# INTERNAL REVENUE SERVICE

## TE/GE TECHNICAL ADVICE MEMORANDUM 200245064

7/22/02

Area Manager, EO Examinations

T:EO:B1

Taxpayer's Name:

Taxpayer's Address:

UIL: 501.00-00

Taxpayer's ID No.:

Years Involved:

Conference Held:

LEGEND:
L =
M =
a =

ISSUES

1. Does L continue to qualify for exemption under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(4)?

2. In the event that L does not continue to qualify for exemption under section 501(a) of the Code as an organization described in section 501(c)(4), what would be the effective date of revocation?

3. Do the administrative services L provides to self-insured employers constitute an unrelated trade or business under section 513 of the Internal Revenue Code?

4. Do the laboratory services L provides for Participating Providers and Enrollees constitute an unrelated trade or business under section 513 of the Code?

## FACTS

### Background

L, formerly known as M. is a nonprofit membership corporation that was incorporated on under the General Nonprofit Corporation Law of the State of a, where it is authorized to perform its activities.

Article II of L's Articles of Incorporation, as amended in , which was in effect at December 31, 1996, at December 31, 1997 and at December 31, 1998 provided:

> That the specific and primary purpose for which this corporation is formed is to defray and assume the costs of professional , by establishing a fund from periodic payments by subscribers or beneficiaries, from which fund said costs may be paid.

L's principal activity consists of contracting with employers, health maintenance organizations ("HMOs"), insurance companies and political subdivisions (collectively. "Subscribers") to arrange for the provision for services for the Subscribers' employees or members ("Enrollees") by professionals with whom L contracts ("Participating Providers"). L also operates a laboratory that produces various products, including

Or , the Internal Revenue Service issued a determination letter to L recognizing L as tax-exempt under section 501(a) of the Code as an organization described in section 501(c)(4). L's status as an organization described in section 501(c)(4) continued up through the tax years under examination.

As of December 31, 1997, L had __ affiliated organizations located in states other than a which were engaged in substantially the same activities as L. (Collectively, these organizations are referred to as "L Affiliates.") In general, each L Affiliate was organized as a non-profit corporation under the laws of the state where it performed its activities. In addition, as of December 31, 1997. L owned all of the stock of a for-profit corporation that was engaged in the business and all of the stock of several other for-profit corporations that were engaged in activities.

### Members

L's Restated Bylaws ("Bylaws") provide that its members consist of two classes: "Director Members" and "Participating Members." (Bylaws, Art. I, Sec. 1.)

Director Members are persons who are members of L's Board of Directors. (Bylaws, Art. 1, Sec. 1(a).) Director Members also include "Public Members." Public Members are defined as:

> Individuals who are neither or other providers, nor employees of L or any of its affiliate organizations, nor any persons who have any significant financial interest in any entity or organization providing or other health care services to the corporation, nor any person who is a spouse of any of the aforementioned individuals. . . .

Bylaws, Art. I, Sec. 1(c).

"Participating Members" are defined as:

> . . . [A]ll persons who are licensed to practice in a and who comply with the provisions of of the Business and Professions Code of the State of a and with the Rules and Regulations set forth in , of the a Administrative Code. . . .

Bylaws, Art. 1, Sec. 1(a).

Although not explained in the Bylaws, a Participating Member in L is

, and who has entered into a provider contract with L known as a "Participating Agreement." Thus, the terms "Participating Member" and "Participating Provider" refer to the same individual.

Governance

L's Board of Directors consists of between eight and fifteen persons. A majority of the Director Members must be Participating Members and/or persons who are panel members of one or more of L Affiliates. The remainder of the directors must be Public Members. A quorum consists of 60 percent of the Director Members. (Bylaws, Art. II, Sec. 1).

As of the dates below, the composition of L's Board was as follows:

| | 12/31/96 | 12/31/97 | 12/31/98 |
|---|---|---|---|
| Participating Members | | | |
| L | | | |
| Affiliates | | | |
| Total | | | |
| Public Members | | | * |
| Total | | | |

* Includes one retired

L is licensed under the
). Pursuant to Art. VIII of L's Bylaws provides for the establishment o
Committee"). As required by , the Committee must regularly and timely make recommendations and reports to the Board of Directors, which must act upon the Committee's recommendations. The Committee, which is elected by L's Subscribers, consists of five members, three of whom must be Subscribers or Enrollees, one of whom must be a member of the Board of Directors and one of whom must be a Participating Member. (Bylaws, Art. VIII, Sec. 4.) The Committee, which must meet at least quarterly, makes the final decision on all matters relating to rates or fees to be paid for professional services to Participating Members (defined below), which includes L's Participating Members as well as Participating Members of L Affiliates. (Bylaws, Art. VIII, Sec. 6.)

Subscribers and Enrollees

On December 31, 1997, L had ____ Subscribers and _____ Enrollees. A breakdown of these Subscribers and Enrollees appears at Exhibit 1. Subscribers and Enrollees and Enrollees consist of the following:

"Full Risk" Subscribers are organizations that pay L a per enrollee per month fixed amount in return for which their Enrollees and their dependents are entitled to receive certain benefits from L's Participating Providers. These benefits vary in general, benefits include the right to receive

that are provided by the Participating Provider.

"Administrative Service Plan" Subscribers are generally large, self-insured organizations for which L provides administrative services only ("ASO"), including processing and paying claims. L processes and pays the claims and the Subscriber's self-insured plan reimburses L for all claim settlement expenses. L receives an administrative fee based on the number of eligible participants in a plan or a percentage of the value of the claims filed each month. Similar to Full Risk arrangements, under Administrative Service Plan arrangements, enrollees and their dependents are entitled to receive certain benefits from L's Participating Providers. These benefits vary . In general, benefits include the right to receive

that are provided by the Participating Provider.

"Commercial Plan" Subscribers are employers of all sizes that offer as a benefit for their employees.

"Health Plan" Subscribers are plans offered by HMOs to their enrollees or by insurance companies to their clients.

"Political Subdivision" Subscribers are state and local governments and agencies of state and local governments that offer as a benefit for their employees.

