I. BASICS OF § 501(c)(3) STATUS.

A. Exemption Generally.

A § 501(c)(3) organization is an entity that has been determined to be exempt from federal income taxation pursuant to § 501(a) of the Internal Revenue Code (“IRC”)\(^1\). While § 501(c) lists 29 different types of exempt status, § 501(c)(3) status is the most advantageous. Advantages of § 501(c)(3) status include:

1. Avoidance of federal (and generally, state) income taxes on net income from activities related to the organization’s exempt purposes.

2. Ability to receive charitable contributions that are deductible by donors for their own income tax purposes. (See Notice 2012-52 – IRS treats charitable contributions to a disregarded domestic single member limited liability company wholly owned and controlled by a U.S. charity as though the contribution were made to the charity.)

3. Qualification for grants from governmental and other charitable sources.

4. Ability to utilize tax-exempt bond financing.

5. Ability to offer certain employee benefit programs (e.g., tax-deferred annuities).

6. Exemption from federal (not state) unemployment taxes.

7. Qualification for preferential postal rates.

8. Depending on state and local law, exemption from state and local real and personal property taxes.

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* The presenters thank the many prior presenters who have contributed to this paper over the years.

\(^1\) All references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended.
9. Depending on state and local law, exemption from state and local sales and use taxes on purchases of goods and services.

B. **Qualification as § 501(c)(3) Organization.**

1. **Types of § 501(c)(3) Organizations.** § 501(c)(3) applies to a broad range of organizations, including those that are charitable, religious, educational or scientific in nature, and those that lessen the burdens of government.

   a. The “promotion of health” has been determined to constitute a charitable purpose. See Rev. Rul. 69-545, 1969-2 C.B. 117.

   b. Rev. Rul. 69-545 established the “community benefit” standard for exemption of healthcare organizations. Key criteria include:


      (2) Provision of hospital care for all who can afford to pay, including through Medicare and Medicaid.

      (3) Use of surplus funds to further exempt purposes.

      (4) Open medical staff.

      (5) Community board, *i.e.*, majority of board are independent community or civic leaders.

   c. Charity care, while not explicitly required by Rev. Rul. 69-545, often serves as a key indicator of community benefit. See, *e.g.*, FSA 200110030 (March 9, 2001).

   d. To be tax-exempt as charitable organizations under § 501(c)(3), hospitals are required to satisfy additional statutory requirements which were enacted in 2010 and codified as § 501(r).

2. **Basis for Exemption.** An organization may qualify for (c)(3) status either on a “stand-alone” basis (*i.e.*, on the basis of its own purposes and activities) or on the theory that it constitutes an “integral part” of the exempt activities of another (c)(3) organization. See Treas. Reg. § 1.502-1(b); GCMs 39830 and 39508; Geisinger Health Plan v. Commissioner, 100 TC 394 (1993), *aff’d* 30 F.3d 494 (3d Cir. 1994).

3. **Organizational Test.**

   a. Organization must be organized exclusively for one or more exempt purposes. Generally must be formed as a nonprofit or nonstock entity under applicable state laws. See, *e.g.*, PLR 200714027 (HMO organized as for-profit entity did not qualify for
exemption under §501(c)(4); incorporation as a for-profit does not preclude (§501(c)(3)) tax-exemption, but may create “adverse implication”. Debs Memorial Radio Fund, Inc. v. Commissioner, 3 T.C. 949 (1944)).

b. Must be organized as a corporation, association, trust, foundation, or community chest.

(1) A limited liability company that is wholly owned by a single exempt organization (exempt under IRC 501(a)) may be disregarded as an entity separate from its owner. Ann. 99-102, 1999-43 I.R.B. 545. In fact, under Treas. Reg. § 301.7701-3(b)(1), a single-member limited liability company is disregarded for tax purposes unless it elects otherwise.

(2) A domestic single-member limited liability company may obtain standalone (c)(3) status if it elects to be classified as an association or by claiming exemption as an entity separate from its owner (e.g., filing Form 990 or Form 1023). See also 2000 and 2001 EO CPE Text, McCray and Thomas, “Limited Liability Companies as Exempt Organizations” and “Limited Liability Companies as Exempt Organizations Update” at http://www.irs.gov/pub/irs-tege/eotopicb01.pdf

c. Organizational documents (generally, articles of incorporation):

(1) Must limit the purposes of the organization to one or more exempt (§ 501(c)(3)) purposes.

(2) Must not expressly authorize the organization to engage in activities that do not substantially further one or more exempt purposes.

(3) Must provide that, upon dissolution, the organization’s assets will be dedicated to an exempt purpose (i.e., that the assets will be distributed only to other (c)(3) organizations or governmental bodies).

See § 501(c)(3) and Treas. Reg. § 1.501(c)(3)-1(b).

d. However, not every activity related to healthcare furthers an exempt purpose. See Federation Pharmacy Services, Inc. v. Commissioner, 625 F.2d 804 (8th Cir. 1980).

(1) See also, e.g., PLR 201128028 (7/15/11), where the IRS considered exemption for a newly-formed affiliate of a large health system. The affiliate was formed to provide consulting and advisory services to unrelated hospitals in over 70 countries around the world, in areas such as
organization and leadership, patient care and quality, nursing, medical staff matters, information technology, etc. The IRS denied exemption, drawing a distinction between:

(a) Ownership and operation of healthcare facilities (that meets the § 501(c)(3) purposes), versus

(b) Provision of management, advisory and consulting services.

