Internal Revenue Service
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Department of the Treasury
Washington, DC 20224

COPY FOR YOUR INFORMATION

Person to Contact: [redacted]
Telephone Number: [redacted]
Refer Reply to: [redacted]
Date: APR 23 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 March 11, 1994 as a nonprofit corporation under [redacted] According to your Certificate of Incorporation, your purposes include supporting and advancing the cooperative efforts of [redacted] and [redacted] Your activities include negotiating and reviewing managed care contracts on behalf [redacted]

Your two members are the [redacted] has been recognized by the Internal Revenue Service as an organization described in section 501(c)(3) of the Code. [redacted] practice association comprised of independent physicians engaged in the private practice of medicine who are on the hospital staff of the [redacted] enters into separate provider agreements with each of its member physicians.

On December 30, 1993, you entered into a service agreement with the [redacted] to provide hospital services to third party purchasers of medical services with whom you may contract. On the same date, you entered into a service agreement with [redacted] for its physician members to provide physician services to third party purchasers of medical services with whom you may contract. In 1995, you entered into an agreement [redacted] a nonprofit, non-exempt preferred provider

[redacted]

organization, to provide hospital and physician services to the third-party payors with whom [redacted]

Your board of trustees is comprised of 12 persons, six of whom are independent physicians engaged in the private practice of medicine and members[redacted]d six of whom are appointed by the [redacted]

You have not adopted a substantial conflicts of interest policy.

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."

[redacted]

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization will not be considered as operating exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized exclusively for any of the purposes specified in section 501(c)(3) unless it serves public, rather than private interests. Thus, an organization applying for tax exemption under section 501(c)(3) must establish that it is not organized or operated for the benefit of private interests.

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.

Rev. Rul. 69-545, supra, provides that an organization whose purpose and activity are providing hospital care is promoting health and 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. The Service noted that a determination of private benefit depends on all the relevant facts and circumstances and the absence of particular factors as set forth in the revenue ruling or the presence of other factors will not necessarily be determinative.

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 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

[redacted]

the performance of other related services. The 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.

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 ruling held that the organization did not qualify under section 501(c)(4) of the Code. The 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."

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. The ruling stated: "An organization is not exempt merely because its operations are not conducted for the purposes of producing a profit . . . providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit."

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 Rev. Rul. 78-41, 1978-1 C.B. 148, a trust created by a hospital to accumulate and hold funds to pay malpractice claims

[redacted]

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.

RATIONALE

1. While the promotion of health is considered a charitable purpose within the meaning of section 501(c)(3) of the Code, arranging for the delivery of health care services, which services are otherwise available, does not directly promote health. There is no broad community benefit in arranging for the provision of health care services to subscribers. [redacted] and its physician members engaged in the private practice of medicine, to provide health care services to third parties is not a charitable activity.

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.

2. 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.

Related - The related organization must be structurally related, not just functionally related, to be considered related for purposes of the integral part theory. Your organization is controlled by a board of directors of which half are elected by [redacted] the organization from which you seek to derive your exemption, and half are elected [redacted] a non-exempt individual practice association comprised of physicians engaged in the private practice of medicine. [redacted] is not structurally related to [redacted] Fifty percent control by the [redacted] does not constitute a sufficient level of control to satisfy the structurally related requirement because [redacted] has effectively a veto power over board matters.

Essential Services - 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

[redacted]

by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. If you were controlled solely by [redacted] and negotiated and reviewed managed care contracts on behalf of [redacted] alone, it is likely that you would satisfy the essential services requirement as well as the relatedness requirement.

Under the regulations, a subsidiary organization that is engaged in an activity that would be considered an unrelated trade or business if it were regularly carried on by the exempt parent, does not qualify for derivative exemption. 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 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. See section 1.502-1(b) of the regulations.

Based on the authorities discussed above, if your activities, negotiating and reviewing managed care contracts on behalf of [redacted] and its physician members engaged in the private practice of medicine, were provided by [redacted] these activities would constitute an unrelated trade or business that is regularly carried on. Under section 1.502-1(b) of the regulations, these activities are not "essential" services that you provide for the [redacted] Therefore, you do not qualify for exemption as an integral part [redacted]

3. 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.

Negotiating and reviewing managed care contracts on behalf of the [redacted] a non-exempt organization unrelated to the [redacted] and on behalf of [redacted] physician members engaged in the private practice of medicine, result in a substantial economic benefit to [redacted] which controls 50% of your board of trustees, and to its individual physician members, by providing these physicians with a stream of

[redacted]

managed care patients. This private benefit violates the proscriptions against private inurement and substantial private benefit. Therefore, you are not operated exclusively for charitable purposes and do not qualify for exemption.

4. When an exempt 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. Negotiating and reviewing managed care contracts on behalf of [redacted] on behalf of [redacted] a non-exempt organization unrelated to the [redacted] and on behalf [redacted] physician members engaged in the private practice of medicine, is a commercial activity that does not further your tax-exempt purpose. Because this activity represents more than an insubstantial part of your activities, it causes 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.

5. Since promotion of health is considered a charitable purpose in the general law of charity, a health care organization may qualify as organized and operated in furtherance of charitable purposes provided it is operated to benefit the community as a whole rather than private individuals or interests. Rev. Rul. 69-545, 1969-2 C.B. 117, establishes a community benefit standard that focuses on a number of factors indicating whether the operation of a hospital benefits 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.

[redacted]

Therefore, a majority of the voting members of the board of trustees of a tax-exempt health care organization should be comprised of independent community members. Since [redacted] elects half of your board of directors, there is no assurance that a majority of the voting members of your board will be comprised of independent community members.

In an exempt health care organization, all transactions and arrangements should be negotiated and approved by a board of independent trustees. Therefore, when a community board of trustees is subject to a substantial conflicts of interest policy, that helps ensure that the board will operate in an objective manner.

One significant fact that will help demonstrate that a tax-exempt health care organization is operating to promote the health of the community as a whole rather than to benefit private interests is the organization's adoption of a substantial conflicts of interest policy. The policy should apply to any transaction or arrangement with an "interested person." An "interested person" is a trustee, a principal officer or a member of a committee with board-delegated powers who has a direct or indirect financial interest. There is no indication that you have adopted a substantial conflicts of interest policy of this nature.

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 Practices Requirements.

[redacted]

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 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]
1111 Constitution Ave, N.W.
Washington, D.C. 20224

For your convenience, our FAX number is (202) 622-5797.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

[redacted]

[redacted]