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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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.4945.04-00

OP: E: EO: T: 4

Contact Person:

NO THIRD PARTY CONTACTS

Telephone Number:

In Reference to:

Date: APR 6 1999

Legend:
M =
N =
O =

Dear Ladies and Gentlemen:

This is in reply to your letter requesting a ruling that the indemnification provision described herein, and any possible payments made pursuant to it (1) will not result in private inurement or in private benefit so as to jeopardize M's exempt status under section 501(c)(3) of the Internal Revenue Code, and (2) will not result in "self-dealing" pursuant to section 4941 or in a "taxable expenditure" pursuant to section 4945.

As background, you state that several Blue Cross and Blue Shield organizations merged in 1985 to form N. N was recognized as exempt under section 501(c)(4) of the Code. Its primary source of revenue came from premiums for traditional indemnity health insurance and services. By 1995, N was providing insurance, directly or indirectly, to more than 1.4 million members, approximately 19% of the total population of your state.

The Tax Reform Act of 1986 added section 501(m) to the Code for taxable years beginning after December 31, 1986. Section 501(m) provides that an organization described in section 501(c)(3) or 501(c)(4) shall be exempt under section 501(a) only if no substantial part of its activities consist of providing commercial-type insurance. At the same time, Congress also added section 833 to the Code. Section 833 provides certain rules concerning the taxability of certain organizations (which include N). Pursuant to section 833, Blue Cross and Blue Shield organizations are taxable as stock property and casualty insurance companies. They are also allowed a deduction (not to exceed taxable income) equal to one quarter of the year's annual claims and liabilities under cost-plus contracts less the prior year's surplus for regular tax. An organization qualifying under

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section 833 is also exempt from certain provisions concerning unearned premiums of property and casualty companies.

From 1987 through 1995, N was a nonprofit corporation that failed to qualify as an exempt organization under either sections 501(c)(3) or 501(c)(4) of the Code and was taxed, for federal income tax purposes, pursuant to section 833.

In 1995, the State amended its statutes to permit certain nonprofit corporations to merge with, or amend their articles of incorporation to become for-profit corporations. The Conversion Legislation provided that prior to such merger or amendment, the company had to submit a written conversion plan to the Insurance Commissioner. N's conversion plan was accepted. In 1996, N converted from a nonprofit corporation to a for-profit corporation and became a wholly-owned subsidiary of O, a for-profit corporation.

Simultaneously with the conversion, O issued shares of Preferred Stock as well as shares of Class A Stock in escrow, and offered each "Eligible Subscriber" five shares of such stock at no cost. An Eligible Subscriber was defined in the Plan of Conversion as a person who was a subscriber of N on a date certain and whom remained a subscriber 17 months later, and as to who distribution of the shares (i) is exempt from registration under the state securities laws of the applicable jurisdictions and (ii) does not violate any applicable law or regulation. As of 1998, there were over 70,000 holders of Class A stock, including the shares held by M.

In 1997, a lawsuit was brought against N and O alleging that the conversion of N to a for-profit corporation violated the State Constitution. N and O defended the lawsuit by contending that N complied with all applicable statutes and regulations, including the Conversion Legislation, and that the conversion had been authorized by the Insurance Commissioner in accordance with the laws of the State.

In an effort to resolve the litigation, the parties entered into a Settlement Agreement in 1998. The Settlement Agreement provides for the creation of a new nonprofit foundation, M. The Agreement calls for O to transfer to M, as an endowment, the Net Settlement Stock, Net Settlement Warrants, and Net Settlement Cash. The Settlement Agreement further stipulates that in consideration of this endowment, M, as a precondition to receiving the Net Settlement Fund, agrees to release, indemnify and hold harmless the Released Persons, [primarily O and N] from and against all damages or losses incurred in defending or responding to any other suit or action arising out of the assertion of any Released Claim.

M was incorporated in September, 1998, to advance healthcare and to make grants to other section 501(c)(3) organizations for the purpose of making healthcare benefits available to individuals. M has been recognized as exempt under section 501(c)(3) of the Code and has been determined to be a private foundation under section 509(a).

