Internal Revenue Service

Department of the Treasury

Washington, DC 20224

[redacted]

Contact Person: [redacted]

Telephone Number: [redacted]

In Reference to: [redacted]

Date: [redacted]

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.

According to your Form 1023 Application, you were incorporated on [redacted] as a [redacted] nonprofit corporation. Your articles of incorporation state your purpose as "[redacted] Each member must be "a health care provider licensed in the State of Florida and registered with the Secretary of State." You filed your application on [redacted] You request [redacted] status for the prior period.

Your purpose is to help your members obtain health care contracts on a group basis with outside organizations that the members might not obtain individually due to their small size. Your [redacted] are providers of behavioral health care (e.g., mental health and substance abuse treatment), unrelated to one another. Your members are exempt under section 501(c)(3) of the Code except for [redacted], which is exempt under section 501(c)(4). You are a feeder-type organization.

Your bylaws provide that each member has one or more director representatives and one vote regardless of director representation. New members must be approved by unanimous vote.

You request an advance public charity ruling under section 509(a)(2) of the Code. Your initial support will come from member contributions (you do not intend to require dues of members). Thereafter, income from contracts awarded through you

[redacted]

will offset your expenses. You had the following revenues and expenses in the following tax years:

item	[redacted]
member contributions	
gross business receipts	
[redacted]	
operating expenses	
excess revenue	

It is intended that generated surplus in any one year will be used to offset future contributions required to operate. Your bylaws provide for refunds of annual cash surplus to the members, allocated in a manner determined by the board.

Section 170(b)(1)(A)(iii) of the Code refers to certain hospitals and medical research organizations.

Section 501(c)(3) of the Code exempts from federal income tax organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 501(c)(4) of the Code exempts from federal income tax civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 501(e) of the Code provides that an organization shall be treated as organized and operated exclusively for charitable purposes, if

(1) such organization is organized and operated solely--

> (A) to perform, on a centralized basis, one or more of the following services which, if performed on its own behalf by a 501(c)(3) hospital, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption: data processing, purchasing (including the purchasing of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services; and

[redacted]

(B) to perform such services solely for two or more hospitals each of which is--

(i) a 501(c)(3) organization,

(ii) a constituent part of a 501(c)(3) organization and which, if organized and operated as a separate entity, would constitute a 501(c)(3) organization, or

(iii) owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of any of the foregoing;

(2) such organization is organized and operated on a cooperative basis and allocates or pays, within 8 1/2 months after the close of its taxable year, all net earnings to patrons on the basis of services performed for them; and

(3) if such organization has capital stock, all of such stock outstanding is owned by its patrons.

Section 502 of the Code provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.

Section 1.170A-9(c)(1) of the Income Tax Regulations provides that a rehabilitation institution, outpatient clinic, or community mental health or drug treatment center may qualify as a "hospital" within the meaning of section 170(b)(1)(A)(iii) of the Code if its principal purpose or function is the providing of hospital or medical care. The term "medical care" includes the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, provided the cost of such treatment is deductible under section 213 by the person treated.

Section 1.501(a)-1(c) of the regulations states that the words "private shareholder or individual" refer to persons having

[redacted]

a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(b)(1)(i) of the regulations provides generally 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 "operates exclusively" for exempt purposes only if it engages primarily in activities that accomplish such purposes. It does not operate exclusively for exempt purposes if more than an insubstantial part of its activities does not further such purposes.

Section 1.501(c)(4)-1(a)(2)(i) of the regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements.

Section 1.501(c)(4)-1(a)(2)(ii) of the regulations provides that an organization is not operated primarily for the promotion of social welfare if its primary activity is carrying on a business with the general public in a manner similar to organizations which are operated for profit.

Section 1.501(e)-1(a) of the regulations provides that section 501(e) of the Code is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization. A cooperative hospital service organization which meets the requirements of section 501(e) and section 1.501(e)-1(a) shall be treated as described in section 501(c)(3). In order to qualify for tax exempt status, a cooperative hospital service organization must--

(1) Be organized and operated on a cooperative basis,

[redacted]

(2) Perform, on a centralized basis, only one or more specifically enumerated services which, if performed directly by a tax exempt hospital, would constitute activities in the exercise or performance of the purpose or function constituting the basis for its exemption, and

(3) Perform such service or services solely for two or more patron-hospitals as described in section 1.501(e)-1(d).

Section 1.501(e)-1(b) of the regulations provides that a 501(e) organization must be organized and operated on a cooperative basis (whether or not under a specific statute on cooperatives). Exemption will not be denied solely because the organization accumulates funds for any necessary purpose instead of paying all net earnings to its patron-hospitals, so long as the funds are not accumulated beyond the reasonably anticipated needs of the organization.

