Bond Case Briefs

Municipal Finance Law Since 1971

IRS LTR: Hospital Organization is Denied Exemption.

The IRS denied tax-exempt status to an organization seeking exemption as a cooperative hospital service organization because it is not organized and operated on a cooperative basis and is not organized and operated solely to perform, on a centralized basis, a service enumerated under section 501(e)(1)(A).

Citations: LTR 201433018

Contact Person: * * *
Identification Number: * * *
Contact Number: * * *
UIL Code: 501.03-00, 501.03-32
Release Date: 8/15/2014
Date: May 20, 2014
Employer Identification Number: * * *
Form Required To Be Filed: * * *
Tax Years: * * *

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.

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,

Tamera Ripperda
Director, Exempt Organizations
Rulings and Agreements
Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter
* * * * *

Contact Person: * * *
Identification Number: * * *
Contact Number: * * *
Fax Number: * * *

Uil Code: 501.03-00, 501.03-32
Date: March 21, 2014

Employer Identification Number: * * *

LEGEND:

Hospital 1 = * * *
Hospital 2 = * * *
Hospital 3 = * * *
Date 1 = * * *
Taxpayer = * * *
Plan = * * *
$x = * * *

Dear * * *:

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

FACTS

You are organized as a nonprofit corporation under state law. Your Articles of Incorporation state that: "The purpose of the Corporation is to enhance collaboration and the development of shared services among nonprofit hospital members and any and all other purposes permitted by law." You have members, and each member must at all times be an organization described in § 501(c)(3). Your current members are three tax-exempt hospitals: Hospital 1, Hospital 2, and Hospital 3.
Each of your members has equal representation in your governance. Your Bylaws provide that "[e]ach member shall designate two individuals who may act on behalf of such member on matters submitted to the members. Each member shall have one vote on each matter submitted to the members."

The members elect your Board of Directors. The number of directors shall be equal to the number of members. Immediately prior to the election of directors by the members, each member shall designate one director candidate. Each of the members shall vote for each of the candidates. Your current Board of Directors consists of three members: your president and director is also the

president of Hospital 1. Your secretary and director is the president of Hospital 2. Your treasurer and director is the president of Hospital 3. Your directors do not receive compensation for their services.

You were formed to be a cooperative hospital service organization. You are designed to evaluate and offer various shared service opportunities among your members, including cost savings possibilities and opportunities to enhance clinical, support, and management services and programs through the cooperative efforts of your members. You provide purchasing services to your member hospitals. Specifically, with the assistance of an independent actuarial, employee benefits, and human resources consulting firm, you negotiated and contracted life, disability, and dental insurance for physicians of your patron-hospitals. The contracts are group contracts specific to each of your member entities and cover or benefit both eligible physician employees and all other eligible employees of your member hospitals. At this time you do not offer any other types of services, though you may offer management services, support programs, and clinical shared services in the future. For example, you intend to share management services, including assistance between hospitals when a key or critical position is open or a project is being undertaken at one member institution and another member institution has a manager with specific expertise in that project area. You would look to share consultative services between the three member hospitals such as looking at different staffing models and how best to utilize all available resources.

On your Form 1023, you state:

In compliance with section 501(e)(2), within 8 1/2 months after the close of the Company's taxable year, the Company allocates or pays all of its net earnings to its patron-hospitals based upon the services performed for them. To date, the Company has retained its earnings to support the exploration and expansion of the services it provides to the patron-hospitals. These retained earnings have been allocated equally among the patron hospitals.

In your letter of Date 1, you state that your current retained earnings are $x, which equals your net income for the period October 1, 2010, through September 9, 2011. You also state that these earnings are held in your account and utilized for shared services such as consultants, educational opportunities, or other expenses incurred and agreed upon by the directors, and that, thus far, no earnings have been allocated between the patron hospitals.

LAW

Section 501(c)(3) provides for the exemption from federal income tax of organizations that are organized and operated exclusively for charitable, scientific or educational purposes, or for the prevention of cruelty to children, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 501(e) provides that an organization shall be treated as an organization organized and operated exclusively for charitable purposes under section 501(c)(3) if: (1) the organization is organized and operated solely (A) to perform, on a centralized basis, one or more of the following services which, if performed on its own behalf by a hospital which is an organization described in section 501(c)(3) and exempt from taxation under section 501(a), would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption: data processing, purchasing (including the purchasing of insurance on a group basis), warehousing, billing and collection (including the purchase of patron accounts receivable on a recourse basis), food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services; and (B) to perform such services solely for two or more hospitals each of which is: (i) an organization described

in section 501(c)(3) and exempt from tax under section 501(a), (ii) a constituent part of an organization described in section 501(c)(3) which is exempt from taxation under section 501(a) and which, if organized and operated as a separate entity, would constitute an organization described in section 501(c)(3), or (iii) owned and operated by the United States, a state, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of the foregoing; (2) such organization is organized and operated on a cooperative basis and allocates or pays, within 8 1/2 months after the close of its tax year, all net earnings to patrons on the basis of services performed for them; and; (3) if such organization has capital stock, all of such stock outstanding is owned by its patrons.

