Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:

Date:

JUL 11 1989

EIN:
Key District: Los Angeles

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(c)(4) of the Internal Revenue Code. We have determined that you do not qualify for exemption under that section of the Code. Our reasons for this conclusion and the facts upon which it is based are explained below.

The information submitted indicates that you were incorporated under the General Corporation Law of the State of . You are the survivor corporation following a merger of the , an organization exempt under section 501(c)(4) of the Code, into your corporation. Your Charter indicates that you are a nonprofit cooperative corporation formed for the purpose of defraying and assuming the costs of professional by establishing a fund from periodic payments by subscribers, from which fund said costs may be paid. You are under the supervision of the Insurance Commissioner of as a prepaid health care plan.

You describe your purposes more specifically in your application as being to establish, maintain, and operate a non-profit service plan in the public interest, whereby and needs may be provided to members or employees of groups and their dependents by a comprehensive program directed to cost containment and achieved through treatment and education of the public to the need for , provided by licensed practitioners of health care under contract with the corporation to assure the accomplishment of these objectives; and to do everything necessary, incidental or appropriate for the performance and fulfillment of the aforesaid objectives and purposes.

EXHIBIT A

Membership in your organization consists of two classes of members; participating members and an administrative member. Your administrative member is [redacted], an organization exempt under section 501(c)(4) of the Code. You plan to purchase technical advice and administrative and management services encompassing sales, accounting, claims processing, customer service, contract administration, data processing, clerical support, and centralized purchasing from the administrative member.

Participating membership is open to all persons who are (1) licensed to practice [redacted] in [redacted] or (2) are persons who (i) are licensed to practice medicine in [redacted], (ii) specialize in [redacted] and (iii) are certified by the American Board of [redacted]. Your Board of Directors is appointed by your administrative member but must consist of one participating member and two laypersons who are not participating members.

Your primary activity is to arrange for and administer prepaid [redacted] programs. These programs are entered into directly with employer groups consisting of at least 10 employees. You contract individually with [redacted] professionals who become your participating members. Under the agreement with the providers all payments for professional services are made on a fee-for-service basis in accordance with actuarialy sound rate schedules adopted by the Board of Directors from time to time. These schedules are based on schedules submitted by the providers reflecting their ordinary fees for such services and your experience with previous claims. Various co-payments exist for specified services. Individual participating practitioners bear the risk of loss if the receipts of your Plan from subscribing members are insufficient to cover costs. The ultimate risk is, thus, on the participating practitioners.

You indicate that you offer a dual choice plan. Subscribers are free to use panel professionals on a prepaid basis. Non-panel professionals may also be used. In the case of outside providers being used, your plan operates as an indemnity plan reimbursing the subscriber according to the schedule of allowances. The policy is also convertible by the employer to a straight indemnity plan rather than a prepaid plan. You also indicate that you have reciprocal agreements with other [redacted] service plans in the State of [redacted]. Under those agreements you

collect the fees and disburse them to your participating members and to the other participating plans. You also provide limited peer review to your membership.

Section 501(m) of the Code provides that an organization may be described in section 501(c)(3) or 501(c)(4) only if no substantial part of its activities consists of providing commercial-type insurance. The legislative intent of section 501(m) was to negate the competitive advantage granted by tax exempt status to entities such as Blue Cross and Blue Shield. This action was deemed warranted because Congress concluded that certain tax exempt health care providers were indistinguishable from their commercial counterparts.

Section 1012(c)(4)(C)(iv) of the Act (not included in the Code), clarified by the Technical Corrections and Miscellaneous Revenue Bill of 1988, provides a special exception for dental benefit coverage provided by Delta Dental Plans Association through contracts with independent professional service providers so long as the provision of such coverage is the principal activity of such Association. This section of the Act does not remove other applicable barriers to qualifying as an organization described in section 501(c)(4) of the Code.

The presence of the private bill indicates Congressional intent to suspend the laws effect upon the operations of the Delta Dental Plans Association. It is clear that, but for the special exception provided for the Delta Dental Plans Association, it would be barred from exemption by reason of section 501(m) of the Code. To be sure, Congress could have been more technically precise in exempting the Plan from section 501(m) and exempted it from the provisions of section 501(c)(4) as well. A fair reading of section 1012(c)(4)(C)(iv) of the Act, however, evidences Congress' finding that the provision of dental insurance coverage by the specified Delta Organizations furthers social welfare purposes, so long as the provision of such coverage is the principal activity of the organization. This special exception is by its own terms limited to the organization specifically named by Congress. It is not a blanket exception applying to any other organization whether similar in operations or not.

