No. 08-_____

IN THE
Supreme Court of the United States

VISION SERVICE PLAN,
Petitioner,

v.

THE UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Consistent with the IRS's longstanding position and Congress's intent, whether a nonprofit health care organization that provides benefits to a broad and substantial class of subscribers qualifies for tax exemption as a "social welfare" organization pursuant to section 501(c)(4) of the Internal Revenue Code of 1986.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, petitioner states that it has no parent companies and no publicly owned company owning 10% or more of its stock.

TABLE OF CONTENTS

APPENDIX

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES & REGULATIONS

LEGISLATIVE & AGENCY MATERIALS

OTHER AUTHORITIES

OPINIONS BELOW

The opinion of the court of appeals is reported at 101 A.F.T.R.2d 2008-656, 2008-1 U.S.T.C. ¶ 50,160, 2008 WL 268075, and 2008 U.S. App. Lexis 2388, and is reprinted in the Appendix ("App.") at 1a-3a. The opinion of the district court is reported at 96 A.F.T.R.2d 2006-7440, 2006-1 U.S.T.C. ¶ 50,173, 2005 WL 3406321, and 2006 U.S. Dist. Lexis 38812, and is reprinted at App. 4a-25a.

JURISDICTION

The court of appeals entered judgment on January 30, 2008. On April 9, 2008, the court denied a timely petition for rehearing and suggestion for rehearing *en banc*. App. 26a. On June 19, 2008, Justice Kennedy extended the time for filing this petition to and including August 7, 2008. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The most directly pertinent portions of section 501 of the Internal Revenue Code of 1986 provide as follows:

> (a) EXEMPTION FROM TAXATION
>
> An organization described in subsection (c) or (d) or section 501(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.
>
> …

(c) LIST OF EXEMPT ORGANIZATIONS:

The following organizations are referred to in subsection (a):

…

(3) Corporations … organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or [for certain other purposes, and within limitations on political activities and private inurement].

(4)(A) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare … and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

…

(m) CERTAIN ORGANIZATIONS PROVIDING COMMERCIAL-TYPE INSURANCE NOT EXEMPT FROM TAX

(1) DENIAL OF TAX EXEMPTION WHERE PROVIDING COMMERCIAL-TYPE INSURANCE IS SUBSTANTIAL PART OF ACTIVITIES

An organization described in paragraph (3) or (4) of subsection (c) shall be exempt from tax under subsection (a) only if no substantial part of its activities consists of providing commercial-type insurance.

> …
>
> (3) COMMERCIAL-TYPE INSURANCE
>
> For purposes of this subsection, the term "commercial-type insurance" shall not include —
>
> (A) insurance provided at substantially below cost to a class of charitable recipients,
>
> (B) incidental health insurance provided by a health maintenance organization of a kind customarily provided by such organizations;
>
> ….

Code sections 501(a), 501(c)(3)-(4), and 501(m), are set forth in their entirety at App. 27a-30a.[1]

The term "social welfare," used in section 501(c)(4), is not defined in the Code. Treasury Regulation § 1.501(c)(4)-1(a)(2) provides in part:

> (i) *In general*. An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated

[1] In this petition, all references to the "Code," and all statutory citations that do not include the United States Code title, are to the Internal Revenue Code of 1986, as amended.

> primarily for the purpose of bringing about civic betterments and social improvements.

The entirety of Treasury Regulation § 1.501(c)(4)-1, which is the only regulation addressing section 501(c)(4) of the Code, is set forth at App. 30a-32a. No regulations have been issued under section 501(m).

STATEMENT OF THE CASE

This case presents a critically important, recurring question regarding the standards governing the tax-exempt status of nonprofit health care enterprises, particularly nonprofit health maintenance organizations (HMOs). Under the common law, which this Court has held is reflected in section 501(c) of the Internal Revenue Code, nonprofit health care organizations are deemed "charitable" entities that promote the "social welfare," and are thus entitled to tax-exempt status, as long as the class of subscribers is not so small that the public benefits are insubstantial. Consistent with the common law, the IRS has long taken the position that nonprofit HMOs, including petitioner Vision Service Plan (VSP), are eligible for tax-exempt status. Indeed, the IRS granted VSP a tax exemption in 1960.

