The health care update summarizes various Private Letter Rulings (PLRs) in three areas of health care for which no major Revenue Rulings were released this year: (1) unrelated business income; (2) health maintenance organizations; and (3) intermediate sanctions.

On September 6, the Internal Revenue Service (IRS) released its annual exempt organization continuing professional education (CPE) text for fiscal year 2001. The CPE text includes an update on health care matters. The health care update summarizes various Private Letter Rulings (PLRs) in three areas of health care for which no major Revenue Rulings were released this year: (1) unrelated business income; (2) health maintenance organizations; and (3) intermediate sanctions.

In addition to the update on health care, the CPE includes sections on limited liability companies and private benefit rules, which may also be of interest to health care entities. These topics are addressed in Client Alert Bulletin No. 121.

Unrelated Business Income
The CPE text addresses two major subtopics related to Unrelated Business Income: (a) the "convenience of the patient" exception, and (b) the "substantially related" test. The CPE text also addresses the application of these subtopics to two specific factual situations—laboratory testing services and smoking cessation programs.

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

In a January 2000 PLR, the IRS looked at whether the rental income that a specialty hospital received from renting its excess inpatient capacity at fair market value to a rehabilitation hospital was unrelated business income under IRC Section 513(a) or debt-financed income under IRC Section 514(a). The IRS found that the leasing arrangement was not an unrelated trade or business or an activity utilizing debt-financed property when the otherwise dormant space was rented to further the specialty hospital's purpose of providing health care to the community and when the arrangement provided a convenient rehabilitation facility for the specialty hospital's own patients without the need for the specialty hospital to establish and fund its own rehabilitation facility. Other factors important to the IRS' analysis were: (1) the specialty hospital's patients were not given admission preference at the rehabilitation
hospital, and (2) insurers favored the early discharge of patients to the rehabilitation unit from the inpatient setting made possible by the close proximity of the rehabilitation facility for cost-savings reasons.

Laboratory Testing Services. The CPE text then applied this exception in the laboratory testing services context. The performance of laboratory testing services by a hospital raises the issue of whether such services are unrelated business activities. The IRS generally analyzes this issue under the “convenience of the patient” exception. For this exception to apply, the specimen must be from a patient of the hospital performing the test. Past Revenue Rulings have helped define when a person is a patient of a hospital under IRC Section 513(a)(2) and have concluded that testing of specimens received from private office patients of hospital staff physicians or from medical clinics is an unrelated trade or business, due to the lack of relationship between the hospital’s tax-exempt purpose and the services provided to non-patients of the hospital and the consequent absence of any “convenience” for hospital patients.

Laboratory Services Contributing “Importantly” to Educational Programs. Under a federal court case, the rationale of which was adopted by the IRS, an exception to the “convenience of the patient” rule exists when the testing of specimens of non-patients contributes “importantly and substantially” to a hospital’s teaching program. Under pertinent Treasury Regulations, in determining whether activities contribute “importantly” to an exempt purpose, the size and extent of the activities must be considered in relation to the nature and extent of the exempt function they purport to serve.

Related Trade or Business Income. In reviewing several Private Letter Rulings on this topic, the CPE text sets forth the following rules with respect to income from laboratory testing services in the context of unrelated trade or business rules:

- Income from laboratory testing services performed on facility inpatients is not income from an unrelated trade or business.
- Income from testing of specimens that contributes importantly to the educational purposes of a facility is not income from an unrelated trade or business, even if specimens are collected from HMO or other patients of contracted (non-employee) physicians. The IRS based this finding on the rationale that the greater number of specimens and the wider the geographic area the specimens are derived from, the more beneficial the learning experience is for residents, fellows and medical technologists in the hospital’s education program.
- Income from laboratory testing services performed on patients of employee physicians is not income from an unrelated trade or business because such services are undertaken for the convenience of employee-physicians and thus meet the “convenience of the patient” exception.
- Income from laboratory testing services performed on specimens from patients who present in person at a facility’s laboratory site is not income from an unrelated trade or business because the patient is considered a patient of the particular facility (even if also the patient of a private physician) and thus the service and resulting income satisfies the “convenience of the patient” exception.

