



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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

200347017

Date: August 29, 2003

Employer Identification Number:

0501.03-30

Issuing Specialist:

4941.04-00

4942.03-00

Toll Free Customer Service:

4943.03-00

4944.03-00

4945.04-06

T:EO:BR1

Dear Applicant:

This is in reply to your letter requesting a ruling concerning your proposed distribution to a for profit corporation for the restricted purpose of providing medical malpractice reinsurance to ensure the availability of medical care in a specific state (the "State").

You have been recognized as an organization described in section 501(c)(3) of the Internal Revenue Code and classified as a private foundation. You were established in 1975 to engage in and conduct charitable activities for the support, development, advancement, enhancement and benefit of the health care system in an eight county area in the State.

Your governing board believes that increasing medical malpractice insurance premiums in the State are causing physicians to abandon their practices, retire early, and/or relocate to other states. In addition, young physicians looking to set up new practices are reluctant to consider the State because of the high cost of malpractice insurance. Even physicians who are willing to pay the high cost of malpractice insurance are having a difficult time finding coverage since most carriers writing insurance have left the State, stopped writing medical malpractice insurance in the State, or have stopped providing coverage to new physicians. The situation is particularly severe in specialties such as neurosurgery, orthopedic surgery, and obstetrics/gynecology and in the southeastern portion of the State. To alleviate these problems, your board decided to create a company that would offer medical malpractice reinsurance services to share some of the risks associated with writing medical malpractice insurance in the State.

State law does not permit the creation of a non-profit corporation for the purpose of writing insurance or reinsurance. Therefore, on April 24, 2003, you formed a reinsurance company (the "Reinsurance Company") as a State business corporation. You own 100% of the outstanding stock of the Reinsurance Company.

The Reinsurance Company maintains a separate corporate identity, will file its own Form 1120 and pay its own income taxes. The Reinsurance Company's Board of Directors and officers are separate from your Board of Directors and officers. The majority of the Reinsurance Company's governing board will consist of independent directors (the "Independent Directors"). Thus, they will not consist of your directors, officers or employees or any person related to the foregoing or any other disqualified persons within the meaning of section 4946 of the Code. You will be authorized to select and remove a minority of the

Reinsurance Company's Board of directors (the "Interested Directors".) At no time will the Interested Directors equal or exceed the number of Independent Directors. The Reinsurance Company will provide reinsurance coverage for most or all of the risks undertaken by insurance carriers providing medical malpractice insurance coverage to physicians in the State. Providing such reinsurance will be the Reinsurance Company's sole activity.

You plan to provide the Reinsurance Company with a grant to enable it to carry out its purpose. Prior to awarding the grant, you and the Reinsurance Company will enter into a grant contract (the "Grant Contract") under which the Reinsurance Company will agree to use the funds provided pursuant to the grant for the sole purpose of providing reinsurance in a manner that fulfills the Reinsurance Company's purposes as described above to help alleviate the malpractice liability insurance problem in the State. The Grant Contract will provide for the termination of the grant and the return of the grant funds if the Reinsurance Company at any time uses any portion of the grant funds for any other purpose.

The Grant Contract will obligate the Reinsurance Company to:

- (1) Repay any portion of the amount granted that is not used for the purposes of the grant;
- (2) Submit full and complete annual reports describing and/or providing:
  - a. the manner in which the funds are spent;
  - b. the progress made in accomplishing the purposes of the grant; and,
  - c. proof of compliance with the terms of the grant;
- (3) Maintain records of the receipts and expenditures and make its records available to you at reasonable times; and
- (4) Refrain from using any of the funds to:
  - a. carry on propaganda or otherwise attempt to influence legislation;
  - b. influence the outcome of any specific public election;
  - c. carry on, directly or indirectly, any voter registration drive;
  - d. make any grant to an individual or organization;
  - e. undertake any activity for any non-charitable purpose, to the extent the use of the funds would be a taxable expenditure if made directly you; and,
  - f. participate or intervene in a political campaign.

The Reinsurance Company will maintain the reports referred to above for four years after completion of the use of the grant funds.