4. Operational Test.

   a. Organization must be operated exclusively for one or more exempt purposes, i.e., it must engage “primarily” in activities that further its exempt purpose or purposes.

      (1) In addition, if an organization engages in activities that are not in furtherance of any exempt purpose, it must do so only to an insubstantial degree. Moreover, it may have to pay taxes on income derived from such activities (see the discussion of unrelated business taxable income below). See Treas. Reg. § 1.501(c)(3)-1(c)(1).

      (2) If an activity is not in furtherance of an exempt purpose, the organization must be prepared to show that it is merely “incidental” to its primary (exempt) activities. IRS will look at:

         (a) The amount of income derived from the activity in comparison to total income.

         (b) The amount of expenditures for the activity in comparison to total expenditures.

         (c) The amount of time the organization’s employees devote to the activity in comparison to total hours worked.

   b. Operational test is not met if either inurement or substantial private benefit is present.

      (1) Private Benefit. Organization must serve a public, rather than a private, interest. Class of persons served by the organization’s activities must be so broad as to be deemed the “public.” Any private benefit that results from the organization’s activities must be incidental, both quantitatively and qualitatively, to the public benefit resulting therefrom. See § 501(c)(3) and Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). See also Rev. Rul. 76-206, 1976-1 C.B. 154; Rev. Rul. 75-384, 1975-2 C.B. 204; GCMs 39862, 39598, 39498 and 37789; PLRs 9233037 and
(2) **Inurement.** A subset of private benefit. Organization’s earnings must not inure in whole or in part to the benefit of “insiders” (referred to as “disregarded persons” in the Code), i.e., persons having a personal and private interest in the activities of the organization (e.g., founders, directors, officers, key employees, or relatives thereof). Prohibition is absolute, i.e., cannot have even a de minimis amount of inurement (in contrast to private benefit). See Treas. Reg. §§ 1.501(c)(3)-1(c)(2); 1.501(a)-1(c).

(a) In earlier years, the IRS indicated that all physicians on a hospital’s medical staff would be considered “disqualified persons.” See GCMs 39862 and 39498.

(b) Since the late 1990s, however, IRS has taken a different view. See Rev. Rul. 97-21, 1997-18 IRB 8; Treas. Reg. § 53.4958-3(g), Ex. 10 and 11; H.R. Rep. No. 506, 104th Cong., 2d Sess. (1996) at 58, note 12 (physicians will be disqualified persons only if they are in a position of substantial influence over the affairs of the organization).

(3) **Penalty for Violations.** Until 1995, IRS’s only remedy was to revoke exemption of the organization. Today, in inurement cases, IRS can impose intermediate sanctions (i.e., penalty excise taxes) on persons who receive improper benefit and on organization’s managers. IRS also may revoke organization’s tax-exempt status, but likely will do so only in egregious circumstances. See § 4958 and Final Regulations, TD 8978, 67 Fed. Reg. 3076 (Jan. 23, 2002).

c. **Operational test is not met if organization engages in impermissible political or lobbying activities.**

(1) **Political Activities.** A § 501(c)(3) organization may not participate or intervene in any campaign on behalf of, or in opposition to, any candidate for public office. § 501(c)(3) and Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii).

(a) This is an absolute prohibition.

(b) Organizations still may undertake certain activities, however, such as publishing nonpartisan voter guides, candidate forums, or “get out the vote” (GOTV) efforts.
(c) If healthcare organization executives participate in such activities, they must do so on their own time and without relying on the organization’s facilities, personnel, supplies or other resources. Moreover, caution should be taken to distinguish that such executives are acting in their individual capacities, and not on behalf of the organization.

(i) See, e.g., PLR 201127013 (7/8/11), describing a tax-exempt hospital system’s formation of a § 501(c)(4) affiliate to house its government affairs activities. The (c)(4) intended to organize and operate multiple political action committees (PACs) to which the hospital system’s employees would be eligible to donate via voluntary payroll deductions. Despite the overlap between system leadership and the (c)(4), the entities were expected to operate independently, and the system would have no role or influence in the selection of beneficiary political organizations.

In PLR 201127013, “operate independently” is based on:

(a) No assets or funds of the § 501(c)(3) organization or its tax-exempt subsidiaries will be used for establishment, administration, or solicitations of contributions to PAC;

(b) Neither the § 501(c)(3) organization nor its tax-exempt subsidiaries make contributions to PAC;

(c) § 501(c)(3) organization and PAC will maintain separate bank accounts, books, records, and prepare separate financial statements, reports, and tax returns;

(d) Any leasing or sharing of employees, goods, services or facilities between the § 501(c)(3) organization or its tax-exempt subsidiaries with the § 501(c)(4) organization or PAC will be conducted at arm’s length and there
will be a reasonable allocation of costs;

(e) Organization and PAC will each have a separate letterhead, address, telephone number, and Internet address;

(f) Solicitations for contributions to PAC will be made by the PAC;

(g) No joint fundraising, postal or electronic mailings or events conducted between PAC and the § 501(c)(3) organization or its tax-exempt subsidiaries;

(h) PAC will not solicit any contributions or transact any other business using the name of the § 501(c)(3) organization or its tax-exempt subsidiaries and will not use mailings signed by the § 501(c)(3) organization's or its tax-exempt subsidiaries' employee, officer, director, or trustee in an official capacity; and

(i) Neither the § 501(c)(3) organization nor its tax-exempt subsidiaries will distribute any material produced or prepared by PAC.

