Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact: [redacted]

Telephone Number: [redacted]

Refer Reply to: CP:E:EO:T:1:[redacted]

Date: JAN 10 1997

Employer Identification Number: [redacted]
Key District: [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.

FACTS

You were incorporated on [redacted] as a nonprofit public benefit corporation under the laws of [redacted]. According to your Bylaws, your purpose is to establish an integrated health care delivery system to provide hospital and physician services to persons in [redacted] through managed care contracts with employers, insurers and other payors of medical services.

Your Articles of Incorporation and Bylaws provide that you have two categories of members, [redacted] and [redacted]. Your sole [redacted] is the [redacted] ("Trust"), an organization exempt under section 501(c)(3) of the Code and affiliated with [redacted] (the "System") and [redacted] ("Hospital"). Your [redacted] are comprised of licensed physicians engaged in the private practice of medicine who are members of the medical staff of the [redacted]. All of your [redacted] have entered into agreements ("Physician Provider Agreements") with your organization for the provision of professional services under health care contracts ("Managed Care Contracts") which you have entered into with various entities, such as employers, insurers, third-party administrators, preferred provider organizations, health maintenance organizations, etc. ("Contractors").

[redacted]

Under your Bylaws, the [redacted] and the [redacted] each elect an equal number of persons on your Board of Directors. One of the Directors elected by the [redacted] must be the Chief Executive Officer of the System. In addition, the Members must elect at least one Director who is a "community representative," a person who is neither a physician nor an employee of the System. Currently, your Board is comprised of seven persons: three Directors elected by the [redacted], three Directors elected by the [redacted] one of whom is the CEO of the System; and one community representative. Your Bylaws do not contain a conflicts of interest policy.

Your Bylaws provide that your [redacted] each pay a membership fee of $[redacted] and your [redacted] pays a membership fee equal to the total membership fees paid by the [redacted]. Additional "dues" or "assessments" may be levied on your members by a vote of two-thirds of your Board, but no more often than semiannually.

Under a typical Physician Provider Agreement, a physician agrees to provide professional medical services to the individuals employed or covered ("Covered Persons") under Managed Care Contracts with Contractors. A physician may continue to provide professional medical services to other patients and may participate in other plans, programs or networks providing medical services to patients. Under a Physician Provider Agreement, you agree to develop a network of physicians, hospitals and other health care providers to provide medical care to Covered Persons; to market the professional medical services of these providers; and to develop, negotiate, enter into and administer Managed Care Contracts with Contractors. Under certain circumstances, you may provide billing and collection services for physician providers.

Currently, you have entered into three Managed Care Contracts, the largest of which is with [redacted]. Under this contract, you agree to require your contracted physician and hospital providers to provide health care services to Covered Persons.

You have also entered into a Hospital Provider Agreement with the System. Under this agreement, the [redacted] agrees to provide medical services to Covered Persons as ordered by the physician providers. These services are provided by persons employed by or under contract with the Hospital. Under this agreement, you agree to develop a network of physicians, hospitals and other health care providers to provide medical care to Covered Persons; to market the professional medical services

[redacted]

of these providers; and to develop, negotiate, enter into and administer Managed Care Contracts with Contractors.

LAW

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(b)(1) of the Income Tax Regulations provides 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 1.501(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."

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), Trusts, sec. 368 and sec. 372; IV Scott on Trusts (3d Ed. 1967), sec. 368 and sec. 372; and Rev. Rul. 69-545, 1969-2 C.B. 117.

[redacted]

Rev. Rul. 69-545, supra, provides that an organization whose purpose and activity are providing hospital care is promoting health and it may therefore qualify as organized and operated in furtherance of a charitable purpose if it meets the other requirements of section 501(c)(3) of the Code. The Service cited various favorable factors in reaching this conclusion.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization will not be considered as operated exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Furthermore, an exempt organization may not be operated, directly or indirectly, for the benefit of private interests. See section 1.501(c)(3)-1(d)(1)(ii) and Rev. Rul. 69-545, supra.

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.

Rev. Rul. 54-305, 1954-2 C.B. 127, describes an organization whose primary purpose is the operation and maintenance of a purchasing agency for the benefit of its otherwise unrelated members who are exempt as charitable organizations. The revenue ruling held that the organization did not qualify under section 101(6) of the Code (the predecessor to section 501(c)(3)) because its activities consisted primarily of the purchase of supplies and the performance of other related services. The revenue ruling stated that such activities in themselves cannot be termed charitable, but are ordinary business activities.

