1987

Business Activities of Tax-Exempts and Affiliates

Jo Ann Blair

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TAX CONFERENCE

1986 Tax Reform -
The Aftermath
also selected topics on Wealth Transfer

BUSINESS ACTIVITIES
OF
TAX-EXEMPTS AND AFFILIATES

Conference Center of the
Williamsburg Lodge
Williamsburg, Virginia

Friday-Saturday, December 4-5, 1987

Jo Ann Blair
Clark & Stant, P.C.
900 Sovran Bank Building
One Columbus Center
Virginia Beach, Virginia 23462
(804) 499-8800
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BUSINESS ACTIVITIES OF TAX-EXEMPTS AND AFFILIATES

By

Jo Ann Blair

I. Overview

A. Exemption from Tax

1. All organizations described in §501(c), §501(d) (religious and apostolic organizations), or §401(a) (qualified pension, profit-sharing and stock bonus plans) are exempt from income tax unless such exemption is denied under §502 or §503. I.R.C. §501(a).

2. Charitable Organizations - §501(c)(3)

a. A §501(c)(3) organization is a corporation, community chest, fund or foundation, (i) organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals; (ii) no part of the net earnings of which inures to the benefit of any private shareholder or individual; (iii) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection §501(h)); and (iv) which does not participate, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.
B. Criteria for a Tax-Exempt Organization

1. The organization must be organized exclusively for an exempt purpose.
   a. The articles of incorporation, or other organizing documents must limit the purposes of the organization to exempt purposes. Reg. §1.501(c)(3)-1(b)(1)(a).
   b. The articles cannot authorize the organization to engage in activities that do not promote the organization's exempt purposes. Reg. §1.501(c)(3)-1(b)(1)(b).
   c. The articles must specify that the organization's assets will be distributed to an exempt organization upon dissolution. Reg. §1.501(c)(3)-1(b)(4).

2. The organization must be operated exclusively for an exempt purpose. That is, the organization must engage primarily in activities which accomplish one or more of its exempt purposes. Reg. §1.501(c)(3)-1(c)(1).

3. No part of the organization's net earnings can inure to the benefit of any private shareholder or other individual. Reg. §1.501(c)(3)-1(c)(2).

4. No substantial part of the activities of the organization can include attempting to influence legislation or to conduct political activities. Reg. §1.501(c)(3)-1(c)(3).

C. Mechanics of Obtaining Tax-Exempt Status

1. In order to qualify as a tax-exempt organization under §501(c)(3), the organization must notify IRS that it wants to be treated as a tax-exempt organization by filing Form 1023, Application for Recognition of Exemption under §501(c)(3) of the Internal Revenue Code.

2. Form 1023 is filed with the key district office of the district in which the organization's principal office or place of business is located (e.g., Baltimore, Maryland for...
organizations whose key district is in Baltimore, Maryland, the District of Columbia, Pittsburgh, Pennsylvania, Richmond, Virginia, or any U.S. possession or foreign country).

3. Form 1023 must be filed within fifteen months from the end of the month the entity is organized (i.e., the date the articles of incorporation are filed with the proper state or local office and acknowledgment of the recording of the articles is received).

4. If the organization files the application timely, the exemption will relate back to the date of organization. If the application is filed late, the exempt status will only be effective from the date of filing.

5. The Service has two hundred seventy days to rule on the exemption application. I.R.C. §7428(b)(2).

6. Each exempt organization must file Form 990, Return of Organization Exempt from Income Tax, annually. This return is an information return and must be filed unless the organization's gross receipts are normally not more than Twenty-five Thousand Dollars ($25,000). Note: Even though such an organization is not technically required to file Form 990, it is advisable to file a return indicating that the gross receipts are below the Twenty-five Thousand Dollar ($25,000) filing minimum.

7. Form 990 is due on or before the 15th day of the 5th month following the end of the organization's tax year.

8. If Form 990 is not filed timely, a penalty of Ten Dollars ($10.00) per day up to a total of Five Thousand Dollars ($5,000) is imposed against the organization unless the late filing is due to reasonable cause. I.R.C. §6652(c).

9. If Form 990 is incomplete or contains incorrect information, a penalty of $5.00 per return up to a maximum of $20,000 is imposed unless the failure is due to reasonable cause in which case the penalty will not be imposed,
or unless the failure is due to intentional disregard in which case the minimum penalty is $100 and the $20,000 maximum shall not apply. I.R.C. §§6723 and 6724.

10. In addition, if an incomplete return is filed or if the return is not filed after written demand by I.R.S., a penalty of Ten Dollars ($10.00) per day not to exceed Five Thousand Dollars ($5,000) can be imposed against the person responsible for filing the return unless he or she shows that the failure to file was due to reasonable cause. I.R.C. §6652(c)(2).

D. Trade or Business of Tax-Exempt Organization

1. An organization may retain its tax-exempt status even though it operates a trade or business as a substantial part of its activities provided that the operation of such trade or business is in furtherance of the organization's exempt purpose and provided further that the organization is not otherwise organized or operated for the primary purpose of carrying on an unrelated trade or business within the meaning of §513. Reg. §1.501(c)(3)-1(e)(1).

