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

NO PROTEST RECEIVED
Release copies to District
Date 12/13/99
Surname [redacted]

[redacted]

Date: SEP 29 1999

Contact Person: [redacted]

ID Number: [redacted]

Telephone Number: [redacted]

[redacted]

Employer Identification Number: [redacted]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were organized under the laws of the state of [redacted] on [redacted] perform behavioral health, managed care and other human services in support of three organizations. These organizations are [redacted], [redacted] [redacted] ([redacted]). Each of these organizations is described in section 501(c)(3) of the Code, but is not related to the others.

You are a membership organization. Membership rights include providing mental health and/or substance abuse care and treatment services pursuant to contracts that you enter into with third party payors. [redacted] your Bylaws state that you have three initial members, which are [redacted], [redacted], [redacted] and that you may add members based on a majority vote of your current membership. In your correspondence of [redacted] you have admitted a fourth member, [redacted] ([redacted]). [redacted] is described in section 501(c)(3) of the Code and is not related to [redacted], [redacted] or [redacted]

Your affairs are managed by a Board of Trustees. Each of your members is entitled to appoint one trustee to your Board.

Activities

Your activities consist of contracting with insurers, HMO's and other payors for the provision of mental health and/or substance abuse care or treatment services to covered persons under these benefit plans. The class of eligible beneficiaries from your activities includes individuals insured by managed care plans in [redacted] Your members will enter into participant group provider agreements with you whereby your members will provide mental health care and treatment services in accordance with the provision of the contracts you will enter into with the various third parties.

You plan on developing and facilitating the intake for all services by employing mental health technicians that will screen patients seeking mental health services. The mental health technicians will

[redacted]

ask various questions about the individual's problem so that the individual may be directed to the appropriate provider. You will verify that each individual is properly insured and will identify the level of service appropriate within their insurance coverage.

You will develop level of care standards which your members must meet in providing services. Level of care standards include credentialing, consumer satisfaction and consumer complaints. Credentialing includes establishing criteria for professionals who provide services, and the maintaining and overseeing of centralized credentialing. You have the right to reject any professional to provide services if you conclude, based on your good faith judgment, that the professional poses a risk to patients or would otherwise jeopardize your business reputation.

You will work with your payors in establishing a complaint resolution ladder to meet and deal with consumer complaints.

You do not provide services to individuals that are part of a charitable class or to Medicare and Medicaid recipients. You provide no educational materials to individuals, but your members provide educational materials. You believe your activities will be expanding the provision of medical care in a large portion of [redacted]

You are responsible for the utilization management of all services throughout the network. This includes examination and oversight of the utilization rate, penetration rate, and out of network standards. You are responsible for assuring that your participant providers work within contractual guidelines.

You are supported by fees for services paid for in the contracts and the provider/members are paid from these fees. You will pay your members in accordance with a fee schedule. You believe that the fee schedule is set up in such a way that you will break even and not make a profit. In the event that there is a surplus, your members will share the surplus.

You have $[redacted] in loans outstanding to your members. For the fiscal year ending [redacted] you expected to have [redacted] in revenues and to disburse [redacted] to your members with the remaining funds being disbursed for various items, leaving you with no profits.

__Stand Alone Basis for Exemption__

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

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order for an organization to be exempt as one described in section 501(c)(3) of the Code, it must be both organized and operated exclusively for one or more exempt purposes. Under section 1.501(c)(3)-1(d)(1)(i)(b) of the regulations, an exempt purpose includes a charitable purpose.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in Code section 501(c)(3) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. __See__ __Restatement (Second) of Trusts__, sections 368, 372 (1959); 4A Scott and Fratcher, __The Law of Trusts__, sections 368, 372 (4th ed. 1989); Rev. Rul. 69-545, 1969-2 C.B. 117.

Section 1.501(c)(3)-1(b)(1) of the regulations provides that an organization is organized

[redacted]

exclusively for one or more exempt purposes only if its articles of organization (a) limit the purposes of such organization to one or more exempt purposes and (b) do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(c)(1) of the 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(e)(1) of the regulations states that an organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) of the Code.

In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Court stated that "the presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

In Rev. Rul. 69-545, 1969-2 C.B. 117, the Service established the community benefit standard as the test by which the Service determines whether a hospital is organized and operated for the charitable purpose of promoting health.

