UBIT Issues for Today’s Healthcare Organizations

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Scope of Presentation

- Part I - Quick Review of the Basics (IRC 501, 511, 512, 513, and 514)
- Part II - The Patient-Nonpatient Rule – From Traditional Settings to Today’s Telemedicine
- Part III – Transactions Between Unrelated 501(c)(3) Hospitals
  - IRC 513(e)’s “Small” Hospital Rule
  - Consulting and Education Arrangements
  - Licensing of Intellectual Property
- Part IV - Joint Ventures and Joint Operating Agreements
- Part V - Allocation of Expenses
  - Financial, UBIT and Bond Implications
- Part VI - Questions
Part I - Quick Review of the Basics

- IRC 501(a) and IRC 501(c) exemption
- IRC 501(c)(3) purposes and other tests
- IRC 501(b) subject to UBIT
- IRC 511(a) and IRC 11 tax UBTI at 35%
- IRC 512(a) unrelated trade or business regularly carried on
- IRC 513 unrelated trade or business defined
- IRC 512(b) modifications to UBIT
- IRC 512(b)(13) add backs for controlled affiliates
- IRC 514 add backs for debt-financed property

Which Lady Best Personifies “the UBIT Rules”?
IRC 501(a), (b), (c)(3) and “the UBIT Rules”

IRC 513(a) - The General Rule
Three Basic Questions

1 - Do the activities constitute a trade or business?
   - Revenue from producing goods, distributing goods, performing services
   - An organization can have multiples trades or businesses
     - Some related, some not
     - Allocate income and expense

2 - Is the trade or business regularly carried on?
   - Not often much of an issue for health care organizations

3 - Is the trade or business “substantially related” to the organization’s exempt purpose?
   - Where the rubber usually hits the road
Are the Activities “Substantially Related”?

- Reg. 1.501(c)(3)-1(e)(1)
  - May operate a trade or business as a substantial part of activities
  - Subject to two requirements
    - 1 - Activities be “in furtherance of” an exempt purpose; and
    - 2 – Not being operated for the “primary purpose” of carrying on an unrelated trade or business as defined in IRC 513
  - Facts and circumstances analysis on primary purpose
- What’s “in furtherance of” and how is it different from “substantially related to”?
  - Use of proceeds to subsidize charitable outputs
  - Activities directly accomplish the exempt purpose

IRC 512(b) – Modifications to UBTI

- Dividends exempt, but
  - At corporate level, payor taxed on income and on built in gain on distributed property
  - Potential add back for debt-financed property
- Interest exempt, but
  - Potential add back for controlled affiliates and debt financed property
- Rents from real property exempt, but
  - Incidental and percentage rents for personal property
  - Potential add back for controlled affiliates and debt financed property
- Royalties exempt, but
  - Potential add back for controlled affiliates and debt financed property
  - Separating fee for services from royalty for use of IP
IRC 512(b)(4) – Interest, Royalty, Rents, Gain and the Debt-Financed Property Rules

- Does it make a difference if buy assets with cash or debt?
  - It just might
  - E.g., if buy stock with “acquisition indebtedness,” the “leveraged” portion of dividends or gain on sale potentially subject to UBIT

- Substantially related use and UBTI
  - 85% related = 100% excluded from UBIT
  - Less than 85% = proportional exclusion from UBTI

- UBIT “taint” not permanent
  - Decreases as leverage decreases
  - Disappears after leverage gone

What is “Acquisition Indebtedness”?

- First, has to be “indebtedness”
- Second, has to be “acquisition indebtedness” incurred
  - 1 - At the time of the acquisition
  - 2 - Before the acquisition if wouldn’t have been incurred but for the acquisition
  - 3 - After the acquisition if wouldn’t have been incurred but for the acquisition and was reasonable to foresee at the time would have to borrow more
  - 4 - Any mortgage or other lien encumbering property to extent of the lien
IRC 512(b)(13) – Payments from Controlled Affiliates

- Control = more than 50%
- Interest, royalties, rents added back
- Except to extent affiliate’s use = substantially related if carried on by controlling organization
- FMV exception for certain payments
  - Binding contract 08-17-06
  - Received after 2005 and before 2012
  - Extender for 2012?

Research - Exclusion of Income and Expense

- IRC 512(b)(7)—
  - Research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof;
- IRC 512(b)(8)—
  - In the case of a college, university, or hospital, all income and expense derived from research performed for any person;
- IRC 512(b)(9)—
  - Where organization is operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, exclude all income derived from research performed for any person, and all deductions directly connected with such income.
Part II – The Patient-Nonpatient Rule – From Traditional Settings to Today’s Telemedicine

Teaching Activities

Rev. Rul. 85-109, 1985-2 CB 165
Lab sales to nonpatients could be in furtherance of exempt purposes.