Without any change in statutory or regulatory law, and without any change in the operations of VSP, the IRS overturned its longstanding position, revoking VSP's tax exemption in 2002. According to the IRS, a nonprofit health care organization that limits its benefits to a class of subscribers is no longer eligible for tax-exempt status, unless it also provides some as-yet-unquantified, unspecified

amount of "community benefits." By condoning the IRS's unfounded departure from the common law in a cursory, unpublished decision, the Ninth Circuit has cast tax exemption law into turmoil, introducing unprecedented uncertainty in a nonprofit industry that relies on tax exemptions in order to fulfill its basic mission of providing health care for the benefit of the community to all applicants. Indeed, the Ninth Circuit's ruling calls into question the tax exemptions for all nonprofit health care organizations, including not just otherwise qualified health plans and HMOs, but also hospitals, nursing homes, and others.

This is directly contrary to Congress's clearly expressed intent. In 1986, Congress struck a balance in determining which nonprofit health care organizations should be exempt from taxes. Section 501(m) of the Code denies a tax exemption to "charitable" and "social welfare" organizations (*i.e.*, section 501(c)(3) and (4) organizations) that offer "commercial-type insurance," such as Blue Cross and Blue Shield. At the same time, however, section 501(m) acts as a savings clause, expressly preserving the existing tax exemption for nonprofit HMOs that do not offer commercial-type insurance. Because nonprofit HMOs are, by their very nature, organizations that provide benefits to a class of subscribers, the IRS's position therefore contravenes Congress's determination that these entities should be eligible for tax-exempt status.

The standards governing the availability of tax exemptions to nonprofit organizations in the health care field is an important issue of federal law that has not been, but should be, decided by this Court.

Because of the billions of dollars involved in this industry and the potentially adverse impact on public health and the cost and availability of health care, the issue should not await the development of a conflict in the circuits. More than enough confusion and uncertainty exists already.

A. The Petitioner, Vision Service Plan.

VSP is a California nonprofit corporation established in 1955 and licensed under California's Knox-Keene Health Care Service Plan Act of 1975 (Cal. Health & Safety Code § 1340 *et seq.*). VSP offers only a single service: vision care. It provides prepaid medical service plans, primarily covering eye examinations and corrective lenses, that deliver services through a network of private practice optometrists and ophthalmologists. VSP contracts with these providers at a discount from their usual and customary rates.

In 1960, the IRS recognized VSP's tax-exempt status under section 501(c)(4). VSP's organization and operations have not changed in any material way since that time, except that it has grown significantly in size and thus serves ever broader portions of the community. Beginning in 1960 as a regional provider, VSP along with its affiliates has become a national provider of vision care.

As a nonprofit entity providing care to a large segment of the community, VSP pursues a goal of maximizing delivery of health care services within the limits of its financial capacity, rather than maximizing net income:

- in 2003, the tax year in question, VSP had over 6 million enrollees, more than 40% of whom were poor or elderly beneficiaries of Medicaid, Medicare, or similar state programs;

- VSP provides millions of dollars in free vision services to uninsured or underinsured children and victims of disasters;

- even for those subscriber groups who participate at full rates, VSP has negotiated discounts with its contract providers of 20% or more off the providers' usual and customary rates, with even deeper discounts for services provided to Medicare and Medicaid patients;

- over a third of the providers in VSP's network are in medically underserved communities;

- VSP has no blackout provisions on enrollment and no limitation for pre-existing conditions;

- VSP has a substantial program of community outreach and patient education on the health benefits of annual comprehensive eye examinations;

- VSP uses its accumulated surplus and reserves for the purpose of providing a business safety net and improving the cost effectiveness and quality of the eye care services it provides;

- no part of VSP's net revenues or assets can inure to any private person or be distributed as dividends; VSP's by-laws preclude such inurement; and

- VSP's Articles of Incorporation affirm its nonprofit business model: the Articles require that if the organization dissolves, its remaining assets are to be distributed "to an educational, research, scientific or health institution, organization, or association to be expended in the advancement of the science and art of optometry."