Unrelated Trade or Business Income. Income from laboratory testing services performed on specimens sent to a facility’s laboratory by non-employee, non-contracted private physicians who collect the specimens at sites other than the facility is income from an unrelated trade or business.

Substantially Related Test
Section 513(a) of the IRC provides that the conduct of a trade or business, which is not substantially related to an exempt organization’s tax-exempt purpose, is an unrelated trade or business. In a June 1998 PLR, the IRS looked at activities conducted within a large integrated health care delivery system consisting of a parent organization, a hospital, a teaching hospital, a clinic and an HMO. The IRS found that the provision of
health care services by the clinic’s employed and contracted physicians to the HMO enrollees in return for the receipt of capitated payments was substantially related to the clinic’s exempt purposes and was thus not unrelated business income to the clinic. In addition, the IRS found the provision of certain ancillary health services by members of the integrated delivery system was substantially related to the various entities’ exempt purposes, even though some of the patients who received the ancillary services might be registered at non-system medical institutions and some of the health care services might be performed at non-system medical institutions or at employer locations.

Application to Smoking Cessation Program. The CPE text then applied this rule in the smoking cessation program context. Under Treasury Regulations, a trade or business is substantially related to a tax-exempt purpose only where a substantial causal relationship exists between the conduct of the trade or business and the achievement of a tax-exempt purpose. Both education and promoting social welfare are tax-exempt purposes under the IRC.10 In a Private Letter Ruling, the IRS concluded that income earned by a clinic and HMO from the provision of tobacco cessation and prevention services to other managed care entities, insurers, employers and providers is not unrelated business income when the services furthered the clinic’s educational purposes and the HMO’s social welfare purposes.11 This determination was based on the fact that the HMO developed an effective smoking cessation program using the clinic’s nurses to educate and counsel smokers and monitor nicotine replacement therapy and sought to replicate the program nationwide by training nurses in organizations outside the HMO system for a fee.

Health Maintenance Organizations
With respect to HMOs, the IRS reviewed PLRs covering commercial-type insurance and Medicaid-Only HMOs.

Commercial-Type Insurance (IRC Section 501(m))
Section 501(m)(1) of the IRC specifies that an HMO otherwise eligible for tax-exemption normally under 501(c)(4) will only be exempt if no substantial part of its activities consists of providing commercial-type insurance. If an organization satisfies this requirement, any activity related to providing commercial-type insurance is treated as an unrelated trade or business subject to tax as an insurance company (under sub-chapter L of the IRC) rather than under IRC Section 511.12

In a technical advice memorandum (TAM), the IRS examined whether an HMO with a point-of-service program provided commercial-type insurance within the meaning of IRC Section 501(m)(1).13 The IRS concluded that the result depended on the type of physician compensation provided:

Capitated payments are not insurance: When the HMO shifts a substantial portion of the risk of loss associated with arranging primary care services to its network primary care physicians through the use of capitated payments, the arrangement does not consist of providing commercial-type insurance within the meaning of IRC Section 501(m)(1).

Fee for service payments are likely insurance: When the HMO does not shift a substantial portion of the risk to physicians, instead retaining the risk of loss associated with additional primary care services for enrollees through a fee for service payment arrangement, the IRS takes the position that the HMO is providing commercial-type insurance under Section 501(m)(1).

The HMO in this example did not withhold any amounts from the payments made to either capitated or fee for service physicians. The implication of the CPE text in this analysis is that the use of withholds may, in some cases, shift risk away from the HMO significantly enough to satisfy the commercial-type insurance test (see Medicaid-Only HMO discussion below).

Medicaid-Only HMOs
According to the CPE text, HMOs that arrange for the provision of health care services solely to Medicaid beneficiaries may qualify for exemption under IRC
Section 501(c)(3), but must also satisfy the requirements of IRC Section 501(m). The CPE text discusses several IRC Section 501(m)(1) issues that apply to HMOs that qualify for exemption under IRC Section 501(c)(3) or (c)(4), based on guidance from the Internal Revenue Manual (IRM) 7.8.1, Chapter 27.

