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New health system compliance focus on tax exemption matters

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Compliance programs of non-profit hospitals and health systems should focus more closely on tax-exemption matters in the wake of the Tax Cuts and Jobs Act (the Act)[1] and recent Internal Revenue Service enforcement initiatives. Such focus is consistent with the general recognition that compliance programs should not be single-subject in nature (e.g., focusing solely on government payment program regulations), but should address the full spectrum of material legal and regulatory risks facing the organization. These new developments present an important opportunity for compliance programs to enhance their value to tax-exempt healthcare organizations, and should be brought to the attention of the board's Audit & Compliance Committee.

The new developments fall into five separate categories: first, the tax-exempt hospital-specific provisions of the newly enacted Tax Cuts and Jobs Act; second, the broader policy themes of the Act as they affect tax exemption compliance; third, enhanced IRS enforcement of the requirements of the charity care/community benefit provisions of Section 501(r) of the Internal Revenue Code; fourth, the recent and unrelated action by the IRS to revoke the tax-exempt status of two hospitals; and fifth, an increasing public presence of the IRS in connection with tax-exemption enforcement and compliance guidelines.

Specific tax changes in the Act

The Act, signed into law on December 22, 2017, contains several noteworthy tax law changes for tax-exempt organizations, including but not limited to healthcare organizations. Many of these new provisions are disadvantageous to the tax-exempt healthcare sector. They include: (1) the elimination of advance refunding bonds (i.e., bonds issued to refinance existing bonds that are not callable within 90 days of the related issuance); (2) provisions that potentially increase organizational exposure to unrelated business income taxation; and (3) a new excise tax on compensation in excess of $1 million and "excess parachute payments" to any of its "covered employees," which applies not only to current compensation, but also to all forms of deferred compensation. These new provisions may create significant tax planning challenges for tax-exempt healthcare systems.[2]

The policy themes of the Act

Particularly important from a tax compliance perspective is the broader "anti-exempt organization" bias that appears to arise from the Act. This can be seen not only in the actual exempt organization provisions enacted, but also in the several punitive proposals made at various points in the legislative process that were not included in the final bill (e.g., the proposed evisceration of the "Rebuttable Presumption of Reasonableness" guidelines under the intermediate sanctions rules of Code Section 4958). The totality of the actual and proposed provisions reflects the perception of many in Congress that the non-profit healthcare sector is inexorably drifting towards the purely commercial sector (and thus should be taxed accordingly).[3] This perspective is prompted by concerns about the consistency of exempt status with several factors, for example: (1) the emergence of the "nation-sized" non-profits — organizations that are national (or even global) in scope and scale; (2) an inability

to distinguish tax-exempt and commercial healthcare; and (3) highly complex, lucrative executive compensation arrangements.

Enhanced 501(r) enforcement

In recent public comments, senior IRS officials have confirmed that the agency is now conducting approximately 400 examinations of tax-exempt hospitals regarding compliance with Internal Revenue Code Section 501(r). As most compliance professionals are aware, Section 501(r) requires tax-exempt hospitals to meet four general requirements: (1) establish written financial assistance and emergency medical care policies; (2) limit amounts charged for emergency or other medically necessary care to individuals eligible for financial assistance; (3) make reasonable efforts to determine whether an individual is eligible for financial assistance before engaging in extraordinary collection actions against the individual; and (4) conduct a Community Health Needs Assessment (CHNA) and adopt an implementation strategy at least once every three years. The regulations implementing Section 501(r) are highly complex and can be operationally challenging for multi-entity health systems because they require facility-by-facility compliance analysis. IRS audits to date have revealed that, in addition to required policies, appropriate board approval for Section 501(r) documents appears to be of great importance to the IRS.[4]

Recent exemption revocations

In 2017, the IRS revoked the tax-exempt status of two separate hospitals. This is an extraordinary measure, particularly since the enactment of the intermediate sanctions excise tax,[5] which was designed to give the IRS an alternative enforcement approach to outright revocation. It is highly unusual to see the IRS revoke the exempt status of a hospital, let alone two in a single year. Loss of exemption can be catastrophic: donors disappear, tax-exempt bonds can become taxable, and major public relations damage occurs.

The first revocation[6] involved unique facts, as it dealt with a so-called "dual status hospital" that was tax-exempt both as an organization described in Section 501(c)(3) of the Code and as an instrumentality of the state whose income was exempt under Section 115 of the Code. Accordingly, the revocation of its Section 501(c)(3) status did not result in the entity being taxable. The revocation was based on the hospital's non-compliance with the requirements of Section 501(r) of the Code (specifically, its failure to timely conduct and adopt a CHNA and implementation strategy).

The second revocation[7] involved a rural hospital that had experienced financial distress. As an alternative to closure of the facility, the hospital system transferred control of the hospital nonprofit entity to the county board for nominal consideration. Later, the county board leased the hospital facility to a for-profit entity, covering property, plant, and equipment, as well as control over the hospital's operations and revenue collection. The adverse determination letter does not state whether the exempt lessor or the for-profit lessee held the license to operate the hospital facility. Following the execution of the lease, the only remaining activities of the tax-exempt entity were to act as lessor of the property, enforcing the lease covenants concerning the operation of the facility and monitoring hospital operations.

The IRS revoked this hospital's tax-exempt status based on its determination that the hospital was not operated exclusively for exempt purposes. The crux of the IRS's position appears to be that the net effect of the lease was the transfer of complete control to the for-profit entity with the exempt entity retaining only an advisory role. According to the IRS, such an arrangement "insures that profit maximization will be the guiding principle under which the [leased] hospital operates."

Taken together with other recent IRS activity and congressional actions, these revocations serve as a reminder to the Audit & Compliance Committee, and its legal and compliance staff, of the importance of exempt organization tax issues. Renewed attention should be devoted to organizational compliance with tax exemption standards. This should include compliance with the highly detailed requirements of Section 501(r) for exempt hospitals as an overlay onto general tax-exempt operational principles, and particular attention to documentation of transactions with for-profit entities, including negotiation of critical protective provisions into such documents.