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Hospitals Take Heed: Gradual Evolution of the IRS' Position on Tax Exemption

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There has been much fanfare, but little discussion, among healthcare experts in the United States regarding the Internal Revenue Service recently published PLR 201731014 (the **Letter Ruling**). The Letter Ruling provides a good opportunity to review where we have come and where we are going in the tax-exempt hospital industry in America.

Let's focus first on the Internal Revenue Service. For years, the IRS was flummoxed by the tax-exempt hospital industry that, at one time, made up more than 80% of the hospital providers in the United States. The Service simply had no method of regulating tax-exempt hospitals short of rescinding the tax-exempt status of hospitals and, therefore, the survivability of the hospital. Tax-exemption was the essential pre-condition to the access of tax-exempt financing that is the best reliable source of capital for rejuvenation and expansion of hospital facilities. The only other pool of funds for capital available to tax-exempt hospitals is donations that, while sometimes significant, are not, on balance, a reliable source of capital for a functioning hospital.

The Service's one weapon was enormous but carried with it the risk of significant collateral damage. More often than not, hospitals are economic engines and social keystones of a community. Rescind, or so the logic held, tax-exempt status and one rescinds the hospital's survivability. Rescind the hospital's ability

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to survive and, as the tautology goes, unintentionally punish the community for the sins of the hospital's leadership. The risk of collateral social damage effectively made the Service's weapon useless.

As a result, the Service has chosen to manipulate the behavior of entities granted tax-exempt status through the selective and broad publication of "instructional position papers" like revenue rulings and, in the instant case, the Letter Ruling. Audits are time and resource intensive. Without a range or penalties or *individual* accountability, the Service appeared to believe that enforcement was compromised. Accurate or not, the Service was reluctant to use its enforcement authority and its frustration initially culminated in the publication of the Hermann Hospital Closing Agreement in October, 1994.

The Service identified and catalogued the inappropriate behavior by Hermann and its medical staff and identified the fines that would be imposed *by agreement of Hermann* (as the IRS's ability to impose the fines was somewhat in doubt). In return, Hermann could retain its tax-exempt status. To the Service's credit, the industry seized on the instructional guidance of the Hermann Closing Agreement and began to make changes.

The Hermann Closing Agreement was followed by additional "guidance" from the Service inclusive of Revenue Ruling 97-21 and Revenue Ruling 98-15 (the latter more pointed on hospital joint ventures) and, of course, a series of CPE (Continuing Professional Education) texts by the EP/EO Division. The culminating achievement for the Service was the passage of Section 4958 of the Internal Revenue Code of 1986 on or about 1998 and the corresponding regulations at Treas Reg. 53.4958-1 et seq. addressing, for the first time, intermediate sanctions and the rights of the Service to seek out and fine individual officers and Board members who authorize transactions with "disqualified persons" of the ilk found in the Hermann Closing Agreement.

More recently, the Service has continued to review and more tightly regulate the tax-exempt hospital industry. Changes in the Form 990 (the annual informational return filed by tax-exempt hospitals) regarding reporting of relationships between the tax-exempt hospital and its Board members, employees and agents have been extraordinary. Likewise, the Patient Protection and Affordable Care Act have extraordinary conditions that require tax-exempt hospitals to limit patient collection activities, grant financial assistance to qualifying patients at or below 200% of the Federal Poverty Level and undertake regular Community Health Needs Assessments.

Although borrowed from an IRS playbook from the 90's, the latest Letter Ruling is a continuation of the Service's "education" of the tax-exempt hospital industry. Not surprisingly, tax-exempt hospitals compose closer to 60% of the hospital providers in the United States today, which is a sea change of extraordinary proportions in the two decades since the Hermann Closing Agreement. In the Letter Ruling, the taxpayer in question had failed to meet its new obligations arising out of Obamacare. As a governmental entity and, therefore, already insulated from Federal income tax, the taxpayer in the Letter Ruling willingly surrendered its tax-exempt status under Section 501(c)(3) of the Code as it desired to avoid the cost in dollars and time necessary to comply with regulations that were and are focused on the tax-exempt hospital industry. That factor *was* lost amidst the flurry of writing about the new "pressure" on tax-exempt hospitals. It's not new pressure. It's just one more brick on the horse cart to which the tax-exempt hospital industry has been hitched for the past two decades. The reality is, we should expect more bricks.

To describe the Service's rules regarding tax-exemption as confusing would be, well, charitable. Competent legal counsel should be consulted for guidance and business practices in this arena.