"Medicare" Subscribers are plans offered by HMOs or insurance companies to their Enrollees who participate in their Medicare supplemental insurance programs. Medicare covers the . But Medicare does no , Thus, L contracts with HMOs and insurance companies to arrange, for their enrollees and clients, for the provision of services that Medicare does not cover.

"Medicaid" Subscribers are plans offered by HMOs or insurance companies to their Enrollees who qualify for Medicaid. These plans provide Medicaid beneficiaries with a examination by a Participating Provider, . Thus, L contracts with HMOs and insurance companies to arrange for the provision of services for their Medicaid enrollees and clients.

Participating Providers

The term "Participating Providers" has the same meaning as "Participating Members." As stated in Bylaws, Art. 1, Sec. 1(b), these are persons who are licensed

to practice in the State of a and who otherwise comply with a law. Although not stated in the Bylaws, a Participating Member (or Participating Provider) in L is

, and who has entered into a provider contract with L known as a "Participating Agreement."

Revenues

L's activities result in the receipt of revenues from various sources. (Exhibit 2.) For 1996 to 1998, L's total revenues were:

| | |
|---|---|
| 1996 | $ |
| 1997 | |
| 1998 | |

The principal sources of L's revenues are:

"Administrative Services" represents revenues from Administrative Service Plan Subscribers, as described above.

"Claims." Prepaid charges received from Subscribers. For Subscribers with fewer than 500 Enrollees, the rates are community rated; for subscribers with 500 or more Enrollees, the charges are experience rated.

"Interest." Interest and dividends received and gains and losses on investments.

"Other Revenue." Various miscellaneous sources of revenue such as for non-L patients, reapplication fees for Participating Providers, and intercompany transactions eliminated when separate company general ledgers are consolidated.

Surplus

At the end of 1996, 1997 and 1998, L's accumulated surplus was as follows: (Exhibit 3.)

December 31, 1996 $

December 31, 1997

December 31, 1998

Employees

As of December 31, 1996, 1997 and 1998, L had____, _____ , and _____ employees, respectively, working in a variety of functions. (See Exhibit 8.)

Activities

L states that it engages in the following community benefit activities:

A. Medicare and Medicaid

As described above, a large portion of L's Enrollees consist of Medicare and Medicaid beneficiaries. L states that as a result of participating in these programs, L has absorbed extensive underwriting losses. (Exhibit 4) The term "Retention" represents that portion of the rate charge that L has allocated internally toward administrative expenses. L retains this amount and does not ultimately distribute it.

In addition, L states that the fees it charges under its Medicare and Medicaid programs are substantially discounted. (Exhibit 5.) The "L Discounts" represent reductions from the standard L administrative service fees which L charges its Subscribers. The "Participating Provider Discounts" represent reductions from the standard fees which Participating Providers normally charge their non-L patients for equivalent services.

B.

These services are available for students up to age 18 or through graduation from high school and whose families earn up to 200 percent of the poverty level and do not participate in anothe insurance

program. The children and their families select a Participating Provider, who provides the services and is then paid by L or an Affiliate. L collaborates with local charitable organizations, which identify the children who are eligible for the program.

L incurred the following expenditures for this program in a :

1996 $

1997

1998

The number of students served by this program in a were:

1997

1998

C. Child Health Assistance Program

In L began a program called Under this program, L provides to low-income children in a . In , this program benefited _____ children. In , L incurred $_____ of expenditures under this program. These expenditures consisted of $_____ of Participating Provider Discounts, which are reductions from the standard fees Participating Providers normally charge their non-L patients for equivalent services; $_____ of L Discounts, which are reductions from the standard L administrative service fees L charges its Subscribers; and $_____ of L underwriting losses, which consists of expenses which L incurs associated with this program.

D.

L's program encourages to visit their L Participating Providers for annual checkups.

s. This program consists of mailing educational brochures to Enrollees, educating Participating Providers, operating an information line for questions, mailing follow-up materials and conducting surveys. In , L incurred $_____ of expenditures for this program, which relates to persons within a as well as outside the state.

E. Patient Newsletter

The ewsletter is part of an overall consumer awareness program to educate the general public on the importance of This program was developed in and the first issue was produced and distributed in In L incurred expenditures of $_____ for this program, which relates to persons within a as well as outside the state. These expenses covered the distribution of _____ copies, which L sent to Participating Providers, where they were available for distribution to Enrollees and to other patients of the Participating Providers. Approximately _____ copies were used as marketing materials.

F. Disaster Relief Program

L collaborates with the to provide immediate services to victims of national disasters in a who, a result of these disasters, L provides claim forms to the and provides services free of charge to victims whose In addition, to assist these victims, L gives every chapter of the claim forms for free services. Participating Providers provide free L reimburses these providers for these services. In and , L incurred $_____ and $_____ of expenditures for this program.

G.

The purpose of the program is to collect and share medical information with health plans and employer groups. The program consists of building automated systems, specifically data warehouses, to collect and store information. The program also emphasizes improving the overall quality of the data. Examples of how this data has been used are:

- Providing information to health plans for use in their ) report to the

- Providing information to health plans to assist their disease management programs, such as

- Conducting internal studies on diseases detected during an examination, with an emphasis on early detection and prevention of

The health plans and subscriber groups with which L shares this information consist of L's Subscribers and Subscribers of L Affiliates located throughout the United States. of the Subscribers are L Subscribers located in a . (Some of the generic data may be reported in L's patient newsletter, , which is available online as well as in Participating Providers' offices.) None of this data has been shared with other non-profit organizations or government agencies.

In operating this program for , L incurred expenses of $_____ for hardware, software and staff resources necessary to develop the data warehousing environment.

L Laboratory

When a Participating Provider orders for an Enrollee, the Participating Provider utilizes the services of an optical laboratory to prepare the required . The Participating Provider may use any one of over 100 independent laboratories with which L has contracted or may use the in-house laboratory operated by L ("L Laboratory"). L operates the L Laboratory

. If the Enrollee obtains from the Participating Provider, the Enrollee or the Participating Provider may provide the or the Participating Provider may order

. If the Participating

. The L Laboratory also performs

Participating Providers with respect to L Affiliates (described below) for the benefit of their Enrollees as well as their non-Enrollee patients. However, the L Laboratory does not perform
not Participating Providers or to other organizations.

