26 CFR Parts 1 and 602

[T.D. 8100]

Income Tax; Taxable Years Beginning After December 31, 1953; OMB Control Numbers Under the Paperwork Reduction Act Cooperative Hospital Service Organizations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the treatment of certain cooperative hospital service organizations. Changes to the applicable tax law were made by the Revenue and Expenditure Control Act of 1968 and by the Tax Reform Act of 1976. The final regulations provide the public with the guidance needed to comply with those Acts and affect organizations seeking to qualify for tax exempt status as organizations described in section 501(e).

DATES: The regulations are effective generally for taxable years ending after June 28, 1968. In the case of an organization performing clinical services, the regulations are effective for taxable years ending after December 31, 1975. However, pursuant to the grant of section 7805(b) relief, an organization that has received a ruling or determination letter recognizing it as exempt under section 501(e) has until

January 2, 1987 to conform its operations to the requirements of the regulations.

FOR FURTHER INFORMATION CONTACT: Sylvia F. Hunt or Harry Beker of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (Attention CC:EE) (202-566-6212).

SUPPLEMENTAL INFORMATION:

Background

On January 11, 1984, the Internal Revenue Service published proposed regulations in the Federal Register to amend the Income Tax Regulations (26 CFR Part 1) under sections 170 and 501 of the Internal Revenue Code of 1954 (49 FR 1384). By notice published in the Federal Register on March 28, 1984 (49 FR 11886), the public was invited to comment orally upon the issues addressed in the proposals. A public hearing was held on May 31, 1984.

This document contains final regulations under sections 170(b)(1)(A) and 501(e). These regulations are issued to conform the regulations to section 109(a) of the Revenue and Expenditure Control Act of 1968 (82 Stat. 269) and section 1312(a) of the Tax Reform Act of 1976 (90 Stat. 1730) and are issued under the authority contained in section 7805 of the Code (68A Stat. 917; 26 U.S.C. 7805).

Comments and Revisions

After consideration of all comments received regarding the proposed regulations, those proposed regulations are adopted, as revised, by this Treasury decision.

Several comments indicated uncertainty as to the meaning of certain of the provisions in the proposed regulations and requested clarification of the positions announced. These recommendations have generally been adopted and are reflected in the final regulations. Thus, for example, an allocation will be deemed sufficient if it consists of bookkeeping entries and written notice to the patron-hospitals; retention of net earnings may be based on the reasonably anticipated needs of the organization; permissible sources of investment income (particularly with respect to rents) have been clarified; radiology services are specifically included within the term "clinical"; and the term "voting rights" of patron-hospitals has been defined.

Other comments recommended more extensive changes concerning accounting and operation practices. These changes, it was noted, would allow greater flexibility for cooperative hospital service organizations. Where these recommendations are neither contrary to the statutory language nor inconsistent with Congressional intent, they have been incorporated in the final regulations. Thus, for example, capital contributions have been excluded from the definition of "net earnings" and need not satisfy the allocation and payment rules; the status of membership dues and related membership assessments, gifts and grants has been clarified; certain income derived from sources that are incidental to the conduct of exempt purposes or functions has been deemed permissible; a section 501(c) organization may own stock in and receive dividends from certain public corporations where such ownership is a condition for obtaining credit; de minimis services to other than patron-hospitals where mandated by a governmental unit as a condition for operating in a particular jurisdiction, or for other reasons, has been deemed permissible; and the effective date provision has been modified for a period sufficient to permit organizations that have already been recognized as exempt under section 501(c) to modify their operations to bring them into conformance with the requirements of the final regulations.

Certain comments, however, recommended changes that would permit cooperative hospital service organizations to engage in practices that are either beyond the scope of or directly contrary to the statutory language of section 501(c). Those recommendations were also inconsistent with the holding of *HCSC—Laundry v. United States*, 450 US 1 (1981). Accordingly, the final regulations do not incorporate recommendations that would, for example, permit a section 501(c) organization to engage in unrelated trade or business so long as those activities do not become the organization's primary purpose; establish wholly-owned for-profit subsidiaries; generally sell services to other than patron-hospitals; engage in any services which are identified by the organization as cost-effective if performed centrally; or pay dividends on the organization's capital stock.

Conforming changes are also made under § 1.170A-9(c)(1) and § 1.501(h)-1 of the Income Tax Regulations.

Nonapplicability of Executive Order 12291

The Commissioner of Internal Revenue has determined that this Regulation is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required.

Regulatory Flexibility Act

The Internal Revenue Service has concluded that the regulations herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Paperwork Reduction Act

The collection of information requirements contained in this regulation has been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB under control number 1545-0814.

Drafting Information

The principal author of these regulations is Harry Beker of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

List of Subjects

26 CFR 1.61-1—1.861-4

Income taxes, Deductions.

