TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Contact Person:

Identification Number:

Telephone Number:

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Employer Identification Number:

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Dear :

This letter is in response to your ruling request under sections 501(c)(3) and 512 of the Internal Revenue Code.

Facts

M is a State of x nonprofit corporation described in section 501(c)(3) of the Code. M controls an integrated regional healthcare system in x. M is the parent holding company of L. M is the sole voting member of L and elects L's Board of Trustees. L is an x nonprofit corporation described in section 501(c)(3) of the Code. L is governed by its Board of Trustees. L's principal facility is an acute care general hospital. L also operates nearby a small critical access hospital and related medical facilities and provides related services throughout the northwest part of x. L provides a full range of medical services to residents of its service areas. L supports numerous community education classes, community support groups and public education seminars. L operates an emergency room that is open to all members of the community regardless of their ability to pay. L has adopted a charity care policy that is provided to all inpatients and outpatients upon registration. Any patient who expresses an interest in learning more about the policy or determining their eligibility can meet with a financial counselor for a further explanation. L's bylaws provide that at all times a majority of its trustees must be independent members of the community. L has adopted a conflicts of interest policy by action of its Board of Trustees.

N is an x nonprofit corporation described in section 501(c)(6) of the Code. N's membership consists of approximately a hospitals and b health systems located in x (collectively, "Member Hospitals"). Currently, all but c of the hospitals are either exempt under section 501(c)(3) of the Code or governmental hospitals.

Over the last several years, insurers writing hospital and professional liability insurance policies for hospitals and physicians in x have either significantly raised their premiums or stopped writing such policies altogether.

Recently, the x legislature has found that medical malpractice litigation represents an increasing danger to the availability and quality of healthcare in the x; that many medical malpractice insurers left the x market as they faced increasing losses, largely as a consequence of rapidly rising compensatory damages and non-economic loss awards in medical malpractice actions; and as insurers have left the market, many physician practices and hospitals have closed down or relocated outside x.

The x legislature has created the x Medical Malpractice Commission. In an interim report, the Commission documented the medical malpractice insurance crisis in the state.

As a result of the skyrocketing costs of obtaining hospital and professional liability insurance, the exit of insurers from the x market, and the flight of physicians from the state, the American Medical Association designated x as a medical malpractice "crisis state."

The inability of physicians in x to obtain professional liability insurance at commercially reasonable rates is causing practicing physicians to limit their services, retire from the practice of medicine or leave the community. As a result of the medical malpractice insurance crisis, the number of qualified physicians available to serve x residents is decreasing, thus also decreasing the level of care available to residents of the communities serviced by L.

In Year aa, N incorporated O under x law as a for-profit corporation. N owns 100 percent of the stock of O. N formed O for the sole purpose of O holding 100 percent of the stock of P. P is an x for-profit corporation registered as an x domiciled insurance company.

N capitalized O with $d. O has two authorized classes of common stock: Class A and Class B. N owns 100 percent of the Class B Shares. As described below, O will offer for sale Class A Shares to N's Member Hospitals. All Class A Shares that a Member Hospital purchases will be restricted stock.

O has 12 directors. The holders of the Class A Shares elect five directors and the holder of the Class B Shares elects seven directors. The only voting rights the holders of the Class A Shares is to elect five directors. Thus, N, the holder of the Class B Shares, has control over O and thus has indirect control over P.

The Class A Shares and Class B Shares share equally in any dividends declared by O. In the event of certain major corporate changes or transactions, such as dissolution, N will be entitled to a priority distribution equal to the greater of 30 percent of all net assets available for distribution or its capital contribution percentage, with the balance distributed to the holders of the Class B Shares.

N formed P to provide, at commercially reasonable rates: (1) professional and general liability insurance coverage to N's Member Hospitals and affiliated entities, and (2) professional liability insurance to non-employee physicians who practice at a Member Hospital ("Staff Physicians"). N believes that offering hospital and professional liability insurance at commercially reasonable rates will help stabilize the x medical malpractice insurance market. P will give no special discounts, rebates or similar benefits to N's Member Hospitals. P will determine premium rates actuarially consistent with normal insurance underwriting principles. These insurance rates will be subject to review by the x Department of Insurance.

In order to ensure that P is properly capitalized, has sufficient reserves to satisfy its potential liabilities and remains qualified to write insurance policies in the State of x, this insurance arrangement requires certain investments in O as a condition to purchasing insurance.

For a Member Hospital to be eligible to purchase hospital liability insurance policies from P, it must purchase from O the number of Class A Shares that is equal in value to the cost of the hospital's first-year premium on a hospital insurance policy written by P (the "Premium Equity Investment").