At a minimum, insurance involves an element of risk-shifting and risk-distribution. Helvering v. LeGierse, 312 US 531 (1941). Based on your representations that you have assumed no risk in

the insurance sense, we conclude that your organization is not subject to section 501(m) of the Code. Our conclusion is based not on your activities, however, but on the fact that you assume no risk in arranging your plan and, thus, you are not providing commercial-type insurance. Special legislation was necessary to spare Delta Dental Plans Association from the operation of section 501(m) of the Code because they did assume the risk of excess dental usage by subscribers and, thus, were providing commercial-type insurance. Reference to dental and [redacted] services in the Conference Committee Report does not remove such services from the operation of section 501(m) of the Code. Such services were simply to be treated in a manner similar to other HMO's providing health care. Thus, we must refer back to the language of section 501(c)(4) of the Code and evaluate your operations within that context.

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

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax 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.

In Consumer-Farmer Milk Cooperative, Inc. v. Commissioner of Internal Revenue, 186 F.2d 68 (1950), the court denied exemption under section 501(c)(4) of the Code because the organization's purpose was determined to primarily benefit its members economic interests and to serve larger public purposes only incidentally.

Rev. Rul. 70-535, 1970-2 C.B. 117, describes an organization formed to provide managerial, developmental and consultative services for low and moderate income housing projects for a fee. The ruling holds that the organization does not qualify under

section 501(c)(4) of the Code because its primary activity is carrying on a business in a manner similar to organizations operated for profit and is therefore, not operated primarily for the promotion of social welfare.

In Rev. Rul. 72-369, 1972-2 C.B. 245, the Service denied exemption under section 501(c)(3) of the Code to an organization formed to provide professional managerial and consulting services to unrelated exempt organizations because the organization's primary activity was carrying on a business with the general public in a manner similar to organizations operated for profit. The Service stated that the fact that the recipients of the services were tax exempt entities did not change the business nature of the activity. Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

Rev. Rul. 75-199, 1975-1 C.B. 160 describes an organization that restricted its membership to individuals of good moral character and health belonging to a particular ethnic group residing in a geographic area. The organization provided sick benefits to members and death benefits to benef...aries. The organization was held not exempt under section 501(c)(4) of the Code because its income was used to provide direct economic benefits to members. Any benefit to the larger community was minor and incidental.

Rev. Rul. 86-98, 1986-2 C.B. 74, describes an individual practice association that provides health services through written agreements with health maintenance organizations. The main functions of the organization are to provide an available pool of physicians who will abide by its fee schedule when rendering medical services to the subscribers of the HMO, and to provide its physician-members with access to a large group of patients, the HMO subscribers, who generally may not be referred to non-member physicians. The organization does not provide the HMO patients access to medical care which would not have been available but for the establishment of the organization, nor does it provide such care at fees below what is customarily and reasonably charged by members in their private practices. Based on these facts, the Service determined that the organization is not described in either section 501(c)(4) or section 501(c)(6) of the Code. The organization is carrying on a business with the general public indistinguishable from similar commercial businesses and its activities benefit the member-physicians rather than the community as a whole.

The determination of whether an HMO providing any type of prepaid health care qualifies for exemption from federal income tax under section 501(c)(4) of the Code is a factual question. The activities of the organization must address a bona fide community need, and should not duplicate services or facilities provided by commercial entities. In addition, the activities of the organization should not confer economic advantages on its participants.

Your primary activity is negotiating contracts for services between interested practitioners and subscribing employer groups for a fee determined in a manner similar to that used by commercial insurers. There is no difference between the amount of services available to the community before and after your creation, nor is there evidence that the fees paid the professionals have been substantially reduced as a result of the formation of your organization. Thus, it appears that your activities do not serve a bona fide community need.

Your primary activity, that of acting as a bargaining agent for participating members and subscribing employers, is similar to the activities described in Rev. Ruls. 70-535, 72-369, and 86-98, supra. It is primarily a business activity and the fact that it is performed in the name of promoting health cannot change the nature of the activity itself. Accordingly, we conclude that your primary activity is conducting a business similar to organizations which are conducted for profit. Therefore you do not operate primarily for the promotion of social welfare within the meaning of section 501(c)(4) of the Code.

In addition, a membership organization such as yours, is essentially a mutual, self-interest type of organization like the one described in Rev. Rul. 75-199, supra. Your income is used to provide direct economic benefits to members and any benefit to the larger community is minor and incidental. Such an organization does not qualify for exemption under section 501(c)(4) of the Code.

Accordingly, we rule that you fail to qualify for exemption under section 501(c)(4) of the Code. You are required to file Form 1120 with your local District Director.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your