Internal Revenue Service

Department of the Treasury

[redacted]

Washington, DC 20224

Person to Contact: [redacted]

Telephone Number: [redacted]

Refer Reply to: [redacted]

Date:

Employer Identification Number: [redacted]
Key District: Los Angeles

Dear Applicant:

We have considered your application for recognition of exemption as an organization described in section 501(c)(3) of the Internal Revenue Code. Based on the information submitted, we have concluded that you do not qualify for exemption under this section.

According to your Form 1023 Application, you were organized on [redacted] as a [redacted] joint powers authority formed by [redacted] district and county hospitals to provide a mechanism to self-insure malpractice, directors and officers, and pollution liability risks. Your purpose is to provide broad, stable coverage at a reasonable cost and the necessary underwriting, claims, marketing, risk management, and financial/accounting services to administer this risk pooling program. Your organizing document, the Joint Powers Authority Agreement ("the Agreement"), states that your purpose is to operate a program of self-insurance and insurance for professional liability and other coverages for the participating hospitals (the "Participants"). Part II(1) of the Agreement provides that your purposes are to provide essential protection to Participants not otherwise obtainable; to secure excess insurance on a group basis; to provide Participants with the mechanisms to accumulate, administer, and invest funds to self-insure as a group various liabilities up to a specified, predetermined amount; and to effect cost savings to Participants in the administration of such insurance and risk management programs as may be established by you in order to reduce the cost of health care to the patient-consumer. Part XIV provides that your principal purpose is to provide for the orderly presentment, examination, investigation, defense, or settlement of certain identified claims made by third parties against the Participants, and that you shall use the sums contributed by the Participants to pay such losses and claims.

Part III of the Agreement creates you as a separate public entity. Part IV(1) provides that you are governed by a board of 13-21 representatives of the Participants. Your Bylaws call for a 14 member board, 13 of which are elected by the Participants,

[redacted]

along with the Chief Executive Officer. Part XIII of the Agreement provides that the parties agree that each Participant shall make payment of contributions to the organization, determined as provided in the Coverage Agreement entered into by such Participant, and that the timely payment of such contributions shall be a condition precedent to the continuation of participation by each Participant. Part XXI(4) calls for distribution of the net assets upon dissolution back to the Participants in the proportion of contributions of each Participant less expenses paid on their behalf.

Most of your activities, including underwriting, claims management, and risk management, are performed by an independent contractor, [redacted] (formerly [redacted]), but you plan to conduct all services by in-house staff in the near future. You lease space from [redacted].

Your sources of support are participant contributions or premiums for coverage, and investment income. Charges are based on actuarially determined claim experience for the various risks that you cover on behalf of the Participants. Contributions (premiums) not immediately used are invested until needed and the investment income decreases the rates that need to be charged. You have total assets of $[redacted] million and annual gross revenues of about $[redacted] million.

Section 501(c)(3) of the Internal Revenue Code exempts from federal income tax organizations organized and operated exclusively for charitable or certain other purposes.

Section 502 of the Code provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.

Section 501(e) of the Code provides that an organization shall be treated as organized and operated exclusively for charitable purposes, if

(1) such organization is organized and operated solely--

> (A) to perform, on a centralized basis, one or more of the following services which, if performed on its own behalf by a 501(c)(3) hospital, would constitute activities in exercising or performing the purpose or

[redacted]

function constituting the basis for its exemption: data processing, purchasing (including the purchasing of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services; and

(B) to perform such services solely for two or more hospitals each of which is--

(i) a 501(c)(3) organization,

(ii) a constituent part of a 501(c)(3) organization and which, if organized and operated as a separate entity, would constitute a 501(c)(3) organization, or

(iii) owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of any of the foregoing;

(2) such organization is organized and operated on a cooperative basis and allocates or pays, within 8 1/2 months after the close of its taxable year, all net earnings to patrons on the basis of services performed for them; and

(3) if such organization has capital stock, all of such stock outstanding is owned by its patrons.

