



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: 200714027

Release Date: 4/6/07

Date: January 9, 2007

UIL Code:
501.04-02

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:
1120

Tax Years:

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code section 501(a) as an organization described in Code section 501(c)(4).

We made this determination for the following reason(s):

You do not satisfy the "not organized for profit" requirement under section 501(c)(4) of the Code and section 1.501(c)(4)-1(a)(1) of the Income Tax Regulations. The additional information you submitted regarding your actual operations does not overcome the other facts, including your form of incorporation and governing documents, which demonstrate that you are organized for profit.

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,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements

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



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: August 24, 2006

UIL Code:
501.04-02

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

L =

M =

N =

O =

P =

Date 1 =

Year 2 =

Date 3 =

Date 4 =

x =

y =

Dear :

This letter supersedes and replaces our letter to you dated Date 4.

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)(4). 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.

FACTS

On Date 1, you were incorporated under Section x (the Business Corporation Act) of the laws of the State of L as a for-profit stock corporation with _____ shares of common stock authorized. Your Articles of Incorporation state that your purpose is: _____ to engage in any activity within the purposes for which corporations may be formed under the Business Corporation Act of [the State of] L." Section y provides that upon dissolution, after payment of all debts, you must distribute any assets remaining to your shareholder.

In Year 2, you received approval from the regulatory agencies in L to offer health maintenance organization ("HMO") services in L. Since then, you have operated as an HMO, providing comprehensive health care services on a prepaid basis through a network of hospitals and

physicians. Your enrollees include employees of small and large employers and Medicare beneficiaries.

M is the sole shareholder of all of your outstanding stock. M is a for-profit insurance company, all of whose outstanding stock is owned by N. N is the parent of an integrated health care system and has been recognized by the Internal Revenue Service as an organization described in section 501(c)(3) of the Code.

N is also the sole shareholder of O, an HMO that is organized as a for-profit stock corporation under the laws of the State of P.

You have not paid any dividends to your shareholder corporation.

Your bylaws provide that you are governed by your Board of Directors, who are elected by your shareholder.

Since your formation, you filed federal corporate income tax returns as a subsidiary in the consolidated Form 1120, U.S. Corporation Income Tax Return, for M and subsidiaries.

On Date 3, you filed Form 1024 requesting recognition of exemption as an organization described in section 501(c)(4) of the Code, effective Date 1, the date of your incorporation.

LAW

Entities exempt from tax under section 501(c)(4) of the Code (by virtue of section 501(a)) are, in relevant part, "civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare," (Emphasis added).

Section 501(c)(4)(B) of the Code, added by Taxpayer Bill of Rights 2, P.L. 104-268, § 1311(b) ("TBOR 2"), states that an entity is described in section 501(c)(4) only if no part of its net earnings inures to the benefit of any private shareholder or individual. This provision is effective for inurement occurring on or after September 14, 1995, except for inurement resulting from binding contracts in effect on that date.

The legislative history states that "a tax-exempt social welfare organization described in section 501(c)(4) must be organized on a non-profit basis and must be operated exclusively for the promotion of social welfare." Committee on Ways and Means Report, House of Representatives, 104th Cong., 2d Sess. Report 104-506 at 53 (March 28, 1996; General Explanation of Tax Legislation Enacted in the 104th Congress, Joint Committee on Taxation, December 18, 1996 at 55 (emphasis added).

Section 1.501(c)(4)-1(a) of the Income Tax Regulations state:

In general – A civic league or organization may be exempt as an organization described in section 501(c)(4) if:

- (i) It is not organized or operated for profit; and
- (ii) It is operated exclusively for the promotion of social welfare. [...]