Rev. Rul. 69-528, 1969-2 C.B. 127, describes an organization formed to provide investment services on a fee basis only to organizations exempt under section 501(c)(3) of the Code. The organization invested funds received from participating tax-exempt organizations. The service organization was free from the control of the participating organizations and had absolute and uncontrolled discretion over investment policies. The ruling held that the service organization did not qualify under section 501(c)(3) of the Code and stated that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

[redacted]

Rev. Rul. 72-369, 1972-3 C.B. 245, describes an organization formed to provide management and consulting services at cost to unrelated exempt organizations. This revenue ruling states:

> Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The fact that the services in this case are provided at cost and solely for exempt organizations is not sufficient to characterize this activity as charitable within the meaning of section 501(c)(3) of the Code.

In Rev. Rul. 77-3, 1977-1 C.B. 140, a nonprofit organization that provides rental housing and related services at cost to a city for its use as free temporary housing for families whose homes have been destroyed by fire is not an exempt charitable organization. This revenue ruling states:

> [I]t is the city rather than the organization that is providing free temporary housing to the distressed families. The organization is merely leasing housing property and providing certain maintenance and other services in connection therewith to the city at cost in a manner similar to organizations operated for profit, and is not itself engaged in charitable activities.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the organization entered into consultant-retainer relationships with five or six limited resource groups involved in the fields of health, housing, vocational skills and cooperative management. The organization's financing did not resemble that of the typical section 501(c)(3) organization. It had neither solicited, nor received, any voluntary contributions from the public. The court concluded that because its sole activity consisted of offering consulting services for a fee, set at or close to cost, to nonprofit, limited resource organizations, it did not qualify for exemption under section 501(c)(3) of the Code.

In Christian Stewardship Assistance, Inc. v. Commissioner, 70 T.C. 1037 (1978), a nonprofit corporation that assisted charitable organizations in their fund raising activities by providing financial planning advice on charitable giving and tax planning to wealthy individuals was held not to qualify under section 501(c)(3) of the Code because its tax planning services were a substantial nonexempt activity enabling the corporation to provide commercially available services to wealthy individuals free of charge.

[redacted]

An organization that merely promotes health, without more, is not entitled to recognition of exemption under section 501(c)(3) of the Code. For example, while selling prescription pharmaceuticals promotes health, pharmacies cannot qualify for recognition of exemption under section 501(c)(3) on that basis alone. In Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980), the Tax Court stated, at 72 T.C. 692:

> Virtually everything we buy has an effect, directly or indirectly, on our health. We do not believe that the law requires that any organization whose purpose is to benefit health, however, remotely, is automatically entitled, without more, to the desired exemption.

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.

In Rev. Rul. 78-41, 1978-1 C.B. 148, a trust created by a hospital to accumulate and hold funds to pay malpractice claims against the hospital was determined to be an integral part organization because the hospital exercised significant financial control over the trust. This was because the trustee was required to make payments to claimants at the direction of the hospital, the hospital provided the funds for the trust and the hospital directed where the funds from the trust were to be paid.

Rev. Rul. 70-535, 1970-2 C.B. 117, describes an organization formed to provide management, development and consulting services for low and moderate income housing projects for a fee. The revenue ruling held that the organization did not qualify under section 501(c)(4) of the Code. The revenue ruling stated:

> Since the organization's primary activity is carrying on a business by managing low and moderate income housing projects in a manner similar to organizations operated for profit, the organization is not operated primarily for the promotion of social welfare. The fact that these services are being performed for tax exempt corporations does not change the business nature of the activity.

[redacted]

Rev. Rul. 86-98, 1986-2 C.B. 74, involved an individual practice association (IPA) of private practice physicians whose purpose was to arrange for the delivery of health services through contracts negotiated with health maintenance organizations (HMOs). The IPA's primary activities were to serve as a bargaining agent for its members in dealing with HMOs and to perform the administrative claims services required by the agreements negotiated with the HMOs. The Service found that the IPA did not provide to HMO patients access to medical care which would not have been available but for the establishment of the IPA, nor did it provide such care below reasonable and customary fees. Because the IPA operated in a manner similar to organizations carried on for profit and its primary beneficiaries were its member-physicians rather than the community as a whole, the Service denied the IPA exemption under sections 501(c)(4) and 501(c)(6) of the Code.

RATIONALE

1. While the promotion of health is considered a charitable purpose within the meaning of section 501(c)(3) of the Code, providing ordinary commercial services for a group of health care providers does not directly promote health. There is no broad community benefit that results from such activities. Providing these services is not a charitable activity but rather an ordinary commercial activity. The fact that one of these health care providers is tax-exempt is irrelevant. See Rev. Rul. 54-305, supra; Rev. Rul. 69-528, supra; Rev. Rul. 72-369, supra; Rev. Rul. 77-3, supra; B.S.W. Group, Inc., supra; Christian Stewardship Assistance, Inc., supra; Federation Pharmacy Services, Inc. v. Commissioner, supra; and Living Faith, Inc. v. Commissioner, supra. The various network, marketing, negotiating and administration services that you provide for your [redacted] are ordinary commercial services. Thus, you are not a direct provider of health care services.

