April 2013

Foot Faults Don't Kill: New Proposed Regulations Provide Helpful 501(r) Guidance to Nonprofit Hospitals

by ***Ofer Lion*** *and* ***Douglas M. Mancino***

New proposed IRS regulations provide much-needed comfort that charitable hospital organizations will not lose their tax-exempt status or undermine the tax-exempt status of bonds issued on their behalf for failure to meet the detailed requirements of section 501(r) of the Internal Revenue Code, if the failure is neither willful nor egregious and the organization promptly makes corrections and related disclosures.

Section 501(r) requires charitable hospital organizations to (i) prepare and implement a community health needs assessment (CHNA); (ii) establish financial assistance and emergency medical care policies; and (iii) adopt certain limitations on charges and billing and collection actions. Because of its "strict liability" language, section 501(r), enacted in 2010, has led to concerns that even minor violations of the section's detailed requirements could lead to a complete loss of tax-exempt status for a charitable hospital organization. Such a loss could trigger an economic disaster, including massive income tax liabilities, loss of the tax-exempt status of bonds issued for the benefit of the organization and other effects, such as loss of local property tax exemptions.

Predictably, the IRS has combined this relief with detailed guidance on other available penalties for noncompliance with section 501(r)'s requirements, as discussed below. The proposed regulations are consistent with IRS recognition of the generally unacceptable consequences of a complete revocation of tax-exempt status of any significant nonprofit hospital organization coupled with the need for alternative enforcement measures such as fines and other "intermediate sanctions." It also reflects the evolving IRS approach of offering both carrots and sticks in terms of greater leniency toward organizations that implement procedures designed to identify and rectify any departures from a strict interpretation of IRS rules. This approach was reflected in the IRS pronouncements in 2011 regarding post-issuance tax compliance policies by nonprofit hospitals and other beneficiaries of tax-exempt bonds. *See* our related client alert, *"IRS Warning to Tax-Exempt Issuers and Borrowers: Implement Compliance Procedures Now"* (November 2011), available at the Hunton & Williams website: www.hunton.com.

The proposed regulations and this client alert help to answer the following frequently asked questions about the application of section 501(r) on issues such as the:

- circumstances under which a hospital organization can lose its tax-exempt status;
- taxation of noncompliant hospital facilities;
- operation of multiple hospital facilities;
- definition of "hospital facility"; and
- application of 501(r) to hospital facilities operated through partnerships.

The new proposed regulations also provide detailed guidance on the CHNA, including related Form 990 reporting requirements and the application of the excise tax for failure to meet the CHNA requirements. These issues are addressed in our client alert "*Community Health Needs Assessment: IRS Issues Interim*

Guidance to Tax-Exempt Hospitals" (April 2013), available at the Hunton & Williams website: www.hunton.com.

Can we lose our exemption for failing to satisfy 501(r)?

Yes. Section 501(r), enacted by the Patient Protection and Affordable Care Act of 2010, provides that a "hospital organization" will not be treated as a 501(c)(3) tax-exempt organization unless it meets the requirements of section 501(r)(3) (CHNA), 501(r)(4) (financial assistance policy), 501(r)(5) (limitation on charges) and 501(r)(6) (billing and collections). The proposed regulations indicate that "a hospital organization failing to meet one or more of the requirements of section 501(r) separately with respect to one or more hospital facilities it operates may have its section 501(c)(3) status revoked as of the first day of the taxable year in which the failure occurs."[1]

What if the failure was minor and inadvertent?

A hospital facility's omission or error with respect to the requirements of section 501(r) will not be considered a failure to meet such requirement of section 501(r) if the omission or error is minor, inadvertent, due to reasonable cause and the hospital facility corrects it reasonably promptly after discovery.

And if the failure was worse than minor and inadvertent?

Even for omissions and errors that exceed "minor and inadvertent" status, if the failure is neither willful nor egregious, it will be excused if the hospital facility corrects and makes disclosure in accordance with rules to be set forth in pending additional IRS guidance.

On the other hand, willful or egregious failures will not be excused even if corrected and disclosed in accordance with the pending guidance. For this purpose, a "willful" failure may be due to gross negligence, reckless disregard or willful neglect.

What will the IRS consider when determining whether to revoke tax-exempt status?

The IRS will consider "all relevant facts and circumstances" including, but not limited to:

1. previous failures;
2. the size, scope, nature and significance of the organization's failures;
3. for multiple hospital organizations, the number, size and significance of the facilities that have 501(r) failures versus those that have complied;
4. the reason for the failures;
5. whether the organization had, prior to the failures, 501(r) compliance practices and procedures;
6. whether the practices and procedures had been routinely followed and the failures occurred through an oversight or mistake in applying them;
7. whether safeguards were in place to prevent future similar failures;
8. whether failures were promptly corrected after discovery; and
9. whether the safeguards and corrections were implemented prior to the IRS discovering the section 501(r) compliance failures.

[1] Prop. Reg. § 1.501(r)-2(a) (emphasis added).

What happens if we have a noncompliant hospital facility but our hospital organization retains its 501(c)(3) tax-exempt status?

A noncompliant hospital facility operated by a hospital organization with multiple facilities may individually be treated as taxable while the hospital organization's 501(c)(3) status remains.

The income derived from the noncompliant hospital facility ("noncompliant facility income") will be subject to tax computed as if the hospital facility was a separate taxable entity and must be reported by the hospital organization on Form 990-T. Each noncompliant hospital facility would need to compute its taxable income separately from the rest of the hospital organization. For example, deductions must be directly connected to the operation of the noncompliant hospital facility, and the net operating losses from one noncompliant hospital facility would not be available to offset either noncompliant facility income from another noncompliant hospital facility or any of the hospital organization's unrelated business taxable income.