In Debs Memorial Radio Fund, Inc. v. Commissioner, 3 T.C. 949 (1944), the taxpayer, originally organized as an unincorporated association, was subsequently organized under the for-profit corporation laws of New York. The taxpayer made profits, though it was restricted by its bylaws to use profits only to improve its radio service or for its civic, education, and cultural purposes. The Tax Court determined that it was not described in section 101(8) of the Internal Revenue Code of 1939 (now section 501(c)(4) of the Code). Id. at 957. The court found that the organization failed to show that it was not organized for profit, noting that the articles of incorporation did not preclude profit from among the corporation's purposes and stating that the corporation cannot be exempt simply because it chooses to use its profits for one purpose rather than another. Id. at 958-9. The court did not base its decision on the fact that the entity was incorporated under the state's for-profit business law. The court instead accepted the proposition that "incorporation under the New York Stock Corporation Law is not itself preclusive of a claim for exemption..." Id. at 957. The court did, however, suggest that an adverse implication could arise from incorporation under a state's for-profit statute. Id. at 958.

The Tax Court's decision was overturned on appeal. In Debs Memorial Radio Fund v. Commissioner, 148 F.2d 948 (2d Cir. 1945), the appellate court determined that the corporation was "not organized for profit" for purposes of § 101(8). The court noted that "the corporation's purposes were stated in its certificate of incorporation as broadly as those of any corporation created under the laws of New York to engage in the business of broadcasting, and its by-laws, as originally adopted, authorized the declaration of dividends from surplus profits of the company." Although shares were issued, the bylaws were subsequently amended to provide that no profits or surpluses of the corporation could be used for distribution as dividends.

The appellate court agreed with the Tax Court that an adverse implication may arise from incorporation under the business corporation law, but that the implication of a profit purpose can be "negated" by extrinsic evidence showing the actual purpose of organizing the corporation. Id. at 950. The court determined that the implication of a profit purpose arising from incorporation under a for-profit statute was overcome by the fact that the founders' objective was to provide free, public radio and by the amendment of the by-laws to prohibit the distribution of profits to shareholders. Id.

In United States v. Pickwick Electric Membership Corporation, an electric membership corporation, organized by authority of the state's Electric Membership Corporation Act, automatically converted to a corporation two years later upon a change in state law. 158 F.2d 272 (6th Cir. 1946). Two years later, the corporation converted into a cooperative, general welfare, non-profit membership corporation under state law. It was a non-profit membership corporation during the two subsequent tax years at issue in the case. The court upheld the district court's ruling that the entity was described in section 101(8), a predecessor of section 501(c)(4) of the Code.

As in Debs Memorial Radio Fund, the court in Pickwick applied a purpose test to determine whether the corporation was “not organized for profit”, examining the purpose for which the entity was first organized (even though the tax years at issue did not include the first years of organization). The court stated that “the actual purpose is not controlled by the corporate form or by the commercial aspect of the business transacted, but may be shown by extrinsic evidence, including the by-laws and the method of operation.” Id. at 276. The court found that the purpose for which the organizers created the organization was to provide electricity to rural areas, to provide electricity at reasonable rates, and that the organizers were not simply seeking an investment vehicle for their funds. It also noted that the entity adopted new bylaws when it converted to a non-profit corporation that required it to use any excess revenue to be distributed to members as refunds or to be used to reduce rates. “Such obligations completely negative the usually accepted meaning of profit motive.” Id.

In Vision Service Plan v. United States, 96 A.F.T.R.2d 2005-7440 (E.D. Cal. 2005), appeal docketed, No. 06-165269 (9th Cir., Feb. 3, 2006), a corporation organized under a non-profit statute sought exempt status under section 501(c)(4). The court found that the organization did not meet the requirements of section 501(c)(4). In response to the organization’s argument that it was organized as a non-profit corporation, the court stated: “The issue, however, is not whether plaintiff is a nonprofit corporation for corporation law purposes, but whether it is one for federal tax purposes.” Id.

Similar issues have arisen in section 501(c)(3) cases.¹ In one case, a school was incorporated under the state’s for-profit business statute. The court nonetheless found that it was exempt as an organization described in the predecessor to section 501(c)(3). Appeal of Unity School of Christianity, 4 B.T.A. 61 (1926). The court pronounced that:

It is said that the fact that the incorporation was under the business law is indicative of its commercial purpose. This might be significant if not otherwise explained, but it is not conclusive. A corporation so organized is not, merely because it is permitted thereby to engage in business, precluded from an exclusively charitable purpose. The purpose of its organization and operation is still a question of fact, and the evidence may be such as to show that its purpose was charitable despite the ordinary implications of the statute under which it was created.