(ii) Compare TAM 200446033 (6/15/04), where the IRS evaluated measures undertaken by the CEO of a tax-exempt hospital, who was also the chairman of the state hospital association, to generate support for the association's PAC. The IRS found that the activities of the CEO should be attributed to the § 501(c)(3) hospital based on a variety of considerations:

(a) The hospital offered its employees the ability to participate in the PAC via payroll deduction.

(b) The hospital's executives, department heads, and management discussed the PAC at
internal meetings in an effort to encourage employee awareness and participation.

(c) The CEO made a video, which was shown at employee meetings, regarding the impact of political input on the hospital industry.

(d) Donation cards were provided to employees at internal meetings.

(e) Managers were encouraged to get a signed donation card from each employee, irrespective of the employee’s decision to participate (apparently to avoid duplicative efforts).

(f) The PAC and the payroll deduction option were described in the hospital’s employee newsletter.

(d) Recommended reading:


(ii) Kingsley, Nonprofits, Disclosure and Electioneering after Citizens United, Taxation of Exempts (WG&L), Mar/Apr 2011.


(e) Political activities of churches. Since 2009, the IRS has lacked the authority to conduct church tax exemption inquiries and examinations when a federal court found that the IRS wasn’t following § 7611. See U.S. v. Living Word Christian Center, 103 AFTR 2d 2009-714. The appropriate high-level Treasury official at the level of Regional Commissioner who was required to approve any church audit before initiated was eliminated during reorganization in 1996. Proposed Regulations were issued in 2009 to eliminate references to the Regional Commissioner and instead provide that the Director, Exempt Organization Examinations, is the “appropriate high-level Treasury official” for purposes of the reasonable belief and inquiry notice requirements under § 7611. See 74 Fed. Reg. 39003 (Aug. 5, 2009). In a hearing on January 20, 2010 regarding the proposed rules, witnesses said the EO Director is not an appropriate official due to potential conflicts of interests which Congress intended prevent by enacting § 7611. Therefore, the IRS should designate the IRS Deputy Commissioner for Services and Enforcement rather than the EO Director as the appropriate high-level official. The promulgation of final regulations under § 7611 remains on the IRS’ 2014-2015 Priority Guidance Plan.

(2) Lobbying Activities. No substantial part of the activities of a § 501(c)(3) organization may be the carrying on of propaganda or otherwise attempting to influence legislation. § 501(c)(3) and Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii).

(a) “Legislation” defined relatively narrowly, e.g., does not include actions by executive branch or independent regulatory agencies.

(b) Covers legislative matters at all levels of government (i.e., local, state and federal).

(c) Organizations seeking greater certainty can elect to be governed by a safe harbor, which provides a sliding scale of permissible lobbying expenditures. See § 501(h); Treas. Reg. §§ 1.501(h)-1 and 1.501(h)-2.

(d) Recommended reading:
II. TYPES OF HEALTHCARE ORGANIZATIONS.

A. Hospitals.

1. Definitions are key, i.e., characterization as a “hospital” is meaningful for various tax purposes. Unfortunately, the term is defined somewhat differently based on the context:

   a. State law.

   b. Public charity status under § 170(b)(1)(A)(iii) and § 509(a)(1):

      (1) The term “hospital” includes a rehabilitation institution, outpatient clinic, community health or drug treatment center, and skilled nursing facility (within the meaning of 42 U.S.C. § 1395x(j)) if the principal purpose or function is the provision of hospital or medical care. See Treas. Reg. § 1.170A-9(d)(1).

   c. Application of § 501(r):

      (1) “Hospital facility” means a facility that is, or is required to be licensed, registered or similarly recognized by a state as a hospital. See Prop. Reg. § 1.501(r)-1(b).

Each of the four criteria of § 501(r) is the topic of proposed regulations, which are cited in the relevant sections below. Proposed regulations were issued in 2012 and 2013 and may be found at 77 Fed. Reg. 38148 (June 26, 2012) and 78 Fed. Reg. 20523 (April 5, 2013). As explained in IRS Notice 2014–2 (Jan. 13, 2014), tax-exempt hospital organizations can rely on the proposed regulations until the publication of final regulations or other applicable guidance.

2. Traditional exemption standard for hospitals -- To be exempt, a hospital must make its services available according to the “community benefit” standard established in Revenue Ruling 69-545, 1969-2 C.B. 117.

3. Additional exemption standards for hospitals are set forth in § 501(r) as a result of healthcare reform (Pension Protection and Affordable Care Act of 2010).
See Exhibit A for a comparison of the statutory requirements of § 501(r) and the proposed regulations.

   
   (1) Conduct a CHNA every three years.
   
   (2) Adopt an implementation strategy to meet the needs identified through CHNA.
   
   (3) CHNA takes into account input from persons who represent the broad interests of the community served by the hospital facility, including those with special knowledge of or expertise in public health.
   
   (4) CHNA is made widely available to the public.
   
   (5) § 4959 imposes a $50,000 excise tax for failure to meet the requirements of § 501(r)(3).

