

200413014



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

T:EO:Br-1

Date: DEC 30 2003

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

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Dear Sir or Madam:

This letter is in response to your ruling request under section 4958 of the Internal Revenue Code.

FACTS

L is a not-for-profit corporation organized under the laws of the State of a. L has been recognized by the Internal Revenue Service as an organization described in section 501(c)(3) of the Code and as a public charity under section 509(a)(1) and 170(b)(1)(A)(iii). L operates an acute care hospital on one campus located in a rural area of the State of a.

L is managed by a Board of Directors consisting of nine voting directors. Three of the directors are required to be physicians holding medical staff appointments. At least one of these physicians must be engaged in general or family practice and another as a specialist. The President of L and, if not already an elected director, the Chief of Staff of the Medical Staff, serve as ex officio, nonvoting members of the Board. Persons on the Board of Directors are elected by the voting directors to staggered three-year terms. The members of L are the

directors of L, and each person, upon being elected as a director, contemporaneously becomes a member of L for the term of his or her directorship.

L plans to expand and renovate its existing facility to provide additional hospital facilities. L plans to finance the entire cost of the expansion and renovation by borrowing the proceeds of new tax-exempt bonds issued by the N. The bonds would consist of two issues, as described below.

L plans to borrow the proceeds of Senior Bonds issued by N to fund approximately 90 percent of the total costs of the expansion and renovation of L's facilities. The maximum amount of Senior Bonds that will be issued will be \$b. The Senior Bonds will be secured through a Master Trust Indenture by the total revenues of L. It is anticipated that the Senior Bonds will receive an "A Minus" rating and possible credit enhancement to "AA." Serial maturities of increasing amounts will be between \$1,000,000 and \$2,300,000 for years 1 through year 20. The Senior Bonds will be fully underwritten with the interest rate to be established after receiving competitive bids from prospective purchasers. It is estimated that the Senior Bonds will provide interest rates between 5 percent and 6 percent with 15 to 20 year maturities.

L plans to borrow the proceeds of Subordinated Bonds issued by the N to fund approximately 10 percent of the total costs of the expansion and renovation of L's facilities. The maximum amount of Subordinated Bonds that will be issued will be \$c.

The Subordinated Bonds will have a single fixed interest rate determined at issuance that will accrue semiannually. The rate will not vary over the term of the Subordinated Bonds and the yield on the Subordinated Bonds will be the same under all possible payment schedules. Interest will be payable on the Subordinated Bonds only if audited prior fiscal year cash flow from operations exceeds a fixed amount. Any accrued but unpaid interest remains a liability of L.

Accrued but unpaid interest on the Subordinated Bonds will accrue interest at the fixed rate at each interest accrual date and will be paid in future years if cash flow from operations exceeds a fixed amount. Principal and all accrued interest will be due at maturity. The Subordinated Bonds will be secured by L's gross receipts on a basis subordinate to all other obligations, current or future, secured by Master Trust Indenture collateral.

The Subordinated Bonds will have a 15 year balloon maturity and will be callable on and after two years after issuance at par value plus accumulated interest. L has a unilateral option to extend the maturity date for five years for two possible such extensions. It is expected that the maximum term of the Subordinated Bonds will be a term of 25 years.

Sixty percent of the Subordinated Bonds (i.e., a maximum of \$d) will be issued as a private placement to accredited institutional investors or accredited individual investors who are not physicians at L. Forty percent of the Subordinated Bonds (i.e., a maximum of \$e) will be issued to M.

The coupon rate of the Subordinated Bonds will be set by the underwriter for the Senior Bonds in the capacity of broker for the sale of the Subordinated Bonds after receiving

competitive bids from disinterested institutional and individual investors to determine the lowest acceptable interest rate at which all of the Subordinated Bonds could be sold at par. The broker will have no interest in L other than performing these and other financial services. The auction process for setting the coupon rate of the Subordinated Bonds will be as follows:

The broker will identify a minimum of 10 accredited institutional and/or individual investors to bid on \$d of Subordinated Bonds. Oral bids will be sought from all identified bidders in multiples of \$100,000 with a maximum bid of \$1,500,000 from any one bidder. The aggregate amount of the total bids received from all bidders must equal or exceed \$3,000,000. A bid summary sheet will be maintained that records all oral bids. Bids will be sorted by coupon rate bid in ascending order. The coupon rate will be set by the broker at the lowest actual coupon rate at which the bid amounts at or below that rate will purchase \$d of Subordinated Bonds.

M is a limited liability company organized under the laws of the State of a. M will be owned by medical staff physicians and by M's manager, an affiliate of L. M will purchase and hold 40 percent of the Subordinated Bonds. M's sole activities will be owning the Subordinated Bonds, disbursing bond interest and principal to its members, facilitating transfer of its ownership interest and regulating compliance with certain healthcare regulatory and tax requirements.

