TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **201218016**
Release Date: 5/4/2012

Date: February 6, 2012

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

UIL: 501.03-00; 501.03-32; 501.27-00

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. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Because you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. 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

**Initiator**
**SE:T:EO:RA:T:1**

**Reviewer**
**SE:T:EO:RA:T:1**

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Contact Person:

Identification Number:

Date: October 27, 2011

Contact Number:

FAX Number:

Employer Identification Number:

UIL: 501.03-00; 501.03-32; 501.27-00

Legend:

A =
B =
C =
Date 1 =
Date 2 =
Date 3 =

Dear :

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

Facts:

You were originally incorporated on Date 1 in the State of A as a mutual not-for-profit insurance company. On Date 2, you re-domesticated and filed a certificate of conversion in the State of B. Your Amended and Restated Articles of Incorporation specifically state that your "primary purpose is to be a non-profit, risk retention captive insurance company." Your Articles further authorize you to provide or enter into arrangements for the provision of insurance of various liability risks of not-for-profit community healthcare clinics in the State of C.

Your primary objective is to provide a quality, affordable, and stable insurance provider, providing medical malpractice and general liability coverage to your community clinic members. Your members are not-for-profit community clinics funded primarily by the federal government

or the state government. The clinics are composed of both rural and urban locations providing medical, dental, and mental health services to lower income individuals in the State of C.

Part IV of the Form 1023 Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code asks for a narrative description of your activities. Your response to Part IV directs us to see the "Business Plan" that accompanies your application. The Business Plan entitled "Plan of Operations (Past & Present)" states that "upon re-domestication you will be licensed in the State of B as a Class 3 Risk Retention Group captive insurance company" as stated in your Articles. Under the heading "Objectives and Goals," it further states that your original primary objective (i.e., to provide a quality, affordable and stable insurance provider, providing Medical Malpractice and General Liability coverage to Community Clinics) continues, however since the company entered run-off on Date 3 it has also been the goal to provide your membership with a "fall-back" option should the medical malpractice market turn and place undue burdens on its membership.

You expect to stay in run-off status for the next five years. As an alternative to procuring insurance from you, your membership formed a purchasing group. The purchasing group contracted with a mutual insurance company to provide its members with medical malpractice and general liability insurance.

Although you continue to exist in run-off status, your surplus increased due to excellent underwriting results and continued investment income that outpaced general and administrative expenses, which also allowed you to settle your claims. With the increase in capital and surplus, you have been able to implement a new insurance company to assist members with their workers' compensation crisis and you continue to look for additional services and/or additional insurance products that the company can provide. For example, you have been able to assume a small portion of the risk of the purchasing group via a reinsurance arrangement with the mutual insurance company. The reinsurance agreement calls for you to reinsure the physicians' administrative defense ("PAD") coverage that the mutual insurance company provides to the members of the purchasing group via an endorsement on the policy. You further stated that you have been providing PAD coverage for several years, and that you expect to continue operating as a reinsurance provider.

You state that your activities are the same now as they were before you converted from a for-profit to a non-profit corporation, and that you have always been in the business of providing insurance coverage either directly or through reinsurance.

You provided an organization chart which shows that you own the preferred stock in a holding company. The holding company holds a 100 percent interest in an insurance company organized by your Board of Directors to assist members with their workers' compensation crisis. You and the related subsidiaries share a common board. One of your executive directors is also the managing director of a management company that provides bookkeeping services to you and the related subsidiaries.

Law:

Section 501(a) of the Internal Revenue Code ("Code") provides for the exemption from federal income taxation of organizations described in section 501(c).

Section 501(c)(3) of the Code describes organizations which are organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 501(e) of the Code provides that an organization shall be treated as an organization organized and operated exclusively for charitable purposes if such organization is organized and operated solely to perform, on a centralized basis, certain specified services, (among them, purchasing (including the purchasing of insurance on a group basis)), which, if performed on its own behalf by a hospital which is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption; and to perform such services solely for two or more hospitals each of which is an organization described in subsection (c)(3). Further, such organization must be organized and operated on a cooperative basis and allocate or pay, within 8 ½ months after the close of its taxable year, all net earning to patrons on the basis of services performed for them. If such organization has capital stock, all of such stock outstanding must be owned by its patrons.

Section 501(m)(1) of the Code provides that an organization described in section 501(c)(3) or (4) shall be exempt only if no substantial part of its activities consists of providing commercial-type insurance.

Section 501(m)(3)(A) of the Code provides that, for purposes of section 501(m), the term "commercial-type insurance" shall not include insurance provided at substantially below cost to a class of charitable recipients.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations ("regulations") provides that an organization must be both organized and operated exclusively for one or more of the purposes specified in section 501(c)(3) of the Code in order to be exempt as an organization described in such section.

