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Hospital Tax Law Update

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The Affordable Care Act has created a sea of new tax requirements for businesses. Among these is new Section 501(r) of the Internal Revenue Code. We have found that there is considerable conflicting information confronting our hospital clients concerning how this new law will affect them and how they need to prepare now to avoid the penalties for noncompliance.

In 2013, new proposed regulations have been promulgated by the Treasury Department. The penalties for noncompliance can include fines and loss of the hospital's tax exemption. Hospitals need to understand these rules now. This newsletter offers a general overview of some of the highlights.

Background

The new Code Section 501(r) imposes, in general, four new requirements on hospitals that wish to retain their tax exempt status under Section 501(c)(3) of the Code. Hospitals must now:

- Conduct a Community Health Needs Assessment (CHNA) and adopt a related implementation strategy at least once every three years, effective for the first taxable year beginning after March 23, 2012
- Adopt and widely publicize a financial assistance policy (FAP)
- With respect to individuals who are eligible under the FAP, charge no more for medically necessary care than the amount generally billed to individuals who have insurance for such care; and
- Refrain from engaging in "extraordinary collection efforts" on an individual before determining if the individual is eligible for assistance under the FAP

New Code Section 4959 also creates an excise tax for failing to meet the CHNA requirements.

The requirements for each of these general categories are complex and the definitions are still evolving. To date, the IRS and Treasury have only issued three sets of guidance for hospitals to comply with the new law and this office is paying close attention to the Service's developing views.

Most recently, the IRS issued temporary regulations and proposed regulations under Code Section 6011 and 6071 addressing how hospitals should report the Section 4959 excise tax they owe for failing to properly meet the CHNA requirements.

The temporary regulations provide that a charitable hospital organization liable for the Section 4959 excise tax must file a return on Form 4720. The return must be filed by the 15th day of the 5th month after the end of the charitable hospital's tax year during which the excise tax liability was incurred. The proposed regulations close the comment period on November 13, 2013.

Note that hospitals are rendered under the new law responsible for identifying, calculating and reporting their own penalties for non-compliance with the law. The net effect of this will be that hospitals which inadvertently fail to comply in some way with the CHNA requirements will also probably also fail to report their error to the IRS and thereby expose themselves to even larger penalties, plus interest.

New CHNA Proposed Regulations

To conduct a CHNA, a hospital must complete all five of the following steps:

1. Define the community it serves
2. Assess the health needs of that community
3. In assessing the community's health needs, take into account input from persons who represent the broad interests of the community, including those with special knowledge of or expertise in public health
4. Document the CHNA in a written report that is adopted by an authorized body of the hospital facility
5. Make the CHNA report widely available to the public

As to each of the important health needs described in the CHNA, the hospital must articulate an implementation strategy including, but not limited to:

- Describing how the facility plans to address the need; or
- Identify the need as one the facility does not plan to address and explain why the facility does not plan to address the need. Hence, hospitals must comprehensively identify community health needs in the CHNA, as simply overlooking significant needs is not an option
- A $50,000 penalty applies for each year in which the hospital does not comply

New CHNA Regulations, cont'd

The most severe penalty for improper compliance with the new CHNA rules is revocation of the hospital's tax exempt status, effective retroactively to the first day of the tax year in which the failure occurs.

The IRS will use a facts and circumstances approach to evaluating whether a hospital should lose its exempt status, including evaluation of the following:

- Whether the organization has previously been noncompliant with the requirements of Section 501(r);
- The size, scope, nature and significance of the noncompliance;
- The reason for the failure of compliance;
- Whether the hospital had established and followed practices and procedures created and enforced for the purpose of ensuring compliance with Section 501(r);
- Whether the hospital has put into place safeguards designed to prevent similar failures from occurring in the future;
- Whether the organization has corrected the compliance failure reasonable promptly after discovery.

As a practical matter, the last two fact tests are unlikely to be available to hospitals which are noncompliant because hospitals generally will not be aware they are noncompliant unless and until the IRS examines their CHNA reports and finds one or more of them inadequate. Accordingly, it is imperative that hospitals be sure their practices and procedures are in place now to ensure not only compliance with Section 501(r) but to protect their tax exemptions if and when the Service examines the reports.

The Service has available a less severe penalty in situations where an organization operates more than one hospital facility. If one of those facilities fails to comply with the new law, the net income from that facility will become subject to income tax, usually at the corporate rate.

The Service has explained that, at least at first, omissions and errors will not be penalized so long as:

1. The omission or error was minor, inadvertent or due to reasonable cause; and
2. The omission or error is corrected as promptly after discovery as is reasonable given the nature of the omission or error.

With this *de minimus* exception, the IRS is merely giving hospitals time to put in place the necessary practices, procedures and personnel to comply with what is sure to be an evolving legal landscape.

There is another important change brought by the new regulations. The 2012 proposed regulations defined a hospital organization as a tax-exempt organization under section 501(c)(3) that operates one or more hospital facilities, including organizations that operate a hospital through a so-called "disregarded entity" (e.g., a single member limited liability company). The new proposed regulations provide that "operating a hospital facility" includes not only operation through a disregarded entity, but also through a joint venture, limited liability company, or other entity treated as a partnership for federal income tax purposes, except in the following limited circumstances: (1) the organization does not have control over the hospital facility sufficient to ensure that its operation furthers an exempt purpose under section 501(c)(3), and consequently the organization treats the operation of the hospital facility as an unrelated trade or business, or (2) the partnership is operated pursuant to certain grandfathering rules for arrangements entered into prior to March 23, 2010. Seeking analytical consistency, the IRS thereby tied the standard for exemption from section 501(r) to the standard used for determining whether a joint venture gives rise to unrelated business taxable income ("UBTI") to a participating tax-exempt organization (a standard first clearly enunciated by the IRS in Revenue Ruling 2004-51.

The new proposed regulations will be effective, with respect to the requirements under section 501(r), as of the date they are published in final or temporary form and, with respect to any filing requirements, will be effective for returns filed on or after the date the rules are published in final or temporary form. The effective date for the 2012 proposed regulations has also been changed to the date those regulations are published in final or temporary form. Hospital organizations can rely upon the proposed regulations for any CHNA conducted or implementation strategy adopted on or before the date that is six months after the proposed regulations are published in final or temporary form, but could continue to rely upon the guidance in Notice 2011-52 only until October 5, 2013.