

# MUCH ADO ABOUT FUNDING— CO-OP HEALTH INSURANCE ISSUERS

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The Patient Protection and Affordable Care Act (the “Affordable Care Act”) added Section 501(c)(29), offering tax exemption to qualified nonprofit health insurance issuers (“Qualified Issuer”).<sup>1</sup> Qualified Issuers must participate in the Consumer Operated and Oriented Plan program (“CO-OP program”) of the Department of Health and Human Services (HHS). In addition to satisfying Affordable Care Act and HHS requirements, Qualified Issuers must also comply with requirements under the Code, as described by the IRS in Notice 2011-23, 2001-13 IRB 588, which explains the exemption standards for this new type of organization and requests public comment.

Soon after issuance of the Notice, however, Congress passed and President Obama signed into law H.R. 1473, which eliminated approximately one-third of the appropriation for CO-OP.<sup>2</sup>

## Why is Congress legislating insurance through Section 501?

Many types of insurance organizations may receive tax exemption under Section 501 under certain circumstances. Section 501(e) permits cooperative hospital service organizations to purchase insurance on a group basis. Section 501(n) treats charitable risk pools as Section 501(c)(3) organizations if they serve only Section 501(c)(3) organizations, are organized under a state law authorizing charitable risk pools, and do not rely primarily on premium payments and capital contributions

made by participants. In addition, small insurance companies are specifically provided tax exemption under Section 501(c)(15), which provides tax-exempt status for insurance companies (other than life insurance companies) that have annual net written premiums (or, if greater, direct written premiums) of \$350,000 or less. The primary intent of Section 501(m) was to deny tax-exempt status to Blue Cross and Blue Shield plans and other entities that provide “commercial type” health insurance,<sup>3</sup> but many health maintenance organizations retain tax-exempt status under Section 501(c)(3) or (c)(4) (although the standards for such exemption have been in an uncertain state for many years).<sup>4</sup> Finally, state-sponsored health insurance pools for high-risk individuals who are otherwise unable to obtain health insurance and state-sponsored workers’ compensation reinsurance organizations are eligible for tax-exempt status under Sections 501(c)(26) and (27), respectively. The Section 501(c)(29) Qualified Issuer is therefore simply another type of insurance organization that Congress has determined is an appropriate recipient for tax-exempt status.

## Qualified Issuers

The Affordable Care Act added Qualified Issuers to the list of tax-exempt organizations under Section 501(c). New Section 501(c)(29) allows these insurers, which cater to individual and small group markets, to obtain federal tax exemption under certain conditions. It also requires such organizations to be nonprofit, membership corporations, substantially all the activities of which consist of issuing health plans to individuals and small groups within the state in which it is licensed.<sup>5</sup>

Nonprofit health insurance cooperatives already exist.<sup>6</sup> Qualified Issuers, like nonprofit

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health insurance cooperatives, are health insurance organizations owned by the patients they insure. Health care costs will be spread among all members. As member-owned organizations, Qualified Issuers will not have the same profit motive as commercial insurers, because any profit generated must be used to benefit members. Qualified Issuers have the potential for lower administrative costs than commercial insurers particularly because members will have every incentive to lower such costs, including marketing and executive compensation.

Finally, Qualified Issuers will not have the same tax costs as commercial insurers because they will benefit from federal tax exemption. For these reasons, members of Qualified Issuers are likely to realize savings.

Qualified Issuers will have to obtain state licenses before offering health insurance coverage. Because guidance from HHS is not yet complete, state insurance officials are wondering which will come first: the chicken (HHS-issued grants and loans, contingent on state licensure) or the egg (state licensure before HHS will issue grants and loans).<sup>7</sup> If HHS does not issue loans and grants before requiring a state certificate of authority, Qualified Issuers will have difficulty working with state insurance officials.