REG-106499-12 (78 Fed. Reg. 20523 (April 5, 2013)) provides a reliable roadmap for hospitals developing a CHNA. As provided in Notice 2011-52, hospital organizations may continue to rely on Notice 2011-52 for any CHNA conducted or implementation strategy adopted on or prior to October 5, 2013. The proposed regulations provide a hospital facility which has conducted a CHNA in its first taxable year beginning after March 23, 2010, 2011 or 2012 has until the 15th day of the fifth month following the close of the first taxable year beginning after March 23, 2012 to adopt an implementation strategy.

   
   (1) Eligibility criteria for financial assistance, and whether such assistance includes free or discounted care.
   
   (2) The basis for calculating amounts charged to patients.
   
   (3) The method for applying for financial assistance.
   
   (4) In the case of an organization which does not have a separate billing and collections policy, the actions the organization may take in the event of non-payment, including collections action and reporting to credit agencies.
(5) Measures to widely publicize the policy within the community to be served by the organization.

(6) A written policy requiring the organization to provide, without discrimination, care for emergency medical conditions (within the meaning of section 1867 of the Social Security Act (42 U.S.C. 1395dd)) to individuals regardless of their eligibility under the financial assistance policy.

See Exhibit A for a comparison of the statutory requirements of § 501(r) and the proposed regulations.


(1) Limits amounts charged for emergency or other medically necessary care provided to individuals eligible for assistance under the financial assistance policy to not more than the “amounts generally billed” to individuals who have insurance covering such care, and;

(2) Prohibits the use of “gross charges.”

See Exhibit A for a comparison of the statutory requirements of §501(r) and the proposed regulations.


(1) The organization must not engage in extraordinary collection actions before the organization has made reasonable efforts to determine whether the individual is eligible for assistance under the financial assistance policy.

See Exhibit A for a comparison of the statutory requirements of § 501(r) and the proposed regulations.

See Exhibit B for an example of a billing and collections timeline, as described in the proposed regulations, during which reasonable efforts must be made to determine if an individual is FAP eligible.


(1) Minor and inadvertent errors due to reasonable cause
(a) Can be excused.

(b) Revocation unlikely, and no disclosure will be necessary when the hospital facility corrects the omission or error as promptly as reasonably possible.

(2) Omissions and errors between minor and inadvertent and willful and egregious

(a) Can be excused.

(b) Correction and disclosure likely required.

(3) Willful and egregious errors

(a) Cannot be excused.

(b) Penalties and disclosure likely.

(c) Facility net income taxed at corporate rate.

(4) Revocation of exemption of the hospital organization is based on a consideration of all relevant facts and circumstances, such as: size, scope, nature, significance, repetition, cause, prior established processes and procedures, safeguards, disclosure, and corrections.

(5) See REG-106499-12 (78 Fed. Reg. 20523 (April 5, 2013)).

B. **Home Health Agencies.**

To qualify for exemption, a home health agency must make its services available to the general public in their homes, make all disbursements for exempt purposes, treat all patients able to pay for its care, and use any surplus to pay for indigent care or otherwise expand services. See Rev. Rul. 68-376, 1968-2 C.B. 246 (hospital based home health agency); Rev. Rul. 72-209, 1972-1 C.B. 148 (freestanding home health agency).

C. **Homes for the Aged/Assisted Living Centers.**

To qualify for exemption, a home for the aged must satisfy the three primary needs of the elderly: the need for housing, the need for healthcare, and the need for financial security. See Rev. Rul. 72-124, 1972-1 C.B. 145; Rev. Rul. 79-18, 1979-1 C.B. 194.

D. **Fitness Centers.**

Fitness centers may be exempt from federal tax where they provide recreational facilities available to the general community, promote the health of a community, or promote education. Additionally, fees must not preclude large segments of the community. See Rev. Rul. 79-360, 1979-2 C.B. 236; IRS CPE Text for Fiscal
Year 2002, Part I, Chapter A “Health Clubs” (October 2001). See also PLR 201123045 (06/10/11) (operation of medical rehabilitation and fitness center was substantially related to exempt purposes).

E. **Physician Practice Plans.**

In three cases in the late 1970s and early 1980s, the Tax Court disagreed with the IRS and found that faculty practice plans affiliated with a medical school and one or more affiliated teaching hospitals qualified for exemption under § 501(c)(3). The practice plans generally billed for the clinical services provided by their physicians, provided services without regard to ability to pay, conducted research, and provided clinical and classroom instruction to students and the hospital’s patients. The IRS non-acquiesced in one case and acquiesced in a second case, the principal distinction being that salaries paid to individual physicians in the latter case were subject to approval by the affiliated university and were not correlated to fees generated from patient care activities. *B.H.W. Anesthesia Foundation, Inc. v. Commissioner*, 72 T.C. 681 (1979), *nonacq.*, 1980-2 C.B.2; *University of Mass. Medical School Group Practice v. Commissioner*, 74 T.C. 1299 (1980), *acq.*, 1980-2 C.B. 2; *University of Maryland Physicians, P.A. v. Commissioner*, 41 T.C.M. (CCH) 732 (1981).

