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

OFFICE OF
CHIEF COUNSEL

DEC 04 2003

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FREV-117030-00

MEMORANDUM FOR ACTING DIRECTOR, EXEMPT ORGANIZATIONS
RULINGS AND AGREEMENTS
T:EO:RA
Attn: Bob Fontenrose

FROM: Chief, Exempt Organizations Branch 2
DC/ACC (TE/GE)

SUBJECT: [redacted]

This memorandum responds to your request that we review [redacted] §501(c)(3) application. [redacted]

Background

[redacted] is a nonprofit community health insurance plan incorporated in the state of [redacted] on [redacted] and licensed by the state as an "organized delivery system" on [redacted] Under Iowa state law, an organized delivery system delivers or arranges to deliver the full range of health care services covered under a standard benefit plan and is accountable to the public for the cost, quality and access of its services and for the effect of its services on their health. [redacted] is applying for exemption as an organization described in section 501(c)(3). Its sole member is [redacted] a §501(c)(3) organization.

[redacted] is licensed to provide health insurance coverage to employers of two or more employees in [redacted] The [redacted] governing board is made up of volunteer directors from the [redacted] community that are appointed by [redacted] does not provide any actual medical or hospital services. Rather, to provide health care to its members, [redacted] contracts with [redacted]

[redacted][1], two related exempt hospitals, as well as three other unrelated exempt hospitals for inpatient services. [redacted] contracts with primary care physicians to provide outpatient services. The primary care physicians are not structurally or financially related to [redacted] or [redacted]

[redacted] articles of incorporation contain the following purposes:

[redacted]

[redacted] does not offer a subsidized membership program, and does not provide services to the poor and distressed, or Medicaid enrollees. [redacted] also does not directly offer health education programs to the community or conduct health research programs. Its primary activity is the administration of the [redacted] health insurance plan to employers in [redacted]

Premiums for [redacted] health plan are actuarially established on a community basis. Groups of [redacted] or more are quoted on a community rate basis, and small groups of [redacted] use the community rate as a basis and are underwritten on the basis of age, size, and claims experience.

Law and Analysis

1. Stand Alone Basis for Exemption

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[1]Although the proposed adverse determination letter states that only [redacted] is related to [redacted] the administrative file suggests that [redacted] is also a subsidiary of [redacted] and is thus a related sister organization of [redacted]

Section 501(c)(3) provides, in part, that organizations shall be exempt from federal income tax if they are organized and operated exclusively for charitable purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual. Treas. Reg. §1.501(c)(3)-1(d)(2) provides that the term "charitable" is used in §501(c)(3) in its generally accepted legal sense.

Promotion of health has long been recognized as a charitable purpose. An organization that seeks exemption on the basis that it promotes health must distinguish itself from ordinary commercial entities that provide health care services. See Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980); Sonora Community Hospital v. Commissioner, 46 T.C. 519 (1966), aff'd, 397 F.2d 814 (9th Cir. 1968). Whether an organization promotes health in a charitable manner is determined under the community benefit standard. Rev. Rul. 69-545, 1969-2 C.B. 117; Sound Health Ass'n v. Commissioner, 71 T.C. 158 (1978), acq. 1981-2 C.B. 2; Geisinger Health Plan v. Commissioner, 985 F.2d 1210 (3rd Cir. 1993).

Organizational Test

We believe that [redacted] fails the organizational test of §501(c)(3). To satisfy the organizational test, the organization's articles of incorporation must limit the organization's purpose to one or more exempt purposes and not expressly empower the organization to engage, except insubstantially, in activities that do not further its exempt purpose. Treas. Reg. §1.501(c)(3)-1(b)(1). The existence, therefore, of a substantial nonexempt purpose is fatal to §501(c)(3) qualification. See Better Business Bureau v. United States, 326 U.S. 279 (1945).