Rev. Rul. 75-197, 1975-1 C.B. 156, held that a nonprofit organization that operates a free computerized donor authorization retrieval system to facilitate transplantation of body organs upon a donor's death qualifies for exemption under section 501(c)(3) of the Code because by facilitating the donation of organs which will be used to save lives, it is serving the health needs of the community and therefore is promoting health within the meaning of the general law of charity.

Rev. Rul. 77-68, 1977-1 C.B. 142, held that a nonprofit organization formed to provide individual psychological and educational evaluations, as well as tutoring and therapy, for children and adolescents with learning disabilities qualified for exemption under section 501(c)(3) of the Code because it both promoted health and advanced education. Because its services are designed to relieve psychological tensions and thereby improve the mental health of the children and adolescents, it promoted health.

In Rev. Rul. 77-69, 1977-1 C.B. 143, an organization was formed as a Health Systems Agency (HSA) under the National Health Planning and Resources Development Act of 1974. As an HSA, the organization's primary responsibility was the provision of effective health planning for a specified geographic area and the promotion of the development within that area of health services, staffing and facilities that met identified needs, reduced inefficiencies and implemented the HSA's health plan. The revenue ruling concluded that by establishing and maintaining a system of health planning and resources development aimed at providing adequate health care, the HSA was promoting the health of the residents of the area in which it functioned. Therefore, the HSA qualified for exemption under section 501(c)(3) of the Code on the basis that it promoted health.

Rev. Rul. 81-298, 1981-1 C.B. 328, held that a nonprofit organization that provides housing, transportation and counseling to hospital patients' relatives and friends who travel to the locality to assist and comfort the patients qualifies for exemption under section 501(c)(3) of the Code because it promotes health by helping to relieve the distress of hospital patients who benefit from the visitation and comfort

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provided by their relatives and friends.

In Professional Standards Review Organization of Queens County, Inc. v. Commissioner, 74 T.C. 240 (1980), acq., 1980-2 C.B. 2 ("Queens County PSRO), the Tax Court held that an organization that reviewed the propriety of hospital treatment provided to Medicare and Medicaid recipients was exempt under section 501(c)(3) of the Code because it lessened the burdens of government and promoted the health of persons eligible for Medicare and Medicaid.

In Rev. Rul. 81-276, 1981-2 C.B. 128, the Service held that a PSRO qualifies for exemption under section 501(c)(3) of the Code because it lessens the burdens of government and promotes the health of the beneficiaries of the Medicare and Medicaid programs.

Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), involved an organization that operated restaurants and health food stores with the intention of furthering the religious work of the Seventh-Day Adventist Church as a health ministry. However, the Seventh Circuit held that these activities were primarily carried on for the purpose of conducting a commercial business enterprise. Therefore, the organization did not qualify for recognition of exemption under section 501(c)(3) of the Code.

Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980), held that while selling prescription pharmaceuticals promotes health, pharmacies cannot qualify for recognition of exemption under section 501(c)(3) on that basis alone.

In Rev. Rul. 71-529, 1971-2 C.B. 234, a nonprofit organization that provided assistance in the management of participating colleges' and universities' endowment or investment funds for a charge substantially below cost qualified for exemption under section 501(c)(3) of the Code.

In Rev. Rul. 72-369, 1972-2 C.B. 245, an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations did not qualify for exemption under section 501(c)(3) of the Code.

In Paratransit Insurance Corp. v. U.S., 102 T.C. 745 (1994), a nonprofit mutual benefit insurance corporation was set up to provide a self-insurance pool for a group of tax-exempt private paratransit providers. The Tax Court held that under section 501(m)(3)(A) of the Code, the organization did not provide insurance at substantially below its costs.

In Nonprofits' Insurance Alliance of California v. U.S., 32 Fed. Cl. 277 (1994), 94-2 USTC (CCH) ¶ 50,593, an organization was formed to administer a group self-insurance risk pool. The U.S. Court of Federal Claims held that the organization did not qualify for exemption under section 501(c)(3) of the Code. The court also held that even if the organization qualified for exemption, it would be precluded from qualifying by reason of section 501(m)(1) because it failed to satisfy the exception in section 501(m)(3)(A) since it did not provide insurance at substantially below cost.

Integral Part Doctrine

Section 502 of the Code states that an organization operated for the primary purpose of carrying on a trade or business for profit is not tax exempt on the ground that all of its profits are payable to one or more tax-exempt organizations.