You will provide timely reports with your forms 990-PF as required by section 53.4945-5(d)(1) of the Foundation and Similar Excise Taxes Regulations. The reports will include the data required by section 53.4945-5(d)(2) of the regulations.

No significant purpose of the investment in the Reinsurance Company is the production of income or appreciation of capital. Any net profits earned by the Reinsurance Company will be retained by it. You do not anticipate that the stock of the Reinsurance Company will appreciate.

### RULINGS REQUESTED

1. The making of the grant to the Reinsurance Company will not jeopardize your status as an organization described in section 501(c)(3) of the Code.
2. The making of the grant to the Reinsurance Company will not constitute an act of self-dealing under section 4941 of the Code.
3. The grant from you to the Reinsurance Company constitutes a qualifying distribution for purposes of meeting the minimum qualifying distribution amount under section 4942 of the Code.
4. For purposes of section 4944 of the Code, the grant will not be considered an excess business holding since it will constitute a program-related investment.
5. Since the grant to the Reinsurance Company will constitute a program-related investment under section 4944(c) of the Code, it will not be considered as an investment that jeopardizes the carrying out of your exempt purpose.
6. The grant will not constitute a taxable expenditure for purposes of section 4945 of the Code, provided you exercise expenditure responsibility with respect to the grant as contemplated by section 4945(h) of the Code.

### LAW

Section 501(c)(3) of the Code describes corporations, trusts, and associations organized and operated exclusively for charitable and other exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense and includes the promotion of health.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest.

Revenue Ruling 73-313, 1973-2 C.B. 174, provides that an organization formed and supported by residents of an isolated rural community to provide a medical building and

facilities at reasonable rent to attract a doctor who would provide medical services to the entire community is exempt under section 501(c)(3). None of the parties involved in founding the organization, in the negotiations with the doctor or in the periodic review of the arrangements were related or associated in any way with the doctor involved.

Section 53.4941(d)-1(b)(4) of the Foundations and Similar Excise Taxes Regulations imposes a tax on acts of self-dealing between a disqualified person as defined in section 4946(a)(1) and a private foundation.

Section 4946(a)(1) of the Code provides, in part, that a disqualified person means, with respect to a private foundation, a person who is (a) a substantial contributor to the foundation, (b) a foundation manager, or (c) an owner of 20 percent of (i) the total combined voting power of a corporation, (ii) the profits interest in a partnership, or (iii) the beneficial interest of a trust or an unincorporated enterprise, which is a substantial contributor to the foundation.

Section 4941(d)(1) of the Code provides, in part, that the term "self-dealing" means any direct or indirect -- (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or any other extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; and (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4942(a) of the Code imposes on private foundations (other than "operating foundations" as defined in section (j)(3)) an excise tax on a foundation's undistributed income.

Section 4942(d) of the Code defines the term "distributable amount" as an amount equal to (1) the sum of the "minimum investment return" increased by certain qualifying distributions recouped by an organization and reduced by (2) the sum of taxes imposed on the private foundation under subtitle A and section 4940 of the Code.

Section 4942(e)(1) of the Code defines the term "minimum investment return" as five percent of the excess of (A) the aggregate of fair market value of all assets other than those which are used (or held for use) directly in carrying out the foundation's exempt purposes, over (B) the acquisition indebtedness (determined under section 514(c)(1) without regard to the taxable year in which the indebtedness occurred). Thus, an organization may exclude from its calculation of "minimum investment return" the value of assets which are used (or held for use) directly in carrying out the organization's exempt purpose.

Section 4942(g)(1)(A) of the Code provides that for the purposes of this section, the term "qualifying distribution" generally means any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(2)(B) of the Code, other than any contribution to (i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in section 4946) with respect to the foundation, except as

provided in paragraph (3), or (ii) a private foundation which is not an operating foundation (as defined in subsection (j)(3)), except as provided in paragraph (3), or (B) any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in section 170(C)(2)(B.)

Section 53.4942(a)-3(a)(2) of the regulations provides that the term "qualifying distribution" means:

- (i) Any amount (including program-related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B), other than any contribution to:
  - (a) A private foundation which is not an operating foundation (as defined in section 4942(j)(3)), except as provided in paragraph (c) of this section, or
  - (b) An organization controlled (directly or indirectly) by the contributing private foundation or one or more disqualified persons with respect to such foundation, except as provided in paragraph (c) of this section;
- (ii) Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in section 170(c)(1) or (2)(B).
- (iii) Any amount set aside within the meaning of paragraph (b) of this section.