[redacted] articles do not limit its purposes to exempt purposes, and its articles expressly permit [redacted] to engage in activities that do not further an exempt purpose. [redacted] articles provide, in part, that [redacted] was created for the purpose of owning and operating health care provider networks for the diagnosis, treatment, and care of the sick and injured. This is not a charitable purpose. See Federation Pharmacy Services, Inc. v. Commissioner, supra; Geisinger Health Plan v. Commissioner, supra. Thus, [redacted] articles permit [redacted] to engage in substantially nonexempt activities. Treas. Reg. §1.501(c)(3)-1(b)(1); see Better Business Bureau v. United States, supra; Sound Health Ass'n v. Commissioner, supra; see also University of Maryland Physicians, P.A. v. Commissioner, T.C. Memo. 1981-23.

Recommendation: [redacted]

Operational Test

[redacted] fails to satisfy the operational test. Like the organization in Geisinger, [redacted] fails to satisfy the community benefit standard established in Rev. Rul. 69-545. [redacted] admits that it cannot provide coverage to its subscribers below cost because it would not be able to exist or meet its obligations under [redacted] law, which requires it to maintain adequate reserves to pay claims. See Nonprofits' Insurance Alliance of California v. United States, 32 Fed. Cl. 277 (1994); Paratransit Insurance Corp. v. Commissioner, 102 T.C. 745 (1994). [redacted] does not provide any charity care or maintain a subsidized membership program. [redacted] is not licensed to provide individual coverage, so there is no way for indigent persons to become members of [redacted] health plan and receive health care services. In addition, [redacted] does not cover Medicare or Medicaid recipients except as secondary payor (in applicable cases), and does not conduct health research programs or offer health education programs to the community.

Rather, selling the [redacted] health plan is a commercial activity that is similar to activities ordinarily carried on by for-profit insurance companies. See Nonprofits' Insurance Alliance of California v. U.S., supra. [redacted] does not offer health insurance to subscribers based on need, or even at a uniform charge. Instead it determines subscriber premiums based on factors affecting the level of risk, or in other words, actuarially, in the same manner that for-profit insurance carriers determine premiums for their customers. Similar to for-profit insurance carriers, [redacted] contracts with other firms to secure reinsurance for catastrophic claims, and its policies provide that the benefits of membership cease when an employer fails to make payments to [redacted] when due. See Federation Pharmacy Serv., Inc. v. Commissioner, supra (membership benefits terminate with failure to pay, making organization no more charitable than commercial cooperative). It appears as though [redacted] exists solely for the purpose of selling insurance to area employers at affordable rates. Under these circumstances, we believe that [redacted] is not operated exclusively for charitable purposes because its operations benefit only its membership, not the poor or the community as a whole.

[redacted] is not entitled to exemption because it arranges for the sale of health insurance and contracts with §501(c)(3) providers that are structurally unrelated to itself and each other. To satisfy the operational test, the organization's resources must be devoted to purposes that qualify as exclusively charitable within the meaning of §501(c)(3). Treas. Reg. 1.501(c)(3)-1(c)(1) provides that an organization will not be regarded as "operated exclusively" for one or more exempt purposes if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

As well as contracting with [redacted] and [redacted] is contracting with three unrelated exempt hospitals and various unrelated primary care physicians to

provide health care services to [redacted] subscribers. Arranging for other hospitals and doctors to provide health care services is not a charitable activity. Thus, [redacted] activities further a substantial nonexempt purpose. Treas. Reg. §1.501(c)(3)-1(c)(1).

Recommendation: [redacted]

2. Integral Part

[redacted] is not entitled to exemption based on the integral part doctrine. The integral part doctrine has three tests: (1) a relationship test; (2) an essential activities test; and (3) an unrelated trade or business test. See Geisinger Health Plan v. Commissioner, supra at 402-403; see also Redlands Surgical Services v. Commissioner, 113 T.C. 47, 93-95 (1999), appeal pending (9th Cir). Treas. Reg. §1.502-1(b) states that organizations are related for integral part purposes if they are either (1) a parent and a subsidiary or (2) subsidiaries with a common parent. [redacted] analyzes the facts under the latter scenario (subsidiaries sharing common parent), and concludes that because [redacted] contracts with unrelated exempt hospitals and unrelated physicians, the relationship test requirements are not met. [redacted] fails the essential services test because [redacted] provision of services is not limited to patients of [redacted] subsidiary hospitals.

