TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Contact Person:

Number: **201436050**
Release Date: 9/5/2014

Identification Number:

Contact Number:

Date: June 12, 2014

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

UIL: 501.03-00

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Because you informed us that you did not intend to protest, the proposed adverse determination is now final.

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose,* and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at

1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Tamera Ripperda
Director, Exempt Organizations
Rulings and Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: April 30, 2014

Contact Person:

Identification Number:

Contact Number:

Fax Number

Employer Identification Number

LEGEND:

Insurance Founder =
Association Founder =
Research Founder =

Dear :

We have considered your application for recognition of exemption from Federal income tax under § 501(a) of the Internal Revenue Code. Based on the information provided, we have concluded that you do not qualify for exemption under § 501(c)(3). The basis for our conclusion is set forth below.

FACTS

You were properly incorporated as a nonprofit public benefit corporation for broad charitable, education and scientific purposes within the meaning of § 501(c)(3). Your Bylaws more specifically describe your purpose to "develop and implement targeted initiatives to improve the safety, quality, accessibility and cost effectiveness of healthcare" in your state.

Your Bylaws refer to three "Founders." The Insurance Founder is a for-profit entity, the Association Founder is an trade association recognized as exempt under § 501(c)(6), and the Research Founder is an exempt entity recognized under § 501(c)(3). Each Founder appoints two directors to your board, and a seventh director may be appointed by a unanimous vote of the "Founders' Directors" in office. (It does not appear that the seventh director has been appointed.) If the chief executive officer of any of the Founders was not appointed as a director, that CEO may serve as a non-voting ex-officio member of your board.

Your bylaws state that if any Founder ceases to exist as an entity, the two directorships appointed by it will be eliminated and the number of directors will decrease by two. There is no provision for increasing the number of entities appointing directors. Only directors may serve as voting members of committees.

You will collaborate with your Founders and other healthcare organizations and government agencies to improve healthcare in your state. Your first project is to reduce preventable hospital readmissions in partnership with an exempt organization in your region. You will focus on reducing readmission for patients with specific medical conditions. You plan to help hospitals identify areas of improvement in their discharge process, implement evidence-based practices to identify and correct common gaps in the discharge process, provide expertise and support to hospital staff and community partners, and help hospitals and communities develop transition strategies.

To accomplish such project goals, you will sponsor "learning opportunities," a website and monthly webinars, data tools and resources including data collection about hospital process and outcome through another organization's data entry system. You expect to spend 80% of your time on these activities, carried out through in-kind and financial support from your Founders.

Each of your projects will include a research component coordinated by a subcommittee of providers and professional researchers. Your first grant went to your Research Founder. This activity will comprise approximately 20% of your time.

You will not pay any employees directly, but you reimburse the Association Founder for the services of one of its employee to manage the first project. All of your six current board members (who are also your officers) are employees, officers or directors of the Founder that appointed them.

All of your revenue is currently provided by unwritten grants from your Founders. However you anticipate soliciting grants from government and private foundations in the future.

LAW

Section 501(c)(3) states that an entity must be organized and operated exclusively for exempt purposes, including charitable, scientific and educational purposes to be recognized as exempt from federal income tax.

Section 1.501(c)(2)-1(c) of the Income Tax Regulations defines the terms "private shareholder or individual" as used in § 501 as persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(c)(1) states 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 § 501(c)(3). 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(d)(1)(ii) provides that an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) states, in part, that the term "charitable" in § 501(c)(3) includes relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes.

Rev. Rul. 69-545, 1969-2 C.B. 117, states that that the promotion of health can be a charitable purpose under the general law of charity, and deemed beneficial to the community. A hospital that benefits a broad cross-section of its community by having an open medical staff and a board of trustees broadly representative of the community, operating an emergency room open to all regardless of ability to pay, and which otherwise admitted all patients able to pay, was operated to serve a public rather than a private interest.

Rev. Rul. 76-206, 1976-1 C.B. 154, illustrates that incidental private benefit will not destroy the qualification of an otherwise educational organization; however, where an organization is serving both public and private interests the private benefit must be clearly incidental to the overriding public interest. A contrary finding will indicate that the organization is serving a private interest.