Upon the organization of M, membership units in M will be sold for \$5,000 cash per unit. M's manager and each physician will own at least one membership unit in M. M will limit ownership to M's manager and an unlimited number of accredited physician investors and up to 35 other physician investors. It is expected that more than 20 physicians, including the four physicians who are voting or non-voting directors of L, collectively will own most of the membership units in M.

The business and affairs of M will be managed by M's manager. M's manager will not be obligated on the Senior Bonds or on the Subordinated Bonds. All matters submitted to the members of M require, at a minimum, the approval of a majority of membership interests. The approval of certain major matters requires the approval of at least 60 percent of the membership interests.

M will make all distributions to its members pro rata based on the amount of each member's respective unit ownership.

Except for patient care delivered in physicians' practice clinics or other hospitals, each physician member of M will be prohibited from engaging in any service capacity for, consulting with, or investing in, any organization that provides facilities and/or services that is competitive with L in the county where L is located or in any of its six contiguous counties located in the State of a. This prohibition will apply as long as the physician is a member of M and for two years thereafter.

Upon a member's material breach of a contract with L or any affiliate, including M, the member's rights may be terminated and such member's units purchased. M's manager will have a continuous purchase option to purchase the defaulting member's units at 90 percent of

par value plus the accumulated interest associated with the units' indirect interest in the Subordinated Bonds held by M.

An individual member of M will have no right to require in-kind distributions and will have no right to require M, L or an affiliate to purchase the member's units.

On August 21, 2003, L's Board of Directors approved the adoption of a new conflicts of interest policy. On September 18, 2003, L's Board of Directors approved the proposed transaction regarding L's issuance of the Subordinated Bonds and formation of M. None of the physician staff member directors of L participated in the discussion or vote approving any of these matters and did not control any individual involved in the approval process.

M's manager and the holders of a majority of M's membership units (who are not directors of L) will approve M's investment in the Subordinated Bonds issued by L.

L has submitted a representation that L's participation in the sale of the Subordinated Bonds to M will not constitute a violation of the Federal Medicare and Medicaid Anti-Kickback laws.

RULING REQUESTED

The process for setting the coupon rate of the Subordinated Bonds to be sold by L to M constitutes an offer received as part of an open and competitive bidding process under section 53.4958-6(c)(2)(i) of the Foundation and Similar Excise Taxes Regulations.

APPLICABLE LAW

Section 4958 of the Code imposes certain excise taxes on each excess benefit transaction between a section 501(c)(3) or a section 501(c)(4) organization and a disqualified person.

Section 4958(c)(1) provides that the term "excess benefit transaction" means any transaction in which the economic benefit is provided by a section 501(c)(3) or section 501(c)(4) organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

Section 4958(f)(1) of the Code defines the term "disqualified person" as to any transaction as any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, and includes a member of the family of such an individual. A disqualified person also includes a corporation, partnership, or trust or estate in which such persons collectively own more than 35 percent of the combined voting power, more than 35 percent of the profits interest or more than 35 percent of the beneficial interest, respectively. See section 4958(f)(3).

Section 53.4958-4(b)(1)(i) of the regulations provides that the fair market value of property, including the right to use property, for purposes of section 4958 of the Code is the fair market value (i.e., the price at which property or the right to use property would change hands

between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of the relevant facts).

Section 53.4958-6(a) of the regulations provides that a transfer of property, or the right to use property, is presumed to be at fair market value if several conditions are satisfied. One of these conditions is that the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination.

Section 53.4958-6(c)(2)(i) of the regulations provides that an authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether, under the standards in section 53.4958-4(b), the property transfer is at fair market value. In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred and offers received as part of an open and competitive bidding process.

RATIONALE

The coupon rate of the Subordinated Bonds will be set by the underwriter for the Senior Bonds in the capacity of broker for the sale of the Subordinated Bonds after receiving competitive bids from disinterested institutional and individual investors to determine the lowest acceptable interest rate at which all of the Subordinated Bonds could be sold at par. The broker will have no interest in L other than performing these and other financial services. The auction process for setting the coupon rate of the Subordinated Bonds, as described above, is a common commercial competitive bidding process for independently and fairly determining the coupon rate for bonds that are sold to the public. Therefore, this process constitutes an offer received as part of an open and competitive bidding process under section 53.4958-6(c)(2)(i) of the regulations.

RULING

The process for setting the coupon rate of the Subordinated Bonds to be sold by L to M constitutes an offer received as part of an open and competitive bidding process under section 53.4958-6(c)(2)(i) of the regulations.

This ruling does not address whether any party to the transaction described above is a disqualified person under section 4958(f)(1) of the Code, nor whether the rebuttable presumption described in section 53.4958-6 of the regulations has been established as to this transaction.

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.

This ruling is directed only to the organization that requested it and may not be used or cited by others as precedent.

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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,

(signed) Marvin Friedlander
Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1