Internal Revenue Service

memorandum

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CC:EBEO:5/BJClary

date: DEC 3 1996

to:
Marc Owens, Director, E:EO

from: JLB
James Brokaw, Chief, Branch 5, CC:EBEO

subject: [redacted]

You separately forwarded the two above-referenced section 501(m) cases to this office for our consideration. Both organizations were created and are governed by an act of the state legislature. The first case involves an organization providing retirement, disability and death benefits to voluntary firefighters. A similar organization was found to be exempt under 501(c)(4) in Rev. Rul. 87-126, 1987-2 C.B. 150. It is our understanding that the exemption in that Rev. Rul. was based on lessening the burdens of government. While that ruling was published after the enactment of 501(m), that Code provision was not discussed in the ruling. The second case involves a [redacted] organization that provides health insurance, for a fee, to residents of the state with pre-existing medical conditions who have been rejected for health insurance by at least two insurance companies.[1] The documents in the administrative file show that the [redacted] You originally denied exemption to the organization, but are now prepared to revoke the denial letter.[2]

While the activities of the two organizations are very different, we are discussing them together in this memorandum because they both involve the same section 501(m) issues. At issue in both cases is whether the organization provides "commercial-type insurance" within the meaning of section 501(m) of the Code. Also, if the insurance is within the general meaning of commercial-type insurance, does it fall within the exception to commercial-type insurance for insurance provided "substantially below cost to a class of charitable recipients."

We conclude that section 501(m) does not preclude section 501(c)(3) or (c)(4) status to the [redacted] organization because, although it is providing commercial-type insurance within the general meaning of section 501(m), the insurance provided by the organization meets the substantially below cost exception for commercial-type insurance. We further conclude that the [redacted] association also provides commercial-type insurance within the general meaning of the term, but that the association does not provide the insurance substantially below cost, nor does it provide

the insurance to a class of charitable recipients. Thus, section 501(m) should preclude the organization from receiving section 501(c)(3) or (c)(4) status. [redacted]

The following discussion provides more details as to why we have concurred in the [redacted] case, but not in the [redacted] case.

DISCUSSION

1. Is section 501(m) applicable where an organization's charitable purpose is lessening the burdens of government?

Section 501(m)(1) precludes an organization's exemption under section 501(c)(3) or (c)(4) if a substantial part of its activities consists of providing commercial-type insurance. The term "commercial-type insurance" does not include insurance provided at substantially below cost to a class of charitable recipients. I.R.C. §501(m)(3)(A).

Some people have questioned whether an organization providing insurance that has as its purported charitable purpose the lessening the burdens of government should be required to provide the insurance substantially below cost. In other words, for purposes of exemption under sections 501(c)(3) and (c)(4), do the usual rules that apply to an organization engaged in ordinary commercial activity necessarily apply when the organization's activities lessen the burdens of government?

Prior to the enactment of section 501(m), the rule for establishing the charitable purpose and operation was the same for an organization providing insurance as it was for an organization engaged in other types of activities of a commercial nature; that is, if an organization's activities are of a commercial nature, and not specifically suited to the accomplishment of an exempt purpose, they will be deemed appropriate to charitable operation only in limited circumstances. In some cases, the provision of goods and services to the poor may constitute relief of the poor and distressed. Also, provision of goods and services to other organizations described in section 501(c)(3) may be considered an activity similar to those carried on by a grant-making charity. In either case, activity will be considered to be conducted in a charitable manner only if the price charged is substantially below the cost of its operations.[3] The substantially-below-cost rule does not apply, however, when the activities of an organization are uniquely suited to the accomplishment of its charitable purposes.[4] In such case, the only inquiry is whether the charges made in connection with the activities significantly detract from the organization's charitable purposes. When the community clearly benefits from an organization's activities, a reasonable charge will

usually not negate this benefit; the only exceptions would appear to be when the charge works to deprive a major part of the community of access to the organization and its program, or when the organization derives a profit from its activities beyond that necessary to the conduct of its exempt function. Thus, the reasonable fee rule applies to charities that engage in activities that directly benefit either members of a charitable class or the community as a whole, while the substantially-below-cost rule only applies to (1) organizations that purport to serve the poor by providing them with commercially available goods or services at a reduced price, and (2) organizations that provide goods or services to other 501(c)(3) organizations.[5]

The two organizations under discussion here each have as at least one charitable purpose the lessening the burdens of government. Since the purported purposes of these organizations does not include relief of the poor or benefiting other exempt organizations, it is arguable that under the reasonable fee rule they would not be required to provide the health insurance or annuities at below cost. Assuming this is true, does the enactment of section 501(m) change the rule to require the insurance to be provided at substantially below cost? One could infer from the fact that Rev. Rul. 87-126 does not mention section 501(m), that the Code provision does not apply to lessening the burdens of government organizations. However, the language of section 501(m) includes all organizations described in 501(c)(3) and (4); it does not differentiate based on an organization's charitable purpose. Thus, we conclude that the statutory requirements of section 501(m) apply to both the [redacted] and [redacted] organizations, thereby precluding exemption under sections 501(c)(3) and (c)(4) if they are found to provide "commercial-type insurance."