Section 170(c)(2)(B) of the Code provides that, for purposes of section 170, the term "charitable contribution" means a contribution or gift to or for the use of a corporation, trust or community chest, fund, or foundation organized and operated exclusively for charitable, educational, or other specified purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 4944(c) of the Code provides that a program-related investment is not considered to be an investment which jeopardizes the carrying out of exempt purposes. A program-related investment is an investment the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property.

Section 53.4942(a)-3(a)(3) of the regulations provides that an organization is controlled by a foundation or one or more disqualified persons with respect to the foundation if any of such persons may, by aggregating their votes or positions of authority, require the donee organization to make an expenditure, or prevent the donee organization from making an expenditure, regardless of the method by which the control is exercised or exercisable. Control of a donee organization is determined without regard to any conditions imposed upon the donee as part of the distribution or any other restrictions accompanying the distribution as to the manner in which the distribution is to be used, unless such conditions or restrictions are described in paragraph (a)(8) of section 1.507-2.

Section 4943(a)(1) of the Code imposes an excise tax on a private foundation's excess business holdings in a business enterprise during any tax year.

Section 4943(c)(1) of the Code states that excess business holdings means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for its remaining holdings in the enterprise to be permitted holdings.

Section 4943(d)(3)(A) of the Code provides that the term business enterprise does not include a functionally related business (as defined in section 4942(j)(4)).

Section 4942(j)(4) of the Code provides that the term functionally related business means (a) a trade or business which is not an unrelated trade or business (as defined in section 513), or (b) an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization.

Section 53.4942(a)-2(c)(3)(iii)(b), Example 1 of the regulations describes a private foundation which operates a functionally related business through a separately incorporated taxable entity.

Section 4944(a) of the Code provides for the imposition of an excise tax on investments which jeopardize the carrying out of exempt purposes.

Section 53.4944-3(a)(2)(i) of the regulations provides that an investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities. For purposes of section 4944 and section 53.4944-1 through 53.4944-6, the term "purposes described in section 170(c)(2)(B)" shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c).

Section 4945(a) of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(4) of the Code provides, in pertinent part, that the term "taxable expenditure" means any amount paid or incurred by a private foundation as a grant to an organization unless such organization is described in paragraph (1), (2), or (3) of section 509(a) or is an exempt operating foundation, or the private foundation exercises expenditure responsibility with respect to such grant.

Section 4945(d)(5) of the Code provides that the term "taxable expenditure" includes any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B) of the Code.

Section 4945(h) of the Code provides that the expenditure responsibility referred to in section 4945(d)(4) means that the private foundation is responsible to exert all reasonable efforts to establish adequate procedures: (1) to see that the grant is spent

solely for the purpose for which made; (2) to obtain full and complete reports from the grantee on how the funds are spent; and, (3) to make full and detailed reports with respect to such expenditures to the Secretary.

Section 53.4945-6(b)(1)(v) of the regulations excludes from the definition of taxable expenditure any item that constitutes a qualifying distribution.

### **Rationale**

You were formed to support, develop, and promote health care in the State. Due to the high cost and limited availability of malpractice insurance, physicians are increasingly unwilling to practice in the State, resulting in longer waiting periods for treatment or the unavailability of services. As a result, residents of the State may have to travel long distances to other states to obtain needed services or do without services entirely. Your proposed investment in the Reinsurance Company is intended to make it financially feasible for physicians to locate or continue to practice in the State and thus to ameliorate the adverse health consequences resulting from a lack of medical providers, particularly in high risk specialties.

Physicians within the State will benefit from the activities of the Reinsurance Company because they will be able to purchase medical malpractice insurance at commercially reasonable rates. However, as in Rev. Rul. 73-313, supra, the benefit to the physicians is incidental to the attainment of the exempt purpose of promoting the health of the community. Therefore, your involvement with the Reinsurance Company will not jeopardize your exempt status under section 501(c)(3) of the Code.

