Internal Revenue Service
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Department of the Treasury

Washington, DC 20224

Contact Person: [redacted]

Telephone Number: [redacted]

In Reference to: CP:E:EO:T:1:[redacted]

Date: AUG 8 1997

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

Dear Applicant:

We have reconsidered 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). In our letter dated [redacted], we proposed to deny your application for exemption under section 501(c)(3). In your letters dated [redacted], you submitted additional information relating to your organization. Based on this additional information, we have determined that our [redacted] letter is now factually incorrect. Accordingly, that letter is hereby revoked and our position is restated herein.

Based on the information in your application and the additional information you subsequently submitted, we have concluded that you do not qualify for exemption under section 501(c)(3). The basis for our conclusion is set forth below.

FACTS

You were incorporated on [redacted] as a not for profit corporation [redacted]. According to your articles of incorporation, your purposes include furthering improvements in the quality and accessibility of mental health care services.

You were organized by [redacted] providers of mental health services located [redacted]. All of these providers are exempt under section 501(c)(3) of the Code and all are currently members of your organization. All of your members provide a comprehensive range of behavioral and mental health services, including prevention and wellness, crisis intervention, psychiatric evaluation and chemical dependency. Under your bylaws, your members elect your board of directors. You have adopted a substantial conflicts of interest policy.

[redacted]

Paragraph Third of your articles of incorporation states that you are organized and operated exclusively for charitable and educational purposes within the meaning of section 501(c)(3) of the Code. Paragraph Third also states that your activities shall include furthering improvements in the quality and accessibility of mental health care services.

[redacted] your bylaws, as amended, provides that your purpose is "to directly provide managed behavioral healthcare services to [redacted] through [your] employees and independent contractors." In addition, [redacted] provides that you also "create and develop behavioral healthcare services that expand [your] customer base and the service delivery capacity of [your] members," and that pursuant to this purpose, you will provide "integrated management services" to your members. These services will include the following:

1. Marketing of your organization;
2. Centralized point of entry to services;
3. Centralized coordination of care;
4. Centralized continuous quality improvement;
5. Centralized billing;
6. Provision of consultation, professional development and community education; and
7. Research and development of new behavioral care products and services.

Therefore, based on your articles of incorporation and your amended bylaws, you are engaged in two related activities, as described below.

1. One activity consists of providing "integrated management services" to your members. Pursuant to an agreement you entered into with your members dated [redacted] ("Services Agreement"), you seek "to further [your] purposes by providing administrative support, planning, coordination and other services to organizations which promote behavioral health." [redacted] the Services Agreement, you provide the following services to your members:

   A. Quality Control Services
   B. Long-range Planning Services
   C. Coordination
   D. Credentialing Services
   E. Third Party Payor Contract Negotiating

[redacted]

In addition, [redacted] the Services Agreement provides that you may provide additional services to your members upon agreed terms. According to [redacted], your members pay for the services they receive from your organization. These payments consist of an application fee of $[redacted] an initial payment based on an assessment established by the board of directors, periodic payments based on the amount periodically assessed by the board of directors, and special payments for services or supplies requested by and provided to a particular member. Your [redacted] budget includes application fees of $[redacted] and member assessments of $[redacted], a total of $[redacted] or [redacted] percent of total budgeted revenue.

2. Your second activity involves the provision of behavioral health services to the patients, enrollees or members of various organizations, such as state agencies, insurance companies, hospitals, health maintenance organizations, etc. You provide these services through contracts with independent providers. All of these independent providers are employees of, or contractors to, the members of your organization.

On [redacted] your members adopted a resolution authorizing you to provide behavioral health services to three organizations. Currently, you have contracts to provide behavioral health services to the following organizations: [redacted] Your [redacted] budget includes revenues from these organizations of approximately $[redacted], or about [redacted] percent of total budgeted revenue.

You have not adopted a charity care policy. Other than through your contractual obligations under these contracts, you do not independently provide behavioral health care services to medically underserved persons in the community for free or at reduced rates. Further, you do not conduct health care education programs that are open to the community for free or at nominal charges and you do not perform medical or health care research.

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.

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.