Physician Compensation Method. In the view of the IRS, an HMO is not providing commercial-type insurance if the HMO shifts a substantial portion of its risk of loss to primary care physicians. Such risk-shifting can be achieved by paying physicians either on a capitated basis or on a fee for service basis, using a Medicaid-approved fee schedule, and withholding a substantial portion of fees paid. The CPE text states that if withholding of a substantial portion of the fees paid does not occur, the Section 501(m) examination guidelines are not satisfied. HMOs may also argue that they meet Section 501(m) by shifting risk of loss under a stop-loss insurance arrangement or a deficit sharing arrangement.

Stop-Loss Insurance. Under stop-loss insurance, if the total annual medical expenses the HMO incurs on behalf of an enrollee exceed a certain amount, the insurer absorbs all or a portion of the excess expenses. (The insurer may impose a maximum it will pay or may cover only certain types of medical expenses such as inpatient hospital care under the stop-loss policy.) Often states require such insurance in the Medicaid provider agreement, or provide the stop-loss insurance themselves, charging for the premium through a deduction in capitated fees paid to the HMO.

According to the CPE text, HMO’s using fee for service physician compensation may obtain stop-loss insurance from an unrelated party. The HMO must then establish that the stop-loss insurance arrangement shifts a substantial portion of the risk of loss to the insurer, or that the risk retained is insubstantial (a facts and circumstances test).

Deficit-Sharing. In a deficit-sharing arrangement, an HMO paying fee-for-service compensation enters into an arrangement with providers to share a portion of an HMO’s operating losses. Again, the HMO must establish that a deficit-sharing arrangement with providers shifts a substantial portion of the HMO’s risk of loss (a facts and circumstances test). According to the CPE text, a deficit-sharing agreement with a related organization (e.g., with member hospitals in the same integrated delivery system) does not shift a substantial portion of the risk of loss because the related organization is part of the HMO’s economic family. The CPE text provides that if the deficit-sharing arrangement is with hospitals that are not structurally related to each other, and each hospital is jointly and severally liable for all of the HMO’s operating losses, not just the losses attributable to the individual hospital’s patients, the HMO may be able to establish that a substantial portion of the risk is shifted.

Commercial-Type Insurance. The CPE text indicates that HMO’s that qualify under Section 501(c)(3) or (c)(4), but that fail to satisfy IRM examination guidelines, may try to argue that although they provide insurance, it is not commercial-type insurance within the meaning of IRC Section 501(m)(1). The premise for such an argument is that such insurance is not generally available to the public (i.e., such insurance is either not offered to the Medicaid population or is not affordable). In the CPE text, however, the IRS concludes that if the health care services offered by Medicaid-only HMOs are considered insurance, it is generally available commercially to the purchaser of the insurance (which is the state, not individual Medicaid beneficiaries within the state), and thus is commercial-type insurance under IRC Section 501(m)(1).

Intermediate Sanctions

The CPE Text discusses a group of cases pending in the U.S. Tax Court (referred to as the “Sta-Home Health Agency cases”), which concern imposition of excise taxes upon disqualified persons and organization managers under the intermediate sanctions rule, IRC Section 4958, and revocation of tax-exemption of three IRC Section 501(c)(3) organizations.

The Sta-Home Health Agency cases involved three family-owned, governed and operated home health
agencies formed in the 1970s in Mississippi. In 1995, the family owners of these organizations transferred the assets and liabilities of these organizations to three Subchapter S corporations, also wholly owned by the same family. No consideration was paid, other than the assumption of liabilities. The appraiser for the family determined that each organization's liabilities exceeded the fair market value of its assets at the time of transfer to the S corporations. The IRS, however, concluded that the fair market value of each organization's assets substantially exceeded its liabilities, making the value of the net assets significantly more than zero.