From through L's revenues from the operation of the L Laboratory represented , respectively, of the total revenues L reported on Form 990 for the respective year.

Issue 1

**Does L continue to qualify for exemption under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(4)?**

APPLICABLE LAW

Internal Revenue Code

Section 501(a) of the Code provides that an organization described in subsection (c) is exempt from income taxation.

Section 501(c)(4) of the Code refers to civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Treasury Regulations

Section 1.501(c)(4)-1(a) of the regulations states:

(1) 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.

(2) Promotion of social welfare.

(i) In general. 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. . . .

(ii) . . . Nor is an organization 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.

Revenue Rulings

In Rev. Rul. 54-394,1954-2 C.B. 131, an organization's sole activity was to provide television reception for its members on a cooperative basis in an area not

readily adaptable to ordinary reception. Members were required to contract for and to pay services and installation fees. In concluding that this organization did not qualify for exemption under section 501(c)(4) of the Code, this revenue ruling stated:

> When an organization's only activity is to provide television reception on a cooperative basis to its members, who contract and pay for such services, such organization is held to operate for the benefit of its members rather than for the promotion of the welfare of mankind.

In Rev. Rul. 55-311, 1955-1 C.B. 72, the members of a local association of employees consisted solely of the employees of a particular corporation. The association operated a bus for the convenience of its members. The association's income was derived from bus fares used to pay for the operation of the bus. Since the bus operated primarily for the benefit of the association's members, this revenue ruling concluded that the association did not qualify for exemption under section 501(c)(4) of the Code.

In Rev. Rul. 62-167, 1962-2 C.B. 142, an organization's purpose was to construct and maintain a reflector-type television station, capable of receiving signals of television stations and reproducing these signals so that satisfactory television would be available to community in general. Membership was available to all persons in the area and the organization's income was derived from membership fees and donations. The reflector-type equipment received signals from three television stations and retransmitted these signals into the community. The signals retransmitted by the reflector-type apparatus were available to any television in the community. This revenue ruling distinguished Rev. Rul. 54-394, supra, because in that revenue ruling the television services were available only to members of the organization and only pursuant to a contract requiring the payment of membership fees and monthly maintenance charges. However, in this revenue ruling the organization operated its system for the benefit of all television owners in the community; it retransmitted television signals for the benefit of the entire community; and it obtained memberships and contributions on a voluntary basis. Therefore, the organization qualified for exemption under section 501(c)(4) of the Code.

In Rev. Rul. 73-349, 1973-2 C.B. 179, an organization was formed to purchase groceries for its membership at the lowest possible prices. It received orders from its members, consolidated them, and purchased the food in quantity. Each member paid for the cost of his food, and each member was assessed an equal monthly service charge for the monthly operating costs. Membership was open to all individuals in a particular community. This revenue ruling stated that the organization was a private

cooperative enterprise for the economic benefit or convenience of its members. Citing Commissioner v. Lake Forest, Inc., infra, this ruling stated that the organization operated primarily for the private benefit of members. Any benefits to the community were not sufficient to meet the requirement of the regulations that the organization operate primarily for the common good and general welfare of the people of the community. Accordingly, it did not qualify for exemption under section 501(c)(4) of the Code.

In Rev. Rul. 75-199, 1975-1 C.B. 160, an organization provided sick benefits for its members and paid death benefits to the beneficiaries of members. Membership in the organization was restricted to individuals of good moral character and health who belonged to a particular ethnic group and resided in a stated geographical area. The organization's activities consisted of holding monthly meetings and maintaining an established system for the payment of sick and death benefits. Its income was derived primarily from membership dues and was used to pay benefits to members and for miscellaneous operating expenses. In concluding that this organization did not qualify for exemption under section 501(c)(4) of the Code, this revenue ruling found that it was essentially a mutual, self-interest organization. Its income was used to provide direct and economic benefits to members and any benefit to the larger community was minor and incidental. This revenue ruling stated:

> Where the benefit from an organization is limited to that organization's members (except for some minor and incidental benefit to the community as a whole), the organization is not operated exclusively for the promotion of social welfare within the meaning of section 501(c)(4) of the Code.

In Rev. Rul. 78-69, 1978-1 C.B. 156, an organization was formed by residents of a suburban community to provide bus transportation during rush hours between the community and the major employment centers in the metropolitan area. During that time, regular bus service was inadequate. The organization contracted for buses and drivers, planned their routes and schedules and arranged for volunteers to collect the fares on each trip. Although everyone may ride the organization's buses for the established fare, almost all riders live in the community. Since revenue from fares was not always sufficient to meet the organization's expenses, the organization sought and received financial assistance from different governmental units. This revenue ruling found that the organization was providing a useful service to all members of the community. The bus service provided was not commercially available and was subsidized by governmental financial assistance. Participation in the organization's activities was open to all community residents and volunteers carried out its activities. This method of operation indicated that the organization was not carrying on a business

with the general public in a manner similar to organizations that are operated for profit. As a result, since it promoted the common good and general welfare of the people of the community, it qualified for exemption under section 501(c)(4) of the Code.

In Rev. Rul. 81-58, 1981-1 C.B. 331, an association of officers of a police department in a community promoted the professional development of its members, educated the public to recognize and appreciate the value of the service of the members and provided a lump-sum payment to each member upon retirement or a lump-sum payment to beneficiaries upon the member's death. Its primary sources of income were from contributions by the general public and through public fund-raising events. Upon joining the organization, members are required to pay a nominal, one-time membership fee. In concluding that the organization did not qualify for exemption under section 501(c)(4) of the Code, this revenue ruling described the organization as essentially a mutual, self-interest type organization. Its income was used to provide direct economic benefits to members. In relying on Rev. Rul. 75-199, supra, the ruling stated:

> Although the class of employees benefited by the organization consist of police officers engaged in the performance of essential and hazardous pubic services and there is an incidental benefit provided by the organization to the larger community, the fact remains that the primary benefits from the organization are limited to its members.