F. **Integrated Delivery Systems.**

An integrated delivery system (IDS) is a healthcare provider (or one or more component entities of an affiliated network of providers) created to integrate the provision of hospital services with professional medical (i.e., physician) services. The IRS has set forth guidance concerning the formation and qualification of an IDS for tax exemption under § 501(c)(3) in a series of CPE Texts. See IRS CPE Texts for Fiscal Years 1994 through 1997. The IRS will apply the community benefit standard, looking for elements such as the integration of medical functions, greater accessibility to healthcare for governmental and indigent patients, research and educational programs, a strong conflicts of interest policy, and a majority community board. See, e.g., *Harriman Jones Medical Foundation, IRS Determination Letter* (February 3, 1994); *Facey Medical Foundation, IRS Determination Letter* (March 31, 1993); and *Friendly Hills Healthcare Network, IRS Determination Letter* (January 29, 1993).

G. **Medical Research Organizations.**

The parameters for an exempt scientific research organization are set forth in the regulations. Treas. Reg. § 1.501(c)(3)-1(d)(5)(i) provides that a scientific research organization must be organized and operated in the public interest. Treas. Reg. § 1.501(c)(3)-1(d)(5)(ii) explains that scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations. For example, scientific research does not include the ordinary testing or inspection of materials or products. See Rev. Rul. 68-373, TAM 8230002, TAM 8020009. Treas. Reg. § 1.501(c)(3)-1(d)(5)(iii) states that scientific research will be regarded as carried on in the public interest if: (a) the results of the research (including any patents, copyrights, processes or formulae resulting from such research) are made available to the public on a nondiscriminatory basis (e.g., commercial sponsors cannot be promised
exclusive or preferential licensing rights); (b) the research is performed for the United States or any of its agencies or instrumentalties or for a state or political subdivision thereof; or (c) the research is directed toward benefiting the public.

H. **HMOs.**

1. To qualify for exemption, an HMO must meet either the community benefit standard (under § 501(c)(3)) or the social welfare standard (under § 501(c)(4)), and must pass muster under § 501(m). Although in *Sound Health Ass’n v. Commissioner*, 71 TC 158 (1978), acq. 1981-2 C.B. 2, an HMO was determined to qualify under § 501(c)(3), it is unusual for an HMO to meet the rigorous fact pattern found there. The more common qualification is under § 501(c)(4). See *Geisinger Health Plan v. Commissioner*, 985 F.2d 1210 (3d Cir. 1993); *IHC Health Plan, Inc. v. Commissioner*, 82 T.C.M. (CCH) 593 (2001); *IHC Group, Inc. v. Commissioner*, 82 T.C.M. (CCH) 606 (2001); *IHC Care, Inc. v. Commissioner*, 82 T.C.M. (CCH) 617 (2001). *But see Vision Service Plan v. U.S.*, 96 AFTR 2d (RIA) 2005-7440 (E.D. Calif. 2005), *aff’d unpublished*, 101 AFTR 2d (RIA 656 (9th Cir. 2008) (holding that an HMO was not described in § 501(c)(4) because it operated for the benefit of its members rather than to promote social welfare, and it carried on a business with the public for profit).

2. § 501(m). Enacted in 1986, this section provides that an organization described in § 501(c)(3) or (4) can be exempt only if no substantial part of its activities consists of providing commercial-type insurance. § 501(m)(3) expressly excludes from the term “commercial-type insurance” insurance provided “substantially below cost to a class of charitable recipients” and “incidental health insurance provided by an HMO of a kind customarily provided by such organization.” The IRS does not interpret this exclusion of incidental health insurance as a blanket exception for HMOs from the § 501(m) commercial-type insurance proscription. The IRS expects a qualifying HMO to minimize its risk either by employing (or otherwise contracting on a fixed fee basis with) physicians providing a substantial proportion of the services being provided or utilizing a non-staff model that can shift a substantial part of the risk to the health care providers (such as capitated fees or discounted fee-for-service with substantial withholds). See Lawrence M. Brauer, Mary Jo Salins & Robert Fontenrose, *Update on Health Care, FY 2002 CPE Text*, p. 156.

However, *See Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355, in which the Supreme Court held an HMO provided both insurance and health care and rejected the idea that capitated payments, etc. shift risk. The IRS pulled examination guidelines for § 501(m) subsequent to *Rush Prudential*; *see also* IRM § 4.76.31.
I. Information Technology Organizations.

1. Referred to variously as regional health information organizations (“RHIOs”), health information networks (“HINs”) and health information exchanges (“HIEs”).

2. Although having certain distinctions in their legal structure and operations, such organizations generally share the common purpose of facilitating the exchange of electronic health records among hospitals, physicians and other healthcare providers. Many such organizations sought IRS recognition of tax-exempt status, requiring the IRS to confront a number of theoretical issues under existing tax law principles (e.g., whether such organizations have an appropriate exempt purpose, whether they result in substantial private benefit, etc.).

3. Strong message sent by Congress in February 2009, in legislative history to American Recovery and Reinvestment Act (“ARRA”), which included specific incentives and appropriations to facilitate the adoption of healthcare I/T:
   
a. [I]f a nonprofit organization otherwise organized and operated exclusively for exempt purposes described in IRC sec. 501(c)(3) engages in activities to facilitate the electronic use or exchange of health-related information . . ., such activities will be considered activities that substantially further an exempt purpose under IRC sec. 501(c)(3), specifically the purpose of lessening the burdens of government. Private benefit attributable to cost savings realized from the conduct of such activities will be viewed as incidental to the accomplishment of the nonprofit organization’s exempt purpose.

