

Health care organizations; medicare and medicaid payments. Medicare and medicaid payments constitute gross receipts derived from the exercise or performance of a health care organization's exempt activities for purposes of the support test of sections 170(b)(1)(A)(vi) and 509(a)(2) of the Code.

#### ISSUE AND FACTS

Do medicare and medicaid payments made to health care organizations exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code constitute gross receipts derived from the exercise or performance of exempt functions within the meaning of sections 170(b)(1)(A)(vi) and 509(a)(2)?

#### LAW AND ANALYSIS

Section 509(a) of the Code provides that the term "private foundation" does not include those organizations described in sections 170(b)(1)(A)(vi) and 509(a)(2).

Section 170(b)(1)(A)(vi) of the Code refers to any organization described in section 170(c)(2) that normally receives a substantial part of its support (exclusive of income received in the exercise or performance of its exempt functions) from a governmental unit or from direct or indirect contributions from the general public.

Section 1.170A-9(e)(7)(i)(a) of the Income Tax Regulations provides that the term "support" does not include any amounts received from the exercise or performance by an organization of its exempt purpose or function.

Section 1.170A-9(e)(8)(i) of the regulations provides that the term "support from a governmental unit" includes any amounts received from a governmental unit, including amounts received in connection with a contract entered into with a governmental unit for the performance of services. However, such amounts will not constitute "support from a governmental unit" for such purposes if they constitute amounts received from the exercise or performance of the organization's exempt functions as provided in section 1.170A-9(e)(7)(i)(a).

Section 1.170A-9(e)(8)(ii) of the regulations provides that any amount paid by a governmental unit to an organization is not to be treated as received from the exercise or performance of its exempt functions if the purpose of the payment is primarily to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public rather than to serve the direct and immediate needs of the payor. For example, section 1.170A-9(e)(8)(ii)(b) provides that amounts paid under governmental programs to nursing homes or homes for the aged in order to provide health care or domiciliary services to residents

of such facilities are considered payments the purpose of which is primarily to enable the recipient organization to provide a service or maintain a facility for the direct benefit of the public, rather than to serve the direct and immediate needs of the payor. Section 1.170A-9(e)(8)(ii) makes reference to section 1.509(a)-3(g) in distinguishing between support from a governmental unit and amounts received from the exercise or performance of an exempt function.

Section 509(a)(2)(A) of the Code requires that an organization described in section 509(a)(2) must normally receive more than one-third of its support in each taxable year from any combination of (i) gifts, grants, contributions, or membership fees, and (ii) gross receipts from an activity that is not an unrelated trade or business (within the meaning of section 513), exclusive of receipts from any person, or from any governmental agency, in any taxable year to the extent such receipts exceed the greater of \$5000 or one percent of the organization's support in such taxable year.

Section 1.509(a)-3(g)(2) of the regulations provides that in distinguishing the term "gross receipts" from the term "grants" (whether from a governmental unit, a nonprofit organization, or a profit making organization), the term "gross receipts" means amounts received from an activity that is not an unrelated trade or business, if a specific service, facility, or product is provided to serve the direct and immediate needs of the payor, rather than primarily to confer a direct benefit upon the general public. In general, payments made primarily to enable the payor to realize or receive some economic or physical benefit as a result of the service, facility, or product obtained will be treated as "gross receipts" with respect to the payee.

Medicare is provided under title XVIII of the Social Security Act, 42 U.S.C. section 1395 et seq. (1976), and consists of so-called basic (Part A) and supplementary (Part B) benefits. Basic medicare is a mandatory program, financed largely by hospital insurance taxes imposed on employers, employees, and the self-employed, which provides hospital insurance benefits for the aged and disabled. Supplementary medicare is a voluntary program, financed largely through premiums paid by those who elect to enroll together with matching contributions from the federal government, which offers the aged and disabled insurance coverage for doctors' services and other items not covered under basic medicare.

Medicaid is provided under title XIX of the Social Security Act, 42 U.S.C. section 1396 et seq. (1976), to enable the states, through either public or private institutions, to furnish medical assistance to families with dependent children and to the aged, blind, and disabled who are unable to afford the costs of necessary medical services. This program is financed by combined contributions from state and federal governments according to a formula provided in the Act.

Medicare and medicaid payments are received in connection with contracts entered into with state and federal governmental units that contemplate the performance of health care services. The stated purpose of the medicare and medicaid programs is to ensure that aged, disabled, and financially needy individuals receive necessary and adequate health care. However, medicare and medicaid payments are primarily made to pay or reimburse for services already provided to individuals eligible under these programs to have health care services paid for, rather than to encourage or enable an organization to provide services to yet unidentified members of the community at large. See, e.g. 42 U.S.C. Secs. 1395d, 1395o, 1396b(g), 1396b(h), 1396b(i), and 1396b(2). The individual medicare or medicaid patient, not a governmental unit, actually controls the ultimate recipient of these payments by his or her choice of a health care organization to perform health care services. Further, these payments enable the patient to realize economic and physical benefits from services which serve his or her direct and immediate health care needs. In view of the foregoing, these payments cannot be characterized as being governmental grants or support from a governmental unit for purposes of sections 170(b)(1)(A)(vi) and 509(a)(2) of the Code, and section 1.170A-9(e)(8)(i) and 1.509(a)-3(g)(2) of the regulations. However, these medicare and medicaid payments would constitute gross receipts derived from the exercise or performance of exempt functions, as described in sections 170(b)(1)(A)(vi) and 509(a)(2) of the Code, and, sections 1.170A-9(e)(7)(i)(a) and 1.509(a)-3(g)(2) of the regulations because they are received in return for medical services provided to individual patients.

In view of the element of control discussed above, the individual patients rather than the governmental agencies are the payors of medicare or medicaid payments for purposes of the one-third support test of section 509(a)(2)(A). Consequently, medicare and medicaid receipts for services provided each patient would be includible as gross receipts to the extent of the greater of \$5000 or one percent of an organization's total support for a taxable year. See section 1.509(a)-3(b) of the regulations.

On the other hand, since medicare and medicaid payments constitute gross receipts derived from the exercise or performance of exempt activities, they cannot be included in determining whether the organization meets the support test of section 170(b)(1)(A)(vi) of the Code. See section 1.170A-9(e)(7)(i)(a) of the regulations.

Compare Rev. Rul. 81-276, 1981-2 C.B. 128, which holds that payments made by the United States Department of Health and Human Services to professional standards review organizations (PSROs) pursuant to contracts entered into between them, constitute support from a governmental unit under section 1.170A-9(e)(8)(ii) of the regulations because these payments compensate the PSROs for a function that promotes the health of the beneficiaries of governmental health care programs in the areas in which the PSROs

operate, and confer a direct benefit on the general public.

HOLDING

For purposes of determining whether an organization is a private foundation under the public support tests of section 170(b)(1)(A)(vi) and 509(a)(2) of the Code, medicare and medicaid payments made to health care organizations exempt from federal income tax under section 501(c)(3) constitute gross receipts derived from the exercise or performance of exempt functions.