

Professional standards review organization (PSRO). An organization was established to perform the services of a professional standards review organization (PSRO) pursuant to section 249F of the Social Security Amendments of 1972, and was designated as a PSRO for a particular area by the Department of Health and Human Services (HHS). It derives all of its support from contracts with HHS that provide for payment for all reasonable and necessary expenses incurred by it in the performance of its functions. The organization qualifies for exemption under section 501(c)(3) of the Code and is not a private foundation under section 509(a) because it is described in section 170(b)(1)(A)(vi). Rev. Rul. 74-553 distinguished.

ISSUES

(1) Does the professional standards review organization described below qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code?

(2) If the organization is described in section 501(c)(3) of the Code, is it also described in section 170(b)(1)(A)(vi) and thus not a private foundation within the meaning of section 509(a)?

FACTS

The nonprofit organization, M, which otherwise qualifies for exemption under section 501(c)(3) of the Code, was formed to establish and perform the services of a professional standards review organization (PSRO) pursuant to section 249F of the Social Security Amendments of 1972, 42 U.S.C. section 1320c et. seq. (1974). M has been designated as a PSRO for a particular area by the Department of Health and Human Services (HHS), and satisfies the requirements for such designation set out in 42 U.S.C. section 1320c et. seq. (1974) and the regulations thereunder. M has engaged solely in activities designed to further the purposes of this statute.

M's principal activity is the review of the professional activities of physicians and other health care practitioners, and institutional and non-institutional providers of health care services, in the provision of health care services and items for which payment is made under medicare and medicaid. In conducting this review, M develops and applies professional norms of care, diagnosis, and treatment and determines whether:

(A) the health care services and items are or were medically necessary;

(B) the qualify of such services meets professionally recognized standards of health care; and

(C) in case such services are proposed to be provided in a hospital or other health care facility on an inpatient basis, whether such services and items could, consistent with the provision of appropriate medical care, be effectively provided on an outpatient basis or more economically in an inpatient health care facility of a different type.

Generally, no payments for health care services or items can be made under medicaid or medicare unless such services or items are reviewed and approved by M.

M's membership is open without charge to all licensed physicians engaged in the active practice of medicine, surgery, or osteopathy in M's designated area. The composition of M's board of directors is not tied to any membership or association in any medical society.

M derives all of its income from contracts with HHS, which provides for the payment of all reasonable and necessary expenses incurred by M in carrying out its functions.

LAW AND ANALYSIS-Issue (1)

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term 'charitable' is used in section 501(c)(3) of the Code in its generally accepted legal sense. Such term includes lessening the burdens of government.

In the government law of charity, the promotion of health is considered to be a charitable purpose. Restatement (Second) of Trusts, Secs. 368, 372; Bogert, Trusts and Trustees, Sec. 374 (rev. 2d ed. 1977); IV Scott on Trusts Secs. 368, 372 (3rd ed. 1967). See Rev. Rul. 69-545, 1969-2 C.B. 117.

The legislative history of the Social Security Amendments of 1972 and the statute itself indicate that Congress' objectives in establishing PSROs were twofold. First, PSROs were intended to reduce overutilization of the health services provided under medicare and medicaid (and the impact of such overutilization on the health of the aged and poor) by assuring that payments for health care services under governmental health care programs would be made only when, and to the extent, medically necessary. See S. Rep. No. 92-1230, 92d Cong., 2d Sess. 254 (1972) and 42 U.S.C. section 1320c. Second, PSROs were intended to enable the medical profession to assume the government's responsibility for reviewing the appropriateness and quality of services provided under medicare and medicaid. See S. Rep. No. 92-1230 at 255-8.

By operating as a designated PSRO and restricting federal health care payments to services that are medically necessary, M

is promoting the health of the beneficiaries of governmental health care programs by preventing unnecessary hospitalization and surgery. In addition, by assuming the government's burden of reviewing the appropriateness and quality of services provided under medicare and medicaid, M is lessening the burdens of government within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations.

