26th Annual Health Sciences Tax Conference

Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?

December 7, 2016
Disclaimer

- EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

- This presentation is © 2016 Ernst & Young LLP. All rights reserved. No part of this document may be reproduced, transmitted or otherwise distributed in any form or by any means, electronic or mechanical, including by photocopying, facsimile transmission, recording, rekeying, or using any information storage and retrieval system, without written permission from Ernst & Young LLP. Any reproduction, transmission or distribution of this form or any of the material herein is prohibited and is in violation of US and international law. Ernst & Young LLP expressly disclaims any liability in connection with use of this presentation or its contents by any third party.

- Views expressed in this presentation are those of the speakers and do not necessarily represent the views of Ernst & Young LLP.

- This presentation is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide tax advice to any taxpayer because it does not take into account any specific taxpayer’s facts and circumstances.

- These slides are for educational purposes only and are not intended, and should not be relied upon, as accounting advice.
Presenters

▸ Nancy Rapisarda
Baystate Health
Springfield, Massachusetts

▸ Robert Vuillemot
Ernst & Young LLP
Pittsburgh, Pennsylvania
robert.vuillemot@ey.com
+1 412 644 5313

▸ Diane L. Bean
Ernst & Young LLP
Columbus, Ohio
diane.bean@ey.com
+1 614 232 7136
Agenda

► Background
► Consequences of the 2016 election
► Internal Revenue Service activity
► Congressional activity
► State and local activity
Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?
The ground on which hospital exemptions are based is shifting

► The distinction between taxable and tax-exempt health systems is becoming increasingly blurred.
► The “halo effect” of tax-exempt status has diminished, and reputational risk has increased because of scrutiny from legislators, media and others.
► Federal, state and local governments are actively seeking new sources of revenues and re-evaluating “tax breaks.”
Post Affordable Care Act (ACA) decrease in percentage of uninsured Americans

The ACA has resulted in a shrinking uninsured population, which weakens a key justification for tax exemption.

Recent press from across the nation

Donald Trump elected President of the United States (2016)

New Jersey revokes property tax exemption of nonprofit hospital (2016)

Massachusetts Attorney General reviews large public charities’ CEO compensation and calls for additional reporting and review (2013)

Treasury promulgates new 501(r) Regulations (2014)

Internal Revenue Service (IRS) denies exemption to accountable care organization (2016)

IRS revokes 501(c)(3) status but grants 501(c)(4) status to health maintenance organization (HMO) (2015)

New Alabama legislation requires entities exempt from sales tax to obtain an annual certificate and provide information about transactions (2015)

Pennsylvania Supreme Court invalidates exemption standards more lenient than the state constitution permits (2012)
Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?

Consequences of the 2016 election
Changes to health care and tax policy

► Trump campaign proposals
  ► Repeal and replace the ACA
  ► Individual, corporate and international tax reform with significantly lower rates

► Congressional proposals
  ► House Ways and Means — “A Better Way” Blueprint
  ► At least six different proposals to replace the ACA

► Uncertainty around potential repeal of the ACA
  ► Will Section 501(r), which enjoyed bipartisan support, survive?
  ► Repeal of Medicaid expansion — possible block grants to the states
  ► Repeal of the Cadillac tax and the medical device excise tax
  ► Fate of the exchanges, individual and employer mandates and employer reporting requirements
IRS activity
First IRS report to Congress on community benefit (2015)

Based on 2011 data

- Charity care provided based on Centers for Medicare and Medicaid (CMS) data:
  - Tax-exempt hospitals: 2.13% of total expenses
- Unreimbursed costs for services provided by means-tested programs based on CMS data:
  - Tax-exempt hospitals: 1.94% of total expenses
- Total community benefit expenses provided by tax-exempt hospitals: 9.67% of total expenses
Second IRS report to Congress on community benefit (2016)

► Based on 2012 data

► Charity care provided based on CMS data:
  ► Tax-exempt hospitals: 2.22% of total expenses

► Unreimbursed costs for services provided by means-tested government programs based on CMS data:
  ► Tax-exempt hospitals: 1.97% of total expenses

► Total community benefit expenses provided by tax-exempt hospitals: 9.84% of total expenses
IRS Tax-Exempt and Government Entities Division (TE/GE) exam selection

