TAX EXEMPT AND
GOVERNMENT ENTITIES

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

Number: **200605013**
Release Date: 02/03/2006
SE:T:EO:RA:T:1

Date: November 8, 2005

Contact Person:

ID Number:

Telephone Number:

UIL: 512.00-00
512-02-00

LEGEND

B =
C =
D =
E =
F =
G =
H =
J =
K =
N =
S =
T =
U =
V =
W =
X =
Y =
Z =

Dear :

B is requesting rulings concerning the unrelated business income tax consequences of partnership income received by a tax-exempt organization in the transaction described below.

FACTS

B is a nonprofit corporation exempt under section 501(a) of the Internal Revenue Code as a health care organization described in sections 501(c)(3) and 509(a)(3). B is the parent corporation of a multi-entity health care system. B owns, directly and indirectly, some or all of the stock of several nonexempt corporations. Through some of these nonexempt corporations, B indirectly owns interests in several partnerships. Additionally, several exempt organizations are wholly-owned subsidiaries of B. B states each entity's primary purpose, directly or indirectly, is the promotion of health within the meaning of section 501(c)(3) of the Code.

C and D are section 501(c)(3) tax-exempt wholly-owned subsidiaries of B. G is a wholly-owned subsidiary of F, which in turn is a wholly-owned subsidiary of E, which in turn is a wholly-owned subsidiary of B. G, F and E are taxable entities. G has S percent partnership interest in H, which in turn has T percent partnership interest in J. H and J are taxable entities. Consequently, B, as G's ultimate parent, has U (S percent multiplied by T percent) percent partnership interest in J. Additionally, C owns N percent of the equity of K, a limited liability company taxed as a partnership. Because C is wholly-owned by B, B also owns N percent interest of the equity of K. B states K provides surgical services on behalf of C.

J is a partnership formed to provide clinical laboratory testing services to its partners, or entities related to its partners, which consists of various medical organizations. In that regard, C, D and K utilize J's services. B states the services J provides to the three entities B controls are in furtherance of B, C and D's exempt purposes.

G's annual net income from its partnership interest in J is approximately W. J's gross income includes approximately X, Y and Z percent for services provided to C, D and K, respectively. Therefore, B's total contribution to J's gross income is approximately V percent (X + Y + Z). B's partnership interest in J (U percent) is less than B's contribution to J's gross revenues (V percent).

As part of a reorganization, G will transfer its partnership interest in H to F. F will then transfer the partnership interest in H to E. E will then transfer the partnership interest in H to B.

RULINGS REQUESTED

B requests the following rulings:

1. C, D, and K's use of J's services, which are directly connected in furtherance of B, C and D's exempt purposes, is attributed to B for purposes of determining B's contribution to J's gross income under section 512 of the Code.

2. B's percentage contribution to J's gross income, based on the contribution to J's gross income by C, D and K as attributed to B, when compared to B's percentage ownership in J is an acceptable measure for determining the portion of B's share of J's net distributive partnership income considered to be exempt function income under section 512 of the Code.

LAW

Section 501(c)(3) of the Code provides for exemption from federal income tax for a corporation organized and operated exclusively for charitable, scientific or educational purposes provided no part of the corporation's net earnings inures to the benefit of any private shareholder or individual.

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

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 connected with the carrying on of such trade or business, both computed with certain modifications.

Section 512(c)(1) of the Code provides if a tax-exempt organization is a member of a partnership which carries on an unrelated trade or business with respect to the organization, the organization must include in computing unrelated business taxable income its share of gross income and directly connected deductions from the unrelated trade or business of the partnership.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business 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 the purpose or function constituting the basis for its exemption.

Section 1.513-1(a) of the Income Tax Regulations defines "unrelated business taxable income" as an organization's gross income derived 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 a trade or business (2) regularly carried on by the organization; and (3) the conduct 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 provides an activity, such as a hospital pharmacy, can be fragmented with portions thereof being related and unrelated, to the organization's exempt function.

Section 1.513-1(b) of the regulations further states 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.

Section 1.513-1(c) of the regulations explains "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 provides 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 purpose.

Section 1.513-1(d)(2) of the regulations provides 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 for which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 1.513-1(d)(4)(i) of the regulations provides gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business.