Rev. Rul. 98-15, 1998-1 C.B. 718 contrasts two joint ventures to illustrate the characteristics that define a joint venture in which an exempt organization may participate with a for-profit partner. In the first situation, the venture is governed by a majority of disinterested people, of whom a majority represent the exempt partner. A majority vote is needed for major decisions. The governing instrument contains a charitable purpose that is explicitly given priority when it conflicts with the business interests of the venture. Returns of capital and distributions of earnings are proportional to ownership. The management company has no previous ties to any parties, was hired for a reasonable term, subject to the ability of the venture to terminate for cause.

The second situation lacks many of the above features that allow the exempt organization to control the venture and thereby ensure that its charitable purpose will be furthered and that any benefit to private parties will be incidental to the charitable purpose. For example, the exempt organization does not have a majority voice on the governing board. There is no explicit charitable purpose in the governing instrument. The management company and the officers are related to the for-profit partner, and the management company has discretion to enter into all but "unusually large" contracts without board approval, and may unilaterally extend the management agreement.

The ruling concludes that in the first situation the exempt organization continues to be operated exclusively for a charitable purpose, but in the second situation it has failed to establish that it will be operated exclusively for exempt purposes when it forms the joint venture.

Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), held that the presence of a single nonexempt purpose, because it was substantial in nature, precluded tax exemption under § 501(c)(3).

Lowry Hosp. Ass'n v. Commissioner, 66 T.C. 850, 859-60 (1976), concluded that a hospital could not be deemed to operate exclusively for charitable purposes, partly because of the "control and dominance" exercised by a single physician over the hospital's affairs. If private

individuals or for-profit entities have either formal or effective control, it's presumed that the organization furthers the profit-seeking motivations of those private individuals or entities.

In Harding Hospital, Inc. v. US, 505 F.2d 1068 (6th Cir. 1974), a non-profit hospital with an independent board of directors executed a contract with a medical partnership of seven physicians. The contract gave the physicians control over care of the hospital's patients and the stream of income generated by the patients, while also guaranteeing the physicians payment for supervisory activities. The court held that the benefits derived from the contract constituted sufficient private benefit to preclude exempt status.

In Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980), the court held that selling prescription pharmaceuticals to elderly persons at a discount promotes health in a general sense, but did not qualify for recognition of exemption under § 501(c)(3) because the pharmacy operated for a substantial commercial purpose.

In Redlands Surgical Services v. Commissioner , 113 T.C. 47 (1999), the Tax Court examined a joint venture between a for-profit hospital system and an exempt organization to own and operate an ambulatory surgery center, managed by a for-profit affiliate of the for-profit partner. The court stated:

> An organization's purposes may be inferred from its manner of operations; its "activities provide a useful indicia of the organization's purpose or purposes." Living Faith, Inc. v. Commissioner, 950 F. 2d 365 (7th Cir. 1991), affd. T.C. Memo. 1990-84...To the extent that petitioner cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Court held that genuine public benefit often provides an incidental benefit to private individuals. But if private interests are served other than incidentally, exemption is precluded. Qualitatively incidental means that the private benefit is a mere byproduct of the public benefit. For private benefit to be quantitatively incidental, it must be insubstantial in amount. The private benefit must be compared to the public benefit of the specific activity in question, not the public benefit provided by all the organization's activities. The more exactly you can quantify the private benefit, the more likely it is to be non-incidental.

ANALYSIS

An entity seeking tax-exempt status under §501(c)(3) must be both organized and operated exclusively for exempt purposes with no part of its net earnings inuring to the benefit of any private shareholder or individual. An organization is "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such purposes specified in § 501(c)(3). Based on the information provided, we cannot find that you are operated exclusively for exempt purposes.

INUREMENT

Although there are few bright lines in the law of exempt organizations, the Internal Revenue Code establishes an absolute prohibition against inurement. The net earnings of an exempt organization may not inure in whole or in part to the benefit of private shareholders or individuals. Section 501(c)(3). The term "private shareholders or individuals" means persons having a personal and private interest in the activities of the organization. Sections 1.501(a)-1(c) and 1.501(c)(3)-1(c)(2). These persons are often referred to as "insiders." The burden of establishing that there is no inurement is on the organization applying for exempt status. Section 1.501(c)(3)-1(d)(1)(2). Your structural and governance relationship with two non-charitable entities presents an opportunity for inurement to them, and you have not demonstrated safeguards against such inurement. Therefore, we cannot recognize you as exempt. Rev. Ru.l 98-15, Redlands, 113 T.C. 47.

