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—from a declaration of the American Bar Association

Ten Things That Could Get a Nonprofit Hospital in Tax Trouble: A General Counsel's Guide to Tax Compliance

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Introduction

A general counsel in the health care sector today needs to be a veritable jack of all trades, able to spot the issues of concern to the organization across multiple legal disciplines even if a broader team is necessary to answer the questions. Tax issues are no exception. The Internal Revenue Service (IRS) continues to be active in auditing tax-exempt hospitals, academic medical centers, clinics, health maintenance organizations, and other prepaid health plans. When the IRS audits an organization, it looks not only at compliance with requirements for tax exemption but also at unrelated business income tax and employment tax. Audits routinely extend to related entities, including taxable subsidiaries. As if the challenges of understanding the tax law's community benefit standard and treatment of joint ventures were not challenging enough, the complexity of the tax rules continues to increase for health care entities, particularly with the implementation of regulations for hospitals under Section 501(r) that require board action on financial assistance policies, restrict billing and collection practices, and demand a new community health needs assessment (CHNA) every three years.[1] Moreover, if potential tax issues are not being identified and addressed during a transaction or financial audit, they may come to light when an IRS audit starts, at which point it can be costly to fix them. In other words, an ounce (or two) of prevention is worth several pounds of cure.

General counsel who have lived through an IRS audit have seen first-hand how easy it is to be surprised by the tax consequences of structures and business practices an organization has long used without concern, from taxing lab revenues to reclassifying workers as employees. A visit

from the IRS also may lead to collateral damage if those who run the hospital also do business with it (e.g., excise taxes on excess benefit transactions). For the truly unfortunate, there are also the dire potential consequences of loss of exempt status for the organization or for interest on its outstanding bonds. Although some general counsel have a strong tax background and handle tax issues for the hospital, others leave many tax issues to finance staff or outside tax advisors. While there is great benefit in working with the hospital's professional tax staff, all general counsel can and should be prepared to spot potential tax problems as part of their duty and responsibility to protect the interests of the organization. Paying attention to tax issues before the IRS comes to audit can make a world of difference. This article provides a thumbnail sketch of ten areas that, in the authors' experience, attract IRS attention on audit and, if the hospital is not prepared, can make it more costly to resolve the audit quickly and favorably.

Minutes as a Road Map to Tax Exposure

The minutes of the governing board and its committees are the window to the soul of a corporation. The authors routinely see IRS agents request and review board and committee minutes on audit for clues about potential tax exposure. Often the minutes themselves contain minimal detail; however, they sometimes refer to presentations made at board meetings. If any of those presentations were made with slides or other written material that is not privileged, the documents are fair game for the IRS and can send an audit off in a troubling direction; for example, motivating an agent to probe for excess benefit.[2] On the other hand, minutes also provide an opportunity for the hospital to highlight how its activities support charitable purposes by promoting the health of the community, to show the commitment of the board to sound governance, and to show prudent business decisions regarding the hospital's unrelated business activities and any affiliated physician practices—particularly if those operations generate losses.

Compliance Tips

Legal counsel should review all board and committee minutes in draft form. In addition, all written presentations and exhibits that may be referenced in the minutes should be reviewed by legal counsel prior to distribution to the board or committee.

Valuations

Transactions of all kinds that involve purchases or sales of the organization's assets or services attract the attention of IRS agents, who are keen to question whether the transaction is within the range of fair market value (FMV). There are few stronger defenses to an IRS challenge than a contemporaneous, thorough, and complete valuation provided by an independent third party. The authors have seen high-end transactions that may look aggressive on their face draw IRS attention until the agents are presented with appropriate supporting valuations. At that point, even the most aggressive agents should pause. However, deficient valuations can do harm to the organization. For example, valuations that are outdated (perhaps more than a year old, but that depends on the circumstances of the relevant market), exclude relevant comparables, do not include all of the assets or liabilities being transferred, make unreasonable assumptions as to growth or expenses, omit the impact of known changes in law or facts, or do not consider all of the IRS preferred methodologies (cost, market, and income) are vulnerable and actually may increase the exposure for loss of exemption or taxes on excess benefit.[3] A history of losses in a hospital-owned physician practice also may lead IRS agents to challenge exemption or assess taxes on excess benefit if there is evidence to suggest the hospital may have overpaid for the practice or may be paying unreasonably high compensation.[4]