Section 501(m)(1) of the Code provides that an organization described in section 501(c)(3) or (4) shall be exempt under section 501(a) only if no substantial part of its activities consists of providing commercial-type insurance. See, e.g., Paratransit Ins. Corp. v. Commissioner, 102 T.C. No. 34 (1994).

Section 501(m)(3) of the Code provides that commercial-type insurance shall not include insurance provided at substantially below cost to a class of charitable recipients.

[redacted]

Section 1.501(c)(3)-1(b)(1)(i) of the Income Tax Regulations provides generally that an organization is organized 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 1.502-1(b) of the regulations provides that if an organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. For purposes of this paragraph, organizations are related only if they consist of:

> (1) A parent organization and one or more of its subsidiary organizations; or
>
> (2) Subsidiary organizations having a common parent organization.

An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.

Section 1.501(e)-1(a) 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. A cooperative hospital service organization which meets the requirements of section 501(e) and section 1.501(e)-1(a) shall be treated as described in section 501(c)(3). In order to qualify for tax exempt status, a cooperative hospital service organization must--

> (1) Be organized and operated on a cooperative basis,
>
> (2) Perform, on a centralized basis, only one or more specifically enumerated services which, if performed directly by a tax exempt hospital, would constitute activities in the exercise or performance of the purpose or function constituting the basis for its exemption, and

[redacted]

(3) Perform such service or services solely for two or more patron-hospitals as described in section 1.501(e)-1(d).

In HCSC Laundry v. United States, 450 U.S. 1 (1981), the Supreme Court held that section 501(e) of the Code was the exclusive and controlling section by which a cooperative hospital service organization could obtain exemption under section 501(c)(3). An organization formed to operate a laundry service for 15 member nonprofit hospitals was held not entitled to exemption because laundry service is not a permitted service under section 501(e)(1)(A).

Section 1.501(e)-1(b) of the regulations provides that in order to meet the requirements of section 501(e), the organization must be organized and operated on a cooperative basis (whether or not under a specific statute on cooperatives).

Section 1.801-3(a)(1) of the regulations provides that the term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by other insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether it is taxable as an insurance company under the Code.

H.R. Rep. No. 426, 99th Cong., 1st Sess., pp. 664-65 (1985), 1986-3 (Vol. 2) C.B. 664-65, pertaining to the purposes for enactment of section 501(m) of the Code, provides that the committee is concerned that exempt charitable and social welfare organizations that engage in insurance activities are engaged in an activity whose nature and scope is so inherently commercial that tax-exempt status is inappropriate. The committee believes that the tax-exempt status of organizations engaged in insurance activities provides an unfair competitive advantage to these organizations. The committee further believes that the provision of insurance to the general public at a price sufficient to cover the costs of insurance generally constitutes an activity that is commercial . . . . [C]ommercial-type insurance generally is any insurance of a type provided by commercial insurance companies.

The General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong., P.L. 99-514, pp. 585-86, contains the following discussion of "commercial-type insurance":

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commercial-type insurance does not include arrangements that are not treated as insurance (i.e., in the absence of sufficient risk shifting and risk distribution for the arrangement to constitute insurance). For example, if a hospital that is exempt from income tax under section 501(c)(3) establishes a trust to accumulate and hold funds for use in satisfying malpractice claims against the hospital, the arrangement does not constitute insurance and accordingly is not treated as providing commercial-type insurance.

Rev. Rul. 77-316, 1977-2 C.B. 53, held that a wholly-owned subsidiary corporation which "insured" the risks only of its parent and the parent's other subsidiaries was not an insurance company for federal tax purposes, and that the contractual arrangement between the domestic parent and subsidiaries and the "insurance" subsidiary did not qualify as insurance. In Situation 1, a parent corporation and its subsidiaries paid amounts as insurance premiums directly to an "insurance" subsidiary. In Situation 2, the premiums were paid to an unrelated insurance company, and the parties agreed that the unrelated company would immediately transfer 95% of the risks under a reinsurance agreement to the "insurance" subsidiary. In Situation 3, the parent and subsidiaries paid premiums to the "insurance" subsidiary, with the understanding that it would transfer 90% of the risk through reinsurance agreement to an unrelated insurance company. In each situation, the "insurance" subsidiary insured no other parties. The Service concluded that the "insurance agreement" with each subsidiary was designed to obtain a deduction for the parent and its other subsidiaries by indirect means that would be denied if sought directly (with a fund set aside for self-insurance). The parent, its "insurance" subsidiary, and its other subsidiaries, though separate corporate entities, represented one economic family, with the result that those who bore the ultimate economic burden of loss were the same persons who suffered the loss. Thus, there was no economic shifting or distributing of risk of loss to the extent that the risks were not retained by an unrelated insurance company. Because the payments were not insurance premiums, the Service ruled that the "insurance" subsidiary conducted no insurance business and was not an insurance company.