4. Approximately one month later, the IRS began issuing determination letters to RHIOs and similar organizations. In FAQs posted on the IRS website, the IRS acknowledged that, through the enactment of ARRA, “Congress recognized that facilitating health information exchange and technology is important to improving the delivery of health care and reducing the costs of health care delivery and administration.” Accordingly, organizations established to facilitate the exchange of health information in a manner satisfying HHS standards would be considered to lessen the burdens of government within the meaning of § 501(c)(3).

J. Accountable Care Organizations.

1. The comprehensive national healthcare reform passed in March 2010 (the Patient Protection and Affordable Care Act, or “PPACA”) directed HHS to establish a Medicare shared savings program (“MSSP”) that promotes accountability for care of Medicare beneficiaries, improves the coordination of Medicare fee-for-service items and services, and encourages investment in infrastructure and redesigned care processes for high quality and efficient service delivery. PPACA contemplated that
healthcare service providers and suppliers would participate in the MSSP through groups known as accountable care organizations (“ACOs”).

2. In Notice 2011-20 (03/31/11), the IRS announced it generally would not consider a tax-exempt organization’s participation in the MSSP through an ACO to result in inurement or substantial private benefit where:

   a. The terms of the tax-exempt organization's participation in the MSSP through the ACO (including its share of MSSP payments or losses and expenses) are set forth in advance in a written agreement negotiated at arm’s length.

   b. CMS has accepted the ACO into, and has not terminated the ACO from, the MSSP.

   c. The tax-exempt organization’s share of economic benefits derived from the ACO (including its share of MSSP payments) is proportional to the benefits or contributions the tax-exempt organization provides to the ACO. If the tax-exempt organization receives an ownership interest in the ACO, the ownership interest received is proportional and equal in value to its capital contributions to the ACO and all ACO returns of capital, allocations and distributions are made in proportion to ownership interests.

   d. The tax-exempt organization’s share of the ACO's losses (including its share of MSSP losses) does not exceed the share of ACO economic benefits to which the tax-exempt organization is entitled.

   e. All contracts and transactions entered into by the tax-exempt organization with the ACO and the ACO's participants, and by the ACO with the ACO's participants and any other parties, are at fair market value.

In considering whether MSSP payments made to the exempt organization would constitute unrelated business income, the IRS stated its expectation that MSSP payments would be derived from activities that are substantially related to the performance of the charitable purpose of lessening the burdens of government within the meaning of Treas. Reg. § 1.501(c)(3)-1(d)(2). In this regard, the IRS cited Rev. Rul. 81-276, 1981-2 C.B. 128, for the proposition that the federal government considers the provision of Medicare to be its burden, and further stated, “Congress established the MSSP to be conducted through ACOs in order to promote quality improvements and cost savings, thereby lessening the government’s burden associated with providing Medicare benefits.”

3. The IRS cautioned, however, that not every activity that promotes health is considered to be a charitable purpose. Accordingly, ACO arrangements entered into outside the MSSP (e.g., with commercial payors) are unlikely to lessen the burdens of government and conceivably

4. The IRS solicited feedback as to the criteria and requirements for evaluating whether ACOs further exempt purposes, both within and outside the MSSP. To date, there has been no public evidence of the IRS issuing determination letters to ACOs seeking recognition of exempt status.

K. Other.


III. PUBLIC CHARITY vs. PRIVATE FOUNDATION STATUS.

A. Nonprofit vs. Tax-Exempt

1. Nonprofit
   a. State law concept
   b. Governed by state’s nonprofit corporation act
   c. Subject to federal income tax (if not also tax-exempt)

2. Tax-Exempt
   a. Federal tax law concept
   b. Generally also incorporated under state’s nonprofit corporation act
   c. Exemption from federal income tax - § 501(a)
   d. Is a private foundation unless qualifies as a public charity
B. **Law/Regulations.**

§ 509(a); Treas. Reg. § 1.509(a) and § 1.170A-9.

C. **Default Rule.**

Since 1969, all § 501(c)(3) organizations are treated as private foundations unless they meet one of the exceptions.

D. **Disadvantages of Private Foundation Status.**

1. Taxes on net investment income, self-dealing, prohibitions on failure to distribute income, excess business holdings prohibitions, investments that jeopardize charitable status and certain taxable expenditures. See §§ 4940-4945.

2. Limits on deductibility of contributions (limited to generally 30% or 20% of AGI, depending on what is contributed, as compared to 50% or 30% for public charities).

3. Additional reporting requirements and restrictions on activities and related party transactions; guidance is old (mostly 1969).

E. **§ 509(a)(1) Organizations.**

§ 509(a)(1) organizations include:

1. A church or a convention or association of churches.

2. An educational organization such as a school or college.

3. A hospital or medical research organization operated in conjunction with a hospital. A hospital is an organization whose principal purpose or function is to provide hospital or medical care or either medical education or medical research. A rehabilitation institution, outpatient clinic, community mental health or drug treatment center, or skilled nursing facility may qualify as a hospital if its principal purpose or function is providing hospital or medical care.