Case Law

In Commissioner v. Lake Forest, Inc., 305 F.2d 814 (4th Cir. 1962), Lake Forest was organized as a nonprofit membership corporation. It entered into an agreement with a federal government agency to purchase two U.S. defense housing projects consisting of 249 one-story residential buildings divided into 584 dwelling units. Lake Forest proposed to devote these properties to a cooperative, nonprofit use as homes for its members. The number of members in the corporation was limited to the number of dwellings available. Preference in membership was given to inadequately housed veterans of World War II, then to inadequately housed veterans of World War I, then to veterans of World Wars regardless of present housing accommodations, and then to "other eligible persons." A member was entitled to purchase the right to perpetually use a dwelling unit at a specific price. A member would pay monthly principal and interest and a monthly operating fee. A member could transfer his perpetual use only to a member of his family. If a member desired to leave the residence, Lake Forest had a right to purchase the perpetual use, but if it did not, the member could sell the use to anyone acceptable to Lake Forest.

In reversing the Tax Court, the Court of Appeals concluded that Lake Forest did not qualify for exemption under section 501(c)(4) of the Code.

The court first concluded that Lake Forest did not meet the dictionary definition of "civic," stating:

> While the [advantages offered by Lake Forest] are available to all citizens eligible for membership, the benefits are not municipal or public in their nature. Nor are they bestowed upon the commonalty as such. United States v. Pickwick Electric Membership Corp., 158 F.2d 272, 276 (6 Cir. 1946). Lake Forest is not a movement of the citizenry or of the community. Rather, at most it is a venture - - unquestionably praiseworthy - - for securing its members living quarters.

305 F.2d at 818.

The court also concluded that Lake Forest did not meet the dictionary definition of "social" or "welfare," stating:

> It does not propose to offer a service or program for the direct betterment or improvement of the community as a whole. [Citations omitted.] It is not a charitable corporation in law or equity, for its contribution is neither to the public at large nor of a public character. [Citations omitted.] Lake Forest does, of course, furnish housing to a certain group of citizens but it does not do so on a community basis. It is a public-spirited but privately-devoted endeavor. Its work in part incidentally redounds to society but this is not the "social welfare" of the tax statute.
>
> . . . .
>
> Whatever the nature of the rights or privileges thus afforded persons other than members, it is a circumstance too insubstantial to qualify the entire activity of the corporation as in the social welfare. Size of membership in ratio to local population is not controlling on whether an organization is "civic' or "social." The number affected is not the criterion. A private project may touch an appreciable segment of the people of a large physical area and yet, for want of the considerations mentioned, not be converted into a civic or social undertaking. Classification as "civic" or "social" depends on the character - - as public or private - - of the benefits bestowed, of the beneficiary, and of the benefactor. [Emphasis added.]

The Court of Appeals concluded:

> . . . [T]he property has been sold to a private corporation having no civic, community or public status, and permitted - - though as a last classification - - to sell shelter not only to veterans but even generally to "other eligible persons", without delimitation, unless each preceding class exercises its preference in 30 days. While the occupancy preferences may contribute to the promotion of social welfare, they do not overbalance the private nature of the project.

The court distinguished U.S. v. Pickwick Electric Membership Corp., 158 F.2d 272 (6th Cir. 1946) by stating:

> [Pickwick] dealt with a situation embraced by the statute. The taxpayer was a public utility corporation organized and run to provide electric energy for several counties under a program authorized and encouraged by the State of Tennessee. One of its purposes was to bring electricity to many communities which had none, as well as to speed the improvement of rural electrification of the area generally. The service and membership could be enjoyed by the public at large and on a nonprofit basis. Although a commercial benefit, it was available to citizens as citizens and promotive of social welfare.

305 F.2d at 819 - 820.

In People's Educational Camp Society, Inc. v. Commissioner, 39 T.C. 756 (1963), a nonprofit membership corporation that was created in 1920 purchased nearly 2,200 acres of land in the Pocono Mountains of Pennsylvania to carry on studies and continue the development of certain liberal and progressive social programs ("Tamiment"). Its membership was limited to 35 persons. In 1936, the organization was recognized as tax-exempt under the predecessor of section 501(c)(4) of the Code, and in 1939, it was recognized as exempt under section 501(c)(4).

Except for 1921 to 1923, Tamiment never received any contributions. Through 1957, Tamiment earned substantial profits, so that its accumulated surplus grew from about $19,400 in 1922 to about $2.3 million in 1957.

By 1956, Tamiment had become the largest and one of the most modern summer vacation resorts in Pennsylvania. By this time, the facilities at Tamiment had been enlarged and improved to a point where they were sufficient to provide accommodations for more than 900 guests. The resort was open to the public. It operated competitively with other mountain resorts in New York City newspapers and it advertised in magazines and in multicolored brochures where it was described as a luxurious resort for summer vacations. Tamiment included 160 attractively furnished cottages, a large central dining hall, 33 bungalows, an administration building, a library, a lecture and concert hall, a large ballroom building, taverns, a clubhouse and dining terrace overlooking the lake, an 18-hole gulf course, another large clubhouse overlooking the golf course and containing a cocktail lounge, a large theater building, 18 tennis courts, and a beach house on the lake where swimming and fishing were available and more than 100 canoes and rowboats. In addition, there were extensive facilities for conducting team sport activities.

Tamiment also offered organized programs for guests who were interested in the theater, music and art. In addition, lectures pertaining to subjects of general interest were presented once a week.

For the fiscal years ended September 30, 1953 through 1957, 93.3 percent of Tamiment's total revenues were derived from operating the Tamiment resort; 83.2 percent of total revenues were used for operating expenses, 4.3 percent of total revenues was expended for social welfare activities, and 2.6 percent of total revenues consisted of contributions and donations to other organizations.

On September 30th of each of the following fiscal years, Tamiment's accumulated surplus was:

| | |
|---|---|
| 1953 | $1,913,550 |
| 1954 | 2,036,911 |
| 1955 | 2,124,602 |
| 1956 | 2,226,081 |
| 1957 | 2,307,098 |

The IRS revoked Tamiment's tax-exemption under section 501(c)(4) of the Code. The Tax Court sustained this revocation, finding that Tamiment was primarily engaged in the operation of the resort at Tamiment, and that "its activities in operating said resort did not in themselves constitute, and were not merely incident to, the promotion of social welfare." 39 T.C. at 767.