The court acknowledged that the terms of the corporation’s charter authorized it to engage lawfully in for-profit activities, but because the evidence was “all to the effect that this was never the purpose or intent and has not been the effect,” the corporation was nonetheless described in § 501(c)(3).

In Roche’s Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938), an entity formed under a state’s for-profit corporation law was nonetheless found to be described in section 501(c)(3) of the Code, because its operations indicated it was organized and operated for charitable

¹ The section 501(c)(3) cases are instructive to the extent the courts are interpreting similar statutory language.

purposes. The Roche's Beach court stated that "extrinsic evidence showed that the actual purpose of organizing the corporation was religious and educational despite the adverse implication arising from the statute under which it was incorporated."

The Roche's Beach court distinguished itself from its prior decision in Sun-Herald Corporation v. Duggan, 73 F.2d 298 (2d Cir. 1934). In Sun-Herald, the court stated that "organized" means "incorporated" and that "organized" and "operated" as found in several exemption provisions in the Code are not interchangeable terms. In a subsequent Sun-Herald case, 160 F.2d 475, 476 (2d Cir. 1947), the court further clarified that its decision in Roche's Beach modified the position it took in the first Sun-Herald decision only to the extent that the certificate of incorporation is not the only test of whether a corporation is "organized" for exempt purposes in section 501(c)(3) of the Code.

A subsequent decision by the 7th Circuit, which analyzed the 2nd Circuit's decisions in Sun-Herald and Roche's Beach, determined that the 2nd Circuit:

was still of the opinion that at the time of the organization of a corporation it must have been the intention of the organizers or incorporators to organize it for exclusively charitable or other exempt purposes; and that no one could organize a business corporation for the purpose of profit and later make it exempt under Sec. 101(6) [section 501(c)(3) of the Code] by the simple expedient of transferring its ownership to an exempt organization.

Universal Oil Products v. Campbell, 181 F.2d 451, 460 (7th Cir. 1950).

Cf. University of Maryland Physicians v. Commissioner, T.C. Memo, 1981-23 (1981) (recognizing that, pursuant to Treasury regulations, the organizational test of section 501(c)(3) of the Code focuses on the powers of the organization as defined in its organizing documents, the court nonetheless found that the corporation was described in section 501(c)(3) even though it was organized under a state's for-profit business law; the court noted that (1) the organization had no choice under state law but to organize under that particular for-profit business law, and (2) the corporation's general powers are not overly broad because they are limited both by state law and by its articles of incorporation as a whole).

RATIONALE

Based on our review of the legislative history, administrative pronouncements and judicial decisions, an entity incorporated under a state's for-profit business statute is not precluded from being exempt under section 501(c)(4) of the Code. Debs Memorial Radio Fund; Pickwick Electric Membership Corp; Vision Service Plan. Cf. Appeal of Unity School of Christianity (incorporation not conclusive for section 501(c)(3)). Nonetheless, the fact that you were incorporated under the State of L's for-profit business statute creates a presumption that you were organized for profit within the meaning of section 501(c)(4). Debs Memorial Radio Fund. Cf. Roche's Beach (incorporation statute created "adverse implication" for section 501(c)(3)).

Based on all the facts and circumstances, we conclude that you are organized for profit. We base this conclusion on the following factors:

1. Articles Permit Engaging in For-Profit Activities.

Your articles of incorporation permit you to engage in any activity a for-profit corporation could engage in under the laws of the State of L. There is no language in the articles limiting your activities to those permitted under section 501(c)(4) of the Code. Debs Memorial Radio Fund (bylaws limited powers); Pickwick Electric Membership Corp. (same). Cf. University of Maryland Physicians (powers limited by articles in section 501(c)(3) case).

We recognize that there is no absolute requirement that an entity's organizing documents explicitly state that it was "not organized for profit" to be described in section 501(c)(4) of the Code. Debs Memorial Radio Fund, *supra*. Nonetheless, the fact that your articles of incorporation authorize you to engage in any activity that a for-profit business could engage in is a significant indicator that you are organized for profit. You argue that you actually operate in a manner that makes you a charitable trust under operation of state law. However, we found no evidence either that your articles of incorporation or state law limit your broad powers.