4. Endowment funds operated for the benefit of certain state and municipal colleges and universities.

5. A governmental unit.

F. **§ 509(a)(1) / § 170(b)(1)(A)(vi) – Publicly Supported Organizations. Normally for fundraising entities (e.g., fundraising foundations).**

An organization will qualify as publicly supported if it passes the one-third support test. If it fails that test, it may qualify under the facts-and-circumstances test.
1. **One-Third Support Test.** An organization will qualify as publicly supported if it “normally” receives at least one-third of its total support from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources.

2. **Definition of “Normally” for One-Third Support Test.** An organization will be considered to “normally” meet the one-third support test for its current tax year and the next tax year if, for the four tax years immediately before the current tax year, the organization meets the one-third support test on an aggregate basis.

3. **Facts-and-Circumstances Test.** The facts-and-circumstances test is for organizations failing to meet the one-third support test. To qualify, an organization must meet the “ten-percent-of-support” requirement and the “attraction of public support” requirement (organized and operated to attract public support).

G. **§ 509(a)(2) Organization – Service Organizations. Normally for service providers (e.g., nursing homes).**

1. **Generally.** § 509(a)(2) excludes certain types of broadly publicly supported organizations from private foundation status. Generally, an organization described in § 509(a)(2) may also fit the description of a publicly supported organization under § 509(a)(1). There are, however, two basic differences:
   a. For § 509(a)(2) organizations, the term support includes items of support and income from activities directly related to their exempt functions. This income is not included in meeting the support test for a publicly supported organization under § 509(a)(1).
   b. § 509(a)(2) places a limit on the total gross investment income and unrelated business taxable income (in excess of the unrelated business tax) an organization may have, while § 509(a)(1) does not.

2. **Tests.** To be excluded from private foundation treatment under § 509(a)(2), an organization must meet two support tests:
   a. **One-Third Support Test.** The one-third support test will be met if an organization “normally” receives more than one-third of its support in each tax year from any combination of:
      
      (1) Gifts, grants, contributions, or membership fees, and
      
      (2) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities in an activity that is not an unrelated trade or business, subject to certain limits. Gross receipts from related activities received from any person or from any bureau or similar agency of a governmental unit are includible in any tax
year only to the extent the gross receipts are not more than
the greater of $5,000 or 1% of the organization’s total
support in that year.

b. **Not-More-Than-One-Third Support Test.** This test will be met if an
organization “normally” receives no more than one-third of its
support in each tax year from the total of:

(1) Gross investment income, and

(2) The excess (if any) of unrelated business taxable income
over the tax imposed on that income.

**H. § 509(a)(3) Organization – Supporting Organization.**

1. **Generally.** § 509(a)(3) differs from the other provisions of § 509 that
describe a publicly supported organization. Instead of describing an
organization that conducts a particular kind of activity or that receives
financial support from the general public, § 509(a)(3) describes
organizations that have established certain relationships in support of
§ 509(a)(1) or § 509(a)(2) organizations.

   a. Thus, an organization may qualify as other than a private
foundation even though it may be funded by a single donor,
family, or corporation.

   b. This kind of funding ordinarily would indicate private foundation
status, but a § 509(a)(3) organization has limited purposes and
activities and gives up a significant degree of independence.

2. **Requirements.** § 509(a)(3) excludes from the definition of private
foundation those organizations that meet all of the three following
requirements:

   a. The organization must be organized and at all times operated
exclusively for the benefit of, to perform the functions of, or to
carry out the purposes of one or more specified organizations
described in § 509(a)(1) or § 509(a)(2).

   b. The organization must be operated, supervised, or controlled by
or in connection with one or more of the organizations described
in § 509(a)(1) or § 509(a)(2).

   c. The organization must not be controlled directly or indirectly by
disqualified persons other than foundation managers and other
than one or more organizations described in § 509(a)(1) or
§ 509(a)(2).
3. **Types of Relationships:**

- Operated, supervised, or controlled by a publicly supported organization (Type I);
- Supervised or controlled in connection with a publicly supported organization (Type II); or
- Operated in connection with one or more publicly supported organizations (Type III).

These rules are designed to insure that the supporting organization will be responsive to the needs or demands of, and will be an integral part of or maintain a significant involvement in, the operations of one or more publicly supported organizations. See Treas. Reg. § 1.509(a)-4(f).

a. **Operated, Supervised, or Controlled by (Type I) or Supervised or Controlled in Connection with (Type II) Organizations Described in §§ 509(a)(1) or 509(a)(2).** These kinds of organizations have a governing body that either includes a majority of members elected or appointed by one or more publicly supported organizations or that consists of the same persons that control or manage the publicly supported organizations. If an organization is to qualify under this category, it also must meet an organizational test, an operational test, and not be controlled by disqualified persons.

b. **Operated in Connection With (Type III) One or More Organizations Described in §§ 509(a)(1) or 509(a)(2).** This kind of § 509(a)(3) organization is one that has certain types of operational relationships. If an organization is to qualify as a § 509(a)(3) organization because it is “operated in connection with” one or more publicly supported organizations, it must satisfy the organizational and operational tests as described above, must not be controlled by disqualified persons (as described earlier) and must satisfy a notification requirement and meet a responsiveness test and an integral-part test.

1. **Notification requirement - Annual notification of support and provision of Form 990 to supported organization.**

2. **Responsiveness is satisfied by having an overlapping board or close and continuous relationship between boards, and by the supported organization having a “significant voice” in the investment policies of the supporting organization, the supporting organization’s timing of grants, manner of making grants and selection of grant recipients, and in otherwise directing use of the income or assets of the supporting organization.**
(3) Integral part test – differing requirements for functionally integrated and non-functionally integrated Type III supporting organizations.