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Section 1.502-1(b) of the regulations provides that a subsidiary organization of a tax exempt organization may be exempt on the ground that the activities of the subsidiary are an integral part of the exempt activities of the parent organization. However, the 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.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of 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 513(a)(2) of the Code provides that the term "unrelated trade or business" does not include any trade or business which is carried on, in the case of an organization described in section 501(c)(3), such as a hospital, by the organization primarily for the convenience of its patients.

Section 1.513-1(a) of the regulations defines "unrelated business taxable income" to mean gross income derived by an organization 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 trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business 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 states that the phrase "trade or business" includes activities carried on for the production of income 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 that "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 states that 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 purposes.

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

Cooperative Hospital Service Organizations

Section 501(e) of the Code provides that a cooperative hospital service organization is treated as if it were exempt under section 501(c)(3) if it performs certain specific service activities enumerated in the statute. These services do not include management services or negotiating contracts. In addition, the enumerated services must be performed for two or more exempt hospitals and the organization must

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allocate or pay, within 8-1/2 months after the end of the year, all net earnings to its members on the basis of the services performed for them. To qualify under section 501(e), the services must be such that if they were performed by an exempt hospital, they would constitute activities in exercising or performing the purpose or function constituting the basis for the hospital's exemption. Therefore, implicit in section 501(e) is the requirement that hospital service organization must also satisfy the community benefit standard of Rev. Rul. 69-545, supra.

Section 1.501(e)-1 of the regulations provides that section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization.

In HCSC-Laundry v. U.S., 450 U.S. 1 (1981), the Supreme Court held that a cooperative laundry organization that served exempt organizations could not qualify as exempt under section 501(c)(3) because laundry services is not one of the activities enumerated in section 501(e).

RATIONALE

Stand Alone Basis for Exemption

1. Promotion of Health

Your activities consist of providing administrative services to your members, a group of unrelated section 501(c)(3) organizations. These services include negotiating managed care contracts on behalf of each of your members with third parties. These third parties include insurers and HMO's, whereby your members will provide mental health services to their enrollees. You are no more than a flow through entity because you receive fees from the third party payors that flow to your members based upon the services that each member provides.

Under the regulations, an organization that is organized and operated exclusively for charitable purposes may qualify for exemption under section 501(c)(3) of the Code. The regulations also provide 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.

The promotion of health has long been recognized as a charitable purpose. Whether a hospital promotes health in a charitable manner is determined under the community benefit standard of Rev. Rul. 69-545, supra. This standard focuses on a number of factors to determine whether the hospital benefits the community as whole rather than private interests. The application of the community benefit standard to exempt hospitals and other exempt health care organizations was sustained in Eastern Kentucky Welfare Rights Org. v. Simon, 506 F.2d 1278 (D.C. Cir. 1974), vacated on other grounds, 426 U.S. 26 (1975); and in Sound Health Association v. Commissioner, 71 T.C. 158 (1978), acq., 1981-2 C.B. 2.

The Service and the courts have recognized that the promotion of health includes activities other than the direct provision of patient care. See Rev. Rul. 81-298, supra; Rev. Rul. 81-276, supra; Rev. Rul. 77-69, supra; Rev. Rul. 77-68, supra; Rev. Rul. 75-197, supra; and Queens County PSRO, supra.

However, an organization that merely promotes health, without more, is not entitled to recognition of exemption under section 501(c)(3) of the Code. See Living Faith, Inc. v. Commissioner, supra; and Federation Pharmacy Services, Inc. v. Commissioner, supra.

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An organization that provides management services, such as soliciting clients and negotiating and executing contracts for section 501(c)(3) organizations that are structurally unrelated to each other and to the providing organization is performing commercial activities that do not satisfy the community benefit standard of Rev. Rul. 69-545, supra. Because your members are not commonly controlled by the same organization that controls you, you and your members are considered to be unrelated.

Providing management services to unrelated tax-exempt organizations to enable them to further their charitable purposes is not an activity that furthers a charitable purpose. See Rev. Rul. 72-369, supra. Rather, it is a commercial activity similar to the management services performed by for-profit organizations. Management services provided to tax-exempt organizations further charitable purposes only incidentally. Any relationship between these services and the furtherance of a charitable purpose is remote and tenuous. Thus, although your activities may promote health, you do not promote health in a charitable manner.

You have not established that a substantial portion of your activities consists of the promotion of health in a charitable manner. Therefore, you do not operate exclusively for a charitable purpose. See section 1.501(c)(3) - 1(c)(1) of the regulations and Better Business Bureau of Washington, D.C. v. United States, supra. As a result, you do not qualify for exemption under section 501(c)(3) of the Code as a charitable organization on the basis that you promote health.