2. The determination of whether an organization is or is not organized or operated for the primary purpose of carrying on an unrelated trade or business is a facts and circumstances determination under which the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one of the exempt purposes are considered. Reg. §1.501(c)(3)-1(e)(1).

E. Revocation of Exempt Status

1. If the unrelated trade or businesses of a tax-exempt organization becomes a substantial part of its activities or one of the organization's primary purposes, its exemption will be revoked. Note: The revocation can be retroactive.

2. The determination of whether an unrelated trade or business is a substantial part or a
primary purpose of a tax-exempt organization is a facts and circumstances determination based on an analysis of the unrelated trade or business's revenue, expenses, and employee time compared with the organization's revenue, expenses, and employee time from related activities.

3. Rule of Thumb - unrelated business activities should not exceed 10% to 30% of the organization's total activities.

F. Hospital as a Tax-Exempt Organization

1. Financial ability test - To the extent of its financial ability, a hospital has to provide health care services to those who cannot afford to pay for the services rendered in order to maintain its tax-exempt status. Rev. Rul. 56-185, 1956-1 C.B. 202.

2. Community benefit test - In order to qualify for exemption a hospital which establishes that it is not operated for the private benefit of its staff physicians or other interests qualifies as a tax-exempt organization even though the hospital limits its care to paying patients. Rev. Rul. 69-545, 1969-2 C.B. 117; See also, Simon v. Eastern Kentucky Welfare Rights Organization, 426 U.S. 26 (1976).

3. Private Inurement - As mentioned above, no part of the net earnings of a tax-exempt organization can inure to the benefit of any private shareholder or individual. Accordingly, a tax-exempt organization can only make reasonable payments for goods and services rendered. Stated differently, the test is whether the interests of charity are sacrificed in favor of the private interests of the founder or those in control.


i. Non-profit hospital successor to for-profit hospital was not entitled to classification as a tax-exempt organization because admissions' policies and emergency room services were limited to patients of its
staff physicians. Furthermore, the hospital entered into favorable leasing and rental arrangements with its staff physicians for its facilities which furthered private interests of its staff, a substantial prohibited non-exempt purpose. Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974).

ii. Compare: arm's length lease of office space to private doctors performing services for the hospital at fair rental value furthered hospital's objective of becoming the leading health center in the community and therefore did not jeopardize the hospital's tax-exempt status or constitute an unrelated trade or business. Rev. Rul. 69-463, 1969-2 C.B. 131.

b. General Rule - In order to maintain its tax-exempt status, the hospital cannot share its net earnings. In specific instances, however, a hospital has been allowed to compensate a specialist based on a fixed percentage of the specialist's department's income, provided the specialist enters into an arm's length agreement with the hospital; receives a reasonable amount for his services taking into account the responsibilities and activities assumed under the contract; and does not control the hospital. Rev. Rul. 69-383, 1969-2 C.B. 113.

c. Compensation as a percentage of revenue. Contingent compensation should be upheld where:

   i. The contingent payments serve a real and discernible business purpose such as achieving maximum efficiency and economy by shifting the principal risk for operating costs to the employee;

   ii. Amount of compensation is not primarily dependent on incoming reve-
nues but rather on accomplishment of charitable objectives;

iii. Review of actual operating results reveals no evidence of abuse or unwarranted benefits; and

iv. Presence of a ceiling or reasonable maximum to avoid the possibility of a windfall to the employee.

d. Other evidences of private inurement are the following transactions which § 501(c)(3) organizations were prohibited from engaging in prior to the Tax Reform Act of 1969 under §503 (§503 now only applies to certain employee pension plans):

i. Lending income or principal without adequate security and reasonable rate of interest;

ii. Paying excessive compensation;

iii. Making services available on a preferential basis;

iv. Purchasing property for more than adequate consideration;

v. Selling property for less than adequate consideration;

vi. Engaging in any other transaction which results in a substantial diversion of income or corpus.

e. Other evidences of private inurement where a for-profit organization is converted into a tax-exempt organization:

i. The tax-exempt organization is controlled by the same persons as the for-profit organization and the tax-exempt organization assumes liabilities of the for-profit organization in excess of the value of the assets received from the for-profit organization.

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ii. Prior owners continue to control the tax-exempt successor hospital and staff privileges are limited to the controlling doctors and the hospital's emergency facilities are not made available to the general public. Rev. Rul. 69-545, 1969-2 C.B. 117.

II. Unrelated Business Taxable Income ("UBTI")

A. History

1. The unrelated business income tax provisions of §§511 through 515 were first adopted in the Revenue Act of 1950. The provisions were enacted to prevent unfair competition with taxable entities. They also served as a basis for reversing the Service's earlier narrow view of permissible business activities of a §501(c)(3) organization. See., e.g., Treas. Reg. 45, art. 517 (1918) (attempting to prohibit a religious organization from engaging in any farming activity; an organization which owns property that is greater than its needs and carries on business activities distinct from the exempt activity is not exempt. O.D. 953, 4 C.B. 261 (1921).

B. Definitions

1. UBTI is the gross income derived by any organization from an unrelated trade or business (as defined in §513) regularly carried on by it, less the deductions which are directly connected with the carrying on of such trade or business. I.R.C. §512(a)(1) (emphasis added).

