IRS, State and Local Authorities Scrutinize Hospital Tax-Exempt Status

By Charles R. Goulding, Jennifer Pariante and Charles G. Goulding

Charles R. Goulding, Jennifer Pariante and Charles G. Goulding look at the growing trend of state and local authorities challenging the tax-exempt status of hospitals.

On March 20, 2013, the City of Pittsburg went to court challenging the tax-exempt status of the University of Pittsburgh Medical Center (UPMC).

The suit championed by Pittsburgh's Mayor claims that this large 55,000-employee, 10-billion-dollar regional healthcare system doesn't meet a state requirement that tax-exempt organizations operate without a profit motive. The city is seeking payroll taxes back to 2007, and loss of tax-exempt status can result in large county property tax assessments and potentially federal and state income tax assessments. The ongoing rapid consolidation of the U.S. healthcare system coupled with the dire budget constraints of some local jurisdictions increase the likelihood of very large potential tax assessments based on similar theories.

Charles R. Goulding, Attorney/CPA, is the President of Energy Tax Savers, Inc., an interdisciplinary tax and engineering firm that specializes in the energy-efficient aspects of buildings.

Jennifer Pariante is an Analyst with Energy Tax Savers, Inc.

Charles G. Goulding is Manager of Energy Tax Savers, Inc.

The Tax Law Development: State Developments

Illinois

The first major case which brought this issue to national attention is *Provena Covenant Medical Center*[1] where the Illinois Supreme Court ruled that the state acted properly in revoking tax-exempt status due to insufficient levels of charity care.

A year later the Illinois Department of Revenue denied property tax status for three more hospitals: Northwestern Memorial Prentice Woman's Hospital in Chicago, Edward Hospital in Naperville and Decatur Memorial Hospital.

To end the 10 years of Illinois litigation presented above, on June 12, 2012, Illinois enacted new property law (35 ILCS 200/15-86). This law provides that a hospital can be issued a charitable exemption if the value of qualifying services or activities as defined exceeds the estimated property tax liability for the year.

California

The California state auditor issued a report in August 2012 in regard to five hospitals.[2] It was concluded that community benefits were not reliably correlated to tax-exempt status. That audit involved Sutter Health, San Leandro Hospital, St. Luke's Hospital in San Francisco, El Camino Hospital in Los Gatos and Mission Health in Laguna Beach.

The Tax Law Development: Federal Developments

Since 1969 the Internal Revenue Code (the "Code") has always required that hospitals meet a Community Health Needs Assessment (CHNA) test to qualify for tax-exempt status. Revenue Ruling 69-545[3] lays out five CHNA factors with the first factor being the operation of a full-time emergency room that provides treatment regardless of a patient's ability to pay.

The Patient Protection and Affordable Act,[4] commonly referred to as ObamaCare, added new Code Sec. 501(r), which strengthens the CHNA requirement. Effective for 2011 tax-exempt organizations must conduct a CHNA assessment at least every three years. A noncomplying hospital is subject to $50,000 excise tax penalty.

The IRS Form 990 required for tax exemption has been revised and now includes 6 questions related to a hospital's CHNA policies. IRS has scheduled 3,300 hospital tax-exemption reviews.

New Code Sec. 501(r)

In addition to complying with the Community Benefit Code Sec. 501(r) requires tax-exempt hospitals to:

1. conduct community needs assessment and implement a strategy to address that need;
2. widely communicate financial assistance policies;
3. limit charges for indigent patients; and
4. adhere to certain billing and collection practices.

On July 25, 2011, the IRS issued Notice 2011-52,[5] which provides guidance and requests comments for CHNA assessments for tax-exempt hospitals. The notice states that Code Sec. 501(r) specifically includes government hospitals.

The Breadth of Tax Exposure

Losing tax-exempt status can expose a healthcare system to a myriad of taxes such as the following.

Payroll Taxes

The UPMC case involves hospital employee payroll taxes.

Property Taxes

Local property taxes are often the target of these audits. In the UMPC case, loss of tax exemption would increase annual property taxes by $16 million.

Federal Income Taxes

An IRS adverse determination would result in an income tax assessment.

State Income Taxes

A state income tax assessment could result from either a state initiated state determination or the reporting of the IRS determination to the state.

Sales Taxes

Loss of tax exemption status can also result in loss of sale tax exemption.

Bright Line Tests

Hospital tax exemption disallowance is a developing area with the different governmental authorities' agencies proffering different tests. Hospital administrators and their advisers need to understand the tests being applied by each jurisdiction with oversight over their organization. As with every major tax exposure area, the key is to *document, document, document*.

The Relevance of Revenue Ruling 69-545 over 40 Years Later

The hospital care industry has evolved greatly in the 40 years since Revenue Ruling 69-545, and much of it seems irrelevant now.