2. Are the organizations proving "commercial-type insurance?"

When section 501(m) was enacted, Congress made clear that providing insurance is an inherently commercial activity and that exemption under 501(c)(3) and (c)(4) will be precluded if an organization provides "commercial-type" insurance as a substantial part of its activities. Section 501(m)(4) provides that the issuance of annuity contracts shall be treated as providing insurance.

The [redacted] organization is providing health and accident insurance, a type of insurance provided by commercial insurance companies. [redacted]

The term, "commercial-type insurance" is not defined in the statute, although the statute provides for a number of specific exceptions. The legislative history states that commercial-type insurance is "any insurance of a type provided by commercial

insurance companies." H. Rep. 99-4226 at 663-665. At least two GCMs, GCM 39703 and GCM 39829,[6] indicate that in some cases the standard might be somewhat lower than the definition given in the legislative history. We stated in those GCM's that the meaning of commercial-type insurance "ordinarily will be based on all the facts and circumstances of any given case." Since the issuance of GCM 39703 and GCM 39829 three courts considering section 501(m) have accepted the definition of commercial-type insurance contained in the legislative history.[7] We see no reason for applying a lesser standard in this case. In our opinion, the [redacted] organization is precluded from exemption under section 501(c)(3) and (c)(4) unless it is within one of the statutory exceptions for commercial-type insurance, despite that fact that the insurance cannot easily or affordably be obtained elsewhere.

The [redacted] association provides benefits to members such as retirement benefits, disability benefits, and death benefits. As stated above, the "issuance of annuity contracts" is considered the provision of insurance for purposes of section 501(m). Based on the language of the statute, as well as the legislative history, we believe that retirement and welfare benefits fall within the meaning of this term. Section 501(m) provides for several exceptions to the definition of commercial-type insurance, in addition to the substantially-below-cost exception. One of these exceptions is for "providing retirement or welfare benefits" by specified church organizations. If Congress had not intended retirement and welfare benefits to fall within the meaning of the term "issuance of annuity contracts" there would have been no need to include a specific exception for the church organizations. Thus, we conclude that the association, by providing retirement and welfare benefits to its members, is providing commercial-type insurance for purposes of section 501(m). Thus, the [redacted] association must come within one of the statutory exceptions to commercial-type insurance to be exempt under 501(c)(3) or (4).

3. Is the insurance being provided substantially-below-cost?

The statutory exception to the definition of commercial-type insurance relevant here is for insurance provided at substantially below cost to a class of charitable recipients. There is no statutory definition of substantially below cost, and the Committee Reports merely refer to Rev. Rul. 71-529, 1971-2 C.B. 234, for the meaning of the term. In that Rev. Rul., the organization provided investment services to other exempt organizations for a nominal fee equal to about 15% of the organization's cost to provide the service.

The [redacted] organization provides health insurance at a premium charge to the insureds that the organization claims to be substantially below cost. [redacted] Our calculations, based on the financial documents in the administrative file, lead us to believe that the premium charge is, in fact, an even lower percentage of actual cost than what the organization

claims and comes very close to, if not within the 15% nominal fee of Rev. Rul. 71-529. Furthermore, unlike some other risk pools requesting exemption in the past, the funding and expenses do not seem to be so front-loaded that the premium charges in later years will amount to a significantly higher percentage of cost than in the organization's early years. The organization states that it's budgeting is set up so that it can continue operating in this same way for the next five years. The organization's large reserves for future operations (vs. its statutory reserves) evidences that this claim is realistic. Accordingly, in our opinion the [redacted] organization is providing insurance at substantially below cost. Thus, if the insurance is being provided to a "class of charitable recipients," within the meaning of section 510(m), its provision of insurance will not preclude its exemption under (c)(3) or (c)(4).

The [redacted] organization, on the other hand, even though it does not directly charge for its retirement or other benefits, is not, in our opinion, providing the benefits at substantially below cost, the reason being that the firefighters are indirectly paying for the benefits with their firefighting services. Although people often talk about an employee being "given" pension benefits, it is obvious that the benefits are really "earned" by the employee through his or her current or past services. We believe that the same reasoning applies here; that is, the organization is merely paying the firefighter amounts he or she has earned (and therefore, paid for) through his or her services.