2. Articles and Bylaws Permit Paying Dividends and State Law Requires Dissolution Distributions to For-Profit Parent.

Like the entity in Debs Memorial Radio Fund, you have issued shares of stock. Unlike you, the entity in Debs Memorial Radio Fund amended its bylaws to prohibit paying dividends. This factor was critical to the court's determination that the entity was not organized for profit. See Pickwick Electric Membership Corporation (bylaws for distributions amended). Although you state that you have never paid dividends to your for-profit shareholder, we have found no language in your articles or bylaws that affirmatively prohibit you from doing so. You state in an attachment to your Form 1023 that you have "never distributed [your] net earnings outside of [N]" However, this response does not address whether you may distribute net earnings to your for-profit shareholder in the future.

Further, applicable state law provides that upon dissolution, after payment of all debts, you must distribute any assets remaining to your shareholder. There are no apparent restrictions on what the for-profit shareholder can do with your assets. We also are not aware of any restrictions on the sale or ownership of the for-profit shareholder's stock by its section 501(c)(3) parent. Cf. Universal Oil Products (exemption under section 501(c)(3) of the Code not determined by simple expedient of transferring ownership to an exempt organization). Therefore, nothing would prevent the distribution of your net earnings or assets to a private individual or shareholder, contrary to the prohibition in section 501(c)(4)(B).

3. Intent to Be Organized as a For-Profit Corporation.

You state that L law does not require an HMO to be formed as a for-profit corporation and that you could have been formed as a non-profit corporation. That fact distinguishes your case from University of Maryland Physicians. The fact that you could have organized under state non-

profit law, but chose not to do so, indicates that you intended to be a for-profit corporation. Debs Memorial Radio Fund; Pickwick Electric Membership Corp.

You also argue that your motivation for applying for exempt status is not tax avoidance but "a desire to comply with [your] state law fiduciary duties to operate the Applicant at the lowest practical cost." You argue that the savings from not paying federal income tax could be used to further the healthcare mission of the system in which you operate. This argument is undermined by the fact that you did not apply to be, or file as, an organization exempt under section 501(c)(4) of the Code, for more than 10 years after you incorporated under state law and became subject to such fiduciary duties. You also stated that you could have reincorporated under the state nonprofit statute at any time prior to 1999 without incurring federal income tax.

4. Actual Operations By Themselves Do Not Establish That You Were Not Organized For Profit.

You argue that you have operated from the beginning as an entity described in section 501(c)(4) of the Code. The courts have interpreted section 501(c)(4) to require an entity both to be "not organized for profit" and "operated exclusively for the promotion of social welfare." See, e.g., Debs Memorial Radio Fund. Evidence that you operated as a nonprofit is a factor indicative that you are not organized for profit. Debs Memorial Radio Fund; Pickwick Electric Membership Corp. Cf. Roche's Beach. But, such evidence does not outweigh the other factors showing that you are organized for profit. Debs Memorial Radio Fund; Pickwick Electric Membership Corp.

CONCLUSION

Based on all the facts and circumstances, you are not "not organized for profit" within the meaning of section 501(c)(4) of the Code. Our conclusions are based on the following factors: (1) you are organized under the State of L's business corporation law; (2) neither your articles nor your bylaws limit your business powers, particularly with respect to dividends; (3) your stock is held by a for-profit corporation, to whom you must distribute your net assets upon dissolution, and there are no apparent ownership or transfer restrictions with respect to the stock of you or your parent; and (4) you can incorporate, and could have incorporated, under L's nonprofit statute.

Therefore, since Date 1, you did not qualify as an organization described in section 501(c)(4) of the Code and section 1.501(c)(4)-1(a)(1) of the regulations. Consequently, you do not qualify for recognition of exemption under section 501(a) of the Code as an organization described in section 501(c)(4) and you must file federal income tax returns.

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 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
SE:T:EO:RA:T:1

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,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437