Qualified Issuers must use their profits, if any, to lower premiums, to improve benefits, or for other programs designed to improve their members' quality of health.<sup>8</sup> A Qualified Issuer (or a related entity or predecessor) must not have been a health insurance issuer on or before 7/16/09 and must not be sponsored by a state or local government, any political subdivision, or any instrumentality of such government or political subdivision.<sup>9</sup>

Through the CO-OP program, Qualified Issuers will receive start-up loans and/or re-

payable grants, which will allow Qualified Issuers to satisfy regulatory requirements necessary for state insurance licensure. To receive loans and/or grants, Qualified Issuers must meet certain statutory requirements, including entering into an agreement with HHS. The agreement must prohibit Qualified Issuers from using loan or grant monies for propaganda, lobbying, or marketing.<sup>10</sup> If a Qualified Issuer fails to meet the agreement's requirements, it must repay HHS an amount equal to 110% of the loan and grant amounts received, plus interest. Also, the IRS could revoke the Qualified Issuer's tax-exempt status under Section 501(c)(29).

HHS issued guidance and requested comments on the CO-OP program in February.<sup>11</sup> The CO-OP program is managed by the Office of Consumer Information and Insurance Oversight (OCIIO), a creation of the Affordable Care Act. To help HHS decide which applicants should receive loans or grants under the CO-OP program, the Affordable Care Act has established a federal advisory board (the "Advisory Board"). Formed in June 2010, the Advisory Board held meetings in January, February, March, and April to discuss standards and receive reports from experts and members of the public.

On 4/15/11, a day after about one-third of the CO-OP program's budget was cut, the Advisory Board provided its final recommendations to HHS about how to award CO-OP grants and loans.<sup>12</sup> The Advisory Board's final report includes substantive recommendations for awarding loans and grants to Qualified Issuers, all of which were designed to foster their creation and provide flexibility. The report's four major principles consist of: (1) ensuring consumer control of Qualified Issuers; (2)

<sup>1</sup> The Patient Protection and Affordable Care Act (the "Affordable Care Act"), P.L. 111-148, 3/23/10, § 1322(h)(1). All references to section 1322 of the Affordable Care Act reflect changes made by Section 10104 of the Affordable Care Act as codified in 42 U.S.C. § 18042.

<sup>2</sup> The "Department of Defense and Full-Year Continuing Appropriations Act, 2011," P.L. 112-10, 4/15/11, § 1857, permanently reducing by \$2.2 billion the \$6 billion that had been appropriated for the CO-OP program. H.R. 1473 also repealed the Affordable Care Act's "free choice voucher" requirement for certain employer-sponsored group health plans. See § 1858.

<sup>3</sup> Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87, 5/4/87), page 584.

<sup>4</sup> See Jedrey and Fine, "Vision Service Plan, Part II," 20 Exempts 1, 44 (Jul/Aug 2008).

<sup>5</sup> 42 U.S.C. § 18042(c)(1).

<sup>6</sup> For example, The United Agricultural Benefit Trust is a non-profit health care plan established in 1983 by farm and ranch owners to provide insurance to their laborers. For more, see [www.uabt.org](http://www.uabt.org).

<sup>7</sup> Pion (Texas Department of Insurance), "Regulating the Regulated: What Carriers Can Expect From PPACA," 2/23/11, available at [www2.americanbar.org/calendar/hl1102-health-care-law-conference/Documents/The\\_Affordable\\_Care\\_Act\\_1.pdf](http://www2.americanbar.org/calendar/hl1102-health-care-law-conference/Documents/The_Affordable_Care_Act_1.pdf).

<sup>8</sup> 42 U.S.C. § 18042(c)(4).

<sup>9</sup> 42 U.S.C. § 18042(c)(2).

<sup>10</sup> 42 U.S.C. § 18042(b)(2)(C)(ii).

<sup>11</sup> 76 Fed. Reg. 5774 (2/2/11).