Compliance Tips

Valuations should be obtained for high-profile transactions, transactions involving key assets or service lines, and transactions involving directors, officers, or their family members. Where practical, consider retaining valuation experts through counsel to provide a basis for claiming privilege. (This approach may require a common interest agreement if the report will be shared with a counter party.) Counsel should review the valuation in draft form with the potential deficiencies noted above in mind, and to ensure the description of the transaction and the approach to valuation is clearly narrated to support the arguments the organization would have to make if the transaction is questioned on audit.

Qualify for the Rebuttable Presumption

Following the rebuttable presumption procedure is like buying an insurance policy. It does not make arrangements with insiders bulletproof, but if done properly it makes a challenge more time consuming and costly for the IRS because the agents have the burden of either proving the arrangement was not a FMV deal or challenging the adequacy of the process and the comparables used. Both are difficult tasks and frequently lead the IRS to refrain from challenging transactions where the organization acted in good faith to meet the presumption. To establish the presumption, three steps must be taken *prior* to making a payment to an insider or incurring a legally enforceable obligation to pay an insider: (1) review and approval by the board or relevant committee (applying an appropriate conflicts-of-interest policy); (2) obtain and rely on appropriate documentation of FMV; and (3) adequately and timely document the basis for the board or committee's decision in the minutes.[5]

Compliance Tips

Timing is key to the rebuttable presumption. Deal negotiations can move fast if the parties are motivated, and there is often pressure to shorten review times and sign the documents before FMV can be adequately documented. One option for accommodating these concerns while preserving the opportunity to establish the rebuttable presumption is to sign the agreement when ready from a negotiation perspective (preferably the counter party only) and make the hospital's obligations subject to approval by the board or a committee of the board that can follow the steps for establishing the rebuttable presumption during its review.

Track Community Benefit Expenditures

In the wake of the Affordable Care Act (ACA), the IRS has stepped up its scrutiny of hospital community benefit activities. Most nonprofit hospitals have made significant strides in tracking community benefit activities since 2008, when the IRS added Schedule H to Form 990 and began requiring hospitals to report community benefit expenditures. The ACA now requires the IRS to review community benefit activities of every tax-exempt hospital at least once every three years. The mandated reviews are done inside the IRS without contacting the hospital for books or records, so the reviews are based on information on Schedule H and from other publicly available sources like websites—though the initial review may lead to a direct contact with the organization for more information. The ACA also created new Section 501(r), which requires tax-exempt hospitals to conduct a CHNA, adopt an implementation plan, and disclose both to the public at least once every three years.[6] The regulations implementing these requirements prescribe in detail the input that must be solicited and the content that must be covered. Failure to meet these requirements can result in an excise tax on the nonprofit hospital or, if the failure is willful and egregious, loss of exemption. State and local officials also may use Schedule H and the new CHNAs to make points as they debate property tax exemptions or other similar tax benefits.

Compliance Tips

To ensure that the CHNA and implementation plan meet the applicable requirements, it is helpful for general counsel to develop a timeline that identifies each of the required steps in the process from the required solicitation of community input, to the drafting of the assessment, through the required board or committee approval of the implementation plan, and sets milestones for tracking timely progress. The community benefit expenditures reported on Schedule H (and any state equivalent) also should be compared with the content of the CHNA and implementation plan to ensure they are consistent. Any inconsistencies that are driven by specific IRS or state rules or requirements should be documented. General counsel also may wish to ask for closer tracking of outcomes of community benefit activities to demonstrate that their true value exceeds their cost. Capturing that value may involve looking at costs avoided when members of the community stay healthier and can avoid losing time at work or needing more-expensive treatment (referred to by valuation experts as "avoided costs").