The Reinsurance Company is not described in section 4946(a)(1) of the Code and, therefore, is not a disqualified person. Thus, awarding the grant to the Reinsurance Company is not an act of self-dealing described in section 4941(d)(1) of the Code.

Section 4942(g) defines a qualifying distribution as any amount paid to accomplish a purpose described in section 170(c)(2)(B), other than a contribution to an organization controlled by a disqualified person or a private foundation. The promotion of the health of the community is a charitable purpose and is, therefore, one of the purposes specified in section 170(c)(2)(B) of the Code. You will not control the Reinsurance Company. Therefore, the proposed grant will be treated as a qualifying distribution.

Private foundations are subject to an excise tax on jeopardizing investments under section 4944 of the Code. Under section 4944(c), program-related investments are specifically excluded from jeopardizing investments. A program-related investment must significantly further the foundation's exempt purpose and must not have been made with the goal of production of income or appreciation in value of property. Further, the funds may not be used to carry on propaganda or otherwise influence legislation or to participate in any political campaign on behalf of or in opposition to any candidate for public office.

The sole reason for forming the Reinsurance Company is to promote the health of the community, which is a charitable purpose described in section 170(c)(2)(B) of the Code. You have represented that no significant purpose of the investment in the Reinsurance Company is the production of income or the appreciation of capital. You have further

represented that the grant will not be used for political or legislative purposes. Accordingly, the grant will be treated as a program-related investment.

Section 4945 of the Code imposes an excise tax on taxable expenditures of a private foundation. A grant to an organization that is not described in paragraph (1), (2), or (3) of section 509(a) is a taxable expenditure unless the private foundation exercises expenditure responsibility as defined in section 4945(h) of the Code.

You and the Reinsurance Company will enter into a Grant Contract. Pursuant to the contract, you will satisfy the requirements of section 4945(h) of the Code. Therefore, the grant will not constitute a taxable expenditure under section 4945(d).

Under section 4944(c), program-related investments are specifically excluded from jeopardizing investments.

Section 4943 imposes a tax on the excess business holdings of a private foundation in a business enterprise. However, the term "business enterprise" does not include a functionally related business.

Since the operation of the Reinsurance Company is conducted in order to effectuate your exempt purpose, the Reinsurance Company is a functionally related business under section 4943. Accordingly, the Reinsurance Company will not be treated as a business enterprise for purposes of determining excess business holdings under section 4943.

### **Rulings**

1. The making of the grant to the Reinsurance Company will not jeopardize your status as an organization described in section 501(c)(3) of the Code.
2. The making of the grant to the Reinsurance Company will not constitute an act of self-dealing under section 4941 of the Code.
3. The grant from you to the Reinsurance Company will constitute a qualifying distribution for purposes of meeting the minimum qualifying distribution amount under section 4942 of the Code.
4. For purposes of section 4944 of the Code, the grant will not be considered an excess business holding since it will constitute a program-related investment.
5. Since the grant to the Reinsurance Company will constitute a program-related investment under section 4944(c) of the Code, it will not be considered as an investment that jeopardizes the carrying out of your exempt purpose.
6. The grant will not constitute a taxable expenditure for purposes of section 4945 of the Code provided you exercise expenditure responsibility with respect to the grant as contemplated by section 4945(h) of the Code.

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

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matters, including questions concerning reporting requirements, please contact the EP/EO Customer Service office at \_\_\_\_\_, a toll free number. The mailing address for that office is: Internal Revenue Service, P.O. Box 2508,

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

The rulings in this letter are based on the fact that the transactions described herein are being undertaken to deal with a unique medical malpractice insurance crisis in the State. If the circumstances change so that practitioners are no longer experiencing an inability to obtain affordable malpractice insurance, you will no longer be able to rely on these rulings. If such a change in circumstances occurs, you should immediately contact the Service to arrange for a prompt and orderly method of divesting your interest in the Reinsurance Company and recovering any remaining grant funds. Any other material change in the facts related to this transaction should also be reported to the Service.

Sincerely,

**(signed) Marvin Friedlander**

Marvin Friedlander  
Manager, Exempt Organizations  
Technical Branch 1