SECTION 501(m) and HMO TAX-EXEMPT STATUS

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I. Recent Developments

A. IRS’s FY 1999 EP/EO Program Letter (the “Workplan”)
   1. In the Workplan, the IRS directs key districts to allocate examination resources to assist the Examination Division CEP teams in auditing tax-exempt HMOs affiliated with Blue Cross/Blue Shield plans. 98 TNT 205-41, Docs. 98-31051 (June 30, 1998).
   2. In particular, the IRS wants to determine whether such HMOs are precluded from exemption under section 501(m), because a “substantial part” of the HMO’s activities consist of providing “commercial-type” insurance.
   3. This is the first indication in recent years of an inclination of the part of the IRS to challenge the tax-exempt status of HMOs.

B. Technical Advice Memorandum (“T.A.M.”), 98 TNT 243-15, Doc. 98-37129
   1. The IRS concluded that an IPA-model HMO which was part of an integrated delivery system that included hospitals and employer physicians count not maintain its section 501(c)(3) status because it failed to met either the Sound Health Hospital standard or the Geisinger integral part standard.
   2. The IRS also supplemented its ruling standard, discussed at Section III.B below, for the 501(m)(3)(B) exception to the definition of “commercial-type” insurance with the following:
      [W]here an HMO pays its contracted physicians almost exclusively under a fee schedule that represents a meaningful discount from the physicians’ usual and customary charges (“discounted fee-for-service”) and also withholds from these payments a significant percent of the fees otherwise payable, pending compliance with periodic budget or utilization standards, the HMO also shifts to the physicians a substantial portion of the risk of economic loss associated with the provision of a substantial amount of health care services to its enrollees. By taking the risk that he or she may not recover the amount withheld, the physician is sharing in any economic loss. Combined with the discounted fee-for-service, this compensation arrangement constitutes a substantial shifting of the risk of loss by the HMO to the physician.
   3. The IRS paid its physicians the greater of 85% of the usual and customary fees or a “capitated fee.” The physicians also were eligible for an additional payment based upon the achievement of a budget surplus (by the HMO?). No portion of the physicians’ fees were withheld by the HMO “pending compliance with periodic budget utilization standards.”
   4. Based on these facts, the IRS concluded that the HMO shifted only an incidental portion of its risk of loss to its “contracted physicians” and, therefore, did not qualify for the section 501(m)(3)(B) exception to the definition of “commercial-type” insurance.

C. The IRS has recently proposed revocation of the tax-exempt status of IHC Health Plans, which is an affiliate of Intermountain Health Care, and integrated delivery system comprised for the most part of exempt entities. IHC Health Plan is the largest HMO in Utah. Press reports suggest that the IRS has concluded that the HMO does not meet the integral part requirements set forth in Geisinger Health Plan v. Commissioner, 30 F.3d 494 (3d Cir. 1994).
II. “Commercial-Type” Insurance
A. Under Section 501(m)(1), an HMO otherwise qualified for tax-exempt status of under 501(c)(3) or 501(c)(4) may obtain that status “only if no substantial part of its activities consists of providing commercial-type insurance.”

B. The words “commercial-type” insurance are not explicitly defined in 501(m) and are not a term of art in the insurance industry. However, the context of its enactment by Congress makes its meaning quite clear. Section 501(m) was enacted to disqualify traditional Blue Cross and Blue Shield plans from exemption under 501(c)(3) or 501(c)(4). In this context, therefore, “commercial-type” insurance simply means indemnity insurance where the insurer promised to reimburse (or indemnify) the subscriber for the costs of covered health care services.

C. Section 501(m) excludes from the definition of “commercial-type_ insurance incidental health insurance of a kind customarily provided by an HMO Section 501(m)(3)(B).

D. In general, contracts between HMOs and their subscribers involve risk shifting and risk distribution, i.e., constitutes contracts of insurance for tax purposes. Helvering v. Legierse, 312 U.S. 531 (1941).

E. In general, Insurance contracts of the kind offered by tax-exempt HMOs to potential subscribers are available commercially from taxable HMOs. See Paratransit Insurance Corporation, 102 T.C. 745 (1994) and Florida Hospital Trust Fund, et. al v. Commissioner, 103 T.C. 140 (1994).

F. Based upon the foregoing, the IRS might be inclined to conclude that HMOs provide “commercial-type” insurance and, therefore, are precluded from exemption by 501(m)(1). However, the legislative history of the tax act that made technical corrections to 501(m) states that:

[T]he provision relating to organizations engaged in commercial-type insurance activities did not alter the tax-exempt status of [HMOs]. HMOs provide physicians or one or more groups of physicians (organized on a group practice or individual practice basis). The conference committee clarifies that, in addition to the general exemption for health maintenance organizations, organizations that provide supplemental health maintenance organization-type services (such as dental or vision services) are not treated as providing commercial-type insurance if they operate in the same manner as a health maintenance organization. H.R. Conf. Rep. No. 100-1104, 100th Cong., 2d Sess. II-9 (1988)

The Conference Committee: (1) calls section 501(m)(30(B) the “general exemption” for HMOs; (2) states unambiguously that it does not matter, for purposes of 501(m)(30(B), how the HMO contracts with its physician provides (e.g., employment, partnership, independent contractor relationship with individuals or groups) and (3) takes the position the HMOs, whether staff, group or IPA model, “provide” physicians and other HMO-type-services. The Conference Committee also states that HMOs offering supplemental HMO-type-services (e.g., dental or vision services) do not provide “commercial-type insurance if they operate in the same manner as a health maintenance organization”

More will be posted late, or see Professor Willis for a copy of the article.