“The Internal Revenue Service will follow that part of the decision in St. Luke’s Hospital of Kansas City v. United States, 494 F. Supp. 85 (W.D. Mo. 1980), holding that a teaching hospital which conducted nonpatient laboratory testing on specimens needed for the conduct of its teaching activities was not engaged in an unrelated trade or business where the outside testing services contributed importantly and substantially to the hospital's teaching program.”
The Patient-Nonpatient Rule

- IRC 513(a)(2) provides an exception to unrelated trade or business income when an activity is conducted for the convenience of an organization’s members, students, patients, officers, or employees.
- The questions then become who is a patient and who is a member?

Patient vs. Non-patient

- Rev. Rul. 68-376, 1968-2 CB 246 provides who is a patient and when pharmacy income is excluded under the “convenience” exception
  - Situation 1—A person admitted to a hospital as an inpatient.
  - Situation 2—A person receiving general or emergency diagnostic, therapeutic, or preventive health services from outpatient facilities of a hospital.
  - Situation 3—A person directly referred to the hospital's outpatient facilities by his private physician for specific diagnostic or treatment procedures.
  - Situation 4—A person refilling a prescription written during the course of his treatment as a patient of the hospital.
  - Situation 5—A person receiving medical services as part of a hospital administered home care program.
  - Situation 6—A person receiving medical care and services in a hospital-affiliated extended care facility.
Laboratory Tests on Private Patients

- Rev. Rul. 85-110, 1985-2 C.B. 166, an exempt hospital performed diagnostic laboratory tests upon specimens from private patients of physicians on the hospital's staff. The IRS held there was UBI where:
  - (1) the hospital was located in a metropolitan area containing commercial laboratories that performed identical tests;
  - (2) the testing did not involve equipment or procedures unique to the hospital; and
  - (3) the commercial laboratories were sufficiently close so that testing could be provided by those laboratories on a timely basis.

Lab income from Patients of Employed Physicians--PLR 8417002

"The only unrelated business taxable income derived from laboratory testing for staff physicians is income from laboratory testing done in connection with patient care where the income from such patient care is retained by the staff physician."

Scenarios:
- Hospital employs the physician
- Hospital controlled exempt organization employs the physician
- Hospital controlled taxable entity employs the physician
- Patient is patient of a hospital, but a hospital that is different than the one providing diagnosis and lab test.
Lab Fees from Joint Ventures

- PLR 9323030
  - Patients of separate entity (rehab hospital) partly owned and controlled by 501(c)(3) hospital
  - A proportionate share of the income was not UBI
  - Query: Would the result be changed by IRC 501(r) if the facility did not have the requisite policies in place?

Services Not Otherwise Available

Rev. Rul. 85-110, 1985-2 CB 166

--The performance of diagnostic laboratory testing, otherwise available in the community, by a hospital exempt from federal income tax under section 501(c)(3) of the Code, upon specimens from private office patients of the hospital's staff physicians constitutes an unrelated trade or business within the meaning of section 513.
Remote Patients

- Are the services not otherwise available?
- PLR 199943051—
  - Private foundation set-aside was qualified distribution under IRC 4942 where used for: home health care, telecommunication techniques, and wireless, physiologic monitoring through low cost video and phone lines will result in many health care benefits, including direct communication between rural, underserved areas and tertiary health care centers

Part III – Transactions Between Unrelated 501(c)(3) Hospitals
IRC 513(e) – Small Hospital Rule

- Both provider and recipient IRC 170(b)(1)(A)(iii) hospitals
- Three requirements
  - Recipient not more than 100 beds
  - Services = exempt function activities if performed by recipient, and
  - Fees not in excess of actual cost
- Services covered
  - Data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel services, including selection, testing, training, and education of personnel
- “Solely” and Reg. 1.513(e)-6(c) example
- Negative inference and Preamble Reg. 1.513(e)-6

Consulting and Educational Arrangements – PLR 201128028

- Organization sought 501(c)(3) status based on providing advisory and consulting services and licensing IP to other hospitals
  - Substantial non-exempt purpose denial, not UBIT
  - No discussion of “substantially related”
- Providing commercially available managerial, administrative, and advisory services not inherently charitable purpose
- American Campaign Academy - education and training not exempt because furthered private interest of employer, not individuals
- Comments regarding
  - Substantially all revenue from fees, not voluntary contributions
  - Not limiting clientele to exempt organizations or governmental organizations
Services and Licensing

- Contractual arrangements frequently involve both services and IP
- Different tax treatment of services and royalties
  - Income from services must directly accomplish the mission to be exempt
  - Royalty income almost always exempt
    - Controlled affiliates
    - Debt-financed property
- Transfer pricing study
- Separately value and price

Part IV – Joint Ventures and Joint Operating Agreements
Affiliation Through LLC or Partnership