<sup>12</sup> See "Revised Report of the Federal Advisory Board on the Consumer Operated and Oriented Plan (CO-OP) Program," available at [http://cciiio.cms.gov/resources/files/coop\\_faca\\_finalreport\\_04152011.pdf](http://cciiio.cms.gov/resources/files/coop_faca_finalreport_04152011.pdf) (5/15/11) (hereinafter, "Advisory Board Report").

maintaining the financial stability of Qualified Issuers; (3) encouraging care coordination, quality, and efficiency; and (4) awarding the first loans and/or grants no later than the end of 2011 so Qualified Issuers can compete in 2014's open enrollment period.<sup>13</sup>

The Affordable Care Act gives priority to applicants that will operate on a "statewide basis, will utilize integrated care models, and have significant private support."<sup>14</sup> The Act's goal is to have at least one Qualified Issuer in each state, although more than one may be created if there is sufficient funding.<sup>15</sup> If a state does not have a Qualified Issuer, HHS can provide incentives to Qualified Issuers from other states to expand operations into such states.

Finally, Qualified Issuers must meet certain statutory governance requirements. A Qualified Issuer must be governed by the majority vote of its members, implement ethics and conflict of interest standards protecting against insurance industry involvement and interference, and "operate with a strong consumer focus, in-

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cluding timeliness, responsiveness, and accountability to members."<sup>16</sup> Furthermore its board of directors may not include representatives of any federal, state, or local government, nor any representative of a health insurance issuer (or related entity).<sup>17</sup>

HHS must begin making loans and grants under the CO-OP program by 7/1/13.<sup>18</sup> By July 2013, HHS must promulgate regulations describing how loans and grants will be repaid.

CO-OP program loans must be repaid within five years and CO-OP program grants must be repaid within 15 years.<sup>19</sup>

### How does a Qualified Issuer become tax-exempt?

Once a Qualified Issuer forms under state non-profit corporation law, enters into a loan or grant agreement with HHS, and meets the state law requirements, it may apply to the IRS for recognition of its federal tax-exempt status. The Code limits a Qualified Issuer's tax exemption to those periods for which the organization complies with both the Affordable Care Act's requirements and the requirements of its loan or grant agreement with HHS.<sup>20</sup>

Qualified Issuers must satisfy the following four conditions to receive tax exemption. First, Qualified Issuers must notify the Treasury by applying for tax exemption.<sup>21</sup> Second, like Section 501(c)(3) organizations, Qualified Issuers must comply with a private inurement prohibition (with exceptions for using profits to lower premiums, improve benefits, or for other programs intended to improve the quality of health care provided to members).<sup>22</sup> Third, no more than an insubstantial amount of a Qualified Issuer's activities may consist of lobbying.<sup>23</sup> Fourth, Qualified Issuers must refrain from engaging in political activity.<sup>24</sup> Qualified issuers that lose their tax-exempt status, or those that do not apply for tax-exempt status, must pay federal income tax.<sup>25</sup>

The Affordable Care Act also imposes other tax reporting and compliance obligations on Qualified Issuers. Section 6033 requires that Qualified Issuers submit annual information returns using Form 990.<sup>26</sup> In addition, such or-

<sup>13</sup> *Id.* at p. 5.

<sup>14</sup> 42 U.S.C. § 18042(b)(2).

<sup>15</sup> 42 U.S.C. § 18042(b)(2)(A)(iii).

<sup>16</sup> 42 U.S.C. § 18042(c)(3).

<sup>17</sup> 42 U.S.C. § 18042(e).

<sup>18</sup> 42 U.S.C. § 18042(b)(2)(D), taking into account state reserve and solvency requirements.

<sup>19</sup> 42 U.S.C. § 18042(b)(3).

<sup>20</sup> Section 501(c)(29)(A).

<sup>21</sup> Section 501(c)(29)(B)(i).

<sup>22</sup> Section 501(c)(29)(B)(ii).

<sup>23</sup> Section 501(c)(29)(B)(iii).