Worker Classification

One of the areas that frequently results in tax liability on audit is worker classification, and in particular classification of physicians. The ACA has increased the stakes because the hospital may owe penalties if it has not offered health coverage to substantially all of its full-time employees.[7] If a hospital has contractors receiving Form 1099 who are performing substantially the same services as employees receiving Form W-2, it is highly likely to motivate the IRS to reclassify the contractors as employees and assess employment taxes for the years under audit. The IRS also will question worker classification where the same person receives both a Form W-2 and a Form 1099 from the hospital for the same year. The hospital must be able to document how the services reported on the Form 1099 are outside the scope of employment and not subject to the same degree of control as employment.[8] It has been decades since the IRS routinely accepted that physicians serving as either medical directors or hospital-based clinicians retained by a hospital were not hospital employees.[9] Having the services covered by a written contract with a physician practice entity can make a significant difference, though even that strategy is not always successful.[10] Moreover, if there is a gap in the written contracts (i.e., operating for some period under an expired contract), the IRS may not be dissuaded from reclassifying the physicians as employees for the gap period. If there is a gap, however, for non-tax reasons the hospital actually may prefer that the IRS reclassify the physicians as

employees. Specifically, classification of the physicians as employees often would allow the arrangement to qualify for the Stark exception and Anti-Kickback Statute safe harbor for employees (which, unlike the professional service arrangements exception and safe harbor, would not require a written contract).[11] In that situation, barring unusual circumstances that trigger the ACA employer penalty, the taxes and penalties associated with reclassification by the IRS would be less than the expected cost of preparing, submitting, and resolving a provider self-disclosure for Stark or Anti-Kickback Statute purposes.

Compliance Tips

Look for the cases that make easy targets for IRS attention. Ask for a list of all individuals receiving both a Form W-2 and a Form 1099 for the past year. Correct any administrative errors that have generated the wrong forms inadvertently, and be sure there is documentation for anyone receiving both forms to explain the distinct category of services the individual provides as an independent contractor. Identify all physicians being paid for medical director or clinical services. Verify that these physicians are either receiving a Form W-2 if paid directly (which would may raise state law questions, at least for patient care services, in a state with a corporate practice of medicine doctrine) or are paid through their practice entity. If you use staffing firms, be sure you know whether they treat the workers they supply as their employees and, if so, do your best to verify that they are a reputable firm with a good compliance record. If the staffing firm becomes delinquent and the IRS needs to collect tax, it may become more interested in whether the staffing firm's clients can potentially be held liable as employers. It is also important to ensure contracts with the staffing agency include language that allows the hospital to take advantage of a safe harbor for contingent workers from the ACA employer penalty.

Fringe Benefits

Standard IRS procedure for auditing an organization of any size includes questions about fringe benefits—which ones the organization offers, to whom are they offered, and whether documentation requirements are followed. The questions are all aimed at determining whether the organization owes employment tax with respect to some of the fringe benefits that it offered on a tax-free basis. For an organization with millions or even billions of dollars in revenue, it can be frustrating to have to compile documentation on business use of automobiles, meal expenses, employee awards, and spousal travel, all of which tend to represent small dollars at the individual employee level. When the questions turn to travel expenses and other reimbursements for board members, the answers can become a sensitive matter with the board. That sensitivity is compounded by the need to identify some fringe benefits for officers, directors, and key employees on Form 990, Schedule J (e.g., first class and companion travel, club dues, housing allowance, and tax "gross up payments"). Few organizations will have a perfect compliance record given all of the specific procedural requirements for excluding fringe benefits from income, but having a strong record of compliance with these small items can be critical in maintaining credibility with the agent when much larger issues come under scrutiny.

Compliance Tips

Have clear written policies for fringe benefits that track the tax requirements. Perform spot compliance checks at periodic intervals to ensure the right documentation is being secured to substantiate reimbursable expenses and their business connection. Make sure tax and finance staff have the backing of senior management when they need to enforce unpopular requirements like the production of automobile logs or validation of business reasons for spousal travel. For the optics of required disclosure of certain fringe benefits on Form 990, Schedule J, consider whether payment of additional cash compensation may be preferable to disclosing those benefits on Form 990. Hospitals facing union-organizing activities or difficult labor negotiations, for example, may find such benefits taken out of context and used to stir sentiment against the hospital.