4. Is the insurance being provided to a class of charitable recipients?

Section 501(m) does not define the phrase "class of charitable recipients" nor is the term used elsewhere in the Code, or even in the regulations. Under section 501(m)'s legislative history, the Committee Reports state that a class of charitable recipients refers to a group of recipients that would constitute a "charitable class" under present law. "Charitable class," however, is yet another undefined term.

We have found no strict legal meaning for the term "charitable class" in Scott, Bogert, or Restatement of Trusts 2d. However, the term is used several places in the Treasury regulations; namely in sections 1.509(a)-4(e), 53.4942(b)-2 and 53.4945-4(b)(2). The term has also been used in a number of published rulings and in GCMs, and occasionally in court opinions, but is used in so many different ways that it is difficult to ascertain any one particular meaning for the term. Sometimes the term is used in the context of charitable purpose (see, e.g., the revenue rulings concerning the elderly and handicapped), sometimes in the context of public vs private benefit (see American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), and Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978)). Other times the term is used to indicate the nature of the individuals comprising the group of potential recipients, or the size of the group (see regs. §53.4945-4(b)(2)), or the indefiniteness of the recipients, and sometimes to indicate all of

these elements (see Aid to Artisans, supra). In other words, the term is primarily used as a shorthand method for saying that an organization meets one or more requirements related to exempt organizations.

In order to determine the meaning of "charitable class" when used in the context of section 501(m), we have looked to see why different groups of recipients have or have not been term a charitable class.

a. The "needy" groups: the poor, distressed and underprivileged. These three groups are often referred to as "recognized" or "traditional" charitable classes, or charitable classes "per se." The most common is the indigent class (sometimes encompassing low income individuals). The Service has also recognized the elderly and the severely handicapped as charitable classes because they are distressed in a variety of ways. In addition, GCM 35210,[8] discussing an organization whose purpose is to aid in the rehabilitation of returning American prisoners of war, stated that the class to be aided is "without question a charitable class." (We assume they would be considered a needy class.) When the term "charitable class" is used in connection with these groups, the issue being discussed is usually whether the group of individuals have a special need or are distressed; and if so, do the activities of the organization satisfy these needs. For example, in GCM 36293,[9] discussing how housing assistance to low income persons can qualify as a charitable activity because it serves to relieve poverty, we stated that such an approach requires the recipients of financial or other forms of assistance to be needy in the sense of being unable to obtain the necessities of life without undue hardship. Also, the first time we recognized the elderly to be a charitable class, we indicated that in making that determination we considered that the senior citizen has a wide range of needs which qualify him as "a fit object for his fellow man's compassion."[10] The Service stated, in Rev. Rul. 77-246, 1977-2 C.B. 190, that it is generally recognized that the elderly and the handicapped, because of advanced age or disability, encounter forms of distress aside from financial considerations. The forms of distress that justify considering the elderly as a group a charitable class of individuals include housing, health care, financial security, and specialized recreation and transportation needs. Activities that serve to relieve such distress are considered charitable activities. However, the mere fact that a group is described as a charitable class does not mean that all activities undertaken on behalf of the group will be considered charitable. "In every case the question must be whether the activities of the organization ... are reasonably calculated to relieve the specific form of distress which causes the group to be termed a charitable class."[11]

b. A group of individuals that is the "object" or "target" of an organization's charitable purpose. The term "charitable class" is sometimes used in a broad sense to encompass those individuals that one would expect to be the beneficiaries of an organization, based on its charitable purposes, e.g., students of a university or

patients of a hospital. This seems to be the sense used in the sections 509, 4942 and 4945 regulations. For example, §1.509(a)-4(e) of the regulations provides that for determining whether an organization meets the permissible beneficiaries and permissible activities requirements for a supporting organization, consideration can be given to certain benefits provided to individual members of the charitable class benefited by a specific publicly supported organization. Under Example (1) of those regulations, alumni, faculty and students are treated as members of a charitable class benefited by a university (where the funding will be used to provided educational activities for the alumni and faculty, as well as the students); under Example (2), church members are treated as members of a charitable class benefited by a church; and Example (5) states that social workers and teachers from Central America are part of a charitable class benefited by an organization that aids underdeveloped nations in Central America. See, also, Regs. §§53.4942(b)-2 and 53.4945-4(b)(2). Rev.Rul. 75-437, 1975-2 C.B. 218, and Rev. Rul. 75-436, 1975-2 C.B. 217, both addressing section 509 issues, state that in granting scholarships to the graduates of a high school, a charitable trust is benefiting members of the charitable class benefited by the schools and governmental units which operate the schools. And in GCM 35897, we concluded that a foundation providing grants, scholarships and loans to members of a social fraternity is providing educational assistance to a charitable class.[12]