Thus, in contrast to for-profit commercial insurers, VSP is not investor-owned, and it provides benefit plans to subscribers without regard to traditional insurance risk analyses (*i.e.*, pre-existing conditions for profit underwriting guidelines). Despite these stark differences, in 2002, the IRS determined that VSP should be taxed as if it were a for-profit commercial insurer. The IRS revoked VSP's tax-exempt status, prospectively, on the ground that it was not "operated primarily for the promotion of social welfare." Neither in 2002 nor in the course of discovery and argument did the IRS contend that VSP's operations had changed since 1960 when the IRS granted VSP a tax exemption.

VSP paid taxes for 2003 and sued for a refund in the United States District Court for the Eastern District of California. The District Court had jurisdiction under 28 U.S.C. § 1346(a)(1).

B. The Proceedings Below.

1. The District Court granted summary judgment for the government. The District Court determined that VSP is not eligible for a tax exemption because "VSP's primary purpose is to serve VSP's paying members." App. 14a. The District Court recognized that "VSP does provide

services through charity programs," but it concluded that "these services to non-enrollees are not, comparatively, substantial…." App. 14a. In the District Court's view, "VSP is operating primarily for the benefit of its subscribers rather than for the purpose of benefitting [*sic*] the community as a whole." App. 18a.[2] The District Court thus would deny 501(c)(4) tax-exempt status to any HMO that limits its benefits to a class of subscribers, no matter how large that class.[3]

2. The Ninth Circuit affirmed. That court gave VSP's appeal short shrift. In a memorandum decision, it stated, without analysis, that VSP is not eligible for tax-exempt status because its "primary purpose" is to "benefit[] VSP's subscribers rather than the general welfare of the community." App. 2a. The Ninth Circuit recognized that "VSP offers some public benefits," but concluded that VSP's

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[2] The District Court also found that VSP's primary activity was "carrying on a business with the general public in a manner similar to organizations which are operated for profit." App. 23a (quotations omitted). The Ninth Circuit expressly refused to reach this issue. App. 3a.

[3] The District Court also seemed to conclude that VSP is not an HMO because it arranges to provide health care services through contract physicians rather than providing the services through physician employees. App. 15a. While the Ninth Circuit did not address this point, the District Court's conclusion is clearly erroneous. Both the IRS and this Court have recognized that "HMOs directly provide *or arrange for* the provision of health care services to members on a prepaid basis." Internal Revenue Manual § 4.76.31.2(1) (emphasis added); *see also Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355, 367 (2002) (the "defining feature of an HMO is receipt of a fixed fee for each patient enrolled under the terms of a contract to provide specified health care if needed") (citation omitted).

subscriber-based structure precluded it from finding that those benefits are "enough for us to conclude that VSP is primarily engaged in promoting the common good and general welfare of the community." App. 2a (emphasis removed). The court did not explain why VSP's "subscribers" were not a sufficiently large body that the promotion of their health care was of benefit to "the common good." Nor did the court explain how its decision could be squared with the common law or the IRS's previously-held position that health care itself is a mission that benefits social welfare.

REASONS FOR GRANTING THE PETITION

I. The Decision Below Conflicts With Longstanding Common Law Principles And Congress's Intent To Preserve Nonprofit HMOs' Tax-Exempt Status.

The Ninth Circuit's decision turns on the premise that an HMO providing health care to a broad but limited class of patients, *i.e.*, less than all members of the community, does not qualify for a 501(c)(4) exemption. This is directly contrary to the common law of charitable trusts, which this Court has held guides interpretation of the Code's charitable exemptions, and which provides that health care is a "charitable" purpose. It is also in conflict with Congress's 1986 judgment that nonprofit HMOs *are* entitled to tax-exempt status. If allowed to stand, the Ninth Circuit's decision will allow the IRS to proceed on an uncertain and unprecedented course, stripping HMOs of a tax-exempt status that enables these organizations to

fulfill their basic, "charitable" mission of providing health care.

