

Regulatory Update for Health Care Tax Exempt Organizations

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**Manager, Exempt Organizations
Technical**

Three Hot Areas

- Intermediate Sanctions – IRC § 4958
- Health Maintenance Organizations (HMO's)
- Joint Ventures

Intermediate Sanctions

Conversions – Valuation Issues

- *Anclothe Psychiatric Center v. Comm'r*, T.C. Memo 1998-273, *aff'd* 190 F. 3d 5341 (12th Cir. 1999).
 - Pre-IRC § 4958 transaction
 - Court upheld IRS revocation of exempt hospital that was sold to insiders for less than FMV
 - Sale price: \$6.6 million.
 - Two years later, resold for \$29.6 million

Intermediate Sanctions

The Basics of IRC § 4958

- 25 % Initial Tax
 - **On** Excess Benefit
 - Provided **by** Applicable Tax Exempt Organization
 - **To** a Disqualified Person
- 200% Second-level tax
 - If EBT not Corrected
- 10% Tax on Knowing Manager
 - Unless participation not willful and due to reasonable cause

Intermediate Sanctions

Basics of IRC § 4958

- Applicable Tax-Exempt Organizations
 - § 501(c)(3) Public Charities
 - § 501(c)(4) Social Welfare Organizations (*e.g.*, HMO's)
- Disqualified Person is a “Person Who is in a Position to Exert Substantial Influence Over the Organization

Intermediate Sanctions

Basics of IRC § 4958

- “Excess Benefit Transaction” includes
 - Compensation
 - Sale, Exchange, or Use of Assets
 - Loan
- In Which Organization Receives Less than the Value in Return

Intermediate Sanctions

Conversions – Valuation Issues

- *Caracci, et. ux., et. al. v. Comm'r*, 118 T.C. No. 25 (May 22, 2002) (*Sta-Home Health*)
 - First IRC § 4958 litigation
 - Several home health agencies transferred to disqualified persons for less than FMV
 - Valuation an issue. TP's argued negative FMV
 - Court found total value > \$5 million
 - Court upheld § 4958, overturned IRS revocation

Intermediate Sanctions

Compensation Issues

- § 4958 Issues Will be Considered in EO Examinations
 - Factual issues
- Planning is Key to Avoiding Difficulty
 - Establish Rebuttable Presumption of Reasonableness –
Treas. Regs. § 53.4958-6
 - Document Intent that Fringe Benefits (other than § 132 benefits) are **Compensation**

Intermediate Sanctions

Rebuttable Presumption

- Three requirements – Regs. § 53.4958-6(c)
 - Advance approval by Authorized Body
 - *E.g.*, Board of Dir., Executive Committee
 - No one with conflict of interest
 - Reliance on Comparable Data
 - Concurrent Documentation
 - Terms and date approved
 - Members of body present for debate and who voted
 - Comparability data relied on and how obtained
 - Reasons for any variance from comparability data
 - Actions by any member with a conflict

Intermediate Sanctions

Fringe Benefits

- Economic Benefits that are treated as compensation are considered with all other compensation to determine reasonableness.
 - Exclude certain kinds, *e.g.*, § 132 exclusions
- Economic Benefit that is **not** treated as compensation is EBT, unless DP can show
 - Properly excluded from income, or
 - Involved legitimate non-comp transaction with organization

Intermediate Sanctions

Showing Intent that Fringe Benefits are Compensation

- Intent shown by Contemporaneous Substantiation
 - Organization reports on original or amended Form W-2, 1099, or 990, filed before audit
 - DP reports benefit as income on original or amended Form 1040, filed before audit
 - Contemporaneous documentation of approval by authorized body or officer
 - Rebuttable Presumption documentation
 - Approved written employment contract

Intermediate Sanctions

Intermediate Sanctions (IRC 4958) Update

- FY 2003 CPE article
- www.irs.gov/pub/irs-tege/eotopice03.pdf

HMO's

Exemption Issues: § 501(c)(3) or § 501(c)(4)