2. An unrelated trade or business is any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under §501. I.R.C. §513(a).
a. The activity must be a trade or business. To constitute a trade or business, an organization must engage in the activity with the primary purpose of producing income or profit. Comm. v. Groetzinger, 107 S.Ct. 980 (1987).

b. The trade or business must be regularly carried on; and

i. The activity must be conducted fairly frequently and on a continuous basis just like the conduct of a comparable activity by a taxable entity. Reg. §1.513-1(c)(1).

ii. An annual fund-raising ball is not conducted with the same frequency and continuity as the activities of a taxable entity and therefore is not an unrelated trade or business. Suffolk County Patrolmen's Benevolent Association, Inc. v. Comm., 77 T.C. 1314 (1981).

c. The trade or business must not be substantially related to the organization's exempt purpose (income from a related trade or business is exempt under §501(a)).

3. If an exempt organization is a partner in a partnership which regularly carries on an unrelated trade or business, in computing its UBI, the organization shall include its share (whether or not distributed) of the gross income from the partnership from the unrelated trade or business and its share of the deductions directly connected with such gross income.

4. The following are excluded from the definition of an unrelated trade or businesses by statute:

a. A trade or business in which substantially all of the work in carrying it on is performed for the organization without compensation. I.R.C. §513(a)(1).
b. A trade or business that is carried on by a §501(c)(3) or §511(a)(2)(B) (State colleges and universities) organization mainly for the convenience of its members, students, patients, officers or employees. I.R.C. §513(a)(2).

c. A business that sells merchandise substantially all of which was received by the organization as gifts or contributions. I.R.C. §513(a)(3).

d. A trade or business that consists of qualified public entertainment activities (as defined in §513(d)(2)) regularly carried on by a §501(c)(3),(4), or (5) organization as one of its substantial exempt purposes (e.g., agricultural fairs). I.R.C. §513(d).

e. A trade or business that consists of a qualified convention or trade show regularly conducted by a §501(c)(3),(4), (5), or (6) organization as one of its substantial exempt purposes. I.R.C. §513(d).

f. A trade or business that furnishes one or more services described in §501(e)(1)(A) (data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel) to one or more hospitals subject to the conditions of §513(e). I.R.C. §513(e).

g. Certain bingo games as defined in §513(f).

h. Certain games of chance.

5. With the proper fact pattern, the following will be treated as related activities and thus will not give rise to UBTI:


b. The sale of hearing aids to patients by a hospital primarily involved in rehabili-

c. The performance of laboratory testing by an exempt hospital on specimens furnished by its staff physicians in the conduct of their private medical practices, but in furtherance of the hospital's educational program. St. Luke's Hospital of Kansas City v. United States, 494 F. Supp. 85 (W.D. Mo. 1980).
I.R.S.'s position is that the performance of testing on specimens from private patients of staff physicians is UBI if the services are otherwise available in the community. Rev. Rul. 85-110, 1985-2 C.B. 166.

d. Non-patient testing where (i) the non-patient testing services were not promoted; (ii) they produced less than one percent (1%) of the hospital's gross revenues; (iii) the hospital did not charge more than its cost; and (iv) there were no commercial medical laboratories within a thirty (30) mile radius. TAM 8131010.

e. A hospital's pharmacy sales to non-patients where the sales are infrequent and the hospital is the sole hospital in a small community. Hi-Plains Hospital v. United States, 670 F.2d 528 (5th Cir. 1982).


g. A museum's sale of greeting card reproductions of art works. Rev. Rul. 73-104, 1973-1 C.B. 263.
See also, Rev. Rul. 74-399, 1974-2 C.B. 172. (museum's operation of a snack bar and cafeteria do not constitute an unrelated trade or business.)
h. The operation of a retail grocery store as part of an organization's therapeutic program for emotionally disturbed adolescents, almost fully staffed by the adolescents, and on a scale no larger than necessary to perform the exempt functions. Rev. Rul. 76-94, 1976-1 C.B. 171.

6. The following activities do generate UBTI to a tax-exempt organization:

a. A hospital's pharmacy sales to non-patients. The test for determining whether the furnishing of goods or services by an exempt hospital is related to its exempt purposes is whether there is a sufficient nexus to patient recovery or convenience. Carle Foundation v. United States, 611 F.2d 1192 (7th Cir. 1979), cert. denied.


C. Exemptions from UBI Tax

1. Passive income such as dividends, interest, annuities, royalties, rental income from real property and gains from the sale or exchange of property, are excluded from the tax on unrelated business income. I.R.C. §512(b)(1), (2),(3),(5).

2. Note: Interest, annuities, royalties and rents derived from a controlled organization (organization 80% of the total combined voting power of all classes of stock entitled to vote and 80% of the total number of shares of all other classes of stock of which is owned by the controlling organization) are included as an item of gross income regardless of whether the activity from which the amounts are derived is a trade business or is regularly carried on. If an exempt organization receives passive income from a controlled corporation, such income is exempt from the tax
on UBI if the controlled organization does not have any UBI. I.R.C. §512(b)(13).

D. Reporting of UBTI

1. UBTI is reported on Form 990-T, Exempt Organization Business Income Tax Return. I.R.C. §6012(a)(2) and (4).

2. Form 990-T must be filed by every domestic or foreign organization exempt under §501(a) that has gross income from an unrelated trade or business of $1,000 or more.