1. Tax exemptions for nonprofit "charitable" and "social welfare" organizations have been part of federal income tax law at least since the Revenue Act of 1913, Pub. L. No. 63-16, § 2(G), 38 Stat. 114, 172. These terms are not defined in the statute. However, this Court has observed that the "common law of charitable trusts" should guide interpretation of the "charitable exemption and deduction sections" of the various tax laws. *Bob Jones Univ. v. United States*, 461 U.S. 574, 588 n.12 (1983), *citing*, *e.g.*, H.R. REP. NO. 91-413, pt. 1, at 43 (1969) (describing "charitable" as "a term that has been used in the law of trusts for hundreds of years"). Similarly, Treasury Regulations provide that "[t]he term 'charitable' is used in section 501(c)(3) in its generally accepted legal sense." Treas. Reg. § 1.501(c)(3)-1(d)(2).

The common law of charitable trusts leaves no doubt that the promotion of health is in itself a charitable purpose.[4] This is true regardless of the percentage of needy patients: relief of poverty is a possible, but not essential, object of "charity." IV-A WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 372 (4th ed. 1989). Moreover, the charitable character of a health care institution is not lost simply because patients pay for the care that they receive.[5] Nor is

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[4] *See*, *e.g.*, 2 RESTATEMENT (SECOND) OF TRUSTS § 372, comment *a* (1959); GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 374 (2d ed. rev. 1991); IV-A WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 372 (4th ed. 1989).

[5] *See*, *e.g.*, *Butterworth v. Keeler,* 219 N.Y. 446, 449, 114 N.E. 803, 804 (1916) (Cardozo, J.) ("What controls is not the receipt of income, but its purpose."); RESTATEMENT § 372

the charitable character of the institution lost simply because its subscribers are limited to fewer than all members of the community, provided that the number of subscribers is not so small as to be of no practical benefit to the community. 2 RESTATEMENT (SECOND) OF TRUSTS § 372, comment *c* (1959) (hereinafter "RESTATEMENT"); *id.* § 375; GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 365 (2d ed. rev. 1991); SCOTT ON TRUSTS §§ 372, 375.

Under the common law of charitable trusts, therefore, VSP is a charitable entity even though the entire public does not participate in VSP's prepaid vision service plans. As the Tax Court held in one of the earliest HMO tax exemption cases:

> To our knowledge, no charity has ever succeeded in benefiting every member of the community. If to fail to so benefit everyone renders an organization noncharitable, then dire times must lie ahead for this nation's charities.

Sound Health Ass'n v. Comm'r, 71 T.C. 158, 185 (1978), *acq.* 1981-2 C.B. 1. If the rule were otherwise, well-known and highly respected nonprofit HMOs could lose their tax exemptions, as could many nonprofit hospitals.[6]

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comment *c*; BOGERT ON TRUSTS & TRUSTEES § 364; SCOTT ON TRUSTS § 372; *E. Kentucky Welfare Rights Org. v. Simon*, 506 F.2d 1278, 1287-1288 (D.C. Cir. 1974), *vacated for plaintiffs' lack of standing*, 426 U.S. 26 (1976).

[6] Similar principles apply to educational and religious institutions, which also provide many services that directly benefit only their students or congregants. *See*, *e.g.*, *Bethel*

Before revoking VSP's tax-exempt status in 2002, the IRS had long agreed with this position. In 1969, the IRS declared that the "promotion of health" is "one of the purposes in the general law of charity that is deemed beneficial to the community as a whole, *even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community*, … provided that the class is not so small that its relief is not of benefit to the community." Rev. Rul. 69-545, 1969-2 C.B. 117 (emphasis added). This ruling made clear that a health care organization that serves a limited but broad class of subscribers, as most HMOs do, is engaged in a "charitable" purpose. The IRS's ruling was grounded in the common law of charitable trusts, and it accurately reflected that law. *See*, *e.g.*, RESTATEMENT §§ 368, 375. *See generally* Robert S. Bromberg, *The Charitable Hospital*, 20 CATH. U. L. REV. 237 (1970) (authored by the IRS lawyer who drafted Revenue Ruling 69-545).

2. The IRS granted VSP a tax exemption under 501(c)(4), which uses the term "social welfare," rather than 501(c)(3)'s "general law of charity." But this should have made no difference. Well-established law makes clear that the two sections are *in pari material*, and therefore must be construed together. *See generally Estate of Sanford v. Comm'r*, 308 U.S. 39, 44 (1939); *United States v. Freeman*, 44 U.S. 556, 564-565 (1845).[7] Consistent with this

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Conservative Mennonite Church v. Comm'r, 746 F.2d 388, 391 (7th Cir. 1984).