Section 1.501(c)(3)-1(b)(1)(i) of the regulations provides that an organization is organized exclusively for one or more exempt purposes only if its articles of incorporation:

a) Limit the purposes of such organization to one or more exempt purposes; and,
b) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities, which in themselves are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(b)(1)(iii) of the regulations provides that an organization is not organized and operated exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by

the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501(c)(3). Thus, an organization that is empowered by its articles "to engage in a manufacturing business," or "to engage in the operation of a social club" does not meet the organizational test regardless of the fact that its articles may state that such organization is created "for charitable purposes within the meaning of section 501(c)(3) of the Code."

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it is engaged primarily in activities which accomplish one or more of such exempt purposes specified in section 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(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Section 1.501(a)-1(c) defines the term "private shareholder or individual" as persons having a personal and private interest in the activities of the organization.

Rev. Rul. 71-529, 1971-2 C.B. 234, concerns an organization formed to aid organizations exempt from tax under section 501(c)(3) of the Code by assisting them to manage more effectively their endowment or investment funds. The organization receives capital from the participating exempt organizations, which capital is then placed in one or more common funds in the custody of various banks. Membership in the organization is restricted to colleges and universities exempt under section 501(c)(3). Its board of directors is composed of representatives of the member organizations. Most of the operating expenses of the organization, including the costs of the services of the investment counselors and the custodian banks, are paid for by grants from independent charitable organizations. The member organizations pay only a nominal fee for the services performed. These fees represent less than fifteen percent of the total costs of operation. The ruling states that, by providing the services described above to its members, the organization is performing an essential function for charitable organizations. By performing this function for the organizations for a charge that is substantially below cost, the organization is performing a charitable activity within the meaning of section 501(c)(3) of the Code.

In Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279, 283 (1945), the Supreme Court said that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes.

In Nonprofits' Insurance Alliance of Cal. v. United States, 32 Fed. Cl. 277 (1994), the Court of Federal Claims considered whether a group self-insurance risk pool with membership consisting of 487 unrelated nonprofit corporations qualified as a tax-exempt organization. The organization was formed to provide reasonably priced liability coverage to its members at stable prices not available from commercial insurers. Noting that the sale of insurance is an inherently commercial activity ordinarily carried on by commercial for-profit companies, the Court found the

plaintiff's activities to be commercial in nature because plaintiff was engaged in the actual underwriting of insurance policies and contracts with other firms to secure reinsurance for claims in excess of a certain amount. The court found that plaintiff's activities possessed many of the attributes of a mutual insurance company, such as accumulated profits that inure to the benefit of members. Further, noting that competition with commercial firms is strong evidence of the predominance of a nonexempt commercial purpose, the court said that, by providing insurance coverage and charging premiums, the plaintiff placed itself in competition with other commercial insurance firms. Finally, the court said that providing insurance to 487 unrelated exempt organizations is not an activity that would normally be performed by the member organizations. Accordingly, the court held that the plaintiff had failed the operational test under section 501(c)(3) because of the existence of a substantial nonexempt, commercial purpose. The court then said that, even assuming that plaintiff qualified as an organization described in section 501(c)(3) of the Code, plaintiff, serving as a group self-insurance risk pool, must demonstrate that section 501(m)(1) of the Code does not preclude its exempt status.

In Florida Hospital Trust Fund v. Comm'r, 103 T.C. 140, 153 (1994), *aff'd*, 71 F.3d 808 (11th Cir. 1996), the Tax Court said that, for purposes of explicating section 501(e) of the Code, the plain meaning of the phrase "purchasing of insurance on a group basis" denotes a commercial transaction in which a cooperative hospital service organization negotiates and executes the purchase of insurance for its members as a group. Noting that the petitioners in the case are organized and operated to provide a means for their respective member hospitals to join together as a group to insure against professional liability and workers' compensation claims, which purposes were effectuated by providing centralized, cooperative insurance services to member hospitals through the employment of actuaries, risk managers, underwriters, accountants, and other insurance consultants, the Court said that, "[f]ar from purchasing insurance, petitioners have assumed the role of the insurer. In the absence of specific statutory language permitting a cooperative hospital service organization to provide insurance services in this manner, we are compelled to conclude that petitioners' activities preclude them from qualifying for exempt status under section 501(e)(1)(A)." The Court noted that the petitioners had asserted that the legislative history of the provision indicates that Congress intended the phrase "purchasing of insurance on a group basis" to be broadly interpreted to permit cooperative hospital service organizations to provide malpractice and general comprehensive insurance on a self-insurance basis. The Court replied that "there is no evidence to support petitioners' contention that Congress intended for the provision to be liberally or broadly construed." Rather, the Court said—

> Given that section 501(e)(1)(A) was amended shortly after the enactment of section 501(m) (which limits the tax-exempt status of organizations *providing* insurance), a more plausible explanation is that Congress intended the amendment to serve as a clarification that a cooperative hospital service organization may *purchase* insurance on behalf of its members without risking a violation of subsection (m).