M's activities may indirectly further the interests of the medical profession by promoting public esteem for the medical profession, and by allowing physicians to set their own standards for the review of medicare and medicaid claims and thus prevent outside regulation. However, such benefits to members of the medical profession are incidental to the benefits M provides in promoting health and lessening the burdens of government. See *Virginia Professional Standards Review Foundation v. Blumenthal*, 466 F. Supp. 1164 (D.D.C. 1979) and *Professional Standards Review Organization of Queens County, Inc. v. Commissioner*, 74 T.C. 240 (1980), acq. 1980-2 C.B. 2. The Service will follow these cases in like situations.

Accordingly, M is operated exclusively for charitable purposes and thus qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

The organization in this case is distinguishable from the one described in Rev. Rul. 74-553, 1974-2 C.B. 168. Rev. Rul. 74-553 holds that a non-profit organization formed by members of a State medical association to operate peer review boards for the primary purposes of establishing and maintaining standards for quality, quantity, and reasonableness of costs of medical services qualifies for exemption from tax under section 501(c)(6) of the Code but not under section 501(c)(3). Unlike the organization described in Rev. Rul. 74-553, membership in M is open by law to all physicians without charge. Further, M is an organization mandated by federal statute as the exclusive method of assuring appropriate quality and utilization of care provided to medicare and medicaid patients. Also, the composition of the board of directors of M is not tied to any membership or association with any medical society. Finally, M has authority to make final decisions regarding quality and utilization of medical care for purposes of payment under the medicare and medicaid programs. See *Virginia Professional Standards Review Foundation v. Blumenthal*, at 1171.

LAW AND ANALYSIS-Issue (2)

Section 509(a) of the Code provides that the term 'private foundation' does not include a section 501(c)(3) organization described in section 170(b)(1)(A)(vi).

Section 170(b)(1)(A)(vi) of the Code describes an organization that normally receives a substantial part of its support (exclusive of income received in the exercise or

performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(c)(3)) from a governmental unit or from direct or indirect contributions from the general public.

Section 1.170A-9(e)(2) of the regulations provides that an organization will be treated as publicly supported for purposes of section 170(b)(1)(A)(vi) of the Code if the total amount of support it normally receives from government units equals at least 33 1/3 percent of the total support it normally receives from all sources.

Section 1.170A-9(e)(7)(i)(a) of the regulations provides that the term 'support' does not include any amounts received from the exercise or performance by an organization of its exempt purpose or function.

Section 1.170A-9(e)(8)(i) of the regulations provides that the term 'support from a governmental unit' includes any amounts received from a governmental unit, including amounts received in connection with a contract entered into with a governmental unit for the performance of services, unless such amounts constitute amounts received from the exercise or performance of the organization's exempt functions as provided in section 1.170A-9(e)(7)(i)(a).

Section 1.170A-9(e)(8)(ii) of the regulations provides that any amount paid by a governmental unit to an organization is not to be treated as received from the exercise or performance of its exempt functions if the purpose of the payment is primarily to enable the organization to provide a service to the direct benefit of the public rather than to serve the direct and immediate needs of the payor.

In this case, HHS pays all reasonable and necessary expenses incurred by M in carrying out its functions. See 42 U.S.C. Sec. 1320c-17. It must be determined whether the amounts, paid to M by HHS, constitute payments made to serve the direct and immediate needs of the government (gross receipts) or payments made primarily to confer a direct benefit upon the general public (support from a governmental unit).

PSROs perform a function that promotes the health of the beneficiaries of governmental health care programs in the areas in which the PSROs operate. Congress has noted that the primary beneficiaries of the PSRO program are the millions of persons dependent on medicare and medicaid for health care. See S. Rep. No. 92-1230 at 256. It follows that the payments made by HHS to M are made primarily to confer a direct benefit upon the general public. Thus, the payments constitute support from a governmental unit under section 1.170A-9(e)(8)(ii) of the regulations.

Since M receives all of its support in the form of support from a governmental unit, it satisfies the 33 1/3 percent public

support test of section 1.170A-9(e)(2) of the regulations. Accordingly, M is described in section 170(b)(1)(A)(vi) of the Code and is not a private foundation within the meaning of section 509(a).

HOLDINGS

(1) The professional standards review organization described above is operated exclusively for charitable purposes and thus qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

(2) The organization is not a private foundation within the meaning of section 509(a) of the Code because it is described in section 170(b)(1)(A)(vi).

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1(a) of the regulations.

In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 74-553 is distinguished.