PART III, Administrative, Procedural and Miscellaneous

Commercial-Type Insurance Activities of Certain Exempt Organizations

Notice 2003-31

I. PURPOSE

This Notice announces that the Treasury Department and the Internal Revenue Service intend to propose regulations providing guidance under § 501(m) of the Internal Revenue Code (the "Code"), which will define the term "commercial-type insurance" and address how § 501(m) applies to organizations described in § 501(c)(3) and § 501(c)(4), including health maintenance organizations. This Notice also requests comments on the content of the regulations to be proposed. Finally, this Notice announces that, in light of the regulations project, the Service is withdrawing from the Internal Revenue Manual the sections of Part 7.8.1, Chapter 27, Exempt Organizations Examination Guidelines Handbook, Health Maintenance Organizations (the "IRM HMO Guidelines") that relate to § 501(m) of the Code.

II. BACKGROUND

A. Legislative History of § 501(m)

Section 501(c)(3) describes organizations organized and operated exclusively for charitable, religious, educational and other specified purposes. Section 501(c)(4) describes organizations not organized for profit but operated exclusively for the promotion of social welfare. Section 501(m) provides that an organization described in § 501(c)(3) or § 501(c)(4) shall be exempt from tax under § 501(a) "only if no substantial part of its activities consists of providing commercial-type insurance." Section 501(m)(3)(A) provides that the term "commercial-type insurance" does not include "insurance provided at substantially below cost to a class of charitable recipients." Section 501(m)(3)(B) provides that the term "commercial-type insurance" does not include "incidental health insurance provided by a health maintenance organization of a kind customarily provided by such organizations."

Congress adopted § 501(m) in 1986 because it was "concerned that exempt charitable and social welfare organizations that engage in insurance activities are engaged in an activity whose nature and scope is so inherently commercial that tax exempt status is inappropriate." H.R. Rep. No. 99-426, at 664 (1985). Congress believed that the "tax-exempt status of organizations

engaged in insurance activities provides an unfair competitive advantage to these organizations" over commercial insurers. Ibid.[1]

B. Definition of Insurance

Neither the Code nor the Income Tax Regulations (the "Regulations") define the term "insurance." The United States Supreme Court, however, has explained that, for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531, 539 (1941).

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

When Congress enacted § 501(m), it followed the Supreme Court's definition of insurance. See 1986 General Explanation, at 585 (Under § 501(m), "commercial-type insurance does not include arrangements that are not treated as insurance [i.e., in the absence of sufficient risk shifting and risk distribution for the arrangement to constitute insurance]," citing Helvering v. LeGierse, 312 U.S. at 539).

C. Definition of "Commercial-Type Insurance"

When § 501(m) was enacted, Congress did not specifically define the term "commercial-type insurance." The legislative history of § 501(m) states that "commercial-type insurance generally is any insurance of a type provided by commercial insurance companies." H.R. Rep. No. 99-426, at 665 (1985); H.R.

[1] For a detailed discussion of the legislative history of § 501(m), see H.R. Rep. No. 99-426, at 662 – 666 (1985); H.R. Conf. Rep. No. 99-841, at II-344 – 351 (1986); Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 583 – 591 (Comm. Print 1987) ("1986 General Explanation"); H.R. Rep. No. 100-795, at 114 – 116 (1988); S. Rep. No. 100-445, at 120 – 122 (1988); H.R. Conf. Rep. No. 100-1104, at 9 (1988); Staff of the Joint Committee on Taxation, Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238), at 115 – 117 (Comm. Print 1988).

Conf. Rep. No. 99-841, at II-345, 346 (1986); 1986 General Explanation, at 585. Congress explained that "the provision of insurance to the general public at a price sufficient to cover the costs of insurance generally constitutes an activity that is commercial." H.R. Rep. No. 99-426, at 664; 1986 General Explanation, at 584.

In Paratransit Insurance Corporation v. Commissioner, 102 T.C. 745, 754 (1994), the court held that "'commercial-type insurance,' as used in § 501(m), encompasses every type of insurance that can be purchased in the commercial market."[2]

In Florida Hospital Trust Fund v. Commissioner, 103 T.C. 140, 158 (1994), aff'd on other grounds, 71 F.3d 808, 812 (11th Cir. 1996), the court held that the term "commercial-type insurance" under § 501(m) means insurance "normally offered by commercial insurers."