Section 1.501(e)-1(d)(3) of the regulations provides that an organization does not meet the requirements of section 501(e) of the Code if, in addition to performing services for 501(c)(3) patron-hospitals, the organization performs any service for any other organization. For example, a cooperative hospital service organization is not exempt if it performs services for convalescent homes for children or the aged, vocational training facilities for the handicapped, educational institutions which do not provide hospital care in their facilities, and proprietary hospitals, unless such services are de minimis and are mandated by a governmental unit as, for example, a condition for licensing.

Section 1.502-1(a) of the regulations provides that in determining the primary purpose of an organization, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities specified in the applicable paragraph of section 501.

Section 1.502-1(b) of the regulations provides that if a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a

[redacted]

tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization 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 (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. For purposes of this paragraph, organizations are related only if they consist of:

(1) A parent organization and one or more of its subsidiary organizations; or

(2) Subsidiary organizations having a common parent organization.

An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.

Rev. Rul. 69-528, 1969-2 C.B. 127, held not exempt under section 501(a) of the Code an organization formed to provide investment services for a fee exclusively to 501(c)(3) organizations. The organization was free from the control of the participants and had absolute and uncontrolled discretion in investing decisions, distributions of income or principal. The Service reasoned that providing investment services on a regular basis for a fee is a business ordinarily carried on for profit and would constitute unrelated business if conducted by one tax-exempt organization for other tax-exempt organizations (citing section 502).

Rev. Rul. 71-529, 1971-2 C.B. 234, held exempt under section 501(c)(3) of the Code an organization that provided assistance in the management of investment funds of member 501(c)(3) universities for a charge substantially below cost. The organization received capital from the participating exempt organizations and placed it in common funds in the custody of various banks. These common funds were controlled and managed by

[redacted]

the organization. The funds were invested upon the advice of independent investment counsel retained by the organization. Its board of directors was composed of representatives of the member organizations. Each member had the right to an accounting of its pro rata share of the investment funds and could withdraw from participation upon thirty days notice. The organization did not make its services available to anyone other than the exempt organizations controlling it. Most of the operating expenses of the organization, including the costs of the services of the investment counselors and the custodian banks, were paid for by grants from independent charitable organizations. The member organizations paid only a nominal fee (less than fifteen percent of the total costs of operation) for the services performed. The Service reasoned that the organization's investment activity was an essential function of the exempt universities, and that the organization performed its activity in a charitable manner by charging its charitable members a fee substantially below cost. The Service distinguished the organization from the one described in Rev. Rul. 69-528 in that the latter organization was primarily engaged in carrying on an investment management business for charitable organizations on a fee basis free from control of the participants.

Rev. Rul. 72-369, 1972-2 C.B. 245, held not exempt under section 501(c)(3) of the Code an organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations. The Service reasoned that providing managerial and consulting services on a regular basis for a fee is trade or business ordinarily carried on for profit, and providing such services at cost solely to exempt organizations is not sufficient to characterize the activity as charitable.

Rev. Rul. 76-416, 1976-2 C.B. 57, held that a hospital described in section 170(b)(1)(A)(iii) of the Code may seek to qualify and be recognized as a publicly supported organization under section 170(b)(1)(A)(vi).

Rev. Rul. 78-41, 1978-1 C.B. 148, held that a trust created by an exempt hospital for the sole purpose of accumulating and holding hospital funds to be used to satisfy malpractice claims against the hospital, and from which the hospital directed the bank-trustee to make payments to claimants, was operated exclusively for charitable purposes and exempt under section 501(c)(3) of the Code. The Service reasoned that the trust operated as an integral part of the hospital and performed a function that the hospital could do directly.

[redacted]

In Better Business Bureau v. United States, 316 U.S. 279 (1945), the Supreme Court considered the meaning of "exclusively" in the 501(c)(3) predecessor provision. The Court held that the existence of a single non-exempt purpose, if substantial in nature, will destroy the exemption.

Associated Hospital Services, Inc. v. Commissioner, 74 T.C. 213 (1980), aff'd per order (5th Cir. Mar. 25, 1981), held that an organization whose sole function was to furnish laundry services at cost to its four member tax-exempt hospitals was prohibited from exemption under section 501 of the Code by section 502. The court noted that the essence of a section 502 organization is its distinctly commercial hue; its activities must be those normally performed by commercial enterprises as distinguished from those activities that most often fall within the province of inherently exempt organizations. The term "for profit," as used in section 502, is merely intended to make clear that a section 502 organization must be a commercial organization rather than an organization operated for an inherently exempt purpose.

In HCSC Laundry v. United States, 450 U.S. 1 (1981), the Supreme Court held that section 501(e) of the Code was the exclusive and controlling section by which a cooperative hospital service organization could obtain exemption under section 501(c)(3). An organization formed to operate a laundry service for 15 member nonprofit hospitals was held not entitled to exemption because laundry service is not a permitted service under section 501(e)(1)(A).

Paratransit Insurance Corporation, 102 T.C. 745 (1994), held in part that an organization did not meet the exception under section 501(m)(3)(A) of the Code for insurance provided at "substantially below cost" where revenues from member contributions were 61%, 80%, and 84% of total expenditures for the three years at issue (and nearly 100% if in-kind expenses were subtracted).