M's Articles of Incorporation include, in part, the following stipulation:

> In consideration of the endowment ...., the Foundation hereby, as a precondition to receiving the Net Settlement Fund pursuant to the Stipulation, releases, indemnifies and holds harmless the Released Persons from and against, and agrees to pay or reimburse the Released Persons for any damages or losses, including attorney's fees and costs, incurred in defending or responding to any suit or action arising out of the assertion of any Released Claim. "Released Claims" means all claims, demands, rights, liabilities, and causes of action, known or unknown, accrued or unaccrued, fixed or contingent, direct or indirect, or derivative, individual or representative, of every nature and description whatsoever, that have been asserted or that could have been asserted in the Civil Action, .... "Released Persons" include all of the Defendants in the Civil Action, or any one of them, and each of their respective past or present directors, officers, employees, principals, agents, insurers, shareholders, attorneys ..., any entity in which any Defendant has a controlling interest, and the successors and assigns of all of the foregoing. Notwithstanding the foregoing, the indemnification from and hold harmless obligations of the Corporation ... shall be limited to the lesser of (a) the fair market value of O's total contribution to the Corporation at the time of such contribution or (b) the fair market value of O's total contributions to the Corporation at the time of payment by the Corporation to or on behalf of the Released Persons.

M has requested rulings that this indemnification provision and any possible payments made pursuant to it (1) will not result in private inurement or in private benefit so as to jeopardize M's exempt status under section 501(c)(3) of the Internal Revenue Code, and (2) will not result in "self-dealing" pursuant to section 4941 or in a "taxable expenditure" pursuant to section 4945. Because the rulings under section 501(c)(3) depend, in part, on our discussion of sections 4941 and 4945, we will address those issues first.

1. Ruling Under Section 4941

Section 4941(a)(1) of the Code imposes a tax on acts of self-dealing between a disqualified person as defined in section 4946(a)(1) and a private foundation.

Section 4946(a)(1) of the Code provides, in part, that a disqualified person means, with respect to a private foundation, a person who is (a) a substantial contributor to the foundation, (b) a foundation manager, or (c) an owner of 20 percent of (i) the total combined voting power of a corporation, (ii) the profits interest in a partnership, or (iii) the beneficial interest of a trust or an unincorporated enterprise, which is a substantial contributor to the foundation. Both N and O are disqualified persons within the meaning of this section because they are substantial contributors.

Section 4941(d)(1) provides, in part, that the term "self-dealing" means any direct or indirect-(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or any other extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; and (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 53.4941(d)-2(f)(1) of the Foundation and Similar Excise Taxes Regulations provides that the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation shall constitute an act of self-dealing. The purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person. Similarly, the indemnification or guarantee by a private foundation with respect to a loan to a disqualified person shall be treated as a use for the benefit of a disqualified person of the income or assets of the foundation. In addition, if a private foundation makes a grant or other payment which satisfies the legal obligation of a disqualified person, such grant or payment shall ordinarily constitute an act of self-dealing to which this subparagraph applies.

Section 53.4941-(d)-2(f)(2) of the regulations provides that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.

Section 53.4941(d)-2(f)(3)(i) of the regulations provides that it shall not be an act of self-dealing when a private foundation indemnifies a foundation manager, with respect to the manager's defense in any civil judicial or civil administrative proceeding arising out of the manager's performance of services (or failure to perform services) on behalf of the foundation, against all expenses (other than taxes, penalties or expenses of correction) including attorney fees, judgement and settlement expenses if (1) such expenses have been reasonably incurred, and (2) the manager did not act willfully and without reasonable cause with respect to the act or the failure to act.

In Underwood v. United States, 461 F. Supp. 1982 (1978), the U.S. District Court for the Northern District of Texas considered whether the return of a conditional contribution was an act of self-dealing within the meaning of section 4941 of the Code. Mr. Underwood had agreed to support the building program of the Southern Methodist University School of Law by contributing a million dollars payable over ten years at $100,000 per year. At the time of making his commitment, Mr. Underwood and all parties agreed that his commitment was conditioned upon his being able to deduct all of his contributions for federal income tax purposes. The Underwood Foundation was established to receive the yearly contributions.

When a portion of the deduction was disallowed because it exceeded the maximum that could be deducted on the grounds that the contributions were made to a private foundation rather than directly to the University, the Foundation returned the excess to Mr. Underwood with the understanding that he would contribute that amount directly to the University. The IRS determined that the return of the contribution by the Foundation was an act of self-dealing.