Your governance structure gives control to your non-charitable Founders. Your Bylaws direct each Founder to select two directors. The non-charitable Founders select four out of a total of six. Thus, the non-charitable entities with independent financial interests in your activities control a majority of your board of directors. (The bylaws allow the directors together to choose a seventh director, but the file does not indicate that this has occurred. As it would be chosen by a majority of non-charitable Founders and they would still have a majority, the seventh director will not change the balance of influence.) Your bylaws also permit the CEOs of the Founders to serve as ex-officio, though non-voting members, of the board if not appointed directors. This increases the influence of each entity.

All of the directors selected by the Founders serve indefinite terms and can only be removed by the entity that selected them. The directors may have personal financial interests through their positions as officers or employees of the Founders, increasing their loyalty to non-charitable goals over your charitable ones. None of your officers or directors represent the broader interest of the community. None of your employees are independent, making you dependent upon a very limited staff loaned by your Founders. You have ceded control to unrelated entities that have independent financial interests in your operations. As you do not have any structure to prevent inurement, we cannot find that your assets will not inure to their benefit. Section 1.501(c)(3)-1(d)(1)(ii), Redlands,113 T.C. 47, Lowry Hospital, 66 T.C. 850.

PRIVATE BENEFIT

Operation for private benefit is an issue distinct from inurement. An exempt organization may generate benefit to private persons, indeed, it is almost inevitable, but the private benefit must be incidental, in both quality and quantity. Incidental in this context means necessary to accomplishing the exempt purpose and of smaller quantity relative to the public benefit. No matter how many exempt purposes an organization has, a single substantial non-exempt purpose, such as producing benefits to private individuals, will prevent recognition as exempt under § 501(c)(3). Better Business Bureau, 326 U.S. 279, 1.501(c)(3)-1(d)(1)(ii).

The directors appointed by your non-charitable Founders have a permanent majority on your board. There is no provision in your articles giving precedence to exempt purposes when they conflict with non-charitable or commercial ones. Your board does not have a majority of directors representing the community to prevent actions that benefit the for-profit affiliates, or initiate actions that benefit the community as a whole. Rev. Rul, 98-15. The inherent and

pervasive conflict of interest on your board prevents us from finding that you will be operated exclusively for your exempt purpose, rather than for the benefit of your Founders.

In addition to the formal control by the directors selected by your Founders, your non-charitable affiliates have considerable opportunity for informal influence over your operations to achieve their business goals rather than your charitable ones. They have contributed all of your funds so far and expect to continue contributing significant amounts, giving them additional financial interest and influence. Your only current employee is actually employed by one of your non-charitable Founders, and you have stated that your activities will be implemented by employees of your Founders. Both the court in Redlands and the Service in Rev. Rul. 98-15 emphasized that relying on interested non-charitable affiliates for such services gives them the opportunity to manage the exempt organization for the financial benefit. Harding, 505 F.2d 1068 and Lowry Hospital, 66 T.C. 850. You have not established any structural barrier to prevent your Founders from selecting the topics of your research, directing its conduct, and preparing the training that results to benefit their private financial interests.

FAILURE TO ESTABLISH AN EXEMPT PURPOSE

Promoting health can be either a charitable purpose or a commercial one. Rev. Rul. 76-206. For example, providing medicine to sick people improves their health. However, selling medicine at market rates to the general public is a commercial rather than a charitable activity. Federation Pharmacy Services, 72 T.C. at 692. You will not heal sick patients, but rather conduct research and training and collect data for members of the healthcare industry.

Research and training can also be conducted either as exempt activities, when dedicated to community benefit, or can be conducted to benefit personal interests. American Campaign Academy, 92 T.C. 1053. Researching ways to reduce hospital readmissions will benefit individuals who depart the hospital in more stable health. However, it will also have measurable and significant financial benefits for insurance companies and other for-profit actors in the healthcare industry that would otherwise be obligated to pay for the subsequent hospital treatment. You have not provided evidence that the research and education you will conduct will primarily benefit the community rather than the physicians, insurance companies, and other for-profit participants in the healthcare industry. Therefore, we cannot regard such benefits as incidental either in amount or character. American Campaign Academy. The interests of your non-charitable Founders in the cost of particular medical events or changes in professional roles and reimbursements may conflict with the interests of individual patients, and the community as a whole.

Therefore, we cannot find that you will operate exclusively for exempt purpose.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative,* if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney.* All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to protest as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree 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 all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service
TE/GE SE:T:EO:RA:T:4

1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

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

Sincerely,

Michael Seto, Manager
EO Technical