L expects that about e Member Hospitals will purchase hospital insurance policies from P. L anticipates that Member Hospitals will purchase, at $g per share, from O about f Class A Shares as Premium Equity Investments. The total Premium Equity Investments are expected to be $h.

For a Staff Physician to be eligible to purchase personal professional liability insurance from P, a Member Hospital must purchase from O the number of Class A Shares that is equal in value to the cost of the physician's first-year premium on a professional liability insurance policy written by P ("Sponsorship Investment"). (The Member Hospital making a Sponsorship Investment is referred to as the "Sponsoring Hospital.") It is not necessary that the Sponsoring Hospital also purchase Class A Shares of O as a Premium Equity Investment. A hospital has the discretion to choose which physicians to sponsor. (The Staff Physician for whom the Sponsoring Hospital has made a Sponsorship Investment is referred to as the "Sponsored Physician.")

A Sponsored Physician who becomes eligible to purchase professional liability insurance from P is required to pay P the full amount of the insurance premiums that P charges. The Sponsoring Hospital will not subsidize any portion of the cost of this insurance. Once a Sponsoring Hospital makes a Sponsorship Investment on behalf of a Sponsored Physician, that physician will always be eligible to purchase insurance from P, regardless of whether the physician remains a Staff Physician at the Sponsoring Hospital.

Once a Sponsoring Hospital makes a Sponsorship Investment for a Sponsored Physician and the physician purchases professional liability insurance from P, the Sponsored Physician will receive insurance protection for medical services the physician performs at the Sponsoring Hospital, at any other hospital in the State of x, whether or not the hospital is a Sponsoring Hospital or a Member Hospital, and for medical services the physicians performs while practicing medicine anywhere in the State of x, including at the physician's private medical offices or at an ancillary health care facility, without regard to whether any person treated was, is, or may be a patient of the physician's Sponsoring Hospital, any other Sponsoring Hospital or a Member Hospital. Thus, this professional liability insurance protects the Sponsored Physician wherever the physician may practice medicine in the State of x.

As long as the Sponsored Physician continues the insurance coverage with P, if the physician is no longer a Staff Physician at the Sponsoring Hospital for whatever reason, O will not return the Sponsoring Investment to the Sponsoring Hospital. However, if the Sponsored Physician cancels insurance coverage with P, the Sponsoring Hospital may apply the Sponsoring Investment relating to that Sponsored Physician to another Sponsored Physician. The Class A Shares the Sponsoring Hospital purchased remain the property of the Sponsoring Hospital unless repurchased by O.

The State of x Department of Insurance has approved this arrangement, which may be changed only with the prior approval of the State of x Department of Insurance.

L has received a legal opinion from its outside counsel that this insurance arrangement does not violate either the Medicare and Medicaid Fraud and Abuse Act or the Stark Law.

L requires that all of its Staff Physicians obtain and maintain their own professional liability insurance as a condition to maintaining their staff privileges at L. The amount of such insurance must be equal to the minimum coverage requirements determined by L's Board of Trustees and Medical Executive Committee.

L intends to operate on a self-insured basis. Therefore, L does not presently intend to make a Premium Equity Investment in O. However, n of L's Staff Physicians, who practice in high risk areas, presently cannot obtain professional liability insurance in the open market at reasonable rates and thus are unable to meet L's minimum professional liability insurance requirements for Staff Physicians at L. Therefore, L's Board of Trustees has determined that unless L makes a Sponsorship Investment in O on behalf of these n Staff Physicians, which would enable them to purchase their own professional liability insurance policies from P, these physicians would be unable to practice at L as Staff Physicians and L would be in serious jeopardy as to the ability to offer the type of medical services to L's patients that these physicians perform.

L's Board of Trustees has determined that purchasing Class A Shares of O as a Sponsorship Investment, to enable the n Staff Physicians to purchase professional liability policies from P, thereby maintaining their positions as Staff Physicians at L, would further L's charitable purposes.

None of the n Staff Physicians is either a trustee or officer of L or M or is a chair of a medical department of L.

A Sponsorship Investment in O on behalf of these n physicians would total approximately $o. However, due to budgetary constraints, L determined that it was not advisable to make this investment out of its own funds.

Therefore, each of the n Staff Physicians has offered to pay L $p, which L will use to make a Sponsorship Investment in O on their behalf, thereby enabling each of the n Staff Physicians to become a Sponsored Physician who could purchase professional liability insurance policies from P. Accordingly, each of the n Staff Physicians has entered into an agreement with L ("Payment Agreement"), the principal features of which are: the payment is irrevocable and unconditional; L will apply the payment to the purchase of Class A Shares in O to support the issuance of a policy of medical professional liability insurance from P to the Sponsored Physician; the Sponsored Physician has no right, title or interest in the Class A Shares and no right to repayment of the payment; the Sponsored Physician has no assurance regarding renewal of the insurance policy; and L makes no representation or warranty regarding the characterization of treatment of the payment for federal income tax purposes.