In this case, the Court disagreed with the Service's position and stated:

> ... the return by the Foundation of the amount of those contributions which the Foundation should not have received and which it was not entitled to keep is not a "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation" within the meaning of section 4941(d)(1)(E) of the Code.

You have indicated that the amount of the Settlement Fund to be transferred to M was subject to heated negotiations. As part of the negotiated settlement that was approved by the Court, the Released Parties agreed to fund M at a certain level provided they would not be subject to further damages or losses incurred in defending or responding to any suit or action arising out of any Released Claim. The parties and the Court determined that it was in their mutual interests to fund M immediately, and have M agree to indemnify and hold harmless the Released Parties limited by the fair market value of the contributed assets, rather than to withhold the funds until all possible collateral claims were finally settled.

The immediate funding of M with the indemnification provisions is similar to the conditional assignment discussed in Underwood, supra. The initial assignment is not a loan within the meaning of section 4941(d)(1)(B) as it is without interest. Nor is the return of assets because of the occurrence of the condition a "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation" within the meaning of section 4941(d)(1)(E). The assets subject to the condition are assets that do not belong to M and which M would not have received and is not entitled to keep in the event a valid claim is made against N or O.

Accordingly, neither the indemnification provision itself or payments made pursuant to it will result in any acts of direct or indirect self-dealing within the meaning of section 4941 of the Code.

2. Ruling Under Section 4945

Section 4945(a) of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(5) of the Code provides that the term "taxable expenditure" includes any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B) of the Code.

The Court in Underwood v. United States, supra, also considered whether a Foundation's return of a conditional contribution was a taxable expenditure within the meaning of section 4945 of the Code. The Court stated that the amounts returned were assets that the Foundation should not have received and which it was not entitled to keep. Such amounts are not an "amount paid or incurred by a private foundation" within the meaning of section 4945.

Should a successful action be brought against N or O triggering the terms of the indemnification clause, the assets subject to the return provisions are only those assets which M should not have received and is not entitled to keep, it is not an "amount paid or incurred by a private foundation" within the meaning of section 4945(d)(5) of the Code.

In addition, even if we viewed the return of assets as an expenditure subject to section 4945, it would be considered to have been made to acquire investments to be used in furtherance of its exempt purposes described in section 170(c)(2)(B) of the Code. See section 53.4945-6(b)(1)(i) of the regulations. The funding of M in the manner described allows the assets to be used immediately to further exempt purposes.

Accordingly, the return of any assets pursuant to the terms of the indemnification provision will not be considered a taxable expenditure within the meaning of section 4945 of the Code.

3. Rulings Under Section 501(c)(3)

Section 501(c)(3) of the Internal Revenue Code provides in part for the exemption from Federal income tax of organizations 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 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be organized and operated exclusively for one or more of the purposes specified in that section. If an organization fails to meet either test, it is not exempt.

Section 1.501(c)(3)-1(b) of the regulations provides, in part, that an organization is organized exclusively for one or more exempt purposes only if its "articles of organization" (a) limit the purposes of such organization to one or more exempt purposes; and (b) do not expressly empower the organization to engage, other 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(c)(1) of 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 the exempt purposes specified in section 501(c)(3). 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(c)(3)-1(d) of the regulations provides, in part, that an organization is not organized or operated exclusively for one or more of the purposes specified in section 1.501(c)(3)-1(d)(1)(i) of the regulations unless it serves a public rather than a private interest. Thus, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled by such private interests.

We have determined that M's operation in accordance with the indemnification provision in its Charter will not result in either an act of self-dealing or a taxable expenditure. Similarly, a conditional gift or a "net gift" will not be viewed as causing M's assets to inure to insiders or to be used for the private benefit of private parties. Accordingly, we rule that the indemnification provision described herein, and any possible payments made pursuant to it will not result in private inurement or in private benefit so as to jeopardize M's exempt status under section 501(c)(3) of the Internal Revenue Code.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

We are informing the Ohio EP/EO key district office of this ruling. Because this letter could help resolve any questions about your exempt status and foundation status, you should keep it in your permanent records.

If you have any immediate questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter. For other matters, including questions concerning reporting requirements, please contact the Ohio EP/EO Customer Service office at 877-829-5500 (a toll free number). The mailing address for that office is: Internal Revenue Service, EP/EO Customer Service, P.O. Box 2508, Cincinnati, OH 45201.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Chief, Exempt Organizations
Technical Branch 4