26 CFR 1.501(a)-1—1.528-10

Income taxes, Exempt Organizations, Cooperatives.

26 CFR Part 602

Reporting and Recordkeeping Requirements.

Adoption of Amendments to the Regulations

PART 1—[AMENDED]

Accordingly, the amendments to 26 CFR Parts 1 and 602 published as a notice of proposed rulemaking in the Federal Register on January 11, 1984 (49 FR 1384) are hereby adopted, as amended, to read as follows:

Paragraph 1: The authority citation for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805 * * *.

Par. 2. Paragraph (c)(1) of § 1.170A-9 is revised to read as follows:

§ 1.170A-9 Definition of section 170(b)(1)(A) organization.

* * * * *

(c) *Hospitals and medical research organizations*—(1) *Hospitals.* An organization (other than one described

in subparagraph (2) of this paragraph) is described in section 170(b)(1)(a)(iii) if:

(i) It is a hospital, and

(ii) Its principal purpose or function is the providing of medical or hospital care or medical education or medical research.

The term "hospital" includes (A) Federal hospitals and (B) State, county, and municipal hospitals which are instrumentalities of governmental units referred to in section 170(c)(1) and otherwise come within the definition. A rehabilitation institution, outpatient clinic, or community mental health or drug treatment center may qualify as a "hospital" within the meaning of subdivision (i) of this subparagraph if its principal purpose or function is the providing of hospital or medical care. For purposes of this subdivision, the term "medical care" shall include the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, provided the cost of such treatment is deductible under section 213 by the person treated. An organization, all the accommodations of which qualify as being part of a "skilled nursing facility" within the meaning of 42 U.S.C. 1395x(j), may qualify as a "hospital" within the meaning of subdivision (i) of this subparagraph if its principal purpose or function is the providing of hospital or medical care. For taxable years ending after June 28, 1968, the term "hospital" also includes cooperative hospital service organizations which meet the requirements of section 501(e) and § 1.501(e)-1. The term "hospital" does not, however, include convalescent homes or homes for children or the aged, nor does the term include institutions whose principal purpose or function is to train handicapped individuals to pursue some vocation. An organization whose principal purpose or function is the providing of medical education or medical research will not be considered a "hospital" within the meaning of subdivision (i) of this subparagraph, unless it is also actively engaged in providing medical or hospital care to patients on its premises or in its facilities, on an inpatient or outpatient basis, as an integral part of its medical education or medical research functions. See, however, subparagraph (2) of this paragraph with respect to certain medical research organizations.

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Par. 3. Section 1.501(e)-1 is redesignated as § 1.501(k)-1.

Par. 4. The following new § 1.501(e)-1 is added immediately after § 1.501(d)-1:

§ 1.501(e)-1 Cooperative hospital service organizations.

(a) *General rule.* 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) (relating to percentage limitations on charitable contributions). 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 as described in paragraph (d) of this section.

(b) *Organized and operated on a cooperative basis*—(1) *In general.* 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 8½ 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. For the recordkeeping requirements of a section 501(e) organization, see § 1.521-1(a)(1).

(2) *Percentage of services defined.* The percentage of services performed for each patron-hospital may be determined on the basis of either the value or the quantity of the services provided by the organization to the patron-hospital, provided such basis is realistic in terms of the actual cost of the services to the organization.

(3) *Retention of net earnings.* 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. See, § 1.537-1(b). Whether there is an improper accumulation of funds depends upon the particular circumstances of each case. 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. For purposes of this paragraph, the term "net earnings" does not include capital contributions to the organization and such contributions need not satisfy the allocation or payment requirements.

(4) *Nonpatronage and other income.* An organization described in section 501(e) may, in addition to net earnings, receive membership dues and related membership assessment fees, gifts, grants and income from nonpatronage sources such as investment of retained earnings. However, such an organization cannot be exempt if it engages in any business other than that of providing the specified services, described in paragraph (c), for the specified patron-hospitals, described in paragraph (d). Thus, an organization described in section 501(e) generally cannot have unrelated business taxable income as defined in section 512, although it may earn certain interest, annuities, royalties, and rents which are excluded from unrelated business taxable income because of the modifications contained in sections 512(b) (1), (2) or (3). An organization described in section 501(e) may, however, have debt-financed income which is treated as unrelated business taxable income solely because of the applicability of section 514. In addition, exempt status under section 501(e) will not be affected where rent from personal property leased with real property is treated as unrelated business taxable income under section 512(b)(A)(ii) solely because the rent attributable to the personal property is more than incidental or under section 512(b)(3)(B)(i) solely because the rent attributable to the personal property exceeds 50 percent of the total rent received or accrued under the lease. Exemption will not be affected solely because the determination of the amount of rent depends in whole or in part on the income or profits derived from the property leased. See, section 512(b)(3)(B)(ii). An organization described in section 501(e) may also derive nonpatronage income from sources that are incidental to the

conduct of its exempt purposes or functions. For example, income derived from the operation of a cafeteria or vending machines primarily for the convenience of its employees or the disposition of by-products in substantially the same state they were in on completion of the exempt function (e.g., the sale of silver waste produced in the processing of x-ray film) will not be considered unrelated business taxable income. See, section 513(a)(2) and § 1.513-1(d)(4)(ii). The nonpatronage and other income permitted under this subparagraph (4) must be allocated or paid as provided in subparagraph (1) or retained as provided in subparagraph (3).