*Id.* at 154 (emphasis in original).

The Court then said that section 501(m) also served as sound authority for denying the petitioners exempt status under section 501(a). Disagreeing with the petitioner's argument that the insurance in question was not "commercial-type" insurance, the Court, citing its opinion in Paratransit Ins. Corp. v. Comm'r, 102 T.C. 745, 754 (1994), said that "we understand that Congress intended for section 501(m) to apply to those organizations providing any 'type of insurance that can be purchased in the commercial market.'" *Id.* at 158.

Rationale:

To qualify as an organization described in section 501(c)(3) that is exempt from Federal income taxation under section 501(a) an organization must demonstrate that it is organized and operated exclusively for charitable or other specified exempt purposes, and that no part of its net earnings inures to the benefit of a private shareholder or individual. An organization that purchases insurance on a group basis for two or more hospitals will be treated as an organization organized and operated for charitable purposes if it is a cooperative hospital service organization that meets the requirements of section 501(e).

Section 1.501(c)(3)-1(a)(1) of the regulations explains that you cannot be exempt under section 501(c)(3) of the Code if you do not meet the organizational test under section 1.501(c)(3)-1(b) or the operational test under section 1.501(c)(3)-1(c).

*Organizational Test*

Section 1.501(c)(3)-1(b)(1) of the regulations explains that you would not meet the organizational test if your articles empower you to engage (as a substantial part of your activities) in activities which in themselves are not in furtherance of one or more of the exempt purposes set forth in section 501(c)(3).

You are organized for the primary purpose of being a non-profit risk retention captive insurance company under state law. Your Amended and Restated Articles of Incorporation authorize you to:

> "1. Provide for or enter into arrangements for the provision of insurance of various liability risks of the Clinics.
> "2. Act as a nonprofit, risk retention captive insurance company in such classes of insurance under applicable law and as are approved by the Insurance Commissioner of the State of B.
> "3. To do and transact any and every other kind of business which is permitted under the general nonprofit corporation and applicable captive insurance laws of the State of B ... and to transact any other lawful business for which nonprofit corporations may be incorporated under the [B Nonprofit Corporations Act]...."

As explained below under the heading "*Organizational Test*," the provision of insurance, and operation as an insurance company, without more, are commercial activities that are not in

furtherance of any exempt purpose described in section 501(c)(3). Since you are organized for the primary purpose of being a risk retention captive insurance company, and, to that end, your articles of incorporation empower you to engage in insurance business, we find that you do not meet the organizational test under section 1.501(c)(3)-1(b) of the regulations. The fact that your articles further provide that you "shall not possess or exercise any power or authority ... that will or might prevent [you] from qualifying or continuing to qualify as a corporation described in § 501(c)(3) of the Code" does not change the fact that your articles empower you to conduct a business that is not in furtherance of any exempt purpose.

*Operational Test*

Section 1.501(c)(3)-1(c)(1) explains that you would be regarded as "operated exclusively" for one more exempt purposes only if you engage primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3) of the Code. The presence of a single nonexempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of the truly exempt purposes. See Better Business Bureau of Washington, D.C., Inc v. United States, above.

We find that you do not meet the operational test under section 1.501(c)(3)-1(c)(1) of the regulations for many of the same reasons that the plaintiff organization in Nonprofits' Insurance Alliance of Cal. v. United States, above, did not meet that test. Like the plaintiff organization in that case, you were formed to provide reasonably priced insurance coverage for a membership consisting of numerous unrelated entities, the community clinics. Like the plaintiff organization, your activities possess many of the attributes of a mutual insurance company. You provide your members medical malpractice insurance, general liability insurance, and physicians' administrative defense coverage, either directly or by reinsuring a portion of the risk under policies issued by a for-profit insurance company. In providing insurance coverage for your members, you are engaged primarily in an inherently commercial activity ordinarily carried on by commercial for-profit companies. In conducting the same activities you conducted as a for-profit organization, you are undoubtedly in competition with other commercial insurers.

In addition, you would not meet the operational test under section 1.501(c)(3)-1(c)(2) of the regulations if you allowed your net earnings to inure to the benefit of persons having a personal and private interest in your activities. One of your executive directors is also the manager director of a management company that provides bookkeeping services to you and the related subsidiaries. You have not provided sufficient details of this arrangement to enable us to assess whether it offends section 1.501(c)(3)-1(c)(2), or otherwise indicates that you are organized or operated for the benefit of "private shareholders or individuals" within the meaning of section 1.501(c)(3)-1(d)(1)(ii).