c. Organizations exempt under section 501(c)(3). In GCM 33980, involving an organization leasing office space to other exempt organizations, we concluded that exempt organizations comprise a "recognizable" charitable class. "To hold otherwise would put form over substance in that exempt organizations served are themselves providing services and benefits to the individuals residing in the local community. Accordingly, the activities of the organization do directly affect the public-at-large."[13]

d. The community as a whole. The public or community is, of course, the ultimate beneficiary of all charitable organizations. It is conceivable that where all individuals in a community are the potential recipients of direct benefits, (for example, a community swimming pool) that the community might be referred to as a charitable class.[14]

e. Individuals receiving benefits as mere "instruments." Some people may be benefited as the result of an organization's activities and the assistance will be considered "charitable" in nature as long as the effect is to benefit the community rather than merely individual recipients. In those cases, the individuals benefited are frequently regarded as the "means" or "instruments" to a charitable end. An example of this can be found in Rev. Rul. 72-559, 1972-2 C.B. 247, where legal interns received financial and other assistance from a charitable organization to provide assistance to economically depressed communities. The ruling concluded that the fact that the recipients of the organization's financial assistance, the legal interns, are not themselves members

of a charitable class does not preclude exemption. "The interns are merely instruments by which the charitable purposes are accomplished." GCMs 36744 and 39883 refer to such individuals as "noncharitable recipients acting as charitable instruments."[15]

How do the recipients of the benefits provided by the two organizations in issue here fit into the above groupings?

In our opinion, the Service should not conclude that an organization fails to provide insurance to a class of charitable recipients merely because the recipients are not indigent. The term "charitable class" used in the legislative history to define a class of charitable recipients is, itself, a term that can be applied to a number of groups or subgroups of beneficiaries. There is no indication that Congress intended that the term apply only to the most narrow use of the term -- namely, indigent persons who could not otherwise afford the insurance -- rather than a broader use of the term that would encompass either (1) a group of individuals who are in need of insurance for reasons other than poverty or (2) a group of individuals for which an organization's charitable purpose is intended to benefit. The use of the term, however, should not encompass a class of recipients who are merely instruments by which an organization's charitable purposes are accomplished, since under present law the term "charitable class" does not include such recipients.

Both organizations under consideration here have as at least one charitable purpose the lessening the burdens of government. But in our opinion the two organizations' recipients fall into separate classifications. We would classify those individuals receiving pension annuities from the [redacted] association as noncharitable recipients acting as mere instruments, while classifying those individuals receiving insurance from the [redacted] organization as needy, or at least the target of the organization's charitable purpose.

By paying pensions to volunteer firefighters, the [redacted] association is lessening the burdens of government by encouraging community members to volunteer their time and effort to fight fires. Thus, the organization is both accomplishing a purpose beneficial to the entire community and assisting the government in carrying out its function of preventing and controlling fires.[16] Also, generally, defraying the general or specific expenses of a city, county or state, or the payment of part of the government's debt is considered a governmental purpose.[17] However, we consider the firefighters here analogous to the legal interns in Rev. Rul. 72-559. The firefighters are receiving financial assistance in the form of retirement and welfare benefits from a charitable organization. There is no indication that the recipients are as a group distressed economically, or otherwise, or are particularly in need of the benefits. They are merely the means or instruments by which the charitable activities to prevent and control fires are accomplished and, accordingly, do not comprise a "charitable class" or a "class of charitable recipients" for purposes of section

501(m).

On the other hand, the [redacted] organization is lessening the burdens of government by ensuring that persons with a medical need and who probably would either not get the medical assistance or would go directly to the government for such care or financial assistance, will be able to obtain the needed care because of health insurance coverage. To us, these individuals, unlike the firefighters, are the target or objects of the organization's charitable purposes. However, we hesitate to say that any group that is the target of an organization's charitable purpose will always be considered a class of charitable recipients for purposes of section 501(m). And we do not think we have to go that far in this case because we believe that, as a group, those individuals receiving health coverage from the [redacted] organization are also a "needy" class, and should be considered a class of charitable recipients on that basis. The individuals receiving health coverage from the [redacted] organization, as a group, can be seen as distressed or needy. All recipients of the insurance coverage have a pre-existing medical condition so that not only their health but also their financial security is at risk. In our opinion, the fact that insurance companies refuse to insure them, or do so only at very high rates, results in a form of distress or a special need. They are needy in the sense of being unable to obtain the necessities of life without undue hardship. While these individuals, as a group, may not have the wide range of needs as do the poor or the elderly or the severely handicapped, we think that because of their very likely need for medical care and the very likely risk of financial ruin without insurance, they should be considered a "charitable class" or a "class of charitable recipients" for purposes of section 501(m).