[7] "[T]he primary difference between the two … is that organizations qualifying under § 501(c)(3) are restricted from substantial involvement in attempts to influence legislation, whereas § 501(c)(4) organizations have greater flexibility in

proposition, "[t]he IRS has a considerable propensity to import federal tax law principles applicable to tax-exempt charitable organizations to shape the law applicable to exempt social welfare organizations." THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS 3 (2d ed. 2007 Cum. Supp.).[8]

Thus, the IRS has specifically recognized that 501(c)(4)'s "social welfare" organizations are a *broader* group than the "charitable" organizations of 501(c)(3). *See N. Calif. Central Servs., Inc. v. United States*, 591 F.2d 620, 625 (Ct. Cl. 1979). Indeed, the IRS typically has used section 501(c)(4) as a "convenient pigeonhole … for organizations that, although worthy, failed to meet the particular requirements of other 501(c) subsections," especially "prepaid medical service organizations." IRS Gen. Couns. Mem. (G.C.M.) 34,709 (Dec. 7, 1971). *See generally* James J. McGovern, *Federal Tax Exemption of Prepaid Health Care Plans*, 7 TAX ADVISER 76 (1976).

Consistent with the common law and with the IRS understanding of the relationship between 501(c)(3) and 501(c)(4), the IRS for many years accepted nonprofit health care organizations such as

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that field." *N. Calif. Central Servs., Inc. v. United States*, 591 F.2d 620, 625 (Ct. Cl. 1979) (summarizing Government's position); *see also Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 546 (1983).

[8] Not in this case, however. Contrary to its earlier litigating position in *N. Calif. Central Servs.*, *supra* n.7, in this case the Government has argued that cases involving exemption section 501(c)(3) are "inapposite"; and the district court agreed. App. 10-11a n.2. The Ninth Circuit did not address the issue.

VSP, the Blue Cross and Blue Shield organizations, and other HMOs as tax-exempt under 501(c)(4), and occasionally under 501(c)(3). *See* Otto Shill, *Revocation of Blue Cross & Blue Shield's Tax Exempt Status: An Unhealthy Change?*, 6 B.U. J. TAX L. 147, 150 (1988); *Developments in the Health Care Field: A Story of Dramatic Change*, at unnumbered p. 2, *in* IRS EXEMPT ORGANIZATIONS, TECHNICAL INSTRUCTION PROGRAM FOR 1988, *at* www.irs.gov/pub/irs-tege/eotopicc88.pdf.

3. In 1986, Congress reviewed the tax-exempt status of health care companies in light of changes in the health care marketplace, particularly the increase in competitive, for-profit health insurers. As part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, Congress adopted what is now Code section 501(m). This section denies a tax exemption under 501(c)(3) and 501(c)(4) to organizations that offer "commercial-type insurance."[9]

At the same time that it revoked tax exemptions for providers of "commercial-type insurance," however, Congress expressly retained the existing tax-exempt status for nonprofit HMOs, including HMOs offering supplemental services such as vision or dental plans. Section 501(m)(3)(B) thus provides that "commercial-type insurance" should *not* include "incidental health insurance provided by a health maintenance organization of a kind customarily

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[9] This provision was aimed specifically at the exemptions of the Blue Cross and Blue Shield organizations. *See*, *e.g.*, Shill, *supra*, at 147; H.R. REP. NO. 99-426, at 664 (1985), *reprinted in* 1986-3 C.B. (vol. 2), at 664.

provided by such organizations." The Conference Committee report explained:

> [O]rganizations that provide supplemental health maintenance organization-type services (such as dental services) are not affected [by section 501(m)] if they operate in the same manner as a health maintenance organization.

H.R. REP. NO. 99-841, at 345 (1986) (Conf. Rep.), *reprinted in* 1986-3 C.B. (vol. 4) 346.

Two years later, the Conference Report for the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3700, confirmed that Congress intended a "general exemption for health maintenance organizations," as well as for "organizations that provide supplemental … services (such as dental or vision services) … if they operate in the same manner as a health maintenance organization." H.R. REP. NO. 100-1104, at 9 (1988), *reprinted in* 1988-3 C.B. 473, 499.