(5) *Stock ownership*—(i) *Capital stock of organization.* An organization does not meet the requirements of section 501(e) unless all of the organization's outstanding capital stock, if there is such stock, is held solely by its patron-hospitals. However, no amount may be paid as dividends on the capital stock of the organization. For purposes of the preceding sentence, the term "capital stock" includes common stock (whether voting or nonvoting), preferred stock, or any other form evidencing a proprietary interest in the organization.

(ii) *Stock ownership as a condition for obtaining credit.* If by statutory requirement a cooperative hospital service organization must be a shareholder in a United States or state chartered corporation as a condition for obtaining credit from that corporate-lender, the ownership of shares and the payment of dividends thereon will not for such reason be a basis for the denial of exemption to the organization. See, e.g., National Consumer Cooperative Bank, 12 U.S.C. 3001 et seq.

(c) *Scope of services*—(1) *Permissable services.* An organization meets 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 section 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).

(2) *Illustration.* The provisions of this subparagraph may be illustrated by the following example.

Example. An organization performs industrial engineering services on a cooperative basis solely for patron-hospitals each of which is an organization described in section 501(c)(3) and exempt from taxation under section 501(a). However, in addition to this service, the organization operates laundry services for its patron-hospitals. This cooperative organization does not meet the requirements of this paragraph because it performs laundry services not specified in this paragraph.

(d) *Patron-hospitals*—(1) *Defined.* Section 501(e) only applies if the organization performs its services solely for two or more patron-hospitals each of which is—

(i) An organization described in section 501(c)(3) which is exempt from taxation 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 any of the foregoing.

(2) *Business with nonvoting patron-hospitals.* Exemption will not be denied a cooperative hospital service organization solely because the organization (whether organized on a stock or membership basis) transacts business with patron-hospitals which do not have voting rights in the organization and therefore do not participate in the decisions affecting the operation of the organization. Where the organization has both patron-hospitals with voting rights and patron-hospitals without such rights, the organization must provide at least 50 percent of its services to patron-hospitals with voting rights in the organization. Thus, the percentage of services provided to nonvoting patrons may not exceed the percentage of such services provided to voting patrons. A patron-hospital will be deemed to have voting rights in the cooperative hospital service organization if the patron-hospital may vote directly on matters affecting the operation of the organization or if the patron-hospital may vote in the election of cooperative board members. Notwithstanding that an organization may have both voting and nonvoting patron-hospitals, patronage refunds must nevertheless be allocated or paid to all patron-hospitals solely on the basis specified in paragraph (b) of this section.

(3) *Services to other organizations.* An organization does not meet the requirements of section 501(e) if, in addition to performing services for patron-hospitals (entities described in subdivisions (i), (ii) or (iii) of subparagraph (1)), the organization performs any service for any other organization. For example, a cooperative hospital service organization is not exempt if it performs services for convalescent homes for children or the aged, vocational training facilities for the handicapped, educational institutions which do not provide hospital care in their facilities, and proprietary hospitals. However, the provision of the specified services between or among cooperative hospital service organizations meeting the requirements of section 501(e) and this section is permissible. Also permissible is the provision of the specified services to entities which are not patron-hospitals, but only if such services are de minimis and are mandated by a governmental unit as, for example, a condition for licensing.

(e) *Effective dates.* An organization, other than an organization performing clinical services, may meet the requirements of section 501(e) and be a tax exempt organization for taxable years ending after June 28, 1966. An organization performing clinical services may meet the requirements of section 501(e) and be a tax exempt organization for taxable years ending after December 31, 1976. However, pursuant to the authority contained in section 7805(b) of the Internal Revenue Code, these regulations shall not become effective with respect to an organization which has received a ruling or determination letter from the Internal Revenue Service recognizing its exemption under section 501(e) until January 2, 1987.

PART 602—[AMENDED]

Par. 5. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. Section 602.101(c) is amended by inserting the following item in the appropriate place in the table:

§ 602.101	OMB control numbers.
* * * * *	
(c) * * *	

§ 1.501(c)-1	1545-0814

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954. (68A Stat. 917; 26 U.S.C. 7805).

Roscoe L. Egger, Jr.,
Comissioner of Internal Revenue.

Approved:

J. Roger Mentz,
Assistant Secretary of the Treasury.

August 15, 1986.

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