3. Form 990-T is due on or before the 15th day of the 5th month after the end of organization's tax year.

4. The tax on UBTI is imposed under §511 and is computed under §11 (the same rate structure as for a regular corporation), but the first $1,000 of UBTI is tax free.

5. As a result of the Tax Reform Act of 1986, the tax on UBTI imposed under §511 must be paid with quarterly estimates. I.R.C. §6154(h) and §6655.

III. Classification of Exempt Organizations—Public Charity versus Private Foundation

A. Private Foundation

1. All §501(c)(3) organizations are presumed to be private foundations unless they can demonstrate that they qualify as a public charity under §509(a)(1), §509(a)(2), or §509(a)(3). I.R.C. §509(a).

2. A private foundation is subject to the following private foundation rules of Subchapter A of Chapter 42 of the Internal Revenue Code:

   a. A tax equal to 2% of the foundation's net investment income. I.R.C. §4940(a);

   b. A tax on various acts of self-dealing as defined in §4941;
c. The minimum distribution requirements for the foundation's income under §4942;

d. A tax on excess business holdings under §4943;

e. A tax on the foundation's investments of its assets in a manner which jeopardizes the carrying out of its exempt purposes under §4944;

f. Restrictions on its expenditures under §4945; and

g. A tax on the termination of its status as a private foundation under §507.

B. Public Charity

1. The following organizations are not private foundations (i.e. are public charities):

a. A church or a convention or association of churches. §170(b)(1)(A)(i).

b. An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance where the educational activities are regularly carried on. I.R.C. §170(b)(1)(A)(ii);

c. An organization which normally receives a substantial part of its support from the United States or any State or political subdivision thereof or from contributions from the general public and which is organized and operated exclusively to receive, hold, invest and administer property and to make expenditures to or for the benefit of a college or university. I.R.C. §170(b)(1)(A)(iv).


e. An organization, the principal purpose or functions of which are the providing of medical or hospital care or medical edu-

Note: In a hospital reorganization the parent's qualification as a public charity under this section is generally inconsistent with its primary function of centralized planning and management.

f. A domestic organization organized and operated exclusively for religious, charitable, scientific, literary or educational purposes or to foster national or international amateur sports competition or for the prevention of cruelty to children or animals which normally receives a substantial part of its support (exclusive of income received in the performance of an activity constituting the basis for its exemption from income tax) from a governmental unit or from direct or indirect contributions from the general public. I.R.C. §170(b)(1)(A)(vi).

i. To qualify under this section the organization must normally receive at least one-third of its support from governmental and/or public sources or at least 10% of its support from governmental and/or public sources and meet other criteria. Reg. §1.170A-9(e)(2) and 1170A-9(e)(3).

ii. In meeting this test an organization can count contributions from an individual, trust or corporation only to the extent that contributions from such person or entity do not exceed 2% of the organization's total support for the year. Reg. §1.170A-9(e)(6)(i).

g. An organization that normally receives more than one-third of its support from any combination of the following:

i. Gifts, grants, contributions, or membership fees;

ii. Gross receipts from admissions, sales of merchandise, performance of
services, or furnishing of facilities in a related activity (excluding receipts from any person or agency of a governmental unit in any taxable year that exceeds the greater of $5,000 or 1% of the organization's support for the year); provided that such receipts are from persons other than disqualified persons as defined in §4946, from governmental units or other exempt organizations; and

iii. Normally receives not more than one-third of its support from gross investment income plus the excess of UBTI over the tax imposed on UBTI. I.R.C. §509(a)(2).

h. An organization which is organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of an exempt organization; operated, supervised or controlled by or in connection with one or more exempt organizations and is not controlled directly or indirectly by one or more disqualified persons. I.R.C. §509(a)(3).

i. Classification under §509(a)(3) is not subject to reexamination as long as the corporate structure and the relationship of the various organizations remains the same. (Compare: classification as a public charity under §509(a)(1) or §509(a)(2) which is determined annually).

ii. Section 509(a)(3) organizations (also known as supporting organizations) are not publicly supported themselves, but are so closely related to §509(a)(1) or §509(a)(2) organizations that are publicly supported that the public control and involvement is deemed to exist.

iii. Stated differently, a qualifying supporting organization may either
be operated, supervised, or controlled by; supervised or controlled in connection with; or operated in connection with one or more publicly supported organizations which qualify as §509(a)(1) or §509(a)(2) organizations.

C. Advantages of Public Charity Status

1. A public charity is not subject to tax on its investment income and is not subject to the excise taxes imposed under §§4940-4945.

2. Most public charities are "50% charities" so that contributions to them are deductible up to 50% of the individual's adjusted gross income (contributions to most private foundations are limited to 30% of an individual's adjusted gross income). I.R.C. §170(b).

3. A public charity is not required to make available its Form 990, Annual Exempt Information Return and is not required to submit the same detailed information that is required of private foundations on Form 990-PF.