Rev. Rul. 78-41, 1978-1 C.B. 148, held that a trust created by an exempt hospital for the sole purpose of accumulating and holding hospital funds to be used to satisfy malpractice claims against the hospital, and from which the hospital directed the bank-trustee to make payments to claimants, was operated exclusively for charitable purposes and exempt under section

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501(c)(3) of the Code. The Service reasoned that the trust operated as an integral part of the hospital and performed a function that the hospital could do directly.

Rev. Rul. 78-338, 1978-2 C.B. 107, held that a corporation which assumed the risks of its 31 unrelated shareholder corporations and their subsidiaries and affiliates issued insurance contracts. No shareholder owned a controlling interest, and no shareholder's individual risk exceeded 5% of the total risks insured. The Service ruled that because the shareholders were not economically related, the economic risk of loss could be shifted and distributed among the shareholders who comprised the insured group.

Rev. Rul. 83-172, 1983-2 C.B. 107, held that a group of 40 employers created to self-insure their risk under the state's workers compensation act was taxable as an insurance company under section 831 of the Code and issued insurance contracts, even though state law regarded the arrangement as self-insurance. The Service reasoned that while state law creates legal interests and rights, the federal tax law designates which of these interests or rights will be taxed.

In Rev. Rul. 88-72, 1988-2 C.B. 31, as clarified by Rev. Rul. 89-61, 1989-1 C.B. 75, the Service discussed the distinction between risk shifting and distributing. Risk shifting occurs where a risk is shifted away from a corporate parent and its subsidiaries. Risk distributing occurs where an insurance company accepts a large number of independent risks, and thereby takes advantage of a statistical phenomenon known as "the law of large numbers"--although the potential loss exposure increases, the average loss incurred becomes increasingly predictable.

In Helvering v. LeGierse, 312 U.S. 531 (1941), the Supreme Court, in discussing the definition of insurance, stated that insurance involves risk shifting and risk distributing.

In Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 308 (1965), acq., 1966-1 C.B. 39, the Tax Court summarized three main cooperative principles:

> (1) Subordination of capital both as regards to control of the cooperative undertaking and as regards to ownership of the pecuniary benefits arising therefrom;
> (2) democratic control by the worker-members themselves; and

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(3) the vesting in and allocation among the worker-members of all the fruits and increases arising from their cooperative endeavor (i.e., the excess of operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor.

Associated Hospital Services, Inc. v. Commissioner, 74 T.C. 213 (1980), aff'd per order (5th Cir. Mar. 25, 1981), held that an organization whose sole function was to furnish laundry services at cost to its four member tax-exempt hospitals was prohibited from exemption under section 501 by section 502. The court noted that the essence of a section 502 organization is its distinctly commercial hue; its activities must be those normally performed by commercial enterprises as distinguished from those activities that most often fall within the province of inherently exempt organizations.

In order to be described in section 501(c)(3) of the Code, you must be organized and operated exclusively for charitable or other exempt purposes. You fail to qualify under section 501(c)(3), on four separate grounds. One, you are not organized and operated exclusively for charitable purposes because you are a hospital cooperative service organization and fail to meet the requirements of the specific exception of section 501(e). Two, your primary activity is the operation of a business for profit and therefore section 502 prohibits exemption under section 501. Three, you provide commercial-type insurance as a substantial part of your activities, and therefore section 501(m) prohibits section 501(c)(3) or (4) status. Four, your organizing document does not specify that you are organized exclusively for charitable purposes.