Revenue Ruling 69-545 presented five factors:

1. Emergency Room Care: Mandatory emergency care was the lynch pin of this revenue ruling. However, broad-based healthcare in the emergency room is extremely expensive and is now discouraged. Many prior emergency room patients can now utilize lower-cost urgent care and mediclinics.
2. Provide nonemergency care services to all individuals who are able to pay: The majority of hospitals

already do this and presumably will increasingly do this in a post-ObamaCare environment.
3. Open Medical Staff: An open medical staff means that no qualified medial professional will be denied privileges at the hospital.
4. Board comprised of Civic Leaders: The growing size and complexity of today's healthcare organizations require boards with deep expertise in all standard board functions including corporate governance, auditing, business strategy and operations.
5. Utilization of surplus for medical training, education and research programs: Although these activities would seemingly be exactly what a major university research hospital does, this standard seems tangentially to relate to community health benefit needs. Presumably the University of Pittsburgh Medical Center did all of these activities and still was challenged by the city.

A hospital that conducts disease research can use that research to aid in their CHNA compliance. Major diseases requiring substantial search include Diabetes,[6] Alzheimer's,[7] Super Bugs[8] and Brain-related[9] diseases. This disease research often involves public private partnerships where the private participant can benefit from R & D tax credits.

Business Planning

Hospitals should designate a senior officer/manager as the responsible tax exemption compliance risk officer. That risk officer should work with outside auditors and professionals familiar with this area and create risk controls, procedures and an annual compliance study. Utilization of outside experts for review is always viewed more favorably by government auditors, administrative agencies and the courts.

The impact of all acquisitions and dispositions and including all material new service lines and terminations should be carefully considered. For example the acquisition of a new facility in an affluent area might put the core entity at risk. This was one of the allegations in the UPMC case. If the acquisition of a troubled institution is being encouraged by a government authority the hospital should strive to enter into an agreement or obtain a ruling that the acquisition will not change tax status.

Consider Pilot Agreements

Pilot agreements are undertakings where an organization agrees to pay a jurisdiction a payment in lieu of takes. Presumably, a properly drafted Pilot with a local authority would insulate the hospital from the economic impact of a status change by that jurisdiction.

Difficult Policy Issues

Tax exemption for large healthcare organizations presents difficult political, economic and social policy issues. In many jurisdictions the hospital network is both the largest employer and building owner. For example in Long Island, New York, a relatively affluent area, the North Shore LIJ hospital system is the largest employer. The UPMC medical complex is Pennsylvania's largest employer. It is very challenging for a jurisdiction to provide a full range of government services without a tax revenue base. Select services such as government-provided police services and building inspection services may be privatized on a fee basis.

Defining Community Benefit

Different Communities can have different community health needs which can also vary by economic cycles. An area with a high number of unwed teenage pregnancies might need prenatal care while another community might have more drug prevention opportunities. During the economic downturn and the residential home price collapse many families in Arizona, California, Florida and Nevada lost their economic safety net. An unprecedented number of municipalities have gone bankrupt in recent years, and major cities with declining populations such as Chicago[10] and Detroit[11] have special needs.

Conclusion

Hospital tax-exempt status is a major current issue. The basic tax rule is that there is no tax assessment statute of limitations for unfiled tax returns. Hospital administration and hospital audit advisers need to be vigilant.

Endnotes

1 *Provena Covenant Medical Center v. Ill. Dep't of Rev.,* 925 NE2d 1131, at 1140 and 1149 (2010).
2 Rept. 2011-126, Cal. State Auditor (Aug. 2012).
3 Rev. Rul. 69-545, 1969-2 CB 117.
4 Patient Protection and Affordable Healthcare Act of 2010 (P.L. 111-148).

[5] Notice 2011-52, IRB 2011-30, 60.

[6] Charles R. Goulding, Andressa Bonafe and Charles G. Goulding, *The R & D Tax Credit Aspects of Diabetes,* Corp. Bus. Tax'n Monthly, Nov. 2013, at 13.

[7] Charles R. Goulding, Andressa Bonafe and Charles G. Goulding, *The R & D Tax Credit Aspects of Alzheimer's,* Corp. Bus. Tax'n Monthly, Nov. 2013, at 9.

[8] Charles R. Goulding, Kenneth Wood and Charles G. Goulding, *The R & D Tax Credit Aspects for Companies Combating "Superbugs,"* Corp. Bus. Tax'n Monthly, pending publication.

[9] Charles R. Goulding, Andrea Albanese and Charles G. Goulding, *R & D Tax Credit Aspects of Brain Mapping,* Corp. Bus. Tax'n Monthly, Dec. 2013, at 13.

[10] Charles R. Goulding, Charles G. Goulding and Gary Savell, *Energy Tax Aspects of Chicago's 7.2 Billion Building Program,* Corp. Bus. Tax'n Monthly, Jan. 2013, at 11–13.

[11] Charles R. Goulding, Shane Holmes and Charles G. Goulding, *The Energy Tax Aspects of Revitalizing Detroit's Building Engine,* Corp. Bus. Tax'n Monthly, Feb. 2013, at 13–14, 52.