24th Annual Health Sciences Tax Conference

Sales and use and excise taxes for tax-exempt and for-profit health care provider organizations

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Overview

With the increased focus at the federal and state levels on transaction-based taxes, this session is designed for tax-exempt and for-profit health care provider organizations looking to get their arms around the cumbersome process of managing federal, state and local transaction tax exemptions in the health care sector.
Agenda

- Nonprofit and charitable entity exemptions
- Health care entity exemptions
- Product-based exemptions
- Use-based exemptions
- Sales and use tax strategic opportunities
- Excise taxes
Nonprofit and charitable entity exemptions
States with exemptions for sales to or purchases by nonprofit and charitable entities

Note: States may impose restrictions and requirements to qualify for nonprofit and charitable status.
Nonprofit and charitable entity exemptions

Overview

- Approximately 29 states have nonprofit or charitable organization exemption for sales and use tax
- Typically, only applies to purchases made by nonprofits
- Must look at jurisdiction’s definition and requirements to qualify as a charitable organization
- Sometimes, nonprofit exemption requires more than just an Internal Revenue Code (IRC) 501(c) (3) tax-exempt status
- Usually involves an application process with documentation requirements, such as financial statements, articles of incorporation, Internal Revenue Service (IRS) determination letter, etc.
- Consider what exclusions apply to the exemption (e.g., construction)
- Some states have a renewal or expiration period, such as annually or every five years, for example
- Need to effectively manage exemption certificates
Exemptions for nonprofit and charitable entities – Colorado

- All sales made to charitable organizations, in the conduct of their regular charitable functions and activities, are exempt from sales and use tax.
- Organizations that are exempt from federal income tax under IRC 501(c)(3) generally will be approved for a sales tax certificate of exemption in Colorado, unless the Department of Revenue chooses to conduct an independent review and make its own determination regarding an organization’s qualifications.
- Per Colorado FYI Publication No. 2, 04/01/2014:
  - The state charitable organization exemption does not apply to locally collected sales tax levied by home-rule cities.
  - Home-rule jurisdictions make their own tax regulations and exemptions, which may differ from the state’s.
- Example: Colorado exemption for “charitable organizations” vs Denver exemption for “charitable corporations”:
  - Separate application
  - Differing definitions
Exemptions for nonprofit and charitable entities – Illinois

- Sales of personal property to a corporation, society, association, foundation or institution organized and operated exclusively for charitable, religious or educational purposes are exempt.
- The organization must be nonprofit to be exclusively charitable.
- There is no formal application, but a cover letter and documents are required.
- There are specific tests for hospitals, e.g., must not discriminate against patients or doctors and cannot refuse admittance due to inability to pay for services.
- An organization must have an active exemption identification number from the Department of Revenue to make tax-free purchases.
- GIL ST 14-0048 (10/08/14) provides that hospitals that qualify as charitable in Illinois are exempt on their sales of food and medicine to their patients, or on their sales of food from a cafeteria operated for the benefit of their employees that is not open to the public.
Exemptions for nonprofit and charitable entities – Texas

- Taxable items sold, leased or rented to, or stored, used or consumed by, an organization qualifying for an exemption from federal income taxes under Section 501(c)(3) are exempt if they relate to the purpose of the organization and are not used for the personal benefit of a private stockholder or individual.

- Organizations are not considered exempt before the date the organization applied for the exemption (effective September 1, 2009).

- Joint ventures:
  - Texas Policy Letter Rulings allow joint ventures of exempt organizations and for-profit organizations to claim sales and use tax exemptions for nonprofits on purchases related to the purpose of the exempt entity.
  - The sales and use tax exemption is allowed based on the percentage of the purchase price equal to the exempt organization’s percentage ownership in the joint venture.
  - This policy position is only applicable to partnerships, not limited liability companies.
Health care entity exemptions
Health care entity exemptions
Overview

- Approximately 22 states have some type of health care entity exemption for sales and use tax (e.g., hospital, nursing home)
- Must look at the jurisdiction’s listing of various health care entity exemptions and requirements
- Sometimes the health care exemption references an IRC 501(c)(3) tax-exempt status
- Usually involves an application process with documentation requirements, such as financial statements, articles of incorporation, IRS determination letter, etc.
- Consider what exclusions apply to the exemption (e.g., construction)
- Some states have a renewal or expiration period, such as annually or every five years, for example
- Need to effectively manage exemption certificates
Health care entity exemptions – Arizona