*Section 501(e)*

While an organization that purchases insurance on a group basis for two or more hospitals would be treated as an organization organized and operated for charitable purposes if it is a cooperative hospital service organization under section 501(e) of the Code, we find that

you do not meet the requirements under that section because you are neither engaged in "purchasing insurance on a group basis" as contemplated under section 501(e)(1)(A) nor are you organized and operated on a cooperative basis as contemplated under section 501(e)(2).

In Florida Hospital Trust Fund v. Comm'r, above, the Tax Court said that "the plain meaning of the phrase 'purchasing of insurance on a group basis' denotes a commercial transaction in which a cooperative hospital service organization negotiates and executes the purchase of insurance for its membership as a group. In so reading the phrase, we find the operative word is 'purchasing'." The Court found that the petitioners, rather than purchasing insurance, had themselves assumed the role of insurer, which activities precluded them from qualifying for exempt status under section 501(e)(1)(A). Similarly, you do not purchase insurance on a group basis for your members. Rather, you are organized and operated as a risk retention captive insurance company for the purpose of providing medical malpractice and general liability insurance to your members. At present, you reinsure the physicians' administrative defense coverage provided to members of the purchasing group. Since you provide, rather than purchase, insurance, you do not qualify for tax-exempt status as a cooperative hospital service organization under section 501(e).

Since we find that you are neither organized nor operated exclusively for a charitable or other exempt purpose, whether as a cooperative hospital service organization or otherwise, you do not qualify as an organization described in section 501(c)(3) of the Code.

*Section 501(m)*

Aside from the issue of whether you are described in section 501(c)(3) of the Code, you would be precluded from exemption from federal taxation under section 501(a) by operation of section 501(m). Section 501(m) says that an organization described in section 501(c)(3) is not entitled to exempt status under section 501(a) if a substantial part of its activities consists of providing commercial-type insurance.

In Florida Hospital Trust Fund v. Comm'r, above, the Tax Court distinguished between purchasing insurance for a hospital group versus providing insurance for a hospital group, with the latter being a non-exempt commercial type activity. The Court said that "in employing the term 'commercial-type' insurance, we understand that Congress intended for section 501(m) to apply to those corporations providing any 'type of insurance that can be purchased in the commercial market'." Saying that "there is no dispute that hospital professional liability and workers' compensation insurance are normally offered by commercial insurers," the Court concluded that petitioners were providing commercial-type insurance within the meaning of section 501(m).

Similarly, we find that the coverage your provide your members – medical malpractice insurance, general liability insurance, and physicians' administrative defense coverage – are types of insurance that can be purchased on the commercial market. Nevertheless, you contend that your activities do not constitute "commercial-type insurance" by reason of section 501(m)(3)(A), which section carves out an exception to the term "commercial-type insurance" for

insurance that is provided at substantially below cost to a class of charitable recipients. In support of your position, you state that your "coverage will always be at a reasonable price" and that, "depending on market conditions, this reasonable price may be substantially lower than the commercial pricing of similar coverage in the open market." But the test under section 501(m)(3)(A) is not whether your prices are substantially lower than commercial pricing, but whether they are substantially below *your costs.*

In Rev. Rul. 71-529, above, we said that an organization providing investment management services to related organization was performing a charitable activity within the meaning of section 501(c)(3) where the member organizations paid only a nominal fee for the services performed for then, which fee represented less than fifteen percent of the total cost of operations. You have not provided evidence that you are providing insurance to your members at anything approximating 15 percent of cost. On the contrary, you state that you serve as a vehicle by which you would guarantee continuity of coverage to the clinics and that coverage will always be at a reasonable price; you make no mention that you will provide coverage at rates that are below your cost. You state in your application that your surplus grew substantially due excellent underwriting results and continued investment income outpacing general and administrative expenses. These financial results would indicate that you are not providing insurance at substantially below cost. In that event, and insofar as your current activities are no different than the activities you undertook as a for-profit entity, we find that your primary purpose, and a substantial amount of your activities, consists of the provision of commercial-type insurance. Consequently, you are precluded by section 501(m)(1) from exemption from tax under section 501(a).

Conclusion:

You do not qualify for exemption under section 501(c)(3) of the Code.

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: 1
Exempt Organizations Technical Group 1
1111 Constitution Avenue, NW
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

| **Initiator** | **Reviewer** |
|---|---|
| **SE:T:EO:RA:T:1** | **SE:T:EO:RA:T:1** |