- TE/GE has developed a data-driven case selection model that uses approximately 190 different queries of Form 990 data.
  - The model is used to identify organizations at highest risk of non-compliance.
  - It is less focused on market segment compliance projects.
  - The model was tested during 2015 and produced a 90% change rate.
  - The model is being more widely adopted for 2016.
- Data model would look at items such as:
  - Payroll expense
  - Number of independent contractors
  - Unrelated business income (UBI) reported on Form 990 but no Form 990T filed
IRS Tax-Exempt and Government Entities Division (TE/GE) exam selection

- Shift of resources from Exempt Organizations (EOs) determinations to Exempt Organizations examinations
  - 15 to 20 EO tax law specialists
- Less field exams, more correspondence exams
- Examinations of tax-exempt organizations are set to increase by approximately 10% in 2016
- Revocations of 501(c)(3) tax-exempt status are increasing
IRS exemption revocations due to audit are increasing after years of decline

Approximately 5,000 EO examinations completed in FY 2016
- 2,109 of these examinations involved filing, organizational or operational issues
- 1,323 involved employment tax issues
- The other primary issues were unrelated business income (611); discontinued operations modifications/revocation (195); inurement/private benefit (192); political, legislative, governance (59); and other (495)
IRS 501(r) exam activity

- Approximately 700 reviews completed in FY16, with 166 referred for field examinations
- Agents have been trained and are currently conducting examinations, typically asking for:
  - Policies and reports with documentation of approval and dates
  - Persons knowledgeable about soliciting community input for Community Health Needs Assessments (CHNAs)
  - Proof of availability of required signs and notifications
  - Amounts generally billed (AGB) workpapers
  - Records of charges to financial assistance policy (FAP)-eligible individuals
  - Copies of notices sent to patients who were subject to extraordinary collection actions
  - Contracts with collection agencies
  - Complaints the hospital has received regarding 501(r) areas
Examinations of tax-exempt organizations to focus on five strategic areas:

- **Exemption**: Issues include non-exempt purpose activity and private inurement, enforced primarily through field examination.
- **Protection of assets**: Issues include self-dealing, excess benefit transactions and loans to disqualified persons, enforced primarily through correspondence audits and field examination.
- **Tax gap**: Issues include employment tax and unrelated business income tax liability, enforced through compliance checks, correspondence audits and field examination.
- **International**: Issues include oversight on funds spent outside the US, including funds spent on potential terrorist activities, exempt organizations operating as foreign conduits, and Report of Foreign Bank and Financial Accounts (FBAR) requirements, enforced through compliance reviews, compliance checks, correspondence audits and field examination.
- **Emerging issues**: Issues include non-exempt charitable trusts and Internal Revenue Code (IRC) 501(r), enforced through compliance reviews, correspondence audits and field examination.
IRS TE/GE tax-exempt bonds: update

► 2007: IRS initiates “soft-contact” compliance checks
► 2008: Introduction of Schedule K
► May 2011: Advance refunding compliance checks
► June 2011: IRS releases draft 2011 Schedule K — asks about written procedures
► August 2011: Revised Voluntary Closing Agreement Program (VCAP) procedures — encourages written procedures
► October 2011: IRS discloses plan to audit nonprofits based on Schedule K filings
IRS TE/GE tax-exempt bonds: update

- Currently: approximately 65 employees in tax-exempt bonds (TEBs)
  - Numbers are down
  - 38 examination agents and 27 law specialists
- Focused exams
  - Small hospitals
  - Sports-affiliated venues
  - Solid waste disposal bonds
  - Advance refundings with variable yields
- Data mining from Schedule K filings for audit selection
- Internal Revenue Manual (IRM) revised but “robust” written procedures still result in favorable exam treatment (timing of VCAP is evidence of robust procedures more so than a written document)
IRS 501(c)(4) HMO determination ruling (Private Letter Ruling (PLR) 201538027)

► Background: A 501(c)(3) holding entity was merged with a 501(c)(4) arranger HMO. The 501(c)(3) entity was the remaining entity. It sought to retain its 501(c)(3) status. The IRS examiner determined that the entity did not qualify for exemption under either 501(c)(3) or 501(c)(4), relying on the IHC Health Plans and Vision Service Plan cases.