No UBI Reported

Perhaps the most lucrative area for the IRS in hospital audits is unrelated business income (UBI). Virtually all agents are suspicious on audit when a hospital either reports no UBI or perennially has a net loss from its unrelated trade or business activities. An agent may challenge how revenues and expenses are allocated between exempt functions and unrelated activities in the same area in an effort to decrease the expenses that may be deducted in computing unrelated trade or business income. For example, if a hospital has a laboratory that mostly performs services for hospital patients but also has an unrelated trade or business testing laboratory specimens for private physician practices, the agent may press the hospital to justify how it is allocating expenses between the two functions.[12] If the hospital is buying or selling services to related for-profit entities, the IRS may argue that the prices are not consistent with market rates and propose to reallocate items of income and expense to generate a bigger tax liability for the hospital or its for-profit affiliates.[13] Hospitals that have these kinds of transactions with affiliates will want to know when they can take advantage of an exception that permits services to be provided at cost.[14]

The authors have seen agents attempt to disallow losses from some lines of activity that have a long history of losses on the grounds that they are not really trades or businesses so that they can tax profits from other lines of unrelated business that would otherwise be offset by the losses. Although a history of losses, by itself, does not prove that an activity is

not a trade or business, it is one factor.[15] A history of losses can be overcome if supported with evidence of a plan for getting the business to profitability, changes in market conditions contributing to the losses, or the possibility of selling the business for a profit despite a history of losses, similar to the experience of certain successful start-ups.[16]

Compliance Tips

Ensure the hospital has a reasonable method for allocating expenses between related and unrelated activity. No specific method is required, but whatever approach is selected, whether it is based on time studies, revenues, number of patients, or other metrics, it should be consistently applied and documented. If allocations are based on the Medicare cost report, they should be adjusted to reconcile cost accounting with tax accounting.[17] If the hospital is buying or selling services to related for-profit entities, seek advice on whether the hospital is able to qualify for one of the limited safe harbors that may allow pricing at or near cost.

Shelf Entities

With a history of reorganizations, mergers, acquisitions, and consolidations, many health care systems today have tax-exempt affiliates that are essentially dormant. Even though they now may fall below the annual revenue threshold for filing a Form 990, Section 6033(j) provides for automatic revocation of exemption if the organization fails to file an annual return or notice with the IRS for three consecutive years. These organizations may be able to file the postcard 990-N to notify the IRS that they continue to claim exemption. (Supporting organizations must file a Form 990 or 990-EZ.) Note that revocation is automatic if this filing is not made for three consecutive years, whether or not the IRS records are up to date and whether or not the organization has received a notice of revocation.[18] If the dormant organization is going to dissolve, a final Form 990 or 990-EZ should be filed.

Compliance Tips

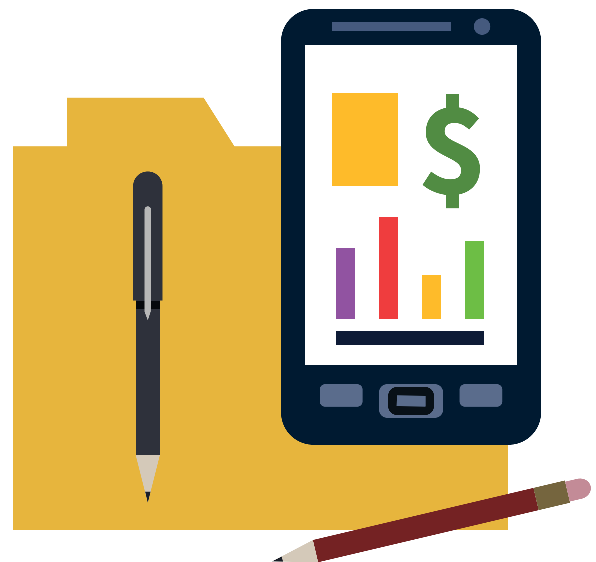
There may be a temptation to dissolve these entities to clean up the organizational chart. General counsel who have seen deals go into holding patterns or go through multiple iterations of structures as they await an IRS determination on exemption appreciate how exemption can become a timing hurdle for significant transactions. This timing issue means that shelf entities with tax-exempt status have strategic value to a health system in deal-making mode. A shelf entity that has kept its return or notice filing current often can be repurposed simply by notifying the IRS of the change in activities on Form 990, Part III if the new activity clearly qualifies for the same exempt status. For example, an entity that planned to provide home health services and received an exemption determination letter on that basis could be used as a different kind of health care service provider if it meets any specific exemption criteria applicable to the new activity. If there are questions as to whether a shelf organization has been automatically revoked, one can start with the Exempt Organizations Select Check listing on the IRS website;[19] however, for certainty, it would be necessary to obtain proof of filing of Form 990, 990-EZ, and 990-N.