The Tax Court concluded that Tamiment's operation of this resort, when considered in relation to its activities as a whole, precluded it from qualifying for exemption under section 501(c)(4) of the Code for several reasons:

First, Tamiment's activities, in operating the resort were not "exclusively," or even principally or primarily, for the promotion of social welfare within the meaning of the statute, citing Lake Forest, Inc., supra. The Tax Court stated:

> . . . [P]etitioner's activities in maintaining and operating the large resort at Tamiment, were not directed to, and did not result in providing benefits either for the public at large, or for any community as a whole. Rather, the facilities and activities at said resort were devoted principally and primarily to providing living accommodations, meals, and a variety of recreational and cultural programs for the personal benefit of paying guests, who were attracted to the resort because it was an enjoyable and luxurious place for summer vacations, and who were willing and able to pay the substantial daily or weekly overall rates which petitioner charged.

> True it is, that both the recreational and cultural activities provided, did benefit those who participated in them. But, when the same are considered in light of the facts that they were furnished for financial consideration, and were paid for by the guests as part of the "package rates" charged therefor, we think it would be overstretching the meaning and intent of the tax exemption statute to include them within the ambit of "promotion of social welfare."

39 T.C. at 768 - 769.

Second, the Tax Court was convinced that the operation of Tamiment was its primary activity and not merely incidental to those social welfare activities that it carried on. In this regard, the Tax Court stated:

> What is even more significant, is the fact that petitioner's total revenues from all sources . . . were disposed of principally in handling the operating expenses of said resort, in enlarging and improving the resorts' facilities, and in making additions to petitioner's accumulated surplus; and that, by comparison, only a relatively insignificant portion of such total revenues was expended in the promotion of social welfare activities.

Ibid.

In addition, the Tax Court compared Tamiment's revenues and social welfare activities to its accumulated surplus for each of the years ended September 30, 1953 to 1957.

The Tax Court concluded by stating:

> We find that the crucial factor, in light of the evidence, is that the sales aspect of plaintiff's work looms so large as to overshadow all else.

39 T.C. at 770.

## ANALYSIS

Organizations described in section 501(c)(4) of the Code include civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare,

Section 1.504(c)(4)-1(a)(2) of the regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting the common good and general welfare of the people of the community. These regulations also state that an organization is embraced within this provision if it is operated primarily for the purpose of bringing about civic betterments and social improvements. To make this determination with respect to L, it is necessary to consider all of the facts and circumstances surrounding L's activities to ascertain whether L is

operated exclusively for social welfare purposes. It is also necessary to determine the extent to which L's activities constitute commercial, rather than social welfare, activities.

L contends that the it engages in various social welfare activities. These contentions are discussed below:

A. Medicare and Medicaid

At December 31, 1997, Medicare and Medicaid (and small employer) enrollment was as follows (see Exhibit 1):

| | | % of Total |
|---|---|---|
| | Enrollees | Enrollment |
| Medicare | | |
| Medicaid | | |
| Small Employer Groups | | |
| Total | | |

Medicare. Medicare does not cover all of an individual's health care services, such as prescription drugs and medicines. Thus, many Medicare beneficiaries purchase supplemental health care insurance to cover health care services that are not covered. This additional coverage may be obtained from a health insurance company or an HMO. Similarly, Medicare covers only a portion of the total health care services relating to

. Thus, when a Medicare beneficiary purchases supplemental Medicare insurance from an insurance company or HMO, additional services, , are often included.

In the present case, various health insurance companies and HMOs subcontract with L for L to arrange for the provision of services to their Medicare clients or enrollees. L has not established that this activity is significantly distinguishable from the same activity carried on by for-profit service arrangers under section 1.501(c)(4)-1(a)(2)(ii) of the regulations.

Medicaid. In recent years, many states have changed from traditional indemnity insurance to a managed care system for the provision of health care services to their Medicaid population. Thus, the state Medicaid agencies contract with insurance companies and HMOs to arrange for the provision of health care services to eligible Medicaid beneficiaries. Since these companies often cannot provide all of the

contracted health care services themselves, such as
and services, these companies frequently subcontract with other organizations to provide these services.

In the present case, various health insurance companies and HMOs subcontract with L for L to arrange for the provision of services to their Medicaid clients or enrollees. L has not established that this activity is significantly distinguishable from the same activity carried on by for-profit service arrangers under section 1.501(c)(4)-1(a)(2)(ii) of the regulations.

L points out that it operates its Medicare and Medicaid programs at a loss, thereby promoting social welfare by underwriting costs for government programs aimed at arranging for the provision of services for individuals who are generally considered as "medically underserved." However, if L's administrative expenses ("Retention") are added back, these programs actually operate at a profit for most years. (See Exhibit 4.) Moreover, L's involvement with Medicare and Medicaid is more a matter of securing contracts from other health insurance companies and HMOs which provide coverage for these populations than contracting directly as a Medicare or Medicaid arranger. Therefore, rather than underwriting unprofitable programs that support socially responsible government programs, L's Medicare and Medicaid programs have both an economic and business purpose underpinning.

B.

L's Program provides services or low-income students whose families qualify neither for employer health insurance nor government assistance.

In order to determine the extent of this program, it is appropriate to compare L's expenditures with its gross revenue and total expenditures, and with its accumulated surplus. (See People's Educational Camp Society, Inc., supra.) (Exhibit 6.) L's expenditures for its Program in and combined was less than of its combined gross revenues and less , of its combined total expenses expenditures in and combined was less of its average accumulated surplus at and

These data indicate that in relation to L's total activities, L's Program represents an extremely minor part of L's total activities.

C. Child Health Assistance Program

L states that in , under this program, L incurred $_____ of expenditures and benefited _____ children, an average of per child. However, $_____ of these expenditures, or percent, represent discounts absorbed by Participating Providers, not L. On this basis, in L incurred only $_____ of expenditures for this program, representing an average of per child. (Exhibit 7.)