► Mere arrangement of care services was said to not meet the community benefit standard or promote social welfare.

► Although the IRS denied the HMO 501(c)(3) exemption, it recognized the entity as tax-exempt under 501(c)(4) without explanation.
Accountable care organization (ACO) — IRS denial of 501(c)(3) exemption application (PLR 201615022)

► ACO formed a clinically integrated network of health care providers to further the “Triple Aim” reform goals of the ACA:
  ► Reducing cost of health care for individuals
  ► Improving patient access to care and quality of care
  ► Improving population health and patient experience

► IRS denied 501(c)(3) exemption because ACO negotiated agreements between payors and providers not affiliated with ACO’s health system
  ► IRS noted that this activity conferred an impermissible private benefit to providers not affiliated with the health system
  ► IRS also noted that ACO would not have qualified as a supporting organization so it would have been classified as a private foundation if exempt

► First IRS guidance regarding ACOs that do not participate in the Medicare Shared Savings Program (MSSP)
  ► Notice 2011-20: MSSP ACOs serving Medicare patients may qualify for exemption
Congressional activity
Congressional activity

► Senator Charles Grassley continues active oversight:
  ► Began investigating Mosaic Life Care hospital in 2015 as a result of media reports on its collection practices
  ► Investigation resulted in significant operational changes and forgiveness of $16.9 million in patient debt
  ► Media outlets identified similar activity by Deaconess Hospital, which then reconsidered its policies
  ► May 24, 2016, letter to Finance and Judiciary Committee members noting these events and promoting “vigorous oversight” to find and fix other examples of abuse
  ► June 9, 2016, letter to IRS noting these events and inquiring about IRS findings of non-compliance and enforcement actions
State and local activity
State and local activity: Florida

- Nationwide, a trend of “decoupling” state and local tax exemptions from federal exemption
  - Governor Rick Scott’s invitation to Yale to move to Florida and escape threats of taxation
  - Governor Scott’s statements on hospital revenue and pricing
- Interest in “payments in lieu of tax” (PILOTs) is growing nationwide
  - Florida Supreme Court is considering whether they can be enforced (AHF-Bay Fund, LLC v. City of Largo)
- 2014 amendments to Florida sales tax exemptions allowing disqualifications based on certain violations
- Property tax assessors focus on “charitable use,” particularly if property is being used wholly or in part for non-charitable uses
  - Special focus on medical office buildings
  - County assessors vary significantly in their inclination to be aggressive
State and local activity: New Jersey

► *Atlantic Health System v. Morrison, New Jersey*
  ▶ Judge noted both nonprofit and for-profit activities of the hospital
  ▶ Stated that the current hospital is very different from original charity intention and that current designation was a legal fiction
  ▶ Hospital and town settled; New Jersey legislature took action, which was vetoed by Governor Chris Christie
State and local activity: West Virginia

► United Healthcare Foundation and Dorothy McCormack Center
  ► Cancer treatment facility in an underserved area running at a loss
  ► State law says any for-profit rentals jeopardize property tax exemption
  ► Court ruled in favor of the hospital, but State of West Virginia is appealing
State and local activity: Pennsylvania

- General Assembly (GA) and state Supreme Court debate which body can grant exemptions
- Pennsylvania constitution says GA can grant exemptions for “purely public charities”
- Court applied this to narrow the power of the GA
- GA passed legislation to change definition of “purely public charities” but the Court struck this down; GA attempted to amend Pennsylvania constitution but looks like it will not succeed
State and local activity: Pennsylvania

► Court said City of Pittsburgh could not try to collect payroll tax from hospital parent organization for each of its subsidiaries
► Court did not say trying to collect the tax was wrong, but that the city would have to try to collect from each subsidiary instead of the overall parent
State and local activity: Illinois

- Was holding hospitals to rigorous five-point test
- Amended statute so that charity care needs to exceed property tax due
- Hospital and town now disputing whether that statute was constitutional and for which tax years it should apply
Questions?
About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2016 Ernst & Young LLP.
All Rights Reserved.

1608-2011220

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.