Congress's judgment should have been determinative in this case. Instead, the Ninth Circuit's decision upholds the IRS's narrow (and erroneous) interpretation of section 501(c)(4) as excluding HMOs that do not provide "enough" additional public benefits. Such a reading would trump Congress's intent that section 501(m)(3) operate as a savings clause for nonprofit HMOs: Congress provided in section 501(m)(3) that HMOs that do *not* provide commercial-type health insurance are still eligible for tax-exempt status.

As this Court has previously made clear in the tax exemption context, the Ninth Circuit's interpretation of the Code is fundamental error. "[I]t is a basic principle of statutory construction that a specific statute, here subsection [501](e), controls over a general provision such as subsection [501](c)(3)." *HCSC-Laundry v. United States,* 450 U.S. 1, 6 (1981). This is "particularly" true when it is consistent with the legislative history and "when the two [provisions] are interrelated and closely positioned, both in fact being parts of § 501 relating to exemption of organizations from tax." *Id.* What was true of sections 501(c)(3) and 501(e) in *HCSC-Laundry* is true of sections 501(c)(4) and 501(m) in this case. The latter is the specific provision in which Congress expressed its intent that HMOs offering incidental health insurance, such as vision and dental care, should continue to be eligible for tax exemptions.

The IRS has deliberately ignored this congressional judgment. It has backed away from its prior ruling that a health care organization is eligible for tax-exempt status, "even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community." Quite to the contrary, the IRS has now proclaimed that it "do[es] not interpret [501(m)(3)(B)] as evidence of congressional intent to generally except HMOs from the proscription of IRS 501(m)(1)." John Francis Reilly et al., *IRC 501(c)(4) Organizations*, *in* IRS EXEMPT ORGANIZATIONS, TECHNICAL INSTRUCTION PROGRAM FOR FY 2003, at I-33. But that is exactly what Congress intended, as both the statutory language and its legislative history make clear. *See* DOUGLAS M. MANCINO,

TAXATION OF HOSPITALS AND HEALTHCARE ORGANIZATIONS § 6.03 (2d ed. 2005).

The IRS's changed position – now condoned by the Ninth Circuit – makes it much more difficult for a nonprofit health care organization to qualify for an exemption under sections 501(c)(3) or 501(c)(4). Despite the fact that the basic mission of these organizations is a charitable one – the promotion of health care – the IRS now requires something more in the way of "community benefits" or "public benefits" in order to qualify for an exemption. *See*, *e.g.*, John M. Quirk, *Turning Back the Clock on the Health Care Organization Standard for Federal Tax Exemption*, 43 WILLAMETTE L. REV. 69, 76 (2007). This movement has been applauded by some[10] and criticized by others,[11] but both supporters and critics agree that the change has occurred. *See also* THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS 165 (3d ed. 2007).

The decision below reflects the most extreme example yet of the IRS's change in position. The IRS has not contended in this litigation that VSP offers "commercial-type insurance," an offering that would bar exemption under section 501(m).[12] Instead, the

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[10] *See*, *e.g.*, John D. Colombo, *The Failure of Community Benefit*, 15 HEALTH MATRIX 29 (2005).

[11] *See*, *e.g.*, Douglas M. Mancino, *The Impact of Federal Tax Exemption Standards on Health Care Policy and Delivery*, 15 HEALTH MATRIX 5 (2005).

[12] The IRS did contend in the lower courts that VSP's "primary activity … is carrying on a business with the general public in a manner similar to organizations which are operated for profit," Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii), and the District Court so found, App. 25a; but the Ninth Circuit expressly

IRS has wrongly sought to impose even more restrictive limits than section 501(m)(3) imposes. The IRS would limit the promotion of "social welfare" under section 501(c)(4) to organizations that are either not subscriber-based, or subscriber-based but provide "enough" additional community benefits. Despite its changed position, the IRS has not withdrawn Revenue Ruling 69-545, which is plainly inconsistent with its new position. *See* Douglas M. Mancino, *The Impact of Federal Tax Exemption Standards on Health Care Policy and Delivery*, 15 HEALTH MATRIX 5 (2005); Bromberg, *supra*. Nor has it promulgated regulations under section 501(m)(3) to explain or clarify its position. Rather, the IRS's new position introduces unwarranted and needless uncertainty and risk into the nonprofit health care sector and beyond, despite the absence of new legislation or regulation.