4. Public charities are not subject to tax on the termination of private foundation status under §507(a).

IV. Hospital Reorganizations

A. Typical Reorganization. The conversion of a single non-profit hospital into a more complex structure under which a tax-exempt parent controls, through interlocking directorates, a number of subsidiaries such as a hospital fund-raising organization, a real estate title holding company, a non-profit corporation, and a taxable business corporation.

1. Such a reorganized structure (i) gives a non-profit community hospital the ability to be involved in new ventures that will produce new sources of capital and income as well as ones that will enhance the hospital's ability to attract doctors and patients; (ii) serves to insulate hospital assets from malpractice
claims; and (iii) gives the hospital flexibility in dealing with the regulated atmosphere in which it operates (e.g., Medicare requirements that certain costs be reduced by revenues generated from non-patient care activities.

Note: the importance of this opportunity has been minimized as a result of amendments under the Social Security Amendments Act of 1983 which changed the basis for most Medicare reimbursement to a flat fee per patient).

2. It is imperative that the §501(c)(3) entities in the structure be classified as public charities and not private foundations (see III above) to avoid the foundation excise tax rules, but more importantly because private foundations are prohibited from dealing freely with related entities, which is essential for the reorganized structure to work.

3. In a typical hospital reorganization taxable subsidiaries are often used to conduct the income producing activities that would produce unrelated business income to the tax-exempt parent. It is important to note that the taxable entity will receive the benefit of all deductions allowable under §162 whereas a tax-exempt entity which is taxed on unrelated business income is only entitled to deductions directly connected with the carrying on of the unrelated trade or business.

4. In the typical hospital reorganization, many of the services such as laundry, data processing, investment and fiscal management previously performed by the hospital are spun-off into subsidiary corporations.

a. In order to maintain their status as tax-exempt organizations, each new corporate entity must establish an independent legal basis for its exemption. The basis for the tax-exempt status of a subsidiary corporation is that it is performing essential services for the exempt parent and/or its related subsidiaries and thus is a "integral part" of the parent corporation's activities. Reg. §1.502-1(b).
b. For purposes of Reg. §1.502-1(b), a related organization is a parent organization and one or more of its subsidiary organizations, or subsidiary organizations having a common parent. An exempt organization is not related to another exempt organization merely because they both engage in the same type of activities.

c. A subsidiary is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business if regularly carried on by the parent organization. Reg. §1.502-1(b).

B. General Counsel Memorandum 39508

1. On May 28, 1986 the Office of Chief Counsel issued General Counsel Memorandum 39508. In this GCM a newly formed parent organization sought exemption under §501(c)(3) and public charity status as a supporting organization under §509(a)(3). The overall structure included the following entities:

a. A, a §501(c)(3) exempt organization operating a hospital and a §509(a)(1) and §170(b)(1)(A)(iii) publicly supported organization.

b. B, the parent corporation, a §501(c)(3) exempt organization and a §509(a)(3) supporting organization which provided overall direction and control for the group.

c. C, a §501(c)(3) exempt organization classified as a §509(a)(2) publicly supported organization.

d. D, a §501(c)(3) exempt organization devoted to health education classified as a publicly supported organization under §509(a)(1) and §170(b)(1)(A)(vi).

e. E, a §501(c)(3) exempt organization operating a blood bank and classified as a §509(a)(2) publicly supported organization.
f. F, a taxable corporation wholly owned by B which provided data processing services to A (hospital) and B (parent); and

g. X, an investment company which is a §501(c)(3) exempt organization and a §509(a)(3) supporting organization. X will hold title to, maintain and develop certain real estate for the exclusive benefit of A (the hospital) and other §509(a)(1) or §509(a)(2) foundations that provide health care, education or research. X will lease the property to taxable and tax-exempt tenants.

2. The issues presented in GCM 39508 were as follows:

a. Whether parent corporation B is precluded by its parent status from qualifying as a §509(a)(3) supporting organization; and

b. Whether investment company X which is a §501(c)(3) organization and which is subordinate to a §509(a)(3) parent organization within the hospital system may also be classified as a §509(a)(3) supporting organization.

3. B (parent) appoints the Board of Directors and approves any changes to the governing instruments (articles of incorporation and bylaws) of A, C, D, E and X.

4. Parent as Public Charity

a. A §509(a)(3) organization is one that has established certain relationships in support of a §509(a)(1) or §509(a)(2) publicly supported organization. In GCM 39508 I.R.S. was very concerned with the apparent contradiction of a parent being classified as a supporting organization for a publicly supported subsidiary.

b. A §509(a)(3) supporting organization must be responsive to the needs or demands of one or more publicly supported organizations and must constitute an integral part of or maintain a significant
involvement in the operations of one or more publicly supported organizations.

c. In order to qualify as a §509(a)(3) organization the parent had to meet one of the following requirements:

i. Be operated, supervised, or controlled by one or more §509(a)(1) or §509(a)(2) organizations;

ii. Be supervised or controlled in connection with one or more §509(a)(1) or §509(a)(2) organizations; or

iii. Be operated in connection with one or more §509(a)(1) or §509(a)(2) organizations.

d. B (parent) was not operated, supervised or controlled by the publicly supported organizations that it served as this type of relationship presumes a substantial degree of direction over the policies, programs and activities of the parent by one or more publicly supported organizations. In the typical hospital reorganization (including the one in GCM 39508) the roles are reversed and the supporting organization is, in fact, the parent.