While the IRS may be hesitant to revoke the exempt status of a large hospital organization, it may be much more apt to invoke this "intermediate sanction" of sorts on particular hospital facilities. Presumably, however, if a noncompliant, taxable hospital facility were to comply fully with section 501(r) in a later tax year, such hospital facility's net income would cease to be taxable.

What about the tax-exempt bonds used to finance a noncompliant hospital facility?

The new proposed regulations provide that the taxation of a noncompliant hospital facility operated by a charitable hospital organization that continues to be recognized as tax-exempt "shall not, by itself, affect the tax-exempt status of bonds issued to finance the noncompliant hospital facility."[2] This is important, since it makes clear that the imposition of the tax does not mean that use of the noncompliant facility constitutes "bad use" for purposes of any tax-exempt bonds issued to finance such a facility.

These statements also support the conclusion that any application of the tax to a bond-financed facility does not constitute an "adverse tax opinion" or one of the "other material events affecting the tax status of the security" for outstanding tax-exempt bonds requiring a disclosure filing with the EMMA system under a standard continuing disclosure agreement pursuant to SEC Rule 15c2-12.

Noncompliance with respect to a single facility, however, may violate bond covenants relating to tax compliance and may be material information required to be disclosed in any new bond offering.

Do all of our hospital facilities need to meet 501(r)'s requirements independently?

Yes. A hospital organization that operates more than one hospital facility must meet the 501(r) requirements separately with respect to each hospital facility.

What if our hospital facility has multiple buildings under a single hospital license?

Multiple buildings operated by a hospital organization under a single state license "are" considered a single hospital facility. (Prior guidance indicated that they "may" be considered a single hospital facility.) Under the circumstances, hospital organizations may wish to consider the pros and cons of licensure consolidation or diversification. Licensure consolidation, for example, could reduce the burdens of preparing community health needs assessments for separately licensed buildings in what could be a single hospital facility for purposes of section 501(r). Licensure diversification, on the other hand, could

[2] Prop. Reg. § 1.501(r)-2(d)(4)(i).

prevent taxation of one noncompliant hospital building from attaching to other buildings under a single license.

What if we have a minority interest in a partnership that operates a hospital facility?

The proposed regulations assert the general rule that a hospital organization "operates" a hospital facility if it is a partner or member in an entity treated as a partnership that operates a hospital facility. Two exceptions are provided.

First, a partner lacking control over the operation of a hospital facility sufficient to ensure that the hospital facility furthers and is substantially related to charitable purposes, so that it is deemed to be engaged in an unrelated trade or business, is not considered to "operate" a hospital facility for purposes of section 501(r). The test for "control" is not based on a fixed percentage. Rather, the test is the same as that applied to determine whether a tax-exempt partner has control sufficient to ensure that a partnership's trade or business is substantially related to exempt purposes, so that the activity does not give rise to unrelated business income.[3]

Second, there is a grandfather rule intended for tax-exempt organizations that are partners with enough control to ensure charitable purposes but not to require the provision of community health care sufficient to ensure compliance with section 501(r). The grandfather rule excludes hospital facilities if two conditions are met. One, at all times since March 23, 2010, the hospital organization must have been organized and operated primarily for educational or scientific purposes and must not have engaged primarily in the operation of one or more hospital facilities, such as a university with a partnership interest in a teaching hospital. Two, pursuant to a partnership arrangement (including any modifications, including side agreements) entered into before March 23, 2010, the hospital organization must not (i) own more than a 35 percent capital or profits interest; (ii) be a general partner or have a similar interest; or (iii) have sufficient control over the operation of the hospital facility to ensure that it complies with section 501(r).

Is our disregarded entity disregarded?

Yes. If a hospital facility is owned and operated by a disregarded entity (e.g., a single-member limited liability company), the hospital organization owner of the disregarded entity is deemed to own and operate the hospital facility.

Our hospital organization owns businesses other than hospital facilities. Is section 501(r) applicable to those nonhospital facilities?

No.

When will these new proposed regulations become effective?

Generally, until the regulations are published as final or temporary regulations, hospital organizations may not rely on either the new proposed regulations or the 501(r) proposed regulations issued in 2012. However, while the proposed regulations have little if any precedential value, they provide a clear indication of how Treasury and the IRS interpret the provisions of section 501(r).

Conversely, the proposed regulations covering the CHNA may be relied on for any CHNA completed, or implementation strategy adopted, on or before the date that is six months after the date temporary or final regulations are published. The CHNA and related reporting requirements and excise taxes are discussed in a separate client alert, "*Community Health Needs Assessment: IRS Issues Interim Guidance to Tax-Exempt Hospitals"* (April 2013), available at the Hunton & Williams website: www.hunton.com.

[3] *See* Rev. Rul. 2004-51, 2004-22 I.R.B. 974; Rev. Rul. 98-15, 1998-1 C.B. 718.

If you have any questions about this alert, these frequently asked questions or section 501(r) generally, please contact any of the Hunton & Williams lawyers listed below.

Contacts

Douglas M. Mancino
dmancino@hunton.com

Matthew D. Jenkins
mjenkins@hunton.com

Mark S. Hedberg
mhedberg@hunton.com

Andrew R. Kintzinger
akintzinger@hunton.com

J. William Gray, Jr.
billgray@hunton.com

Ofer Lion
olion@hunton.com

Robert Dean Pope
dpope@hunton.com

William H. McBride
wmcbride@hunton.com

Caryl Greenberg Smith
carylsmith@hunton.com