L's expenditures for its Child Assistance Program in was slightly more than , of its gross revenues and of its total expenses. In additio expenditures in was only slightly more than of its accumulated surplus at

These data indicate that on a per child basis and in relation to L's total activities, L's Child Health Assistance Program represents an extremely minor part of L's total activities.

D.

This program is directed to encourage L Enrollees to visit their Participating Providers for annual checkups for detection of
While this program is beneficial, it is directed toward Enrollees and not toward members of the general public who are not Enrollees. Furthermore, this program aims to benefit not just Enrollees of L in a , but also Enrollees in L Affiliates outside of a , which is outside L's community.

L's expenditures for its Program in was less than of its gross revenues and of its total expenses. In addition, L's expenditures in was only slightly more than of its accumulated surplus at

These data indicate that in relation to L's total activities, L's Program represents an extremely minor part of L's total activities.

E. Patient Newsletter

Under this program, L distributed a health care newsletter. However, the distribution was limited to its Participating Providers, who made the newsletter available to their patients, both Enrollees and non-Enrollees. By limiting distribution to its Participating Providers, L did not distribute the newsletter to members of the general public, except for those patients of Participating Providers who were not Enrollees. Furthermore, this program aims to benefit not just Enrollees of L in a , but also Enrollees in L Affiliates outside of a , which is outside L's community.

L's expenditures for its Newsletter in was less than of its gross revenues and of its total expenses. In addition, L's Patient Newsletter expenditures in was only slightly more than , of its accumulated surplus at

These data indicate that in relation to L's total activities, the Patient Newsletter represents an extremely minor part of L's total activities.

F. Disaster Relief Program

Under this program, L reimburses Participating Providers who provide free services. , to victims . However, L has not demonstrated the extent to which it publicizes this program either to the , to local , to its Participating Providers or to victims. This may be why L incurred only $_____ and $_____ in and , respectively, for this program. In addition, when measured in relation to L's gross revenues, total expenses and accumulated surplus, this program represents an extremely minor part of L's total activities.

L's expenditures for its Disaster Relief Program in and was only of its combined and gross revenues and ) of its total expenses. In addition, L's Disaster Relief Program in was ) of its average accumulated surplus at

These data indicate that in relation to L's total activities, the Disaster Relief Program represents an extremely minor part of L's total activities.

G.

Under this program, L collects and shares medical information with health plans and employer groups, which data is used to provide information for , to assist their disease management programs, and in conducting internal studies on diseases detected during examination. However, this information is distributed only to health plans and employer groups which are L's Subscribers in a and Subscribers of L Affiliates located elsewhere in the country. None of this data is shared with other non-profit organizations or government agencies.

Therefore, although L has incurred substantial amounts for this Program ($_____), the information under this Program directly benefits only Subscribers of L and Subscribers of L Affiliates and indirectly benefits only the Enrollees in these Subscribers' plans. Members of the community who are not L's Subscribers, Subscribers of L Affiliates or Enrollees in their plans do not benefit from this Program. Therefore, because this Program benefits Subscribers and their Enrollees almost exclusively, rather than the community as a whole, this Program does not constitute a social welfare activity under section 1.501(c)(4)-1(a) of the regulations.

Discussion

Section 1.501(c)(4)-1(a)(1) of the regulations requires that an organization be operated "exclusively" for the promotion of social welfare. Section 1.501(c)(4)-1(a)(2) provides that an organization is operated "exclusively" for the promotion of social welfare if it is "primarily" engaged in promoting the common good and general welfare of the people of the community.

L contends that much of its activities constitute social welfare activities. The services L arranges for its Medicaid Enrollees and its Small Employer Group Enrollees are considered to benefit the general community because these persons are generally considered as being "medically underserved." In addition, L engages in some other activities that benefit the general community. However, whether considered both quantitatively and qualitatively, all of these activities represent only a very minor part of L's total activities, Instead, L's activities principally benefit its Enrollees rather than persons who are medically underserved. For example, in , L's expenditures that are considered as benefiting the community in general constituted less than of L's total revenues, approximately of its total expenses, and percent of its accumulated surplus at (See Exhibit 10.)

Persons who are considered as medically underserved comprise approximately 24 percent of L's enrollment and Enrollees in large employer groups and members of large health plans comprise approximately 76 percent of L's enrollment. (See page 22; Exhibit 1.)

Simply because L arranges ervices for a large number of persons in the community and engages in a small amount of social welfare activities does not establish that it is a social welfare organization within the meaning of section 501(c)(4) of the Code. As the court of appeals stated in Commissioner v. Lake Forest, Inc., supra:

> Classification as "civic" or "social" depends on the character - - as public or private - - of the benefits bestowed, of the beneficiary, and of the benefactor.

L's social welfare activities during the examination years, whether considered in relation to L's total revenues, total expenses, accumulated surplus, or total enrollment, are minor, incidental and insignificant. See People's Educational Camp Society, Inc. v. Commissioner, supra. Therefore, based on any measure, it cannot be said that L is primarily engaged in promoting the common good and general welfare of the people of the community within the meaning of section 1.501(c)(4)-1(a)(2) of the regulations.

Further, a nonprofit corporation whose activities benefit primarily its enrollees, rather than the general public, does not promote the common good and general welfare of the people of the community within the meaning of section 1.501(c)(4)-1(a) of the regulations. Depending on how a particular organization operates, the same activities may cause different results under section 501(c)(4) of the Code. Rev. Rul. 54-394, supra, and Rev. Rul. 62-167, supra, both involved the provision of television services, but since the organization in the latter ruling provided services to the entire community, rather than just to its members, it qualified for exemption as a social welfare organization. Similarly, Rev. Rul. 55-311, supra, and Rev. Rul. 78-69, supra, both involved the provision of bus transportation. In the former ruling, the bus service benefited the organization's members, but in the latter ruling, the community as a whole benefited from the bus service, and thus qualified for exemption as a social welfare organization. Since L's activities benefit its Enrollees almost exclusively, its activities do not promote the common good and general welfare of the people of the community within the meaning of section 1.501(c)(4)-1(a) of the regulations.