- PLR 20112802 – arrangements don’t create partnership
- But, what if they do?
- IRC 512(c), Rev. Rul. 2004-51, Info Ltr 2005-0051
  - Considered to directly carry on proportionate share of JV activities
  - Help on the patient/nonpatient rule
  - Pass through of royalty income
- Level of Activity
  - Substantial activity, exemption risk
  - Insubstantial activity, “only” a UBIT risk
- Two-prong test
  - 1 – Express “charitable” purpose
  - 2 – Retain sufficient control

Affiliation Through Joint Operating Agreements

- Marv Friedlander – “What’s the fuss?”
  - Fees for support that is not direct provision of health care (e.g., management, fiscal, administrative services), usually subject to UBIT
  - Our old friend, IRC 513(e)
  - FY 1997 EO CPE Text, Virtual Mergers
- Virtual Merger
  - Participating entities retain separate existence
  - Create “super parent” (joint operating company)
  - Enter into JOA and related agreements
  - Delegate control over finance and operations to super parent
- Theory - Integral part doctrine
  - Financial integration under the JOA creates functional equivalent of parent-subsidiary relationships among the constituent organizations
  - Not UBTI but “merely a matter of accounting”
Part V - Allocation of Expenses
Financial, UBIT and Bond Implications

Focus on Allocation of Expenses

- IRS 2012 Workplan
  - "EO will be looking at organizations that report unrelated business activities on Form 990 but have not filed a Form 990-T. In addition, we will analyze Form 990-T data to develop risk models that will help us identify organizations that consistently report significant gross receipts from unrelated business activities but declare no tax due." (p.8)
  - The IRS is required to review the community benefit activities of hospital organizations at least once every three years.

- Risk areas
  - Large NOLs with no net UBI
  - Dual use of facilities, e.g. lab and pharmacy (page 9 Form 990)
  - Inconsistencies between Parts of Form 990, 990-T and Schedule K
  - ASC 740-10 (FIN 48)—Expense allocation is a tax position
Schedule K and Bond UBI Issues

- Schedule K asks whether there is any unrelated use or private business use of a bond financed facility (See IRC 145 that counts both private business use and unrelated use nonqualified use).
- If an organization allocates a portion of a building to unrelated business activity, that is documentation regarding the use of the proceeds.
- The allocation for purposes of offsetting UBI should be consistent with the amount reported as used for unrelated purposes for the bonds—private business use and unrelated use cannot exceed 5% of the bond proceeds, and when take into account 2% for costs of bringing bond to market, have only 3% left (look at use over the life of the bond).
- If have a private use of a bond financed facility, e.g., contract out the pharmacy to a private company, this may create UBI (see IRC 150(b)(3)).

Unrelated Trade or Business Expenses

- Trade or business requires a profit motive
- If there are losses from the activity on a continual basis, the IRS and the courts have taken the position that there is no profit motive and therefore the trade or business requirement has not been met.
- Portland Golf Club, 497 US 154(1990)
- Groetzinger, 480 US 23(1987)
- There may be a legitimate reason for the loss, as outlined in the IRS Compliance Questionnaire--Colleges and Universities
College and University Questionnaire
Possible Reasons for Losses

- **A**: Business was in start-up phase
- **B**: Actual costs were significantly greater than anticipated or budgeted
- **C**: Competitive pressures prevented pricing to allow for full recovery of costs
- **D**: Less demand for product or service than was projected
- **E**: Business was in business cycle downturn
- **F**: Budgeted to operate at breakeven or a loss because doing so contributed to the organization’s exempt mission
- **G**: Business was in winding-up phase
- **H**: Other.

Item Must Be Deductible under IRC

- Ordinary and necessary (IRC 162)
- Cannot just take numbers off the Medicare Cost Report (39843 (04/15/91)
  - Capitalization versus deductions
  - Depreciation schedules
  - Nonqualified deferred compensation
  - Bad debt allowances versus direct write-offs
  - Fifty percent of business meals
  - Overhead items
Three Baskets of Expenses

- Directly connected to UBI activity—proximate and primary—deduct in full
- Exempt/related expenses—do not deduct at all
  - E.g., fundraising, CHNA
- Dual use—allocate on a reasonable basis

Reasonable Method

- More than one method may be reasonable and may not have to be the best
  - IRS will not litigate until regulations changed and "reasonableness" test is amended
Allocation of Overhead

- Gross receipts allocation method is never reasonable if users are charged different amounts.
- Example: Hospital laboratory
  - Different patients, whether patients of the hospital or patients of private physicians may be charged more or less depending upon the rate negotiated with the insurance company.

Caution

- Hospitals will be reviewed every three years for compliance with 501(r) requirements and the IRS will be looking at available documents including Forms 990 and 990-T.
- IRS has a workplan project to focus on organizations that file Form 990 with gross UBI and no net UBI on Form 990-T.
- Dual use of facilities such as for laboratories and pharmacies will come under scrutiny regarding allocation of expenses.
- Over-allocating dual-use expenses to unrelated uses can also have implications for tax exempt bonds.
Part VI - Questions and Discussion