- Arizona provides an exemption from certain classifications of transaction privilege tax for the following health care entities:
  - Licensed hospitals organized and operated exclusively for charitable purposes (no part of the net earnings inures to the benefit of any private shareholder or individual), including nursing care institutions, residential care institutions or kidney dialysis centers
  - “Qualifying health care organizations” – entity recognized as nonprofit under IRC Section 501(c) and that uses, saves or invests at least 80% of all monies that it receives from all sources each year only for health and medical-related educational and charitable services; or monies used, saved or invested to lease, purchase or construct a facility for health and medical-related education and charitable services included in the 80% requirement
  - Arizona TPT Procedure No. 99-5, 07/25/1999 provides documentation requirements for securing annual exemption, including calculation.
  - Nonprogram cities allow exemption, except when the item is for use in activities resulting in gross income from unrelated business income.
Health care entity exemptions – various

- California: no exemption provided for purchases by “medical service facilities”
- Illinois: tangible personal property sold to a hospital owner that owns one or more hospitals licensed under the Hospital Licensing Act or operated under the University of Illinois Hospital Act, depending on the value of qualified services provided
- New York and Pennsylvania: exemption for retail sales to hospitals that qualify as charitable organizations
Health care entity exemptions – Texas

- Purchases of taxable items by nonprofit hospitals are exempt if the items are sold, leased, rented, stored or consumed for the exempt purpose of the qualifying hospital or hospital system and are not used for the personal benefit of a private stockholder or individual.

- A nonprofit hospital or hospital system shall provide community benefits that include charity care and government-sponsored indigent health care.

- The application form to complete includes submission of a copy of the IRS determination letter.
Health care entity exemptions – updates

► Connecticut: Special Notice No. 2014(3) (07/30/2014)
  ► From July 1, 2014 to June 30, 2017: The sale of tangible personal property or services to and by an acute care hospital operating as a sole community hospital for its exclusive purposes is exempt from sales and use tax.

► Oklahoma: Oklahoma Letter Ruling No. LR 13-044 (09/17/2013)
  ► Hospitals, clinics and similar institutions, as well as physicians, are considered the end users or consumers of all tangible personal property and services used in the provision of health care services, unless the provider holds an Oklahoma direct pay permit.
  ► This applies to medical products, durable products, replacement parts, and labor and warranty.
Product-based exemptions
Product-based exemptions

States may exempt items from sales and use tax depending on what the product is:

- Drugs
- Devices

Some states attempt to administratively apply “use-based” restrictions to “product-based” exemptions by denying exemptions when purchased by care providers.

- Prescription drugs – who is purchaser? If hospital or provider, exemptions may not always be respected
- Health care regulatory framework can be leveraged to defend or claim exemptions
Federal legend classification

- Caution: federal law prohibits dispensing without a prescription or Rx only:
  - Drugs
  - Devices
- Exemptions requiring prescription:
  - Sales to providers vs sales to patients
  - Structure and function tests (replaces a missing part of the body)
  - Curative properties tests (treats disease, affects physical condition, and not diagnostic or anesthetic, etc.)
The United States Pharmacopeia and National Formulary listings

- Exemptions: statutory and regulatory references
  - United States Pharmacopeia
  - National Formulary
  - Supplements thereto
- State Controlled Substances Act definitions
  - Commonly refer to national standards
- Taxability determinations, audits, ruling requests, abatements
Federal classification impacts

- Missouri Private Letter Ruling No. LR 7360, February 6, 2014
  - Tumor-treating fields therapy is held not qualifying as a prescription drug for tax-exempt purposes in Missouri because the Food and Drug Administration classifies it as a device under federal law.

  - Sale of an intrauterine contraceptive device is not exempt as durable medical equipment (DME), but is nevertheless exempt due to federal classification as a prescription drug.
States with streamlined sales taxes

- Uniformly defined terms and exemption administration
  - Prosthetic device – a replacement, corrective or supportive device worn on or in the body, including repair and replacement parts, to:
    - Artificially replace a missing portion of the body
    - Prevent or correct physical deformity or malfunction
    - Support a weak or deformed portion of the body
  - Durable medical equipment is:
    - Equipment that can withstand repeated use
    - Primarily and customarily used to serve a medical purpose
    - Generally, is not useful to a person in the absence of illness or injury
    - Not worn in or on the body
States with streamlined sales taxes