Section 1.501(e)-1(a) of the Income Tax Regulations ("regulations") provides that section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization. A cooperative hospital service organization which meets the requirements of section 501(e) and this section shall be treated as an organization described in section 501(c)(3), exempt from taxation under section 501(a), and referred to in section 170(b)(1)(A)(iii). In order to qualify for tax exempt status, a cooperative hospital service organization must (1) be organized and operated on a cooperative basis; (2) perform, on a centralized basis, only one or more specifically enumerated services which, if performed directly by a tax exempt hospital, would constitute activities in the exercise or performance of the purpose or function constituting the basis for its exemption; and (3) perform such service or services solely for two or more patron-hospitals.

Section 1.501(e)-1(b)(1) provides that in order to meet the requirements of section 501(e), the organization must be organized and operated on a cooperative basis (whether or not under a specific statute on cooperatives) and must allocate or pay all of its net earnings within 8 1/2 months after the close of the taxable year to its patron-hospitals on the basis of the percentage of its services performed for each patron. To "allocate" its net earnings to its patron-hospitals, the organization must make appropriate bookkeeping entries and provide timely written notice to each patron-hospital disclosing to the patron-hospital the amount allocated to it on the books of the organization.

Section 1.501(e)-1(b)(3) provides that exemption will not be denied a cooperative hospital service organization solely because the organization, instead of paying all net earnings to its patron-hospitals, retains an amount for such purposes as retiring indebtedness, expanding the services of the organization, or for any other necessary purpose and allocates such amounts to its patrons. However, such funds may not be accumulated beyond the reasonably anticipated needs of the organization. Moreover, where an organization retains net earnings for necessary purposes, the organization's records must show each patron's rights and interests in the funds retained.

Section 1.501(e)-1(c) provides that an organization will meet the requirements of section 501(e) only if the organization performs, on a centralized basis, one or more of the following services and only such services: data processing, purchasing (including the purchasing and dispensing of drugs and pharmaceuticals to patron-hospitals), warehousing, billing and collection, food, clinical (including radiology), industrial engineering (including the installation, maintenance and repair of biomedical and similar equipment), laboratory, printing, communications, record center, and personnel (including recruitment, selection, testing, training, education and placement of personnel) services. An organization is not described in § 501(e) if, in addition to or instead of one or more of these specified services, the organization performs any other service (other than services referred to under paragraph (b)(4) that are incidental to the conduct of exempt purposes or functions).

In HCSC-Laundry v. United States, 450 U.S. 1, 6 (1981), the Supreme Court held that, as a basic principal of statutory construction, § 501(e), a specific statute, controls over a general provision such as § 501(c)(3). In addition, the court said that the legislative history showed that Congress intended

§ 501(e) to be exclusive and controlling for cooperative hospital service organizations.

In Florida Hospital Trust Fund v. Commissioner, 103 T.C. 140, 153 (1994), the Tax Court stated that "from our perspective, 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."

ANALYSIS

We have determined that you do not qualify as a cooperative hospital service organization under § 501(e) of the Code. First, you are not organized or operated on a cooperative basis. Secondly, you are not organized and operated solely to perform, on a centralized basis, a service enumerated in § 501(e)(1)(A).

Section 1.501(e)-1(b)(1) of the regulations provides that, in order to meet the requirements of § 501(e), an organization must be organized and operated on a cooperative basis (whether or not under a specific statute on cooperatives) and must allocate or pay all of its net earnings within 8 1/2 months after the close of the taxable year to its patron-hospitals on the basis of the percentage of its services performed for each patron. Your Articles of Incorporation neither mention that you are structured on a cooperative basis nor do they require you to allocate or pay, within eight and one-half months after the close of each taxable year, all of your net earnings to your patron hospitals on the basis of the percentage of your services performed for each. Thus, you are not organized on a cooperative basis as required by the regulations.