Finally, section 1.501(c)(4)-1(a)(2)(ii) of the regulations states 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 L has not established that its activities, including arranging for the provision of services for Medicare and Medicaid beneficiaries. are significantly distinguishable from the same activities carried on by for-profit ervice organizations.

In conclusion, based on all the facts and circumstances, L has not established that it is operated primarily for the purpose of bringing about civic betterments and social improvements within the meaning of section 1.501(c)(4)-1(a)(2)(i) of the regulations. L's operations benefit almost exclusively its Enrollees. Its social welfare activities, in relation to its total activities, are minor, incidental and insignificant. Finally, L has not established that its activities are significantly distinguishable from the same activities carried on by a business operated for profit, as required in section 1.501(c)(4)-1(a)(2)(ii). Thus, L is not primarily engaged in promoting the common good and general welfare of the people of the community. As a result, it is not operated exclusively of the promotion of social welfare within the meaning of section 1.501(c)(4)-1(a)(2)(i). Consequently, L does not continue to qualify for exemption under 501(a) of the Code as an organization described in section 501(c)(4).

Issue 2

**If L does not continue to qualify for exemption under section 501(a) of the Code as an organization described in section 501(c)(4), what would be the effective date of revocation?**

The Commissioner, TE/GE, pursuant to the authority under section 7805(b)(8) of the Code, has exercised this authority to grant retroactive relief to L with respect to the revocation of its exemption under section 501(c)(4). Therefore, the effective date of revocation will be the date of the letter from the Area Manager to L notifying L that its exemption under section 501(c)(4) of the Code has been revoked.

Issue 3

**Do the administrative services L provides to self-insured employers constitute an unrelated trade or business under section 513 of the Internal Revenue Code?**

**Issue 4**

**Do the laboratory services L provides for Participating Providers and Enrollees constitute an unrelated trade or business under section 513 of the Code?**

APPLICABLE LAW

Section 501(a) of the Code provides that an organization described in subsection (c) is exempt from income taxation.

Section 511(a) of the Code provides that the unrelated business taxable income of organizations described in subsection 501(a) is subject to taxation.

Section 512(a) of the Code provides that the term "unrelated business taxable income" means the net income an organization derives from an unrelated trade or business regularly carried on.

Section 513(a) of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its tax-exempt purpose.

Section 513(a)(2) of the Code provides that an unrelated trade or business does not include any trade or business which is carried on by a section 501(c)(3) organization primarily for the convenience of its members, students, patients officers or employees.

Section 1.513-1(b) of the Income Tax Regulations states, in part:

> Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purpose of an organization.

Section 1.513-1(c)(1) of the regulations provides that in determining whether a trade or business from which a particular amount of gross income derives is "regularly carried on," the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued should be considered. For example, specific business activities are considered "regularly carried

on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

Section 1.513-1(d)(2) of the regulations provides that a trade or business carried on by an organization is related to its tax-exempt purpose if the conduct of the business activities has a causal relationship to the achievement of the organization's tax-exempt purpose. It is "substantially related" if the causal relationship is a substantial one. Thus, the activity must contribute importantly to the accomplishment of the organization's tax-exempt purpose. Whether an activity contributes importantly to the accomplishment of the organization's tax-exempt purpose depends in each case upon the facts and circumstances involved.

Section 1.513-1(d)(3) of the regulations provides that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved should be considered in relation to the nature and extent of the exempt function which they purport to serve.

Rev. Rul. 78-435, 1978-2 C.B. 181, involved a section 501(c)(3) organization whose primary activity was the operation of a clinic providing various rehabilitation services to handicapped persons, including those with hearing deficiencies. The clinic tested and evaluated the hearing of its patients with hearing deficiencies and recommended types of hearing aids that may be necessary in each case. Patients who wish to purchase hearing aids from the clinic may do so. Upon purchase, the clinic fitted the hearing aids to insure maximum assistance to the patients in the correction or alleviation of their hearing deficiencies. This revenue ruling held that the sale of hearing aids as an integral part of the clinic's program to test and evaluate patients with hearing deficiencies contributes importantly to the clinic's purpose of promoting the health of such persons.

Section 7805(b)(8) of the Code provides that the Internal Revenue Service may prescribe the extent, if any, to which any ruling shall be applied without retroactive effect.

In Rev. Rul. 78-289, 1978-2 C.B. 180, the IRS revoked the ruling letter that it had previously sent to an organization recognizing it as exempt from federal income tax. Under section 7805(b) of the Code, this revocation was effective prospectively. The IRS also determined that the organization regularly carried on a business activity that was not substantially related to the performance of the organization's tax-exempt purpose. When section 7805(b) is applied in the case of the revocation of an organization's exemption letter, the revocation is effective at a later date than would be

the case if section 7805(b) relief were not applied. Until that effective date, the organization is treated as though it were exempt from Federal income tax under section 501(a).

ANALYSIS

**Issue 3**

**Do the administrative services L provides to self-insured employers constitute an unrelated trade or business under section 513 of the Internal Revenue Code?**

L's Subscribers fall into two categories: Full Risk and ASO. Full Risk Subscribers are organizations that have a prepaid arrangement with L under which they pay L a per enrollee per month fixed amount in return for which their Enrollees and their dependents are entitled to receive certain benefits from L's Participating Providers. These benefits vary. In gener

that are provided by the Participating Provider.

ASO Subscribers are generally large, self-insured organizations that pay L for providing administrative services, including processing and paying claims. L processes and pays the claims and the Subscriber's self-insured plan reimburses L for all claim settlement expenses. L receives an administrative fee based on the number of eligible participants in a plan or a percentage of the value of the claims filed each month. Similar to Full Risk arrangements, under Administrative Service Plan arrangements, enrollees and their dependents are entitled to receive certair benefits from L's Participating Providers. These benefits varv

Included in the total services that Full Risk Subscribers receive from L in return for their fixed payments are billing and processing activities. Under ASO plans, which are self-funded arrangements, L charges the Subscriber a separate fee for the performance of these services. Under both programs, these services are necessary

and integral parts of L's overall activities of arranging for the provision of for Enrollees.