► Uniformly defined terms and exemption administration
  ► Drug – compound, substance or preparation, and any component of a compound, substance or preparation, other than “food and food ingredients,” “dietary supplements” or “alcoholic beverages”:
    ► Recognized in the official United State Pharmacopeia, official Homeopathic Pharmacopeia of the United States or official National Formulary, and supplement to any of them
    ► Intended for use in the diagnosis, cure, mitigation, treatment or prevention of disease
    ► Intended to affect the structure or any function of the body
  ► Mobility-enhancing equipment:
    ► Primarily and customarily used to provide or increase the ability to move from one place to another and which is appropriate for use either in a home or a motor vehicle
    ► Is not generally used by persons with normal mobility
    ► Does not include any motor vehicle or equipment on a motor vehicle normally provided by a motor vehicle manufacturer
States with streamlined sales taxes

- Streamlined Sales and Use Tax Agreement (SSUTA) Health Care Item List (product-specific classifications)
- SSUTA Health Care Item List Addendum
Marketplace Fairness Act of 2013 (MPFA)

- Would allow the state to require sales and use tax collection by remote retailers that lack physical presence if the state:
  - Is a streamlined sales tax full-member state
  - Adopts and implements minimum simplification requirements set forth by the MPFA
  - Contains a small-seller exception
- If passed, MPFA would allow states to require sales and use tax collection by “remote sellers” with more than $1 million in annual “remote sales”
- Passed in the Senate on May 6, 2013 (69 to 27)
- Political division?
  - Not Democrat vs Republican but sales tax states vs non-sales tax states
Potential SSUTA benefit erosion due to MPFA “minimum simplification” alternative

- The MPFA is directed at “remote retailers” but the minimum simplification option is likely to erode state conformity with the SSUTA.
  - Uniformly defined terms
  - Uniform sourcing
  - Uniform exemption administration
  - Uniform certificates and returns
  - Bundled transactions limits on caps and thresholds
  - Tax holidays
  - Rounding
  - Refunds requirements
  - Controversy resolution options (Compliance Review and Interpretations Committee (CRIC), Governing Board (GB) sanctions)
At-risk SSUTA benefits specific to health care and health sciences industries

- Uniformly defined terms and exemption administration (prosthetics, drugs, prescription, DME, mobility enhancing equipment (MEE), dialysis, enteral feeding, insulin, med. oxygen, over-the-counter (OTC), Medicare, etc.)
  - SSUTA Health Care Item List (product-specific classification)
  - SSUTA Health Care Item List Addendum
- Bundled transactions (50% rule on drugs, DME, MEE, OTC drugs, medical supplies), e.g., “kits, packs, trays”
- Uniform Exemption Certificates
  - No “good-faith” requirement for vendors:
    - Limits potential audit exposure of sellers
    - Flexibility to providers on entity and use-based exemptions (Medicare and Medicaid)
      - Facilitates Health Insurance Portability and Accountability Act compliance
Use-based exemptions
Use-based exemptions

- Exemptions based on how the product is used
- Exemptions requiring prescriptions
- Medicare and Medicaid
  - Exemption may be limited to certain products provided to recipients of Medicare or Medicaid benefits
  - Paid directly by Medicare or Medicaid vs reimbursed
- Exemptions may be based on a product’s function; for example:
  - Tennessee: a prosthetic must replace, correct or repair a portion of the body, and DME only qualifies if it is for home use and sold pursuant to a prescription
Use-based exemptions

- **OTC drugs used pursuant to a prescription:**
  - **Michigan:** Sales of over-the-counter drugs for human use pursuant to a prescription are exempt from sales tax.
  - **NJ:** Division of Taxation has proposed amendments to rules on medical equipment and drugs to clarify when purchases are not subject to sales and use taxes.
  - **Colorado:** All sales of nonprescription drugs or materials when furnished by a licensed provider as part of professional services provided to a patient are exempt from sales tax.
  - **Tennessee:** OTC drugs are exempt from sales and use tax when sold for human use and dispensed pursuant to a prescription.
Use-based exemptions

- States may try to re-characterize product-based exemptions as use-based exemptions.
- Used to treat malady, injury or illness?
  - Alabama: Any items “used for the treatment of illness or injury or to replace all or part of a limb or internal body part purchased by or on behalf of an individual pursuant to a valid prescription and covered by and billed to Medicare, Medicaid, or a health benefit plan” are exempt from sales tax.
  - New York: Drugs and medicines intended for use in the cure, mitigation, treatment or prevention of illnesses or diseases are exempt from sales tax.
Federal drug/device approvals

