their abilities would be most useful.

Sufficient cash to provide working capital will be transferred to P by H at the consummation of the reorganization. Following the initial transfer, it is anticipated that there will be further cash transfers between P and H. Another factor which will influence future transfers of cash is efficient management. For example, where assets owned by H are not directly related to its hospital activities, such assets may be transferred to P or S in order to allow the management to focus exclusively on hospital-related activities.

After the reorganization, H and P will share some assets, personnel and services in an effort to reduce, through economies of scale, the overall cost of providing health care services. A fee may or may not be charged for these shared services. To the extent there are transactions between the exempt organizations and S, such transactions will be conducted on an arm's-length basis and it is anticipated that the charges for goods or
Gaylord Farm Association, Inc.

services provided in connection with such transactions would be at fair market value.

Section 170 of the Code, in part, provides, subject to certain limitations, for the allowance of a deduction for charitable contributions to corporations, trusts, funds or foundations that are organized and operated exclusively for charitable, scientific or educational purposes, i.e. described in section 170(c).

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax for organizations that are organized and operated exclusively for charitable, scientific or education purposes, as long as, among other conditions, no part of the net earnings inures to the benefit of any private individual or shareholder.

Section 509(a) of the Code provides that a section 501(c)(3) organization shall be a private foundation unless it is described in sections 509(a)(1) through 509(a)(4).

Section 509(a)(1) of the Code includes organizations that are described in sections 170(b)(1)(A)(i) through (vi).

Section 509(a)(3) of the Code describes an organization that is organized and operated exclusively to support one or more specified 509(a)(1) or (2) organizations which has a degree of control or supervision over the supporting organization.

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 received by an exempt organization from an unrelated trade or business regularly carried on by it, less allowable deductions.

Section 512(b)(1) of the Code excludes from unrelated business taxable income all dividends, interest, payments with respect to securities loans (as defined in Section 512(a)(5)), and annuities, and all deductions directly connected with such income.

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
Gaylord Farm Association, Inc.

for income or the use it makes of the profits derived) to the exercise by the organization of its exempt functions.

section 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 income from a trade or business, to be substantially related to purposes for which an exemption is granted, the production or distribution of 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, in part, that in determining unrelated business taxable income for a given year, there shall be included a percentage of the gross income calculated in the ratio of the average acquisition indebtedness for the year to the average adjusted basis to the organization for that same period.

Rev. Rul. 78-41, 1978-1 C.B. 148, describes a trust whose sole purpose is 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 and because it 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.

The purposes and activities of H will not be altered as part of the reorganization. H will continue to provide acute care and related medical services to the public. Additionally, H will continue to be a hospital, operate an emergency room and provide medical services to the needy irrespective of their ability to pay. Therefore, the status of H under sections 501(c)(3) and 509(a)(1) and 170(b)(1)(A)(iii) will not be affected by the reorganization.

After the proposed reorganization, P will be operated for the purpose of supporting H and the provision of health care to the community. P will perform services in support of H that H could perform for itself consistently with H's exempt function. Under Rev. Rul. 78-41, 1978-1 C.B. 148, P will be considered an integral part of H in the delivery of health care to the community. Therefore, P's exemption under section 501(c)(3) of the Code after the proposed reorganization will not be affected.
Gaylord Farm Association, Inc.

Following the proposed reorganization, P will continue to be organized and operated exclusively to support H. The bylaws of P will continue to require that a majority of the persons on H's Board will also be on P's Board. Therefore, P will continue to be described in section 509(a)(3) of the Code.

Investment in the stock of a for-profit corporation is allowed to a section 501(c)(3) organization. P's ownership of the stock of S would be allowable on that basis alone. Dividends are a standard source of revenue for section 501(c)(3) organizations and are excluded from unrelated business taxable income under section 512(b)(1) of the Code. Thus the holding of the stock of S and the receipt of dividends will not jeopardize P's exemption under 501(c)(3) nor be unrelated business taxable income to P. The taxable income of S is not attributable to P because this is a separate legal entity conducting its own operations and P is not involved in the day-to-day operational management of S.

An exempt organization can deal with nonexempt entities as long as it is doing so to further its own exempt purposes and is not operating to serve the private interests of the nonexempt entities. Exempt organizations are not prohibited from conducting normal business transactions with for profit entities. S operates as part of the system overseen by P which is providing health care to the community, H's and P's exempt purpose. The furnishing of assets, services and/or personnel by H or P for fair market value in an arm's-length transaction would be allowable as a business transaction of H or P even to an unrelated entity. Thus this would not affect H's or P's exempt status.

The transfers of stock and other assets, funds, services and/or personnel among the exempt entities during and after the reorganization will be for the purpose of better provision of medical care and service to the community. This is the exempt purpose of all of these exempt entities. Therefore, any income realized would be from a related, rather than an unrelated, activity. Thus such transfer of assets and/or payments for services between the various entities during or after the reorganization would not be subject to unrelated business income tax under sections 511 through 514 of the Code.

Similarly, because such payment for or transfers of assets and/or services among the exempt entities would be in furtherance of their exempt purposes, such transactions would not adversely affect the exempt status under section 501(c)(3) of the Code of the involved entities. These entities will continue to conduct
Gaylord Farm Association, Inc.

their exempt functions in furtherance of their exempt purposes, H will continue to be a hospital and P will continue to support H. Thus neither the exemptions nor the classifications under section 509(a) of the Code would be adversely affected by the reorganization.

Also, because they remain exempt under section 501(c)(3) of the Code, contributions to H and P will continue to remain deductible under section 170.

Accordingly, based on the information provided as stated above, we have concluded that:

1. After the amendment to the Certificate of Incorporation and Bylaws of H and the proposed reorganization, H will continue to qualify as an organization described in sections 501(c)(3), 509(a)(1) and 170(b)(1)(A)(iii) of the Code.

2. After the proposed reorganization, P will continue to qualify as an organization described in sections 501(c)(3) and 509(a)(3).

3. P's ownership of 100% of the issued and outstanding voting stock of S and P's receipt of dividends from S will have no adverse affect on P's status under sections 501(c)(3) and 509(a)(3) and the taxable income of S will not be construed to be unrelated business income to P or H unless subject to the provisions of section 512(b)(13), and any dividends received by P from S will not be unrelated business income to P.

4. The proposed transfers of cash and other assets and the sharing of personnel, services, facilities and expenses by and between H and P will not jeopardize the continued tax-exempt status of H and P as organizations described in section 501(c)(3); adversely affect H or P's status as public charities under sections 509(a)(1) or 509(a)(3); or give rise to unrelated business taxable income under sections 511-514 to either H or P.

5. After the amendments to the Certificate of Incorporation and Bylaws of H and the proposed reorganization, contributions to H and P will continue to be deductible by the donors as provided in section 170.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than the sections described above. This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.
Gaylord Farm Association, Inc.

We are informing your key District Director of this ruling. Because this letter could help resolve any questions about your exempt status and foundation status, you should keep it in your permanent records.

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. For other matters, including questions concerning reporting requirements, please contact your key District Director.

Sincerely yours,

[Signature]
Jeanne S. Gessay
Chief, Exempt Organizations
Rulings Branch 2