DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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UIL No.
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Contact Person:

Identification Number:

Telephone Number:

Employer Identification No.:

Legend
Hospital =
Parent =
L =
Date x =
Date y =

Dear :

This letter responds to your request for rulings under section 512(b)(13) of the Internal Revenue Code.

Facts

Hospital is a nonprofit corporation that was formed under the laws of the State of L. Hospital is described in section 501(c)(3) of the Code and is classified as an organization described in sections 509(a)(1) and 170(b)(1)(A)(iii). Hospital is a part of a large healthcare system ("System") governed by Parent.

Parent is a nonprofit corporation that was formed under the laws of the State of L. Parent is described in section 501(c)(3) of the Code and classified as an organization described in section 509(a)(3). Parent controls a large healthcare system consisting of both tax-exempt and taxable organizations. Hospital and Parent share a common governing board and common key employees including Hospital's president, vice-presidents, secretary, and treasurer.

A number of professional medical corporations ("PCs") that engage in the private practice of medicine are affiliated with the Parent. Each PC was formed as a professional corporation under the laws of the State of L. All of the PCs file tax returns either on Form 1120 or Form 1120-S.

The acquisition, formation and operation of the PCs were substantially funded through formal

and informal loans and advances from Parent and Hospital. A small portion of the debt outstanding represented funds that Parent borrowed from an outside lender at a certain interest rate and re-loaned to the PCs at the same rate through written loan agreements. Most of the loans and advances from Parent and Hospital were made without written loan agreements or notes. Repayments of principal and interest amounts by the PCs have been infrequent. Parent and Hospital accrued the unpaid interest and added it to the balance of the outstanding debt. As of Date x and Date y, a substantial amount of this debt was outstanding.

This ruling request involves six of these PCs. The six PCs practice medicine in the following areas: comprehensive health services, surgical and musculoskeletal services, cardiovascular and thoracic surgery, radiology, family medicine, and pediatrics. No patients of the six PCs are also patients of Hospital.

The law of the State of L requires that a licensed physician hold the stock of a professional corporation engaged in the practice of medicine. Pursuant to the agreements discussed below, an employee-physician of Hospital is the sole shareholder of each PC. (Hereafter, each such employee-physician-shareholder is referred to as "Physician.")

Hospital, the PCs and the Physicians have entered into employment agreements, shareholder agreements, and affiliation agreements. (Hereafter, these agreements are referred to collectively as "Agreements.") Hospital has represented that there are no material differences between each of these employment agreements, shareholder agreements and affiliation agreements. In the case of PCs that filed tax returns on Form 1120-S, none of the Physicians reported their share of the applicable corporation's income and losses on their individual income tax returns.

In the employment agreement, Physician is employed by Hospital as the chairman of one of Hospital's departments. In the related affiliation agreement, Hospital provides management, professional, and administrative services to the PC. The shareholder agreement provides for Physician to purchase PC stock for a nominal amount; requires Physician to be employed by Hospital through the PC, and prohibits Physician from selling, assigning, transferring, hypothecating or otherwise disposing of or encumbering the stock. The shareholder agreement prohibits any involuntary transfer of the stock and requires Physician to take necessary action to remain the sole shareholder and director of the PC. In the event Physician's employment with the PC terminates, the shareholder agreement requires that Physician sell all shares to an individual selected by Hospital for the same nominal value that Physician paid. The shareholder agreement states the stock certificates issued to Physician bear a legend referring to the restrictions on the transfer of the stock pursuant to the shareholder agreement. The employment agreement provides that Physician is not entitled to the profits or losses from the operation of the PC and requires Physician to give to Hospital any income received from the PC.

The PCs each entered into affiliation agreements with Hospital under which Hospital provides management, professional, and administrative services to each PC. The agreement provides that each party has the ability to unilaterally terminate the agreement. However, under some of

the employment agreements and bylaws of the PCs, a Physician is prevented from exercising this right.

Rulings Requested

1. For taxable years ending Date x and Date y, was Hospital or Parent a "controlling organization" with respect to the PCs, within the meaning of section 512(b)(13)(A) of the Code?

2. If the answer to Ruling Request No. 1 is Yes, did the PCs have "net unrelated income" or "net unrelated loss" under section 512(b)(13)(B) of the Code?

3. If the answers to Ruling Requests No. 1 and 2 are Yes, is the interest received or accrued by Hospital and Parent from the PCs treated as gross income derived from an unrelated trade or business under section 512(b)(13)(A) of the Code?