Section 1.501(e)-1(b)(3) says that a cooperative hospital service organization need not pay all its net earnings to its patron hospitals, but may retain an amount for a necessary purpose so long as it allocates such amounts to its patrons. Where the organization retains net earnings for necessary purposes, its records must show each patron's rights and interests in the funds retained. Furthermore, § 1.501(e)-1(b)(1) says that to "allocate" its net earnings to its patron-hospitals, the organization must make appropriate bookkeeping entries and provide timely written notice to each patron-hospital disclosing to the patron-hospital the amount allocated to it on the books of the organization. In your Form 1023 (filed only three months after the close of your first taxable year), you stated without further explanation or evidence, that:

In compliance with section 501(e)(2), within 8 and one-half months after the close of the Company's taxable year, the Company allocates or pays all of its net earnings to its patron-hospitals based upon the services performed for them. To date, the Company has retained its earnings to support the exploration and expansion of the services it provides to the patron-hospitals. These retained earnings have been allocated equally among the patron hospitals [emphasis added].

However, in your letter of Date 1, and in response to our request for additional information about how you allocate earnings among your member hospitals, you stated that: "Taxpayer's earnings are held in the Taxpayer account and utilized for shared services such as consultants, educational opportunities, or other expenses incurred and agreed upon by the directors. Thus far, no earnings have been allocated between the patron hospitals [emphasis added]."

Not only do these two statements contradict each other, but by the time you submitted your Date 1 letter, you should have already made payments or allocations to your patron-hospitals for your tax years ending in 2009 and 2010. By your own admission, then, you have not complied with § 501(e)(2) and § 1.501(e)-1(b)(1).

Furthermore, to qualify as a cooperative hospital service organization, you must perform, on a

centralized basis, one of the services specified in § 501(e)(1)(A), but only such services. You appear to be relying on that part of the statute that provides that a cooperative hospital service organization may engage in "the purchasing of insurance on a group basis." But it is not clear to us that your activities amount to purchasing insurance. In Florida Hospital Trust Fund v. Comm'r, 103 T.C. at 153, the Tax Court stated that "from our perspective, 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 your application Form 1023, you state that you "coordinate the purchasing of life, disability, and dental insurance on a group basis," and that you have "negotiated and contracted for life, dental, and disability insurance," however you never say that you executed the purchase of insurance for your members as a group. Your Form 1023 "statement of revenues and expenses" shows expenses for "professional fees" and a small amount of unclassified expenses. A "profit and loss statement" submitted with your letter of Date 1, shows expenses for "insurance initiatives." We are uncertain whether any of these amounts went toward the purchase of insurance on a group basis.

In response to our request for copies of contracts you have negotiated, you provided a copy of three contract applications with Plan, one for each of your members. Each application lists one of your members as the "Name of Group" and the member's address as the "billing address." Under "Additional Provisions," the application states that: "This agreement is part of the Taxpayer purchasing alliance made up of [Taxpayer's patron members]. Each participating entity will have separate banking arrangements." Each application is executed by an authorized representative of the member hospital named in the application. Given this language, it is unclear to us whether you actually execute and purchase insurance on behalf of your members, or whether you merely coordinate the selection of insurance providers and negotiate the terms of the policies, but leave the execution and purchasing of the policies to the individual members. Furthermore, in the future, you intend to offer services with respect to the sharing of management services, resource and educational opportunities, and nursing and provider staff among and between your member hospitals. It is unclear whether any of these services are among the specific services enumerated in § 501(e)(1)(A). It is likewise unclear whether the sharing of such services among or between the hospitals is the same as the performance of services "on a centralized basis." Consequently, we cannot say that you are operated solely to perform, on a centralized basis, a permissible service (and only a permissible service) under § 501(e)(1).

Because § 1.501(e)-1(a) says, and the Supreme Court in HCSC-Laundry v. United States holds, that § 501(e) creates the exclusive means by which a separate entity that provides shared services to otherwise unrelated hospitals may qualify for exemption as an organization described in § 501(c)(3), your failure to satisfy the requirements of § 501(e) means that you also fail to satisfy the requirements of § 501(c)(3).

CONCLUSION

In light of the above, we conclude that you are not organized and operated exclusively for exempt purposes within the meaning of § 501(c)(3).
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 IRS 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 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
1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.
If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Thank you for your cooperation. We have sent a copy of this letter to your representative as indicated in your power of attorney.

Sincerely,

Michael Seto
Manager,
Exempt Organizations Technical

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