Nonprofits' Insurance Alliance of California, 32 Fed.Cl. 277 (1994), held in part that an organization did not meet the exception under section 501(m)(3)(A) of the Code for insurance provided at "substantially below cost" where the members paid about 65% of the total cost of operations, or 47%, 65%, and 78% for the three years at issue (and substantially more if certain non-commercial loans were not treated as contributions).

We find that you do not meet the requirements for exemption under section 501(c)(3) of the Code because you are not

"organized" or "operated" exclusively for exempt purposes. The organizational test is not met because your articles of incorporation do not limit your purposes to those permitted under section 501(c)(3). A purpose to help licensed health care providers obtain contracts is not an exclusively exempt purpose. Also, "all other lawful purposes" is not an exclusively exempt purpose.

The operational test is not met, in several respects. One, you are a hospital cooperative service organization and fail to meet the requirements of section 501(e) of the Code. Two, your primary activity is the operation of a business for profit and therefore section 502 prohibits exemption under section 501. Three, your net earnings will inure, in part, to the benefit of a private shareholder or individual, in violation of section 501(c)(3). Four, you have a substantial commercial purpose, and you will not be operated substantially below cost exclusively for the benefit of 501(c)(3) controlling organizations.

Your members are providers of behavioral health care, and appear to qualify as "hospitals" as defined in section 170(b)(1)(A)(iii) of the Code and the regulations thereunder. The fact that most of your members are not classified as 170(b)(1)(A)(iii) hospitals for purposes of section 509 does not mean that they do not qualify as hospitals, as Rev. Rul. 76-416 indicates.

Your sole purpose is to provide services for your members. You are democratically controlled by your members. Your net profits are allocated back to your members. Under these circumstances, we find that you are organized and operated on a cooperative basis, within the meaning of section 501(e) of the Code.

Section 1.501(e)-1(a) of the regulations and HCSC Laundry provide that a cooperative hospital service organization is not exempt under section 501(c)(3) of the Code unless it qualifies under section 501(e). Since the provision of marketing services is not a permitted activity under section 501(e)(1)(A), you do not qualify as a charitable organization under section 501(c)(3). Even if such services were permitted, you would not be described in section 501(e) and 501(c)(3) because you perform services for a member [redacted] that is not described in section 501(c)(3), in violation of section 1.501(e)-1(d)(3) of the regulations.

Regardless of section 501(e) of the Code, you are not entitled to exemption under section 501 because you are described

in section 502. Your primary purpose is to conduct a group marketing business at cost on behalf of your members. Such activity, like the investment business in Rev. Rul. 69-528, the management and consulting business in Rev. Rul. 72-369, and the insurance business in Associated Hospital Services, Inc., is an inherently commercial activity and therefore a business conducted "for profit." Although the Service sometimes recognizes the 501(c)(3) exemption of subsidiary organizations that carry on activities which are an integral part of its controlling 501(c)(3) parent (as in Rev. Rul. 78-41), this rule does not apply to organizations controlled by several unrelated 501(c)(3) organizations. You are like the organization described in section 1.502-1(b) of the regulations that carries on an unrelated business on behalf of several unrelated organizations. You do not meet the exception under section 1.502-1(b) for dealings between parent and subsidiary organizations merely because your members are represented on your board. Therefore, section 502 of the Code prohibits your exemption under section 501.

You are also not described in section 501(c)(3) of the Code because your net earnings inure, in part, [redacted]. As one of your founding cooperative members with an interest in your net profits, [redacted] has a personal and private interest in your activities. We regard [redacted] as a private shareholder or individual since is not exempt under section 501(c)(3).

You are also not described in section 501(c)(3) of the Code because you have a substantial commercial purpose. As discussed above, the provision of group marketing services is a business activity. The provision of such services at cost solely to controlling 501(c)(3) organizations is not an exclusively charitable activity unless such services are rendered substantially below cost, as Rev. Ruls. 69-528, 71-529, and 72-369 and Associated Hospital Services, Inc. indicate. Unlike the situation in Rev. Rul. 71-529, however, your services are not provided "substantially below cost" as that term was construed in Rev. Rul. 71-529, Paratransit Insurance Corporation, and Nonprofits' Insurance Alliance of California. Instead, you plan to provide your services at cost, and your income statements for two tax years indicate that you have operated at a surplus.

We also find that you do not meet the requirements for exemption under section 501(c)(4) of the Code, in two respects. One, you are described in section 502, as discussed above. Two, your primary activity is carrying on a business like

[redacted]

organizations operated for profit, as discussed above, in violation of section 1.501(c)(4)-1(a)(2)(ii) of the regulations.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) or (4) 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.

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 judgement 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:

[redacted]

[redacted]

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

Sincerely,

[redacted]
Exempt Organizations

[redacted]