In Geisinger Health Plan v. Commissioner, 985 F.2d 1210 (3d Cir. 1993 ("Geisinger"), a health maintenance organization did not qualify for exemption under section 501(c)(3) of the Code because it did not primarily benefit the community; rather, it primarily benefited its enrollees.

[redacted]

Section 501(e) of the Code provides that a cooperative hospital service organization is treated as if it were exempt under section 501(c)(3) if it performs certain specific service activities enumerated in the statute for two or more exempt hospitals and allocates or pays, within 8-1/2 months after the end of the year, all net earnings to its members on the basis of the services performed for them.

Section 1.501(e)-1 of the regulations provides that section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization.

Section 1.170A-9(c)(1) of the regulations defines a "hospital" as including a community mental health or drug treatment center that provides medical care. Medical care includes the treatment of any mental disability or condition, whether on an inpatient or outpatient basis, provided that the cost of such treatment is deductible as a medical expense under section 213 by the person treated.

In HCSC-Laundry v. U.S., 450 U.S. 1 (1981), the Supreme Court held that a cooperative laundry organization that served exempt organizations could not qualify as exempt under section 501(c)(3) because laundry services is not one of the activities enumerated in section 501(e).

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 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. 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.

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.

RATIONALE

In essence, you are engaged in two principal activities. One activity is providing behavioral and mental health care services for various third parties, which you do with employed and contracted professionals. Your other activity is providing various administrative and management services for your member organizations.

1. 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. Rul. 69-545, 1969-2 C.B. 117, 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. 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. Another significant fact is that the board of directors requires the conduct of periodic reviews of the organization's activities to ensure that it is operating in a manner consistent with accomplishing its

[redacted]

exempt purposes and that its operations do not result in private inurement or impermissible benefit to private interests.

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. Thus, to qualify for exemption under section 501(c)(3) of the Code, you must demonstrate that you satisfy the community benefit standard.

You have adopted a substantial conflicts of interest policy, which includes provisions for periodic reviews. However, you have not adopted a charity care policy; you provide behavioral or mental health services only to persons designated by your contracted third party payors; you do not independently provide behavioral or mental health care services to indigents, the elderly or to other persons generally considered to be medically underserved; you do not conduct health care education programs for the community; and you do not perform medical or health care research. To the extent that you engage in any of these activities, you do so pursuant to your contractual obligations with third party payors, not on your own.

Therefore, based on all the facts and circumstances, you do not satisfy the community benefit standard of Rev. Rul. 69-545, supra.

2. 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.

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 these health care

providers are 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 provision of "integrated management services" for your member organizations is not a charitable activity 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 members in return for specific payments plus additional amounts assessed by your Board. You may also provide additional services to your members as may be required, for which a member will make additional payments. Providing these services for your members is a commercial activity that does not further your tax-exempt purpose. In [redacted], almost [redacted] percent of your revenue is expected to come from providing these services. Because this activity represents more than an insubstantial part of your total activities, 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.

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. 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, 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 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. 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.

You are controlled by several unrelated exempt organizations and operate for the purpose of providing various administrative and management services to your members, all of which are exempt organizations. If any one of your members regularly carried on these activities for the other members, these activities would be an unrelated trade or business. Therefore, the services you provide for your members are not essential services. As a result, you do not qualify for exemption under section 501(c)(3) of the Code. See Rev. Rul. 78-41, supra.

4. An organization that provides services for more than one exempt hospital, including community mental health clinics, may qualify for exemption under section 501(c)(3) if it meets the requirements of Section 501(e) of the Code. However, the exemption applies only to organizations providing the services specifically enumerated in the statute and the regulations. Since section 501(e) is the exclusive means by which a hospital service organization may qualify for exemption under section 501(c)(3) (see section 1.501(e)-1 of the regulations and HCSC-Laundry, supra), a hospital service organization providing services other than those specifically enumerated in the statute does not qualify.

The various services you provide for your members, which are considered hospitals under section 1.170A-9(c)(1) of the regulations, are not the services specifically enumerated in section 501(e) of the Code. Furthermore, you do not meet the requirements of section 501(e)(2) regarding allocation or payment of net earnings. Therefore, under section 501(e), you do not qualify as an organization that is treated as exempt under section 501(c)(3).

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.

[redacted]

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 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 thirty (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]

[redacted]

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

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1