Enforce/Monitor Conflicts Policy

Good governance matters to the IRS. The agency believes that a well-governed organization is more likely to be a tax-compliant organization. Taken to extremes, if an organization has long gaps between board meetings or fails to document key decisions in the minutes or oversee compensation and other financial relationships with insiders or does not follow an appropriate conflict-of-interest policy, it increases the risk of excess benefit or inurement that can jeopardize exempt status.[20] The IRS asks numerous questions on Forms 990 and 1023 about compensation, conflicts of interest, and financial relationships with insiders. The Form 1023 instructions include a model conflict-of-interest policy that is strongly encouraged for all Section 501(c)(3) organizations, including tax-exempt hospitals.[21] The IRS also has incorporated governance into the audit process, requiring agents to complete a two-page governance checksheet at the outset of an audit of any Section 501(c)(3) organization, including nonprofit hospitals.[22]

Compliance Tips

General counsel can use the IRS checksheet as an annual check on corporate governance activities. Although several of the questions in Parts 2-7 of the checksheet overlap with the governance and financial relationship questions in Part VI of the Form 990 and Schedules J and L, the checksheet is a more in-depth diagnostic tool that asks about compliance



with existing policies and procedures and efforts in monitoring potential conflicts of interest.

Know Your Public Charity Status

All Section 501(c)(3) organizations are classified as either private foundations or public charities, with private foundations being subject to more-restrictive rules on their activities, investments, and distributions. Although hospitals that provide patient care are treated as public charities *per se*, classification for health system parent entities and other affiliates may be less clear. System parents, for example, typically qualify as supporting organizations described in Section 509(a)(3). Supporting organizations are further broken down into three types based on their relationship with their tax-exempt affiliates. It is important to understand a supporting organization's type because the requirements for maintaining public charity status vary by type.[23] Failure to meet some of these requirements can mean that an organization will be treated as a private foundation, giving the IRS a basis to impose taxes and filing requirements that would not otherwise apply.

Compliance Tips

Supporting organizations formed prior to 2012 likely have self-reported their type on Form 990 with no actual IRS determination, creating the possibility of a dispute on audit. General counsel may want to ensure that there is clarity about the public charity status of each tax-exempt entity in the hospital's system. Changes in IRS procedures in 2012 have streamlined the process and set the user fee at $400 for obtaining an IRS determination of type for supporting organizations, far less than the current IRS charge of $28,300 to file a private letter ruling request.[24] Having a clear record on public charity status allows the general counsel to inventory the requirements that have to be met each year and ensure responsibility is assigned. For example, certain supporting organizations must provide written notice each year to the public charities that they support.[25]

Conclusion

Paying attention to these ten potential tax problems can pay significant dividends when the IRS arrives for an audit, reducing the length and cost of the exam and exposure to potential taxes and penalties. As with any good insurance policy, it is better to have it and not need it than to be caught bare when the IRS arrives.