The IRS found that:

1) each of the family members involved was a disqualified person under the intermediate sanctions law (IRC Section 4958(f)(1)(A) and (B));

2) the transfer of organization net assets to the S corporations was for less than adequate consideration;

3) the family members engaged in an excess benefit transaction under the intermediate sanction law (IRC Section 4958(c)(1)) when their shares in the S corporations increased as a result of the transfer of assets;

4) the S corporations were also indirectly disqualified persons and the transfer of net assets to the S corporations also constituted an excess benefit transaction between the organizations and the S corporations;

5) none of the excess benefit transactions were corrected;

6) certain of the family members were organization managers who participated knowingly and willfully in the excess benefit transactions;

7) the transfer of net assets to the S corporations for less than adequate consideration was a substantial activity not in furtherance of the exempt purposes of the organizations in violation of the operations test of Treas. Reg. 1.501(c)(3)-1(c)(1); and

8) the organizations conferred private inurement on the family members and impermissibly benefited private interest in violation of the proscriptions against private inurement and private benefit, and thus were no longer serving their exempt purposes of promoting health and benefiting the community.

The IRS therefore imposed various excise taxes on the family members and corporations, and revoked the tax-exemption of the three organizations at issue. This litigation is pending.

**Internal Revenue Manual Updates**

On November 4, 1999, Chapter 28 was added to the Internal Revenue Manual, addressing taxes on excess benefit transactions and procedural elements of application of the intermediate sanction law, IRC Section 4958.

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1 See Procedural and Training Manuals IRS CPE Textbooks Section 501(c)(3)—Charities, Exempt Organization Continuing Professional Education Technical Instruction Program for Fiscal Year 2001 (Sept. 6, 2000). The ten topics addressed in the 2001 CPE text are:

1. Title Holding Companies
2. Limited Liability Companies as Exempt Organizations—Update
3. Exemptions of Canadian Charities Under the United States-Canada Income Tax Treaty
4. Update on Health Care
5. College Housing
6. Trust Primer
7. Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions
8. Private Benefit Under IRC 501(c)(3)
9. State Charitable Solicitation Statutes
10. Current Developments

2 The IRS declined to issue a Private Letter Ruling regarding a UBIT cost allocation question because of the inherently factual nature of the question presented.

3 The facilities involved were part of the same university teaching system.

4 See IRC Section 513(a)(2).


7 Treas. Reg. 1.513-1(d)(3). An important fact for the IRS under St. Luke’s and Rev. Rul. 85-109 was that the diagnostic testing program was relatively small in size compared to the other activities of the pathology department and business was not actively solicited through advertising or otherwise.

8 See PLR 9837031, 9851054, 200025059.

9 The CPE text also illustrates these points through a complicated fact situation involving a group of hospitals that formed a limited liability company to provide laboratory services and entered management and cost allocation agreements with respect to such services. See PLR 9851054 released on September 25, 1998.

10 Likewise, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to tax-exempt purposes, the services from which the gross income is derived must contribute importantly to the tax-exempt purposes. See Treas. Regs. 1.513-1(d)(2), 1.501(c)(3)-1(d)(1)(i), 1.501(c)(4)-1(a).

11 See PLR 9837031.

12 IRC Section 501(m)(2).

13 The conclusions in this TAM are consistent with guidelines for IRS examiners included in 7.8.1 Internal Revenue Manual, Exempt Organizations Guidelines Handbook, Chapter 27, Health Maintenance Organizations.

14 See Malone & Hyde, Inc. and Subsidiaries v. Commissioner, 62 F.3d 835 (6th Cir. 1995).


16 See Paratransit Insurance Corporation v. Commissioner, 102 T.C. 745 (1994) (holding that commercial insurance is insurance that is generally available commercially) and Florida Hospital Trust Fund, et al. v. Commissioner, 103 T.C. 140 (1994), aff’d on other grounds, 71 F.3d 808, 812 (11th Cir. 1996)(holding that commercial-type insurance does not have to be generally available to the public).

17 See Treas. Regs. 1.501(c)(3)-1(c)(3) and 1(d)(1)(ii).