<sup>24</sup> Section 501(c)(29)(B)(iv).

<sup>25</sup> It has not been determined whether Qualified Issuers meet the "risk shifting" and "risk distribution" requirements, first described in *Helvering v. LeGierse*, 312 U.S. 531, 25 AFTR 1181 (1941), to be taxed as insurance companies under the Code's special insurance company tax rules in subchapter L, Section 801 et seq.

<sup>26</sup> Section 6033(m), as amended by section 1322(h)(2) of the Affordable Care Act.

<sup>27</sup> Section 6033(m)(1)-(2).

<sup>28</sup> See Form 990, Part V, Line 13.

<sup>29</sup> Section 4958(e)(1), as amended by Section 1322(h)(3) of the Affordable Care Act. Section 4958 contains a series of penalty excise taxes, generally referred to as the "intermediate sanctions." Under Section 4958, disqualified persons (that is, certain persons in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization) who receive "excess benefits" from the tax-exempt organization, and certain organizational managers who approve such benefits, are subject to the imposition of penalty excise taxes. No penalty excise tax applies to the organization itself.

<sup>30</sup> That is, a Section 501(c)(29) organization may allow its earnings to inure to the benefit of members in limited circumstances (lowering premiums, improving benefits, or providing other health quality improvement programs).

ganizations must disclose the amount of their reserves, as well as the amount required by each state in which they are licensed to issue qualified health plans.<sup>27</sup> Part V of the core Form 990 includes questions designed to elicit these required disclosures.<sup>28</sup> The Act also makes a Qualified Issuer an “applicable tax-exempt organization” for Section 4958 purposes.<sup>29</sup> Accordingly, Qualified Issuers are subject to the excess benefit transaction rules, commonly called “intermediate sanctions.”

With the exception of the Affordable Care Act’s private inurement prohibition carve-out for membership benefits,<sup>30</sup> Section 501(c)(29) organizations must also meet many of the same operational and reporting requirements as Section 501(c)(3) organizations. The Advisory Board recommended also requiring Section 501(c)(3)-type dissolution requirements if a Section 501(c)(29) organization converts or is sold to a for-profit entity.<sup>31</sup>

### Has the IRS issued guidance on Qualified Issuers?

Notice 2011-23 reiterates the organizational, operational, and annual reporting requirements that Qualified Issuers must meet to obtain and maintain their tax-exempt status. However, the IRS is not yet accepting tax exemption applications for Section 501(c)(29) organizations. The Notice explains that the IRS intends to issue a revenue procedure to explain how Qualified Issuers may apply for tax-exempt status. While the IRS finalizes the promised revenue procedure, aspiring Section 501(c)(29) organizations are advised to incorporate as nonprofit member corporations, begin the state insurance licensure process, and commence negotiations with HHS under the CO-OP program.

Notice 2011-23 and the promised revenue procedure will describe *when* Qualified Issuers will be recognized as tax-exempt. The Notice explains that the IRS intends to treat the effective date of a Qualified Issuer’s tax exemption as its formation date or 3/23/10,<sup>32</sup> whichever is

later. This assumes that the Qualified Issuer’s purposes and activities have been consistent with the Section 501(c)(29) requirements since its formation date. Generally, it is the administrative practice of the IRS to recognize a tax-exempt organization’s exemption from its formation date.<sup>33</sup>

The Notice instructs Section 501(c)(29) organizations to file a Form 990 for each tax reporting period, even if they have not yet been recognized as tax-exempt by the IRS. To satisfy this interim reporting requirement, a Qualified Issuer must complete Form 990, Part V, Line 13 and indicate on page 1 that it is filing a Form 990 under the belief that it complies with Section 501(c)(29).