2. **Substantially Below Cost**

Providing management services to unrelated tax-exempt organizations at cost to enable them to further their charitable purposes is not an activity that furthers a charitable purpose. See Rev. Rul. 72-369, supra. On the other hand, an organization that provides investment advisory services to section 501(c)(3) colleges and universities for a charge that is substantially below cost qualifies for exemption under section 501(c)(3). See Rev. Rul. 71-529, supra. In this revenue ruling, most of the organization's operating expenses were paid for by grants from independent charitable organizations. The member organizations paid only a nominal fee for the services performed – less than 15 percent of the total costs of operation.

In Nonprofits' Insurance Alliance of California v. U.S., supra, the U.S. Court of Federal Claims considered the absence of "donative intent" as one important factor. 32 Fed. Cl. at 293. The court also emphasized that the fees paid by the member organizations were not "nominal" or "insubstantial" in relation to total costs. Ibid. See also, Paratransit Insurance Corp. v. U.S., supra.

You have not established the presence of donative intent on the part of your organization in providing management services to your members at below market rates. Your members are not paying anything for your services, but you were established to provide management services for your members, whereby all fees from arranging for managed care contracts will flow to them. Basically all revenues beyond your costs are going to your members.

As a result, under Rev. Rul. 71-529 and Rev. Rul. 73-369, because you do not provide management services to tax-exempt organizations at substantially less than your cost, you do not qualify for exemption under section 501(c)(3) of the Code.

Integral Part Doctrine

Under section 1.502-1(b) of the regulations, one organization may derive its exemption from a

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related organization that is exempt under section 501(c)(3) of the Code if the former organization is an integral part of the exempt organization. To obtain exemption derivatively, two requirements must be met: (1) the two organizations must be "related" and (2) the subordinate entity must perform "essential" services for the parent. Section 1.502-1(b) of the regulations includes the following example of an organization that is considered as providing essential services: a subsidiary which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. See Rev. Rul. 78-41, supra.

(1) Related. Under section 1.502-1(b) of the regulations, a subsidiary organization that is engaged in an activity that would be considered an unrelated trade or business if it were regularly carried on by the exempt parent does not provide an essential service for the parent. The regulations include an example of a subsidiary organization that is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization.

Thus, if the subsidiary organization were owned by several unrelated exempt organizations and operated for the purpose of furnishing electric power to each of them, it would not be exempt because the business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. For this purpose, organizations are related only if they consist of a parent and one or more of its subsidiaries, or subsidiaries having a common parent. An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities. See section 1.502-1(b) of the regulations.

You are controlled by four unrelated section 501(c)(3) organizations. Therefore, you are indirectly controlled by unrelated section 501(c)(3) organizations that are not structurally related to each other. As a result, you do not satisfy the relatedness requirement.

(2) Essential Services. Your activities consist of providing management services to your members that are unrelated to one another. As explained above, your performance of these services to these unrelated tax-exempt organizations does not constitute the promotion of health in a charitable manner. Since you do not meet the relatedness test, for purposes of section 1.502-1(b) of the regulations, you could not provide essential services to satisfy the integral part test.

As a result, you do not qualify for exemption under section 501(c)(3) of the Code based on the integral part doctrine.

Cooperative Hospital Service Organizations

An organization that provides services for hospitals that are exempt under section 501(c)(3) of the Code may qualify for exemption under section 501(c)(3) if it meets the requirements of section 501(e). However, the exemption applies only to organizations that provide one or more of the services specifically enumerated in the statute and regulations, including "clinical services". Since section 501(e) is the exclusive means by which a hospital service organization may qualify for exemption under section 501(c)(3) (see section 1.501(e)-1 of the regulations and HCSC-Laundry, supra), a hospital service organization providing services other than those specifically enumerated in the statute does not qualify for exemption.

Your activities on behalf of your members do not include the services enumerated in section 501(e) of the Code. However, even if they did, as explained above, you do not satisfy the community benefit standard of Rev. Rul. 69-545, supra, a requirement for exemption under section 501(e) of the

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Code. Therefore, under section 501(e), you do not qualify as an organization that is treated as exempt under section 501(c)(3).

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio EP/EO key district office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, EP/EO Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
[redacted]
OP:E:EO:T:1, Room 6514
1111 Constitution Ave, N.W.
Washington, D.C. 20224

For your convenience, our Fax number is [redacted] If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Techncial Branch 1