CONCLUSIONS

We conclude that section 501(m) should preclude exemption in the case of the [redacted] because (1) the retirement and welfare benefits are in reality in payment for services performed by the firefighters and, therefore, cannot be considered provided substantially below cost; and (2) the recipients of the benefits, the firefighters, act merely as instruments of the association's charitable purpose of lessening the burdens of government, and are not themselves a charitable class or a class of charitable recipients for purposes of section 501(m). [redacted]

With respect to the [redacted] we conclude that section 501(m) does not preclude exemption. [redacted]

[redacted] We have also concluded that the insurance is provided to a class of charitable recipients. While the meaning of that term is far from clear, there is no indication that Congress intended to limit that term to a very narrow interpretation that would preclude providing medical insurance to sick individuals or those with pre-existing conditions. In fact, recent legislation indicates that Congress considers health insurance a basic necessity and wants to protect individuals with pre-existing conditions from financial risk through health insurance coverage. [redacted]

NOTES

1. Beginning in 1997, this organization may be exempt under new Code section 501(c)(26), enacted by sec. 341 of the Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191). At issue here is whether the organization is precluded from exemption under section 501(c)(4), and involves years prior to 1997.

2. Additional basic facts about the two organizations are set out in more detail in various memoranda in the two administrative files.

3. See GCM 38877, [redacted] EE-76-80 (Apr. 9, 1992), and GCM 38447, [redacted] EE-63-79 (Jul. 17, 1980). At one point in the [redacted] organization's request for exemption under 501(c)(4), the Service indicated that the organization must provide its insurance free of charge to those who cannot afford to pay the premiums charged. It should be noted that in Rev. Rul. 61-72, 1961-1 C.B. 188, the Service concluded that an organization that provides, at substantially-below-cost, care and housing to aged individuals who would otherwise be unable to provide for themselves without hardship qualifies for exemption despite the fact that it may exact a uniform fee from all the residents for admission to the home, making no provision for eliminating or reducing charges for those unable to pay the fee. The Service recognized in that ruling the charity is not limited to so-called "free" care of indigents, but may also be dispensed in the form of services below cost. (Rev. Rul. 61-72 distinguished Rev. Rul. 57-467, 1957-2 C.B. 313, which holds that a home for the aged that does not accept charity guests and requires the discharge of guests who fail to pay the required fee is not entitled to exemption, noting that in that ruling the services were not provided at less than cost.) Thus, as long as an organization provides its goods or services substantially-below-cost, there is no requirement that it provide the benefit without charge to those who cannot afford the set fee or premium.

4. GCM 37257, [redacted] I-262-73 (Sept. 15, 1977).

5. [redacted] id, at pp. 14-15.

6. GCM 39703, [redacted] EE-56-86 (Sept. 30, 1987), and GCM 39829, [redacted] EE:TR-58-28-90 (Aug. 24, 1990).

7. Paratransit Insurance Corp. v. Commissioner, 102 T.C. 745, 754 (1994); Florida Hospital Trust v. Commissioner, 103 T.C. 140, 158 (1994), aff'd 71 F.3d 808 (11th Cir. 1994); see, also, Nonprofits' Insurance Alliance of California v. United States, 32 Fed. Cl. 277 (1994).

8. GCM 35210, [redacted] I:I-5138 (Jan. 26, 1973).

9. GCM 34073, [redacted] I-2836 (Mar. 12, 1969).

10. GCM 36293, [redacted] I-214-73 (May 30, 1975).

11. GCM 39487, [redacted] EE:-86-85 (Mar. 21, 1986).

12. GCM 35897, [redacted] I-452-73 (July 15, 1974).

13. GCM 33980, [redacted] I:I-3126 (Nov. 22, 1988).

14. Id.

15. GCM 36744 [redacted] I-153-75 (May 25, 1976); GCM 39883, [redacted] EE:TR-45-335-90 (Apr, 1, 1992).

16. See Rev. Rul. 71-99, 1971-1 C.B. 151.

17. See GCM 39613, [redacted] EE-125-86 (Jan. 28, 1987), and authorities discussed therein.