- § 501(c)(3)
 - If providing members direct hospital and medical services, *i.e.*, like a hospital
 - *Sound Health Ass'n v. Comm'r*, 71 T.C. 158 (1978), *acq.* 1981-2 C.B. 2.
 - Standard to qualify is “promotion of health that benefits the community.” Rev. Proc. 69-545, 1969-2 C.B. 117 (*e.g.*, factors such as emergency room, Medicare/Medicaid, community board, training)

HMO's

Exemption Issues: § 501(c)(3) or § 501(c)(4)

- Not § 501(c)(3)
 - Will not qualify if HMO an arranger, even if established by § 501(c)(3) hospital
 - *Geissinger Health Plan v. Comm'r*, 985 F.2d 1210 (3rd Cir. 1993);
 - *IHC Health Plans Inc. et. al. v. Comm'r*, T.C. Memo 2001-246, 247, 148. (On appeal to 10th Cir.)
 - Courts held
 - Not operated exclusively for charitable purposes by promoting health of the community
 - Did not qualify based on relationship to tax-exempt hospital

HMO's

Exemption Issues: § 501(c)(3) or § 501(c)(4)

- § 501(c)(4)
 - HMO may qualify as a social welfare organization if accessible by an underserved segment of the community.
 - *e.g., elderly, individuals, small employers, etc.*

HMO's

Exemption Issues: § 501(m) Bar

- If providing commercial-type insurance is substantial part of activities § 501(m) denies exemption under (c)(3) or (4)
- Directed at BC/BS organizations
- No definition of “commercial-type insurance”

HMO's

Exemption Issues: § 501(m) Bar

- Several court cases have interpreted it as “same type that commercial carriers offer.”
 - Cases did not involve HMO
 - *Paratransit Insurance Corporation v. Comm’r*, 102 T.C. 745 (1994)
 - *Florida Hospital Trust Fund v. Comm’r*, 103 T.C. 140 (1994), *aff’d* on other grounds 71 F. 3rd 808 (11th Cir. 1996)
 - *Nonprofits’ Insurance Alliance of California*, 32 Fed Cl. 277 (1994)

HMO's

§ 501(m)

- *Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355 (2002), held an HMO was providing insurance.
 - Not a tax case
 - Upheld a State HMO Statute
 - Held ERISA did not preempt state statute because HMO provided insurance
- We are reviewing whether rationale of *Rush* affects how § 501(m) applies to HMO's.

Joint Ventures

Rev. Rul. 98-15, 1998 C.B. 718

- Two examples where hospital puts all assets in partnership with for-profit partners
- Situation 1 meets § 501(c)(3) because
 - JV governing documents commit to benefit community as whole;
 - Charitable purposes trump profits;
 - Exempt partner controls partnership;
 - Management contract reasonable.
- Situation 2 did not meet § 501(c)(3)
 - No binding obligation to serve charitable purposes;
 - Shared control limits ability to require charity

Joint Ventures

Examples

- *Redlands Surgical Services v. Comm'r*, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F 3rd 904 (9th Cir. 2001).
 - Subsidiary of tax-exempt hospital entered JV with for-profit to operate outpatient surgery center.
 - Court upheld denial of § 501(c)(3) status
 - NP partner lacked control;
 - Did not show benefited community – no Medicare/Medicaid, or charity care

Joint Ventures

Examples

- *St. David's Health Care System v. U.S.*, No. 01 CV-46 (W.D. Tex. June 7, 2002)
 - § 501(c)(3) hospital in 50/50 Partnership with for-profit
 - District Court, on summary judgment, held consistent with exempt status
 - Court found tax-exempt's lack of authority to require charity did not affect status if actual operations OK
 - On appeal to Fifth Circuit

Joint Ventures

- IRS/Treasury Committed to Additional Guidance on Joint Ventures
- Situations may be Ancillary JV
 - § 512(c) provides partnership income retains its character, so EO partner's share of partnership's income from unrelated activity is UBI

Customer Service

Toll Free Exempt Organizations Assistance
1-877-829-5500

IRS Exempt Organizations Website
www.irs.gov/eo

IRS Forms and Publications Website
www.irs.gov/formspubs