[redacted] is not entitled to exemption based on the integral part doctrine, and agree with the reasons you cite in the proposed adverse letter. However, the proposed adverse determination letter does not address [redacted] argument that it is an integral part of [redacted] its parent organization. This argument needs to be addressed in the proposed adverse determination letter.

Under the parent/subsidiary scenario, [redacted] appears to satisfy the relationship test. Its sole member is its parent, [redacted], and it has a community board of directors appointed by [redacted] See Geisinger Health Plan v. Commissioner, 100 T.C. 394, 402 (1993), aff'd, 30 F.3d 494 (3rd Cir. 1994); Squire v. Students Book Corp., 191 F.2d 1018 (9th Cir. 1951). [redacted] does not, however, satisfy the essential services test or the unrelated trade or business test. To pass the essential services test, a subsidiary must perform essential services directly for the exempt parent or for the class the parent benefits. See Geisinger Health Plan v. Commissioner, supra at 400. To pass the unrelated trade or business test, a subsidiary must not be primarily conducting an unrelated trade or business with respect to the parent's exempt purposes. See Geisinger Health Plan v. Commissioner, supra at 404-406; §1.502-1(b). The exempt purpose of [redacted] is to promote the health of the public by ensuring that quality health care services are available, accessible, and affordable to all residents

within the [redacted] area regardless of their ability to pay. The facts show that [redacted] participates in an activity that does not promote community health. See Sound Health Association v. Commissioner, supra. Therefore, [redacted] activities do not further the exempt purposes of its parent, [redacted] and [redacted] cannot rely on the integral part doctrine as a basis for its exemption.

Recommendation: [redacted]

3. Section 501(m)

[redacted] is also precluded from exemption based on §501(m). Section 501(m) restricts the insurance activities of organizations described in §501(c)(3) and §501(c)(4). Section 501(m)(1) specifically denies tax exemption to organizations providing "commercial-type insurance" as a substantial part of their activities.

While commercial-type insurance is not defined in the Code or regulations, the court held in Paratransit Insurance Corp. v. Commisioner, supra at 754, that "commercial-type insurance, as used in §501(m), encompasses every type of insurance that can be purchased in the commercial market." See Florida Hospital Trust Fund v. Commissioner, 103 T.C. 140, 158 (1994), aff'd, 71 F.3d 808 (11th Cir. 1996). The court concluded the organization's insurance was commercial-type insurance because it was of the same type that commercial insurance carriers offered, it was not offered to members based on need or a uniform charge and premiums were determined using the same risk and actuarial factors as commercial insurers. Id. at 754. The absence of an actual commercial competitor does not render §501(m) inapplicable to an organization offering commercial-type insurance. See Florida Hospital Trust Fund, supra at 160.

Section 501(m) does not apply if the activities do not constitute insurance. See Rev. Rul. 77-316, 1977-2 C.B. 53; Rev. Rul. 78-338, 1978-2 C.B. 107. The essential ingredients of insurance are risk shifting and risk distribution. See Helvering v. Le Gierse, 312 U.S. 531 (1941); Rev. Rul. 77-316, 1977-2 C.B. 53; Rev. Rul. 78-338, 1978-2 C.B. 107. Risk distribution occurs as the insurer extends coverage to, and collects premiums from, additional parties. See Rev. Rul. 89-61, 1989-1 C.B. 75. See also Paratransit Insurance Corp. v. Commissioner, supra at 754; Jordan, Superintendent of Insurance v. Group Health Association, 107 F.2d 239 (D.C. Cir. 1939).

