Regulatory Update for Health Care Tax Exempt Organizations

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Three Hot Areas

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

Conversions – Valuation Issues

• *Anclote 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

  ▪ 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
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
  ▪ 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)
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
  ▪ 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


- 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