e. B (parent) was not operated in connection with a publicly supported charity or charities because its articles of incorporation did not specify by name each publicly supported organization it would support. Although this could be corrected by an amendment to the articles, as the overall hospital structure grows constant amendment to the articles of incorporation would be necessary.

f. Instead, B (parent) tried to qualify as an organization supervised or controlled in connection with one or more publicly supported charities. This requires common supervision or control among the governing bodies of all organizations involved, such as common directors so
that the supporting organization will be responsive to the needs and requirements of the public charities. Accordingly, a majority of the members of the Board of Directors of the §509(a)(3) parent must also be on the Board of every publicly supported charity.

g. In GCM 39508, I.R.S. concluded that the particular parent in issue could qualify as a public charity under §509(a)(3) because its control and management was vested in the same persons that controlled or managed the publicly supported subsidiaries. Speculating on future growth of the structure in question, the GCM comments that as the overall structure follows a natural drive to expand, the expansion will by definition result in a progressive weakening of the control relationships necessary for the parent to qualify as a supporting organization under §509(a)(3).

5. Investment Corporation X as a Public Charity

a. The second issue decided in GCM 39508 was whether X (investment corporation) a subordinate §509(a)(3) organization in the same system can support a §509(a)(1) or §509(a)(2) organization through an intervening §509(a)(3) parent.

b. X was created to hold title to, maintain and develop real estate properties for the exclusive support and benefit of the hospital and other unspecified public charities that provide health care, education or research, or that conduct activities in support of health care, education or research.

c. With respect to this issue, GCM 39508 states that although support of a §509(a)(1) or §509(a)(2) organization through another §509(a)(3) organization probably was not intended by Congress the language of the regulations permit such an arrangement; provided that X and each publicly supported organization it sup-
ports is controlled or managed by the same persons as the hospital.

d. The basis for finding the subsidiary organization X in GCM 39508 an integral part of the exempt activities of the parent was the control that the tax-exempt parent had over the activities of its subsidiary. Control and close supervision by the exempt organization together with the dedication of the profits to the exempt organization can establish the requisite integral relationship. Rev. Rul. 68-26, 1968-1 C.B. 272.

e. Note: In order to demonstrate the necessary continuing public support which gives rise to public charity status as opposed to private foundation status, all of the subsidiary corporations must remain active.

C. For Profit Enterprises as a Subsidiary

1. A tax-exempt parent may hold the stock of a wholly owned taxable subsidiary without endangering the tax-exempt status of the parent provided that the following tests are met:

   a. The subsidiary is formed for a bona fide business purpose;

   b. The subsidiary is not a mere instrumentality of the parent organization (i.e., a majority of the subsidiary's board of directors are independent of the parent's board of directors);

   c. The parent organization does not actively participate in the day to day management of the subsidiary; and

   d. All transactions between the parent and the subsidiary are at arms length. GCM 39326 (8/31/84).

2. In the absence of all four of the factors listed in paragraph 1, I.R.S. will disregard
the subsidiary and attribute all of its activities to the exempt parent if there is clear and convincing evidence that the subsidiary is merely an agent of the parent.

3. If a majority of the members of subsidiary's board of directors are not members of the parent's board, overlapping officers should be permissible provided that each entity pays the officers reasonable compensation for the services performed for such entity. PLR 8352091 (9/30/83).

4. Parent and subsidiary may share offices. PLR 8244114 (8/6/82).

5. Arguably each type of goods or services shared by the parent and the subsidiary do not have to be charged at fair market rates as long as the overall arrangement is an arms-length arrangement. PLR 8528081 (4/19/85).

6. Subsidiary must not, however, become a "substantial activity" of the parent. Sharing less than 10% of the parent's assets or services should be permissible. PLR 8321157 (2/28/83).

7. The preferred manner for capitalizing a subsidiary is a single nominal investment in exchange for all of the stock to avoid any argument that the parent is not being operated exclusively for exempt purposes. PLRs 8514040 (1/9/85) and 8503045 (10/23/84).

8. If I.R.S. respects the parent and subsidiary as separate entities, the subsidiary's taxable income is not UBTI to the parent. Furthermore, the dividends the parent receives from the subsidiary are also not UBTI, but as a general rule other payments to the parent are UBTI. PLRs 8625078 (3/27/86) and 8514040 (1/9/85).

9. All or a portion of any interest, annuities, royalties and rents paid to a tax-exempt parent by its subsidiary may be taxable as unrelated business income to the tax-exempt parent. I.R.C. §512(b)(13).
D. Merger of Exempt Hospitals

1. If two or more hospitals merge, the parent must have the power to direct and control the subsidiaries. If the hospitals control the parent, I.R.S. will treat the parent and its subsidiaries as cooperative service organizations for which §501(e) is the sole means of exemption. HCSC Laundry v. United States, 450 U.S. 1 (1981). Accordingly, if any of the new subsidiaries provide services not listed in § 501(e)(1)(A) (e.g., laundry services), such subsidiary would not be exempt under §501(c)(3).