The [redacted] health plan constitutes insurance because it contains the essential ingredients of risk shifting and risk distribution. [redacted] subscribers have shifted a

substantial portion of their economic risk to [redacted] because its plan pays for all of their covered health care services in exchange for an annual premium. The annual premium is fixed for each subscriber regardless of the level of medical care utilized. Thus, [redacted] has assumed the economic risk that a particular subscriber's covered health care services may exceed the premiums paid. See Paratransit Insurance Corp. v. Commissioner, supra at 754.

Further, [redacted] has not shifted most of the risk that it assumed from its subscribers to the health care providers with which it contracts. [redacted]% of [redacted] physicians are paid on a fee for service basis. As a result, [redacted] economic risk varies in direct proportion to the number and cost of health care services its subscribers need. Even though [redacted] utilizes a discounted fee schedule and premiums are actuarially established on a community basis, [redacted] does not withhold any portion of its payments to physicians as a mechanism to force compliance with periodic budget or utilization standards.

[redacted] relies on the fact that [redacted] providers' fees are not subject to a withhold. [redacted] argues that its exemption should not hinge on whether it implements a withhold. Utilizing a withhold, [redacted] argues, ignores the current risk to rural populations of diminishing access to quality health care services. While diminishing access to health care may in fact be a reality in rural areas, utilizing a withhold indicates a transfer of financial risk to providers. It is a factor in determining whether an organization is providing insurance. In this case, not utilizing a withhold suggests that [redacted] is providing insurance. [redacted] also retains the economic risk from subscribers who exercise their right to use out-of-network providers. Based on these facts, we agree that [redacted] is engaging in insurance activities.

We next look at whether [redacted] insurance activities are commercial. The type of insurance [redacted] offers to its participants is basic health insurance, a type of insurance provided by a number of commercial insurance carriers. See Paratransit Insurance Corporation v. Commissioner, supra at 754; Florida Hospital Trust Fund v. Commissioner, supra at 158. [redacted] offers health coverage to both large and small employers, and uses a community rating method, making adjustments for small group employees' individual risk factors on the basis of age, size, and claims experience. [redacted] does not offer free or reduced cost coverage to any subscribers. Thus, [redacted] determines its premiums using the same cost and risk factors as commercial insurers. See Paratransit Insurance Corporation, supra. Accordingly, we believe [redacted] activities closely resemble those of commercial insurance companies.

Recommendation: [redacted]

[redacted]

4. Section 501(e)

Even if [redacted] were entitled to exemption under §501(c)(3) or §501(m), §501(e) provides an independent basis for denying [redacted] exemption. Section 501(e) provides for exemption of certain hospital service organizations organized and operated solely to perform specified services for exempt member hospitals. Section 501(e)(1)(A) lists the specified services as data processing, purchasing (including the purchasing of insurance on a group basis), warehousing, billing and collection (including the purchase of patron accounts receivable on a recourse basis), food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services. The legislative history states that section 501(e) does not grant tax exempt status if the hospital service organization performs any service other than those specified in the new subsection. See also HCSC-Laundry v. United States, 450 U.S. 1 (1981); Associated Hospital Services, Inc. v. Commissioner, 74 T.C. 213 (1980), aff'd per order, (5th Cir. 1981). In this case, [redacted] provides a steady flow of patients to two related exempt hospitals, three unrelated hospitals, and other unrelated physicians. [redacted] is not a cooperative, and does not perform any of the services specified in §501(e)(1)(A); therefore, §501(e) is another independent basis for denying exemption.

Recommendation: [redacted]

In conclusion, [redacted] that [redacted] health plan is not entitled to exemption under §501(c)(3) or §501(m), and the additional basis of §501(e). [redacted]. If you wish to discuss this matter with us or have any questions, please contact me or Stephanie Caden at (202) 622-6010.

ELIZABETH PURCELL