In Nonprofits' Insurance Alliance of California v. U. S., 32 Fed. Cl. 277, 284 (1994), the court compared the organization's activities to commercial insurance companies and found they were "commercial in nature."[3]

III. NEED FOR GUIDANCE

Treasury and the Service believe that guidance is necessary to provide § 501(c)(3) and § 501(c)(4) organizations with greater certainty as to the definition of the term "commercial-type insurance" and how § 501(m) applies to organizations described in § 501(c)(3) and § 501(c)(4), including health maintenance organizations. The Code does not define the term "commercial-type insurance," and no regulations or published guidance have been issued under § 501(m). In addition, since the enactment of § 501(m), there have been significant developments in the insurance and health care industries, including changes in the operation of health maintenance organizations.

Taxpayers have asked the Service to provide guidance under § 501(m), defining the term "commercial-type insurance" and describing the application of the exceptions in § 501(m)(3)(A) and § 501(m)(3)(B). Treasury and the Service intend to propose regulations under § 501(m). The proposed regulations will define the term "commercial-type insurance" and address how § 501(m) applies to organizations described in § 501(c)(3) and § 501(c)(4), including health maintenance organizations.

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[2] The court also found that the organization did not satisfy the exception in § 501(m)(3)(A). 102 T.C. at 757-758.

[3] The court also found that the organization did not satisfy the exception in § 501(m)(3)(A). 32 Fed. Cl. at 292.

Treasury and the Service expect that these regulations will apply prospectively, effective as of the date that final regulations under § 501(m) are published in the Federal Register. Treasury and the Service will consider proposing appropriate transition rules, if necessary.

IV. WITHDRAWAL OF IRM

A health maintenance organization that satisfies the IRM HMO Guidelines is treated as qualifying for exemption under either § 501(c)(3) or § 501(c)(4), as applicable, and its activities are not treated as "commercial-type insurance" under § 501(m). In light of the regulations project, the Service is withdrawing for further study the sections of the IRM HMO Guidelines that relate to § 501(m).

V. REQUEST FOR COMMENTS

Treasury and the Service request comments on the content of the regulations to be proposed, including the definition of the term "commercial-type insurance" and the application of § 501(m) to organizations described in § 501(c)(3) and § 501(c)(4), including health maintenance organizations. In particular, comments are requested on what factors may be indicative of "commercial-type insurance."

In addition, comments are requested on the exception from "commercial-type insurance" in § 501(m)(3)(A). Comments are specifically requested on: (i) the meaning of the term "insurance provided at substantially below cost," (ii) the application of this exception to Medicaid-only health maintenance organizations, and (iii) the treatment of grants or contractual payments from states or the Federal government for purposes of this exception.

Further, Treasury and the Service request comments on the exception from "commercial-type insurance" in § 501(m)(3)(B). In light of the legislative history, comments are specifically requested on: (i) what historical industry data or other criteria the Service should use to determine whether the health insurance a health maintenance organization provides is "of a kind customarily provided by such organizations"; (ii) what factors or criteria the Service should consider in determining whether a health maintenance organization's "principal activity" is "providing health care"; (iii) what factors or criteria the Service should consider in determining whether the health insurance a health maintenance organization provides is "incidental to the organization's principal activity of providing health care"; and (iv) how this exception should be applied to a health maintenance organization that does not provide "health care to its members predominantly at its own facility through the use of health care professionals and other workers employed by the organization."[4]

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[4] See H.R. Rep. No. 99-426, at 665; 1986 General Explanation, at 585.

VI. SUBMISSION OF COMMENTS

Comments should be submitted by August 25, 2003 in writing and should include a reference to Notice 2003-31.

Comments may be submitted to:

Internal Revenue Service
Attn: T:EO:RA:T:1 (Notice 2003-31)
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Comments may be hand delivered between the hours of 8 a.m. and 4 p.m., Monday through Friday, to:

T:EO:RA:T:1 (Notice 2003-31)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Alternatively, comments may be sent via facsimile to (202) 283-9462 or via e-mail to tege.501m@irs.gov and include a reference to Notice 2003-31.

All comments submitted will be available for public inspection and copying.

VII. DRAFTING INFORMATION

The principal author of this Notice is Lawrence M. Brauer, TE/GE Division, Exempt Organizations. For further information on this notice, contact Mr. Brauer at (202) 283-9457 (not a toll-free call).