In U.S. v. American Bar Endowment, 477 U.S. 105 (1986), the income a tax-exempt organization derived from offering group insurance to its members constituted an unrelated trade or business because the activities of assembling the group, negotiating the insurance companies, and administrating a group policy were activities provided by private commercial entities to make a profit.

ANALYSIS

Under sections 513(a) of the Code and 1.513-1(a) of the regulations, the receipts of a tax-exempt organization are treated as unrelated business taxable income only if they meet all of the following requirements:

A. The income is from a “trade or business;”

B. The trade or business is “regularly carried on” by the organization; and

C. The conduct of the trade or business is not “substantially related” (other than through the production of funds) to the organization’s performance of its exempt functions.

The determination of whether an activity conducted by a tax-exempt organization rises to the level of a "trade or business" within the meaning of section 162 of the Code is based on all the facts and circumstances. While neither the sole nor the predominant factor, the presence of a profit motive is one factor that is taken into consideration. In U.S. v. American Bar Endowment, 477 U.S. 105 (1986), the Supreme Court concluded ABE’s insurance program was carried on for the production of income and had the characteristics of a business. The Court concluded the insurance program was a "trade or business" for purposes of the unrelated business income tax. The Court rested its decision on the "profit motive" theory of section 162(a) of the Code. Under this theory, an activity is a trade or business if it is entered into with the dominant hope of making a profit.

In this case, the partnership activities of H and J are a regularly carried on trade or business. J is engaged in providing medical services to B’s related entities. This activity is typically a commercial activity carried on with the intention of earning a profit and therefore constitutes a regularly carried on "trade or business" within the meaning of sections 512 and 513 of the Code.

In order to determine whether B's distributive share of ordinary income from J's gross income constitutes unrelated business taxable income under section 512(a)(1) of the Code, it is necessary to "look through" the partnership and determine whether the partnership's trade or business is substantially related to B's exempt purposes under section 501(c)(3). To be substantially related, the partnership's trade or business must further the organization's exempt purpose. J's activities of furnishing laboratory services are related to the exempt activities of C, D and K, the three organizations B controls. Therefore, J's activities are substantially related to B's exempt purpose. If J were B's subsidiary, the portion of J's income derived from providing laboratory services to B's exempt organizations would not constitute unrelated business taxable income. Therefore, B's activities being carried out through its partnership interest in J should not result in different tax treatment in accordance with section 512(c)(1) of the Code.

If a tax-exempt organization is a member in a partnership which carries on a trade or business related to the organization's exempt purpose, and its ownership interest is less than its percentage contribution to the partnership's gross income, the organization's distributive share would not constitute unrelated business taxable income. However, if the exempt organization's ownership percentage exceeded its percentage contribution to the partnership's gross income, then the excess percentage of the exempt organization's distributive share of partnership income would constitute unrelated business taxable income under section 512(a)(1) of the Code.

In this case, B has U percent ownership interest in J and contributes V percent of J's gross revenues. Provided J's business is substantially related to B's exempt purpose and B's ownership percentage (U percent) in J is less than B's percentage contribution (V percent) to J's gross income, B's distributive share of J's partnership income is related to B's exempt function and none of the distributive share would constitute unrelated business. Therefore, B's distributive share does not constitute unrelated business taxable income under section 512(a)(1) of the Code.

CONCLUSION

Based on B's representations, and the applicable law, we conclude:

1. C, D, and K's use of J's services, which are directly connected in furtherance of B, C and D's exempt purposes, is attributed to B for purposes of determining B's contribution to J's gross income under section 512 of the Code.

2. B's percentage contribution to J's gross income, based on the contribution to J's gross income by C, D, and K as attributed to B, when compared to B's percentage ownership in J is an acceptable measure for determining the portion of B's share of J's net distributive partnership income considered to be exempt function income under section 512 of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative. 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.

This ruling letter is directed only to the organizations that requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited as precedent.

Please keep a copy of this ruling letter in your permanent records.

If you have any questions about this ruling, please contact the persons whose name and telephone number are shown above in the heading of this letter.

Sincerely yours,

Lawrence M. Brauer
Acting Manager
Exempt Organizations
Technical Group 1

Enclosure: Notice 437