TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

INFO **2003-0225**

Date: MAY 29 2003

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Contact Person:
xxxxxx xxxxxxxx
Identification Number:
xx-xxxxx
Contact Number:
(xxx) xxx-xxxx

Employer Identification Number: xx-xxxxxxx

Dear Sir or Madam:

This is in response to your letter dated April 10, 2003, submitted on your behalf by xxxxxxx x. xxxxx, CPA, your authorized representative. You request an Information Letter, as defined in Rev. Proc. 2003-4, 2003-1 I.R.B. 123, Sec. 8.01, pertaining to the below facts. You understand that such a letter "is advisory only and has no binding effect on the Service."

You are a voluntary employees' beneficiary association which is exempt from federal income tax as an organization described in section 501(c)(9) of the Internal Revenue Code. You have been organized for the purpose of providing medical benefits for eligible employees of participating employers. Until now, participating employers have consisted of behavioral healthcare providers exempt from tax under section 501(c)(3) of the Code. Recently, one of the participating employers announced its intention to relinquish its tax exempt status, and continue to operate as a for-profit behavioral healthcare provider. However, this employer has stated its desire to continue to participate in your benefit plan.

Section 512(a)(3)(B) of the Code provides, in part, that the term "exempt function income" includes all income "which is set aside...in the case of an organization described in paragraph (9), (17), or (20) of section 501(c), to provide for the payment of life, sick, accident, or other benefits..."

Section 512(a)(3)(E)(i) of the Code limits the amount of the above set-aside generally to the qualified asset account limit set forth in section 419A(c).

Section 512(a)(3)(E)(iii) of the Code provides that the set-aside limitation "...shall not apply to any organization if substantially all of the contributions to such organization

are made by employers who were exempt from tax under this chapter throughout the 5-taxable year period ending with the taxable year in which the contributions are made."

Inasmuch as all of your participating employers have been tax exempt to date, the above set aside limitations have been inapplicable. As you consider the tax implications of allowing the participation of a member who is not tax exempt, you request guidance concerning the meaning of "substantially all" within the context of section 512(a)(3)(E)(iii) of the Code.

While the term "substantially all" is not specifically defined in sections 511-513 of the Code, nor in the corresponding Income Tax Regulations, nevertheless, as a matter of administrative practice, the Internal Revenue Service has consistently interpreted the phrase to mean 85 percent. For illustration, the 85 percent standard is reflected in the Service's treatment of the exception for volunteer labor in the definition of unrelated trade or business in section 513(a)(1) of the Code and section 1.513-2(b)(1) of the regulations. Furthermore, section 53.4942(b)-1(c) of the Foundation and Similar Excise Taxes Regulations explicitly defines the term "substantially all" to mean 85 percent or more in the context of "qualifying distributions" and the criteria for operating foundation status under section 4942(j)(3) of the Code.

In light of the foregoing discussion, you may reasonably assume that the term "substantially all", as used in section 512(a)(3)(E)(iii) of the Code, will be interpreted by the Service to mean 85 percent or more. However, please bear in mind that this is not a ruling letter and thus has "no binding effect on the Service."

If you have any questions about this advisory letter, please contact the person whose name and telephone number are shown in the heading of this letter.

Thank you for your cooperation.

Sincerely,

(signed) Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4