Law

Section 511(a)(1) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Under section 512(a)(1) of the Code, the term "unrelated business taxable income" means the gross income derived by any organization from any "unrelated trade or business regularly carried on," less the applicable deductions and modifications.

Under section 513(a) of the Code, the term "unrelated trade or business" means ". . . any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. . . "

Under section 1.513-1(a) of the Income Tax Regulations, an exempt organization's gross income is treated as "unrelated business taxable income" if:

(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 the trade or business is not substantially related to the organization's performance of its exempt functions.

Under section 1.513-1(d)(2) of the regulations, a "trade or business" is "related" to exempt purposes "only where the conduct of the business has causal relationship to the achievement of exempt purposes." A "trade or business" is "substantially related" "only if the causal relationship is a substantial one." That is, "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 [tax-exempt] purposes." Whether activities productive of gross income contribute importantly to the accomplishment of a tax-exempt purpose "depends in each case upon the facts and circumstances involved."

Section 1.513-1(d)(3) of the regulations provides that the size and extent of the activities must be considered in relation to the nature and extent of the exempt function which they purport to serve. If the organization realizes income from activities which are conducted on a larger scale than is reasonably necessary for the performance of its exempt functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. See Geisinger Health Plan v. Commissioner, 100 T.C. 394, 405 (1993) (determination of whether conduct is substantially related "considers the degree to which income is earned from services rendered or sales made to persons who are not patients of the exempt affiliated entity."), aff'd 30 F.3d 494 (3rd Cir. 1994); Redlands Surgical Services v. Commissioner, 113 T.C. 47, 95-96 (1999) (conduct was not substantially related to affiliated organization when the patient populations did not overlap substantially), aff'd per curiam 242 F.3d 904 (9th Cir. 2001); IHC Health Plans v. Commissioner, T.C. Memo 2001-246 (by contracting for services from independent physicians, operations were conducted on scale larger than reasonably necessary to accomplish affiliate hospital's exempt purposes), aff'd 325 F.3d 1188 (10th Cir. 2003).

Sections 512(b)(1), (2), and (3) of the Code exclude from the computation of unrelated business taxable income interest, dividends, royalties, and rents from real property, and rents from personal property leased with such real property, if the rents attributable to such personal property are only an incidental amount of the total rents received under the lease.

Section 512(b)(13) of the Code provides special rules for certain amounts of income an exempt organization receives from a controlled entity.

Section 512(b)(13)(A) of the Code provides that notwithstanding sections 512(b)(1), (2) and (3), a "specified payment" that an exempt organization receives or accrues from a "controlled organization" is treated by the controlling organization as unrelated business taxable income to the extent such payment reduces the "net unrelated income" of the controlled entity (or increases its net unrelated loss). All deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business are allowed.

Section 512(b)(13)(B)(i)(I) of the Code states that the term "net unrelated income" means, in the case of a controlled entity not exempt under section 501(c)(3), the portion of the entity's taxable income which would be unrelated business taxable income if such entity were exempt and had the same exempt purpose as the controlling organization.

Section 512(b)(13)(C) of the Code states that the term "specified payment" means any interest, annuity, royalty, or rent.

Section 512(b)(13)(D)(i) of the Code provides, in part, that the term "control" means in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of such corporation.

Section 512(b)(13)(D)(ii) of the Code provides that section 318 (relating to constructive ownership of stock) shall apply for purposes of determining ownership of stock in a corporation, and similar principles shall apply for purposes of determining ownership of interests in any other entity.

The Pension Protection Act of 2006, Pub.L. 109-280, Title XII, section 1205(a) (Aug. 17, 2006), added new section 512(b)(13)(E) to the Code. Section 512(b)(13)(E) generally provides that section 512(b)(13)(A) applies only to that portion of a specified payment that the controlling organization receives or accrues that exceeds the amount that would meet the requirements of section 482. Section 512(b)(13)(E) only applies to payments made pursuant to a written binding contract in effect on August 17, 2006 that are received or accrued after December 31, 2005 and on or before December 31, 2007.

Frank Lyon Co. v. U.S., 435 U.S. 561, 572 (1978) held that ownership for federal income tax purposes is determined by beneficial interest. See Rev. Rul. 2003-91, 2003-2 C.B. 82 (federal taxation based on having "sufficient incidents of ownership," not mere legal title).

Himmel v. Commissioner, 338 F. 2d 815 (2d Cir. 1964), states that stock ownership involves three important rights: (1) the right to vote and thereby exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation. See Rev. Rul. 81-289, 1981-2 C.B. 82; Rev. Rul. 85-106, 1985-2 C.B. 116.

