

Internal Revenue Service

Department of the Treasury

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COPY FOR YOUR
INFORMATION

Date 10-15-97 10/16/97

Surname [REDACTED]

Person to Contact: [REDACTED]

Telephone Number: [REDACTED]

Refer Reply to: CP:E:EO:T:1

Date: AUG 27 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.

Information presented discloses that you were incorporated on [REDACTED] as a nonprofit corporation [REDACTED]. Your Articles of Incorporation indicate, among other things, that the purposes for which you were organized are:

- a) To be operated for the benefit and to carry out the purposes of a non-exclusive provider network organization, to wit: community health planning, contracting, information and data collection and dissemination, offering health care plans, and other activities related to the promotion of health of persons within the corporation's service area, including the making of contributions to exempt organizations for such purposes, which in the opinion of the Board of Directors, may be justified by the facilities, personnel, funds or other requirements that are or can be made; and,
- b) To engage in any and all activities consistent with and in furtherance of the above purposes.

In your application you state that you are comprised of members all of whom are either nonprofit corporations exempt from federal income tax under section 501(c)(3) of the Code or county hospitals which are instrumentalities of [REDACTED]

You indicate that you were formed to assist those hospitals in the performance of their functions specifically with respect to enabling the hospitals to contract more effectively with managed care organizations, employers and others, and to

[REDACTED]

broaden the community service offered by those hospitals by enabling more cost effective care to be rendered by providing for more effective utilization review and quality management services. You state also that you will facilitate better public access to hospital services and managed care contractors, and provide utilization and quality services. A brochure you submitted entitled [REDACTED]

[REDACTED] states, in part, that you provide [REDACTED] access to communities of all sizes from [REDACTED]. You further indicate that you assist employers and payors to control the quality, cost and delivery of employee health care benefits.

In a letter to the Internal Revenue Service dated [REDACTED] you stated as follows:

[REDACTED] exists to provide a mechanism for single source contracting by payors with its member hospitals for health services requested in multi-site locations. The intent is to allow health care purchasers in [REDACTED] to have regional access for their beneficiaries (employees, enrollees, etc.) to health care with a single contract. [REDACTED] has executed provider agreements with its [REDACTED] organizations. We plan to have these [REDACTED] hospitals contractually deliver physician and ancillary providers to [REDACTED] within the next [REDACTED] days. Upon completion of [REDACTED] network development, we plan to enter into contracts with self-funded employer groups, third party administrators, PPOs, provider-sponsored organizations, and general insurance carriers to provide services to people covered by such plans.

....

[REDACTED] will arrange for services to be provided through its members. [REDACTED] will charge an access fee which will be set per employee per month. These services will include access to all regional participating network providers at negotiated discount rates, inclusion in marketing material, access to network practice protocols, and participation in education programs.

A representative membership agreement between you and one of your members contains the following provisions:

3. Services to Members:

[REDACTED]

Members shall receive services from the Corporation, including, but not limited to, active marketing of the Corporation's network of providers (including members and participating providers) to employees, brokers, insurance companies, third party administrators, preferred provider organizations, health maintenance organizations and other third parties in an effort to maintain and, as possible, increase the extent to which patients access health care and related services through the Corporation's members and participating providers.

4. Payment Terms:

In exchange for services provided by the Corporation and membership therein, Members shall pay annually to the Corporation a sum determined by the Board of Directors of the Corporation according to the following formula:

(A) One-half (1/2) shall be divided equally among the Members;

(B) One-half (1/2) shall be pro-rated among the Members according to each Member's respective total number of inpatient admissions as determined according to the most current guide of [REDACTED]

Payment shall be made [REDACTED] in advance and shall be non-refundable.

Section 501(c)(3) of the Internal Revenue Code (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(c)(1) of the federal Income Tax Regulations (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 are 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(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.

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.

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.

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. 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 against the hospital was determined to be an integral part organization because the hospital controlled the trust. The trustee was required to make payments to claimants at the direction of the hospital, the hospital provided the funds for

[REDACTED]

the trust and the hospital directed where the funds from the trust were to be paid.

To qualify for exemption under section 501(c)(3) of the Code, an organization must be organized exclusively for an exempt purpose. While the promotion of health is considered a charitable purpose within the meaning of section 501(c)(3) of the Code, providing management, administrative and contracting services for a group of tax-exempt healthcare providers does not directly promote health. Instead, you are providing ordinary commercial services for a group of tax-exempt healthcare providers. 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. See Rev. Rul. 54-305, supra; Rev. Rul. 69-528, supra; Rev. Rul. 72-369, supra; and B.S.W. Group, Inc., supra.

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.

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. The related organization must be structurally related, not just functionally related, to be considered related for purposes of the integral part theory. 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 (1) 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 contracting and network management services to your members for a fee. Although all of your members are exempt organizations, if any one of them regularly carried on these activities for the other members, these activities would be an unrelated trade or business. Therefore, you do not qualify for exemption under section 501(c)(3) on the theory that you are an integral part of your exempt members.

An organization that provides services for more than one exempt hospital 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 HCHC-Laundry, supra), a hospital service organization providing services other than those specifically enumerated in the statute does not qualify.

The various contracting and network management services you provide to your members 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).

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

[REDACTED]

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 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]
CP:E:EO:T:1, Room 6514
1111 Constitution Ave, N.W.
Washington, D.C. 20224

For your convenience, our FAX number [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