Therefore, you are neither organized nor operated exclusively for charitable purposes under sections 1.501(c)(3)-1(b) and 1.501(c)(3)-1(c)(1) of the regulations. For the same reasons, you would not qualify as an organization described in section 501(c)(4) of the Code. See Rev. Rul. 70-535, supra, and Rev. Rul. 86-98, supra.

2. When an exempt health care organization, such as a hospital, conducts various essential services or support activities that do not constitute the direct provision of health care services (e.g., management, fiscal, administrative or investment services), the hospital's exemption is not jeopardized

as long as the activities are not of such magnitude or character that the Service questions whether the hospital has a substantial non-exempt purpose (see Better Business Bureau of Washington, D.C., supra) or whether private interests are being served more than incidentally. The revenue rulings discussed above provide examples of substantial commercial activities that did not further the tax-exempt purposes of the organizations. The various network, marketing, negotiating and administration services that you provide for your [redacted] are not charitable activities because these services are indistinguishable from ordinary commercial activities. You are not furnishing these services on a charitable basis but are providing them to your [redacted] in return for specific membership fees, "dues" and assessments." These activities reflect a substantial nonexempt purpose that disqualifies you for exemption under section 501(c)(3) of the Code. Because these activities represent more than an insubstantial part of your activities, they cause you to fail the "operational test" under section 1.501(c)(3)-1(c)(1) of the regulations because you are not "operated exclusively" for a tax-exempt purpose.

3. Under section 1.502-1(b) of the regulations, one organization may derive its exemption from a related organization exempt under section 501(c)(3) of the Code if it 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.

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. Since you are controlled by the Trust, a tax-exempt organization, and by physicians engaged in the private practice of medicine, you do not satisfy this first requirement.

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.

Under the regulations, however, 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

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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.

Similarly, 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.

You are controlled by the Trust, a tax-exempt organization, and by physicians engaged in the private practice of medicine. Therefore, if the Trust regularly carried on the various network, marketing, negotiating and administration services that you provide for your [redacted], the Trust would be considered as engaged in an unrelated trade or business. Therefore, the services you provide for your [redacted]s are not essential services and you do not satisfy the second requirement.

As a result, you do not qualify for exemption under section 501(c)(3) of the Code as an integral part of the Trust. See Rev. Rul. 78-41, supra.

4. The various network, marketing, negotiating and administration services that you provide for your [redacted] M[redacted] result in providing them with a substantial economic benefit in the form of a stream of additional patients. With respect to the [redacted] on your Board of Directors, this economic benefit violates the proscription against private inurement in section 1.501(c)(3)-1(c)(2) of the regulations. With respect to the other P[redacted], this economic benefit violates the proscription against substantial private benefit in section 1.501(c)(3)-1(d)(1)(ii). Therefore, you are not operated exclusively for charitable purposes and do not qualify for exemption under section 501(c)(3) of the Code.

The economic benefit you provide to your [redacted] would also prevent you from being recognized as exempt under sections 501(c)(4) or 501(c)(6) of the Code. See Rev. Rul. 86-98, supra.

5. The promotion of health is considered a charitable purpose in the general law of charity. Thus, a health care organization may qualify as organized and operated in furtherance of charitable purposes if it is operated to benefit the community as a whole rather than private individuals or interests. Rev.

[redacted]

Rul. 69-545, supra, establishes a community benefit standard that focuses on a number of factors to determine whether a hospital operates to benefit the community as a whole rather than private interests. In this revenue ruling, control of a tax-exempt hospital by a board of trustees composed of "independent civic leaders" was a significant fact. The application of the community benefit standard of Rev. Rul. 69-545, supra, 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, 71 T.C. 158 (1978), acq., 1981-2 C.B. 2. One significant fact that will help demonstrate that a tax-exempt health care organization promotes the health of the community as a whole, rather than benefiting private interests, is the organization's adoption of a substantial conflicts of interest policy.

You have not adopted such a policy. Therefore, in the absence of a substantial conflicts of interest policy, it cannot be presumed that you satisfy the community benefit standard of Rev. Rul. 69-545, supra. Therefore, you have failed to establish that you will be operated exclusively for charitable purposes under section 1.501(c)(3)-1(c)(1) of the regulations.

CONCLUSION

For the reasons stated above, 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, 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 Practice 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 judgment or

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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 copies will be forwarded to your key district office. Thereafter, any questions 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 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]
CP: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,

(Signed) Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1