Your sole purpose is to provide service to hospitals owned and operated by a political subdivision, agency or instrumentality of [redacted]. You are democratically controlled by the Participants who elect your board, and your net profits are allocated to the Participants in proportion to their participation; thus, you are organized and operated on a cooperative basis. Cooperatively organized organizations ordinarily do not qualify for exemption under section 501(c)(3) of the Code, because they violate the "organized and operated exclusively for charitable purposes" requirement of that section.

Section 501(e) of the Code is an exception to that general rule, however. Under section 501(e), cooperative hospital service organizations are treated as if they meet the "organized

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and operated exclusively" requirement if they meet the specific requirements of section 501(e). The activities which the cooperative hospital service organization may perform are specifically enumerated in section 501(e)(1). Absent inclusion in the specific enumeration, the activity is not permitted under section 501(e) and the exemption allowed under that section as an exception to the requirements of section 501(c)(3) fails. See: section 1.501(e)-1(a) of the regulations and HCSC Laundry, supra.

Since issuing insurance contracts or assuming or self-insuring risks (as opposed to purchasing insurance) is not a permitted activity under section 501(e), you do not qualify as a charitable organization under section 501(c)(3).

Regardless of section 501(e) of the Code, you are not entitled to exemption under section 501 because you are described in section 502. As discussed below, you operate an insurance business, and operating such business is your primary purpose. The provision of malpractice, directors and officers, and pollution liability insurance is an inherently commercial activity and therefore a business conducted "for profit." You are like the organization described in section 1.502-1(b) of the regulations, carrying on an unrelated business on behalf of several unrelated organizations. Therefore, section 502 prohibits your exemption under section 501.

Even if you otherwise qualified under the section 501(e) exception to certain requirements of section 501(c)(3) of the Code, section 501(m) precludes your exemption under that section since you provide commercial-type insurance as a substantial activity. While your activity may not be regarded as insurance and you may not be classified as an insurance company under state law, state law characterization of such activity is not controlling for federal tax purposes. See section 1.801-3(a)(1) of the regulations; Rev. Rul. 77-316; and Rev. Rul. 83-172. Instead, it is the character of the business actually done which determines whether you are an insurance company and, similarly, whether you issue insurance contracts.

Your primary activity involves assuming the malpractice, directors and officers, and pollution liability risks of your Participants. You receive contributions or premiums from your Participants assessed on the basis of actuarial risk factors, which must be paid by the Participants in order to participate in the program. The premiums are used to defend and settle such claims as they arise. Like the situation in Rev. Rul. 73-338 and unlike Rev. Rul. 77-316 and Rev. Rul. 78-41, your premiums are paid by a large number of unrelated entities. Therefore, the

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premium payments involve the risk shifting and distributing characteristic of insurance contracts. Further, the insurance is commercial-type insurance because it is of a type ordinarily provided by commercial insurance companies, and it is provided at cost, on a mutual or cooperative basis.

A fourth reason that you do not qualify for 501(c)(3) status is that your organizing document, the Agreement, does not adequately specify that you are organized for 501(c)(3) purposes, as specified in section 1.501(c)(3)-1(b)(1)(i) of the regulations. Instead, they merely describe your activities which, as explained above, are not deemed exempt under section 501(c)(3) of the Code.

Accordingly, you do not qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue 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, 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 to our office at:

Internal Revenue Service
[redacted]
1111 Constitution Avenue, N.W.
Washington, DC 20224

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 Practice Requirements.

If you do not protest this proposed 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 judgment or decree under this section shall not be issued in any proceeding unless the United States 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 copies will be forwarded to your key District

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Director. Thereafter, any questions you have about your federal income tax status should be addressed to that office. The appropriate State officials will be notified of this action in accordance with section 6104(c) of the Code.

Sincerely yours,

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[redacted]
Chief, Exempt Organizations
Rulings Branch 3

Initial Review

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6/22/94 6/22/1994