In Nebraska Dep't of Revenue v. Lowenstein, 513 U.S. 123 (1994), the Court recharacterized the taxpayer's form so as to accord with economic reality.

Analysis

Ruling Request No. 1

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While a Physician holds legal title to the shares of stock of each of the PCs, each of the Physicians merely are acting as Hospital's nominees pursuant to the Agreements and are not beneficial owners. Frank Lyon Co. v. U.S., supra. Instead, Hospital holds all the significant rights granted by stock ownership. Himmel v. Commissioner, supra; Rev. Rul. 85-106, supra; Rev. Rul. 81-289, supra. Pursuant to the shareholder agreements, at any time, Hospital can replace the present Physician and cause the Physician to sell the stock of the PC to another Physician of its choosing at the same nominal price that the first Physician paid for the stock. The various Agreements provide that each Physician holds the stock of the PC at Hospital's pleasure and Physician cannot act with regard to the stock contrary to Hospital's instructions.

Parent and Hospital apparently agree that the Agreements would normally be treated as giving Hospital beneficial ownership of the equity interest in each of the PCs. However, Parent and

Hospital contend that under the law of the State of L, non-physician ownership of medical PCs is prohibited, and as a result, the Agreements are unenforceable. They contend that L law specifically prohibits a physician from holding the stock of a medical PC as a nominee or proxy for a non-physician.

Even if the Agreements between Hospital, the PCs and the Physicians are not legally enforceable under L law, it is still appropriate to treat the Agreements as valid because: (i) the parties have acted in accord with the Agreements; (ii) the parties intend to continue to honor the Agreements; (iii) Hospital and other Physicians have honored similar Agreements in the past; and (iv) there is no economic incentive for a Physician not to honor the Agreement. Treating the Agreements as valid accords with business reality and is the result the parties intended. Nebraska Dep't of Revenue v. Lowenstein, supra.

Therefore, because Hospital beneficially owns by vote more than 50 percent of the stock of the PCs, Hospital is a controlling organization of the PCs within the meaning of section 512(b)(13)(A) of the Code.

Ruling Request No. 2

The PCs' provision of medical services to their own patients does not have a substantial causal relationship to the achievement of Hospital's exempt purposes. Geisinger Health Plan, supra; Redlands Surgical Services, supra; IHC Health Plans, supra. Thereby, the PCs are conducting their activities on a larger scale than is reasonably necessary for the performance of Hospital's exempt functions. Section 1.513-1(d)(3) of the regulations; IHC Health Plans, supra. Consequently, the PCs are engaged in an unrelated trade or business with respect to Hospital. Therefore, the PCs' income (or loss) from providing medical services to its patients, less applicable deductions, is "net unrelated income" (or "net unrelated loss") within the meaning of section 512(b)(13)(B) of the Code.

Ruling Request No. 3

Hospital and Parent received and accrued interest from the PCs pursuant to the loans and advances they made to the PCs to acquire, form and operate such PCs. Because interest constitutes a "specified payment" within the meaning of section 512(b)(13)(C) of the Code, the receipt or accrual of such interest by Hospital and Parent is gross income derived from an unrelated trade or business under section 512(b)(13)(A) , to the extent it reduces the PCs' net unrelated income (or increases its net unrelated loss).

You did not request a ruling on the applicability of new section 512(b)(13)(E) of Code, nor did you submit facts to support such a ruling. Further, we are declining to rule on the applicability of this section pursuant to Rev. Proc. 2006-4, section 8.01 because of the factual nature of the value of the loans and advances.

Rulings

1. For taxable years ending Date x and Date y, Hospital was a "controlling organization" with respect to the PCs within the meaning of section 512(b)(13)(A) of the Code.

2. The PCs' income (or loss) from providing medical services to its patients, less applicable deductions, is "net unrelated income" (or "net unrelated loss") under section 512(b)(13)(B) of the Code.

3. Interest received or accrued by Hospital and Parent from the PCs is gross income derived from an unrelated trade or business under section 512(b)(13)(A) of the Code.

The rulings contained in this letter are based upon information and representations you submitted accompanied by a penalty of perjury statement executed by an appropriate official. While we have not verified any of the material you submitted in support of the request for rulings, it is subject to verification on examination. This ruling also is based on the understanding that there will be no material changes in the facts upon which it is based.

This ruling 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. Further, except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Internal Revenue 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.

In accordance with the Powers of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Stephen B. Grodnitzky
Manager,
Exempt Organizations
Technical Group 1