► 510K device approvals
  ► Approved uses
  ► Off-label uses

► Center for Drug Evaluation and Research (CDER)
  ► Approved uses (new drug application (NDA))
  ► Off-label uses:
    ► Proper characterization is critical to proper tax treatment
    ► Navigate various state exemption constructs
    ► Product-based vs use-based distinctions
State exemptions tied to Medicaid or Medicare programs

Source: Multistate Associates
Variations

- Even when focusing only on states that refer to these federal programs for purposes of defining exempt products, there are wide variations:
  - Medicaid vs Medicare
  - Part A vs Part B
  - Reimbursed vs paid for by government
  - Drug vs device
Sales and use tax strategic opportunities
Strategic opportunities

- Manufacturing classification opportunities:
  - CT scans and x-rays
  - Dialysis centers – blood processing, water purification
  - Assembly of prosthetic devices
  - Compounding drugs
- Structure planning – procurement companies
- *Nortel* and *Lucent* cases
Nortel Networks case

- California Court of Appeal held that software licensed to operate switching equipment was exempt from sales tax under the state’s Technology Transfer Agreement (TTA) statute.
California Superior Court held that software agreements (licenses) to operate telephone switching equipment were exempt from sales tax as a matter of law under the state’s TTA statute.

It relied on *Nortel* decision.

Ernst & Young LLP is actively filing refund claims for health care clients based on the *Lucent* decision.

There is an urgency in filing claims due to potential for retroactive legislation.
Excise taxes
Medical device excise tax (MDET) update

- Enacted as part of the Patient Protection and Affordable Care Act, the MDET imposes on manufacturers, importers and producers a tax at a rate of 2.3% of the price of the first sale or use of medical devices in the United States, effective January 1, 2013.
- It is expected to bring in nearly $30 billion in tax revenue over 10 years.
- Issues for providers:
  - Separately stated excise tax on invoices for purchases of medical devices
  - Price increases for medical devices post-2013
  - Importer liability
Fuel tax

- Certain states, such as New York, have exemptions for purchases by qualified hospitals and health care providers for all uses.
- Most states allow ambulances and other emergency vehicles to purchase tax-free fuel:
  - If the tax is paid, a refund would be available in the states that allow tax-free purchases.
  - Keep in mind that many states will tax fuel purchases, where state excise tax refunds are sought, under the sales and use tax code. However, since some states do not impose sales tax on nonprofit health care businesses, the sales tax is not required to be remitted on those purchases.
- Consider other uses:
  - With hospital generators: Is dyed diesel being used? Was sales tax remitted on the purchase?
- Qualified blood collector organizations:
  - Qualified blood collector organizations, with the appropriate federal registration, are not subject to federal fuels excise taxes.
Excise tax on vaccines

- Federal excise tax is imposed on certain vaccines sold by the manufacturer, or the importer, in the US.
- Tax is imposed on a per-dose instance, so one vaccine can contain multiple taxable doses, each taxed at the $0.75 rate.
- Manufacturers and importers pay the tax on the Form 720 on a quarterly basis.
- Key exemptions:
  - No tax is applied if the sale is for further manufacture.
  - No tax is applied if the vaccine is exported.
  - The tax becomes refundable if the vaccine is returned or destroyed.
  - Claims must be made within six months of the return date or the destruction date.
Air transportation excise taxes

- Air transportation excise tax is imposed on the amount paid for taxable transportation by air of people (7.5%) or property (6.25%).
- Exemption is provided under Section 4261(g) for air transportation for the purpose of providing emergency medical services by helicopter or fixed-wing aircraft equipped for and exclusively dedicated on that flight to acute care emergency medical services.
- PLR 201010010: charter flights to an organ recovery site and from a recovery site back to the transplant site are exempt under Section 4261(g).
- Several considerations are involved if a refund is sought.
Foreign insurance taxes
Patient-centered outcomes research fee

- Foreign insurance taxes
  - Excise tax on amount of premiums paid on policies issued by foreign insurers
  - Paid by the person who pays premium to the foreign insurer or to any nonresident person, such as a foreign broker; otherwise, any person who issued or sold the policy or who is insured under the policy is required
  - Must pay the tax and file a Form 720 (quarterly) to the IRS

- Patient-centered outcomes research fee
  - Fee imposed on plan sponsors of applicable self-insured health plans, based on amount per average number of lives covered under the policy for that policy year (three methods to determine lives)
  - File Form 720 annually to report and pay the fee on the second quarter Form 720 of the year following the last day of policy year
Questions?
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