VSP fits squarely within section 501(m)(3)'s savings clause, *i.e.*, it is an HMO that does not offer commercial-type insurance. The IRS's more stringent interpretation of sections 501(m)(3) and 501(c)(4) is contrary to Congress's intent and the IRS's prior position granting tax exemptions to entities like VSP.

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declined to rest its decision on this basis. App. 3a. The subsequent congressional decision reflected in section 501(m) effectively supersedes the regulation, as it applies to nonprofit HMOs such as VSP. *See Chevron U.S.A. Inc. v. Natural Res. Defense Council*, 467 U.S. 837, 842-843 (1984) (legislative judgment controls).

II. VSP Is Exactly The Sort Of Nonprofit Organization That Congress Intended To Remain Tax-Exempt.

VSP is an HMO for federal tax purposes. "The defining feature of an HMO is receipt of a fixed fee for each patient enrolled under the terms of a contract to provide specified health care if needed." *Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355, 367 (2002). In the evolution of the health care industry, HMOs are moving away from the original staff or group model, in which services are rendered by employees or by a closely affiliated medical group, to what is referred to as a contract or network model, such as the one that VSP uses. *See generally U.S. Health Care, Inc. v. Healthsource, Inc.*, 986 F.2d 589, 591-592 (1st Cir. 1993) (describing evolution of HMOs from use of physician employees to use of contract physicians).

The IRS attempts to distinguish staff-model HMOs, which it describes as "providers," from contract-model HMOs such as VSP, which it disparages as mere "arrangers" of health-care services.[13] Section 501(m) makes no such distinction,

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[13] *See*, *e.g.*, Leah D. Embry Thompson & Robert K. Kolbe, *Federal Tax Exemption of Prepaid Health Care Plans After IRC 501(m)*, at unnumbered p. 16, *in* IRS EXEMPT ORGANIZATIONS, TECHNICAL INSTRUCTION PROGRAM FOR FY 1992, *at* www.irs.gov/pub/irs-tege/eotopicl92.pdf:

> The Service continues to hold that only HMOs that provide medical services, with only incidental insurance attributes, are covered by the IRC 501(m)(3)(B) exception. In all other cases, the insurance aspects outweigh the service aspects.

and the legislative history shows that none was intended.

Congress was well aware that HMOs take various forms. The Conference Committee report on the Tax Reform Act of 1986 observed:

> HMOs provide physician services in a variety of practice settings primarily through physicians who are either employees or partners of the HMO or through contracts with individual physicians or one or more groups of physicians (organized on a group practice or individual practice basis).

H.R. REP. NO. 99-841, *supra*, at 346. In the statute, Congress drew no distinction between "providers" and "arrangers," such as the one the IRS seeks to make.

The legislative history of section 501(m) is also explicit that supplementary vision and dental plans, of the sort provided by VSP, were the type of "incidental health insurance" Congress had in mind. *See id.*; STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 585-586.

Nor did Congress make HMOs' continued tax-exempt status depend on their provision of free care. Care offered substantially below cost is specified in section 501(m)(3)(A) as a separate exclusion from "commercial-type insurance." HMO-type organizations excluded under section 501(m)(3)(B) are not required also to satisfy the test of section 501(m)(3)(A).

The IRS's revocation of VSP's tax-exempt status, over 40 years after it was initially granted, represents an unauthorized departure from the established law of charitable trusts and from the specific judgment of the 1986 Congress, as well as from the IRS's own interpretation of section 501 expressed in Revenue Ruling 69-545. The IRS lacks any authority in legislation or in its own regulations for this departure.

III. It Is Vitally Important To A Large Sector Of The American Economy That The Question Presented Be Resolved Without Delay.