2. If the merging hospitals actually control the nominal exempt parent, the Service may deny exemption to the parent on the theory the parent is actually a subsidiary of several unrelated organizations. Reg. § 1.502-1(b). For purposes of this regulation, two or more organizations are related only if they consist of (i) a parent organization and one or more subsidiaries or (ii) two or more subsidiary organizations having a common parent.

a. Organization formed to provide managerial and consulting services at cost to independent unrelated exempt organizations did not qualify for exemption. Rev. Rul. 72-369, 1972-2 C.B. 245.

b. An organization that provided assistance in managing endowment funds or investment funds maintained by other exempt organizations who were members of the organization, for fees representing less than fifteen percent (15%) of the total costs of operation (the balance came from independent charitable organizations) qualified for exemption under § 501(c)(3). Rev. Rul. 71-529, 1971-2 C.B. 234.

V. Charity as a Partner

A. Private Inurement. If a tax-exempt organization is a partner in a partnership, the tax-exempt status of the organization will be jeopardized if the
partnership is found to serve a private interest (i.e., there is private inurement). The private benefit cannot be substantial in comparison with the overall public benefit conferred by the activity. Any private benefit must be incidental to the activity which benefits the public at large. PLR 8541108 (7/19/85).

B. Facts and Circumstances Analysis. The test as to whether a partnership serves a private interest is a facts and circumstances analysis under which substance prevails over form. The following rulings illustrate the facts and circumstances analysis:

1. A tax-exempt organization that produced a motion picture film as a joint venture with a commercial film distributor under which the tax-exempt organization and the commercial distributor each received a certain amount of the gross receipts and each were responsible for paying certain expenses did not jeopardize its exempt status. This GCM states that a facts and circumstances test must be applied because not every joint venture between an exempt organization and a commercial entity is automatically legally incompatible with the requirement that a §501(c)(3) organization be operated exclusively for public purposes, but if the arrangement is one for the sharing of net profits, then the tax-exempt organization will lose its tax-exempt status. GCM 37259 (9-17-77); See also, Plumstead Theater Society v. Comm., 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982).

2. Where a partnership agreement provided that the partnership would operate on a break-even basis and would not sustain a profit or loss, I.R.S. held that the exempt organization was protected from any potential conflict of interest and therefore the venture would not jeopardize its tax-exempt status. GCM 37852 (2-9-79).

3. A neighborhood association was found to be acting in furtherance of its charitable purposes while acting as general partner in a real estate partnership. The partnership was created to acquire abandoned and vacant houses
in a deteriorated neighborhood, rehabilitate the houses and sell or rent them predominantly to low income individuals. The ruling found that the partnership agreement adequately insulated the exempt general partner because: (i) the exempt organization had a right of first refusal on partnership property; (ii) the exempt organization only made nominal contributions to partnership capital; (iii) the exempt organization shared the obligation to meet deficits and to provide additional capital with other general partners; (iv) federally imposed guidelines prevented the organization's profit motive from being a material factor; (v) persons related to the exempt organization could not participate; and (vi) the organization only expected to break-even. Furthermore, the exempt organization could foreclose on the deed of trust and the foreclosure proceeds were expected to exceed the loans to the partnership. PLR 8338127 (6/23/83).

C. Characteristics of Permissible Charitable Partner.
The following characteristics are helpful in obtaining favorable rulings from the Service when a tax-exempt organization is a general partner:

1. Insulation of the tax-exempt organization from the fundamental responsibilities (i.e., general management) of a general partner.

2. Tax-exempt organization has minimal operational responsibilities and duties.

3. Formation of a special committee staffed by individuals who are not board members or investors of the tax-exempt organization to monitor the organization's responsibilities as general partner. See, GCM 39444 (11/13/85).

4. Insulation of the tax-exempt organization from liability on the mortgage and for operating deficits.

5. Federal income guidelines that restrict the pursuit of profit. See, GCM 39005 (6/28/83).

6. Absence of limited partners reduces the risk of undue enrichment.
7. Note: Under the analysis employed by I.R.S., the above factors are not as important if the partnership operates in furtherance of the exempt organization's exempt purposes. (See, paragraph D, below).

D. The McGovern Approach to Charity as a Partner

1. In December, 1985, James J. McGovern, the Director, Employee Plans and Exempt Organizations Division, Office of Chief Counsel, Internal Revenue Service prepared an article published in Tax Notes analyzing the tax consequences of tax-exempt organizations serving as general partners in limited partnerships. McGovern concludes that there is a tension/conflict between partnership law under which the general partner has a fiduciary obligation to maximize the profit to the limited partners and the rules governing tax-exempt organizations that prohibit private inurement.

2. McGovern summarizes the Service's position as a two part test:
   a. Whether the organization is serving a charitable purpose;
   b. Whether the joint venture permits the tax-exempt organization to act exclusively in furtherance of the purposes for which its exemption was granted and not for the benefit of the limited partners (i.e., the tax-exempt organizations' assets must not be at risk for the benefit of the taxable partners).