Rulings Requested

1. L's making of Sponsorship Investments in O will not jeopardize L's status as an organization described in section 501(c)(3) of the Code.

2. L's receipt of payments from Sponsored Physicians under the Payment Agreement will not be included in unrelated business taxable income under section 512 of the Code.

Law

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax for organizations organized and operated exclusively for charitable, educational and religious purposes, provided that no part of the organization's net earnings inure to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) of the Income Tax 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 of such exempt purposes specified in section 501(c)(3) of the Code. 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(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals as defined in section 1.501(a)-1 (sometimes referred to as "insiders").

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" as used in section 501(c)(3) of the Code includes its generally accepted legal sense. The promotion of health is a recognized charitable purpose. Rev. Rul. 56-185, 1956-1 C.B. 202, as modified by Rev. Rul. 69-545, 1969-2 C.B. 117; Rev. Rul. 80-114, 1980-1 C.B. 115; and Rev. Rul. 83-157, 1983-2 C.B. 94.

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 considered 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.

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 form 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 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(b) of the regulations, the term "trade or business" has the same meaning as it has in section 162 of the Code. The regulations state:

> [A]ny activity of a section 511 organization which is carried on for the production of income and with otherwise possesses the characteristics required to constitute a "trade or business" within the meaning of section 162 - - and which, in addition, is not substantially related to the performance of exempt functions - - presents sufficient likelihood of unfair competition to be within the policy or the tax. [Emphasis added.]

Under section 1.513-1(c)(1) of the regulations, whether a "trade or business" is "regularly carried on" depends on "the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued." Activities are "regularly carried on" "if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."

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."

Rationale

L's Board of Trustees has determined that purchasing Class A Shares of O as a Sponsorship Investment, to enable the n Staff Physicians to purchase professional liability policies from P, thereby maintaining their positions as Staff Physicians at L, will further L's charitable purposes. In addition, after L makes the Sponsorship Investments in O, L will continue to operate in the same manner and continue to carry on the same activities as it did prior to making the Sponsorship Investments. Thus, L will continue to meet the requirements for exemption established in Rev. Rul. 69-45, supra.

None of the n Staff Physicians is either a trustee or officer of L or M or is a chair of a medical department of L. Therefore, L's making of Sponsorship Investments in O will not result in the inurement of net earnings to or for the benefit of "insiders" in violation of the prohibition in section 1.501(c)(3)-1(c)(2) of the regulations. In addition, L's making of Sponsorship Investments in O will not impermissibly serve private interests in violation of the prohibition in section 1.501(c)(3)-1(d)(1)(ii).

Therefore, L will continue to qualify for exemption as an organization described in section 501(c)(3) of the Code. Consequently, L's making of Sponsorship Investments in O will not adversely affect L's current status as an organization described in section 501(c)(3).

Due to budgetary constraints, L determined that it was not advisable to use its own funds to make a Sponsorship Investment in O on behalf of the n Staff Physicians. Therefore, each of the n Staff Physicians has offered to pay L $p, which L will use to make a Sponsorship Investment in O on their behalf, thereby enabling each of the n Staff Physicians to become a Sponsored Physician who could purchase professional liability insurance policies from P. Accordingly, each of the n Staff Physicians has entered into an agreement with L ("Payment Agreement").

L's Board of Trustees has determined that purchasing Class A Shares of O as a Sponsorship Investment, to enable the n Staff Physicians to purchase professional liability policies from P, thereby maintaining their positions as Staff Physicians at L, will further L's charitable purposes. Therefore, L's activities involving the receipt of these payments from Sponsored Physicians has a substantial causal relationship to L's achievement of its exempt purposes. Thus, L's receipt of the payments of $p from the Sponsored Physicians will not result in unrelated business taxable income to L under section 512 of the Code.

Rulings

1. L's making of Sponsorship Investments in O will not jeopardize L's status as an organization described in section 501(c)(3) of the Code.

2. L's receipt of payments from Sponsored Physicians under the Payment Agreement will not be included in unrelated business taxable income under section 512 of the Code.

This ruling 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.

In addition, we are expressly not ruling as to whether a payment to L made by a Staff Physician with whom L has a Payment Agreement is deductible by the Staff Physician under any section of the Code.

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 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.

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.

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

Sincerely,

Lawrence M. Brauer
Acting Manager
Exempt Organizations
Technical Group 1

Enclosure
Notice 437