The uncertain state of tax exemptions for nonprofit health care organizations in general, and for HMOs in particular, is an area of "white-hot controversy." Travis L. Blais, *California Judge Makes Hash of Tax Exempt HMOs in Vision Service Plan*, 7 TAX & FINANCE 8-10 (Spring 2006) (newsletter of Tax & Finance Practice Group of American Health Lawyers Ass'n). "[T]he current state of the law in this area can only be characterized as incoherent." Richard L. Schmalbeck, *The Impact of Tax-Exempt Status: The Supply-Side Subsidies*, 68 LAW & CONTEMP. PROBS. 121, 129 (2006). "[N]onprofit health care organizations have entered an era of palpable uncertainty about what they must do to retain valuable exemptions." Quirk, *supra*, at 105.

The decisions below, although not published in the Thomson/West reports of federal decisions, have been closely followed by practitioners in the area. The revocation of VSP's tax exemption has been severely and correctly criticized as "inconsistent with clearly expressed congressional intent, recent

Supreme Court precedent, state regulatory schemes, and well-established IRS administrative practice." Christopher M. Jedrey & Charles R. Buck, *Health Care Organizations*, TAXATION OF EXEMPTS 280 (May/June 2006).

The conclusion reached by the courts below, that serving primarily fee-paying users precludes tax-exempt status, means "the loss of tax-exempt status for almost all currently tax-exempt HMOs. The implications of such an IRS position for hospital tax-exempt status also would be troubling." *Id.* at 282. Moreover, the Ninth Circuit's assertion that VSP's "public benefits" are "not enough" to qualify it for tax exemption, without any explanation or guidance as to what is "enough," or how it should be determined, only exacerbates the difficulty of tax planning for such organizations, and is plainly wrong.

The health care segment of the economy is critically important. In 2006 domestic health care spending amounted to $2.1 trillion, or $7,026 per person. Aaron Catlin et al., *National Health Spending in 2006: A Year of Change for Prescription Drugs*, 27 HEALTH AFFAIRS 1, 14 (2008). About half of the revenues in this portion of the economy are earned by nonprofit organizations. *See* BUREAU OF THE CENSUS, 2006 SERVICE ANNUAL SURVEY, NAICS 62, HEALTH CARE AND SOCIAL ASSISTANCE SERVICES Tables 8.1 & 8.5, *available at* http://www.census.gov/svsd/www/services/sas/sas_data/62/2006_NAICS62.pdf. Almost 90 percent of the revenues of these nonprofit health care organizations comes from the delivery of goods and services to those that they serve rather than from contributions. KENNARD T.

WING ET AL., THE NONPROFIT ALMANAC 2008, at 178 (The Urban Inst. 2008). The court of appeals' decision that there must be "enough" "public benefits" of an unspecified type to outweigh by some undefined measure the health care provided to paying patients, puts the tax-exempt status of all such organizations at risk.

Uncertainty about their tax-exempt status removes much of the incentive for these health care organizations to remain nonprofit. Conversion of such organizations to tax-paying, profit-maximizing status, as happened with many of the Blue Cross and Blue Shield organizations following the loss of their tax exemptions in 1986, has serious implications for the public health and welfare. Studies have repeatedly shown the superior quality of care provided through nonprofit HMOs compared to that provided through for-profit HMOs. *See* John P. Geyman, *The Corporate Transformation of Medicine and Its Impact on Costs and Access to Care*, 16 J. AM. BD. OF FAM. PRAC. 443, 444 (2003); David U. Himmelstein et al., *Quality of Care in Investor-Owned vs. Not-for-Profit HMOs*, 282 J.A.M.A. 159 (July 14, 1999); Robert Kuttner, *Must Good HMOs Go Bad? The Commercialization of Prepaid Health Care, Parts I and II*, 338 N.E.J.M. 1558, 1635 (May 21 & 28, 1998). *See also* Mark Schlesinger & Bradford H. Gray, *How Nonprofits Matter in American Medicine, and What To Do About It*, HEALTH AFFAIRS w287-w303 (June 2006) (superior performance of nonprofit hospitals and nursing homes).

CONCLUSION

The result below threatens established tax practice and congressional intent alike; and it jeopardizes the tax-exempt status of an important segment of the economy. The ruling that VSP's "public benefits" were "not enough" to justify a tax exemption for an HMO provides the industry with no guidance at all, where guidance is urgently required. The issues are clearly presented. The petition for a writ of certiorari should be granted.

Respectfully submitted,

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