Under section 1.513-1(d)(2) of the regulations, a trade or business carried on by an organization is substantially related to its tax-exempt purpose if the conduct of the business activities has a substantial causal relationship to the achievement of the organization's tax-exempt purpose. Thus, the trade or business must contribute importantly to the accomplishment of the organization's tax-exempt purpose.

As described above, the Commissioner, TE/GE has exercised her discretion to grant L relief under section 7805(b) to limit the retroactive effect of this revocation until the date the Service notifies L that its exempt status under section 501(c)(4) has been revoked. Therefore, under Rev. Rul. 78-289, supra, until that date, the Service treats L as though it were exempt from Federal income tax under section 501(a).

Under Rev. Rul. 78-289, during the section 7805(b) relief period, arranging for the provision of services for Enrollees is treated as though it furthered social welfare purposes under section 501(c)(4). These activities consist of performing services for Full Risk Subscribers and for ASO Subscribers. Therefore, because the services L performs for ASO Subscribers are necessary and integral parts of L's overall activities of arranging for the provision of services for Enrollees, these services contribute importantly to the accomplishment of L's purported tax-exempt purpose. As a result, these services have a substantial causal relationship to the achievement of L's purported tax-exempt purpose under section 1.513-1(d)(2) of the regulations. Consequently, these activities are substantially related to L's exercise or performance of its purported tax-exempt purpose under section 513(a) of the Code.

**Issue 4**

**Do the laboratory services L provides for Participating Providers and Enrollees constitute an unrelated trade or business under section 513 of the Code?**

In Rev. Rul. 78-435, supra, a section 501(c)(3) clinic that provided rehabilitation services to handicapped persons, including those with hearing deficiencies. The clinic tested and evaluated the hearing of its patients with hearing deficiencies and recommended types of hearing aids that may be necessary in each situation. Patients who wished to purchase hearing aids from the clinic could do so, in which case, the clinic fitted the hearing aids to insure maximum assistance to the patients in the correction or alleviation of their hearing deficiencies. Based on these facts, this

revenue ruling held that sale of hearing aids as an integral part of the organization's program to test and evaluate patients with hearing deficiencies contributes importantly to the clinic's purpose of promoting the health of such persons.

An important fact in Rev. Rul. 78-435 was that the tax-exempt health care provider that performed the testing and evaluation services for its patients also sold the hearing aids to the patients and fitted them to each patient.

In the present case, an Enrollee is entitled to receive from a Participating Provider. If the Participating Provider determines that the Enrollee needs to have his/her the Participating Provider will recommend, or prescribe, the needed. The Enrollee is free to anywhere. However, since the Enrollee is

In addition, if the Enrollee chooses to

the Enrollee is responsible for paying the Participating Provider the additional charges. When the Participating Provider orders for the Enrollee, the Participating Provider is free to from any laboratory, such as the L laboratory or an independent laboratory approved by L.

Under Rev. Rul. 78-289, during the section 7805(b) relief period, arranging for the provision of services for Enrollees is treated as though it furthered social welfare purposes under section 501(c)(4).

In Rev. Rul. 78-435, the tax-exempt health care provider, in connection with the provision of specific health care services to its patients, sold to its patients certain medical equipment to help alleviate the patients' maladies. In the present case, L is not a health care provider, but an arranger of services for the beneficiaries of its Subscribers. The health care providers are the Participating Providers. In addition, L does not sell . Thus, the present situation differs markedly from Rev. Rul. 78-435. As a supplier of professionals, L has the same relationship with Participating Providers as an independent supplier of has with any professional. The fact that L is also the arranger of services by the Participating Provider for the Enrollees does not enhance L's relationship with the Participating Provider as a supplier of products. Therefore, L's sale of

importantly to furthering L's purported tax-exempt purpose of arranging for the provision of services to Enrollees. does not contribute

The Participating Provider provides services and to the Enrollee. Pursuant to L's contract with the Subscriber, L is a third-party that pays the Participating Provider the contracted amount for the

Provider purchases . If the Participating ; from the L Laboratory, L is also a vendor to the Participating Provider. The Enrollee is not a patient of L and the Enrollee is not a customer of L, since the Enrollee is not purchasing The only relationship the Enrollee has with L is that of a third-party beneficiary of the contractual arrangement between L and the Enrollee's Subscriber.

Since the Participating Provider is free to for the Enrollee from any approved laboratory, including the L Laboratory, the laboratory services the L Laboratory performs for the Participating Provider are no different than the laboratory services an independent laboratory performs for the Participating Provider. The laboratory services performed by the L Laboratory are not unique. Indeed, Participating Providers use approximately 100 independent commercial laboratories to perform the same services as does the L Laboratory. The laboratory services the L Laboratory performs for the Participating Providers contribute no more importantly to the accomplishment of L's purported tax-exempt purpose than do the , laboratory services performed by the independent commercia laboratories.

Therefore, the services the L Laboratory performs for the Participating Provider do not contribute importantly to the accomplishment of L's purported tax-exempt purpose and therefore do not have a substantial causal relationship to the achievement of L's purported tax-exempt purpose under section 1.513-1(d)(2) of the regulations. Consequently, these services are not substantially related to L's exercise or performance of its purported tax-exempt purpose under section 513(a) of the Code.

## CONCLUSIONS

1. L does not continue to qualify for exemption under section 501(a) of the Code as an organization described in section 501(c)(4) and the determination letter recognizing L as an organization described in section 501(c)(4) should be revoked.

2. Since the Commissioner, TE/GE has granted relief under section 7805(b) of the Code, the effective date of revocation will be the date of the letter from the Area Manager to L notifying L that its exemption under section 501(c)(4) of the Code has been revoked.

3. The administrative services L provides to self-insured employers do not constitute an unrelated trade or business under section 513 of the Internal Revenue Code.

4. The laboratory services L provides for Participating Providers and Enrollees constitute an unrelated trade or business under section 513 of the Code.

A copy of this memorandum is to be given to the organization. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

- END -

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EXHIBITS

Redacted