Finally, the Notice requests public comment on general matters related to Qualified Issuers and a few specific issues. For example, the Treasury Department and IRS have asked for comments on whether they should consider special factors when Qualified Issuers apply for tax exemption and on the Notice’s proposed effective date of tax exemption for Qualified Issuers. In addition, comments were requested on whether any special considerations should be given in applying to Qualified Issuers the prohibition on private inurement, the limitation on lobbying activities, the prohibition on political activities, the excess benefit transaction rules, or the unrelated business income tax under Section 511.

### What about CO-OP program funding?

Despite IRS, HHS, and Advisory Board efforts to foster creation of Qualified Issuers, Congress recently passed and President Obama signed legislation eliminating about one-third of the CO-OP program’s appropriations.<sup>34</sup> Based on the House Appropriations Committee’s summary, one might conclude that the 2011 legislation “terminates” the CO-OP program altogether.<sup>35</sup> However, the law only reduces funding for the CO-OP program, from \$6 billion to \$3.8 billion. This means that

<sup>31</sup> See Advisory Board Report, *supra* note 12 at page 11. The Report states that Section 501(c)(29) should have conversion requirements that parallel those applicable to Section 501(c)(3) organizations. More specifically, the Report states: “Upon the termination, dissolution or final liquidation of the Corporation in any manner and for any reason, the Board of Directors shall first pay or provide for the payment of all liabilities of the Corporation; all remaining assets shall be distributed for one or more exempt purposes within the meaning of Section 501(c)(3) of the Code (or the corresponding

section of any future federal tax code), or shall be distributed to the federal government, or to state or local government, for a public purpose.”

<sup>32</sup> This is the Affordable Care Act’s effective date.

<sup>33</sup> Rev. Proc. 2011-9, 2011-2 IRB 283.

<sup>34</sup> H.R. 1473, *supra* note 2.

<sup>35</sup> See House Appropriations Committee, “Summary—Final Fiscal Year 2011 Continuing Resolution” (4/12/11), page 4, available at [http://appropriations.house.gov/\\_files/41211SummaryFinalFY2011CR.pdf](http://appropriations.house.gov/_files/41211SummaryFinalFY2011CR.pdf).

potential Qualified Issuers will have access to about \$78 million in funding per state.

While this reduction was trumpeted as a victory against “ObamaCare,”<sup>36</sup> it was unlikely that any of the \$2.2 billion in “savings” would have been spent to support Qualified Issuers. According to the nonpartisan Congressional Budget Office, only \$3 billion of the \$6 billion would have been made available under the CO-OP program between 2010 and 2019.<sup>37</sup> While Qualified Issuers cannot offer a health plan in a state until that state has established the health insurance market reforms mandated by the Affordable Care Act,<sup>38</sup> it is possible that the fed-

eral government could step in if a given state does not act.

### Conclusion

The IRS has issued its first guidance under Section 501(c)(29) and the Advisory Board has issued its final report. Appropriated funds could begin flowing as soon as the end of 2011. These monies will be used to provide assistance in meeting startup costs and state solvency requirements. Because a Qualified Issuer’s profits must be used to lower premiums, to improve benefits, or for other health quality improvement programs, Qualified Issuers that are tax-exempt under Section 501(c)(29) advance the Affordable Care Act’s primary objectives of improving access to health care services while better controlling the costs of such services. Therefore, despite the recent funding cut and the ongoing litigation challenging the Affordable Care Act more generally, the roadmap for creating the first Qualified Issuers is relatively clear. ■

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<sup>36</sup> *Id.*

<sup>37</sup> Congressional Budget Office, “Preliminary Analysis of the Chairman’s Mark for the America’s Healthy Future Act, as Amended” (10/7/09), page 6 (Oct. 7, 2009), available online at: [http://www.cbo.gov/ftpdocs/106xx/doc10642/10-7-Baucus\\_letter.pdf](http://www.cbo.gov/ftpdocs/106xx/doc10642/10-7-Baucus_letter.pdf).

<sup>38</sup> 42 U.S.C. § 18042(c)(6), citing to 42 U.S.C. § 300gg *et seq.*

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