E. Response to the McGovern Two Part Test

1. The better reasoned view is that the issue is the nature and extent of the benefits, both cash flow and tax preferences, available to the limited partners as a result of the joint venture with the tax-exempt organization. If the investors receive excessive benefits, the tax-exempt organization's exemption should be revoked. Stated differently, limited partners should only receive a reasonable return on their capital investment. See, Hopkins, "Tax

F. Congressional Action Should Be Sufficient

1. The Code, the regulations and the case law all make it clear that a tax-exempt organization can serve as a general partner (even the sole general partner) of a partnership without jeopardizing its exempt status. Congress has enacted legislation to correct perceived abuses. This legislation together with the analysis suggested by Bruce Hopkins provide sufficient restrictions on an exempt organization's ability to serve as a general partner.

2. The Tax Reform Act of 1984 enacted the tax-exempt leasing rules to stop abusive sale-leaseback practices by exempt organizations.

   a. Prior to the 1984 Act, a technique frequently employed was the sale of income producing property from an exempt organization to private investors who would then lease it back to the exempt organization. Under the 1984 Act, if 35% of a piece of property is leased to a charity, accelerated depreciation is available only if:

      i. The charity did not finance the property through tax-exempt bonds;

      ii. The charity did not have an option to purchase the property directly or indirectly at the expiration of the lease;

      iii. The lease has a term in excess of 20 years; and

      iv. The charity had no prior equity or leasehold interest in the property.

   b. The Tax Reform 1984 Act also eliminated non-prorata allocations of deductions and credits between an exempt organization partner and other investors.
3. The Tax Reform Act of 1986 imposed further restrictions on limited partnerships in general and as a result minimized the attractiveness of being a limited partner in a partnership with an exempt organization as a general partner.

   a. Repeal of the investment tax credit.

   b. Enactment of the passive activity loss rules of §469.

   c. In addition, the Tax Reform Act of 1986 retained the restrictions on tax-exempt entity leasing and added an anti-abuse provision to prevent the use of partnerships and other pass-through entities from structuring transactions to avoid the restrictions on depreciation deductions.

G. Trap for the Unwary – Joint Ventures Can Jeopardize Tax-Exempt Status of Qualified Plans

1. If I.R.S. enforces §414(m) and the regulations thereunder, then the participation of physicians, their professional corporations and a hospital in certain joint ventures may render the qualified pension and other employee benefit plans of these entities taxable, subjecting both employers and employees to adverse tax consequences, possibly with retroactive effect.

2. Section 414(m) is applicable when a physician, hospital, or other entity has an ownership interest in a joint venture and also provides services to the joint venture or to a third party through the joint venture. In such situations, §414(m) treats all entities participating and having an ownership interest in the joint venture as an affiliated service group for purposes of applying the §401 qualification criteria. Accordingly, the employees of the affiliated entities are treated as if they are employed by a single entity, and their respective benefit plans are examined in the aggregate to determine whether the anti-discrimination rules and other §401 criteria have been met. If the §401 criteria are not
met, all of the plans of the affiliated entities may lose their qualification.

3. Two general fact patterns give rise to affiliated service groups:

a. A service organization (organization the principal business of which is the performance of services) which is a shareholder or partner in another organization ("first service organization or "FSO") which regularly performs services for third parties and which regularly performs services for the FSO, or is regularly associated with the FSO in performing services for third persons.

i. For example, a preferred provider organization ("PPO") joint venture between a hospital and a group of physician professional corporations, where one or more of the physician professional corporations owns an interest in the PPO and provides patient care services to individuals through or on behalf of the PPO and where the hospital also has an ownership interest in the PPO and provides services to individuals through or on behalf of the PPO may constitute an affiliated service group if the PPO is treated as a first service organization within the meaning of §414(m). If the entities constitute an affiliated service group and if the employee benefit plans for the physician professional corporations are not comparable to the hospital's plan, an aggregation of all of the employee benefit plans may not meet the §401 criteria for qualification, thus leading to a disqualification of all of the plans.

ii. Where a physician professional corporation regularly provides services to a joint venture while a legally distinct but affiliated entity (e.g., the physician individually)
owns an interest in the joint venture, I.R.S. may apply constructive ownership rules to attribute the ownership of the physician's individual shares to the professional corporation of which the physician is the sole or majority stockholder. Alternatively, the Service may attribute the interest in the joint venture from the professional corporation to the individual physician. Section 414(m)(6) states that for purposes of determining ownership the constructive ownership rules of §318(a) shall apply. Regardless of the approach, the result will be the existence of an affiliated service group and the possible disqualification of the employee benefit plan of the physician professional corporation.

b. An organization which devotes a significant portion of its business to performing services for a FSO and 10% or more of the organization is owned by persons who are officers, highly compensated employees or owners of the FSO.

i. For example, a physician professional corporation with an ownership interest in a PPO which also has an interest in a partnership which operates an independent free standing laboratory may also constitute an affiliated service group even though the remaining interests in the laboratory are owned by physicians or physician professional corporations that do not own an interest in the PPO if (i) the PPO is an FSO within the meaning of §414(m); (ii) the laboratory partnership contracts with the PPO to perform laboratory services for the PPO's patient subscribers; and (iii) ten percent (10%) or more of the interest of the laboratory partnership is held by persons who are officers, highly compensated
employees or owners of the PPO. If the entities are treated as an affiliated service group, the plans of these entities may be disqualified.

4. To date I.R.S. has not actively relied on §414(m) to disqualify the employee plans of various hospital groups but the literal language of the statute supports such a position.
REFERENCES