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1 All section references are to the Internal Revenue Code of 1986, as amended (Code) unless otherwise noted.
2 *See, e.g.*, TAM 9451001 (Apr. 14, 1994); *LAC Facilities v Commissioner*, No. 94-604T (Ct. Cl. 1998) (appeal voluntarily dismissed).
3 *See* Rev. Rul. 59-60, 1959-1 C.B. 237; *Anclote Psychiatric Ctr., Inc. v. Commissioner*, T.C. Memo 1998-273, *aff'd per curiam*, 190 F.3d 541 (11th Cir. 1999); TAM 200244028 (June 21, 2002); C.F. Kaiser and A. Henchey, FY1996 CPE Text, Ch. Q: Valuation of Medical Practices, p. 408; C.F. Kaiser, P. Haney & T.J. Sullivan, FY1995 CPE Text, Ch. L, Integrated Delivery Systems and Joint Venture Dissolutions Update, pp. 165, 167 & 176-81.
4 *See, e.g.*, C. Wright & F. Stokeld, *Revocation Threat Against Hospital System Chastens Exempts*, Tax Notes Today 1997 TNT 244-3 (Dec. 19, 1997).
5 Treas. Reg. § 53.4958-6.
6 For an overview of the new 501(r) regulations, *see* C. Livingston & G. Griffith, "Protecting Your Hospital's Tax-Exempt Status: Compliance with the Affordable Care Act and Final IRS Section 501(r) Regulations" (Jones Day, Mar. 2015).
7 *See* 26 U.S.C.§ 4980H(a).
8 *See, e.g.*, Rev. Rul. 87-41, 1987-1 C.B. 296 (20-factor test for control).
9 *See, e.g.*, Rev. Rul. 66-274, 1966-2 C.B. 446; Rev. Rul. 72-203, 1972-1 C.B. 324; Rev. Rul. 73-417, 1973-2 C.B. 332; TAM 9535001 (Mar. 14, 1995); TAM 9535002 (Mar. 29, 1995).
10 Compare *Idaho Ambucare Ctr., Inc. v. United States*, 57 F.3d 752 (9th Cir. 1995), with *Dutch Square Med. Ctr. v. United States*, 74 AFTR 2d, ¶ 94-5425 (D.S.C. 1994).
11 42 C.F.R. § 411.357(c); 42 C.F.R. § 1001.952(i).
12 *See, e.g.*, Rev. Rul. 68-376, 1968-2 C.B. 246; Rev. Rul. 85-109, 1985-2 C.B. 165; Rev. Rul. 85-110, 1985-2 C.B. 166.
13 Code § 482.
14 *See* Rev. Proc. 2007-13, 2007-1 C.B. 295; Treas. Reg. § 1.482-9.
15 *See, e.g.*, Internal Revenue Manual ¶ 4.10.36(3).
16 Treas. Reg. § 1.183-2(b)(4) & (6); FS-2008-23 (June 2008); *Dennis v. Commissioner*, T.C. Memo. 2010-216; *Engdahl v. Commissioner*, 72 T.C. 659, 669 (1979).
17 *See* Treas. Reg. § 1.512(a)-1(c); GCM 39843 (Apr. 5, 1991).
18 Legislation was recently introduced that, if enacted, would require the IRS to notify organizations within 300 days of automatic revocation, with a procedure for reinstatement without an application if the organization can demonstrate that it did not receive the required notice. S. 918 (introduced, Apr. 14, 2015).
19 *Available at* www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check.
20 TAM 200243057 (July 2, 2002).
21 Instruction for Form 1023, p. 9, Part V, Line 5a & App. A (Rev. June 2006).
22 The checksheet and instructions are *available at* www.irs.gov/file_source/pub/irs-tege/governance_check_sheet.pdf and www.irs.gov/file_source/pub/irs-tege/governance_guide_sheet.pdf, respectively.
23 Treas. Reg. § 1.509(a)-4.
24 *See* Rev. Proc. 2015-1, 2015-1 I.R.B. 1, App. A., ¶ (A)(3)(c)(ii); Rev. Proc. 2015-8, 2015-1 I.R.B. 235, § 6.09.
25 Treas. Reg. § 1.509(a)-4(i).