(a) **Functionally Integrated Criteria.** A supporting organization meets the integral part test as a functionally integrated Type III supporting organization if the organization either:

(i) Engages in activities “substantially all” of which “directly further” the exempt purposes of one or more supported organizations;

(ii) Is the parent of each of its supported organizations; or

(iii) Supports a governmental supported organization.

For purposes of determining whether substantially all of a supporting organization’s activities directly further the exempt purposes of the supported organization, all pertinent facts and circumstances are taken into consideration. Activities that “directly further” the exempt purposes of the supported organization are activities that are conducted by the supporting organization itself, but would normally be engaged in by the supported organization(s). See Reg. § 1.509(a)-4(i)(4).

(b) **Non-functionally Integrated Criteria.** A supporting organization meets the integral part test as a non-functionally integrated Type III supporting organization if the organization either:

(i) Satisfies both the annual distribution requirements and attentiveness requirements; or

(ii) The pre-November 20, 1970 trust requirements are met.

The annual distribution rule requires a supporting organization to distribute an amount equaling or exceeding the supporting organization’s distributable amount for the taxable year to or for the use of one or more supported organizations, on or before the last day of the taxable year.

To meet the attentiveness requirement, a non-functionally integrated Type III supporting organization must distribute one-third or more of its distributable amount to one or more
supported organizations that are attentive (see Treas. Reg. § 1.509(a)-4(i)(5)(iii)) to the operations of the supporting organization and to which the supporting organization would be responsive. See Treas. Reg. § 1.509(a)-4(i)(5).

Distributable Amount. An organization’s distributable amount for a taxable year is an amount equal to the greater of 85% of the supporting organization’s adjusted net income from the taxable year immediately preceding taxable year or 3.5% of the excess of the aggregate FMV of all of the supporting organizations non-exempt-use assets from the immediately preceding taxable year. See Treas. Reg. § 1.509(a)-4T(i)(5)(ii).

4. **Recommended Reading.**


c. Notice 2014-4, IRB 2014-2, 274 (Jan. 6, 2014), which provides interim guidance for Type III supporting organizations seeking to qualify as functionally integrated by supporting a governmental supported organization.

5. **Background on Recent Changes that are Incorporated Above in the § 509(a)(3) Discussion.** Supporting organizations are now subject to a host of new rules enacted as part of the Pension Protection Act of 2006 (H.R. 4), signed into law on August 17, 2006. The new provisions include additional disclosure requirements, limitations on related party transactions, new distribution requirements for certain Type III organizations, the extension of certain of the private foundation rules to certain supporting organizations, and limitations on contributions that may be received by supporting organizations from private foundations.

d. On August 2, 2007, the IRS released an advance notice of proposed rulemaking concerning: (1) the payout requirement for Type III supporting organizations that are not functionally integrated; (2) the criteria for determining whether a Type III supporting organization is functionally integrated; (3) the modified requirements for Type III supporting organizations that are organized as trusts; and (4) the requirements regarding the type of information a Type III supporting organization must provide to its supported organization(s) to demonstrate that it is responsive to its supported organization(s). REG-155929-07, 72 Fed. Reg. 42335 (Aug. 2, 2007).

e. On September 23, 2009, the IRS issued proposed rules regarding payout requirements for Type III supporting organizations that are

f. See PLR 201019034 (05/14/10) for a recent illustration of the manner in which the IRS applies the supporting organization rules, resulting in that particular context in reclassification of the organization as a private foundation.

g. On December 28, 2012, Treasury released T.D. 9605 (77 Fed. Reg. 76426) which sets forth new final and temporary regulations governing Type III supporting organizations. The new regulations, Treas. Reg. § 1.509(a)-4T, revised the annual amount required to be distributed as a “distributable amount” by non-functionally integrated Type III organizations from 5% of the fair market value of its non-exempt-use assets per year to the greater of 85% of adjusted net income or 3.5% of the fair market value of the supporting organization’s non-exempt-use-assets. In addition, the final regulations provide transition relief for meeting the notification requirement, and made various changes to the transition rules. See Treas. Reg. § 1.509(a)-4T(i)(5)(ii)(B) and § 1.509(a)-4(i)(11).

IV. UNRELATED BUSINESS INCOME TAX (“UBIT”).

A. Concept.

1. Possible Tax Liability. Even though § 501(c)(3) organizations are generally exempt from income taxation, they still may have to pay tax (unrelated business income tax, or “UBIT”) on amounts derived from certain activities outside the scope of their exempt functions. See §§ 511-514.

2. Purpose. One purpose of UBIT is to prevent tax-exempt organizations from unfairly competing against taxable entities conducting the same or similar types of activities. See Treas. Reg. 1.513-1(b); H. Rep. No. 2319, 81st Cong., 2d Sess. (1950) at 36-37.


B. General Rules.

1. Definition of Unrelated Trade or Business. § 511 provides that UBIT is imposed on income derived from an “unrelated trade or business.” § 513 provides that an “unrelated trade or business” exists where three factors are met.

   a. The activity constitutes a “trade or business.”

      (1) Generally includes any activity carried on for the production of income from the sale of goods or the
performance of services. See § 512(a)(1), § 513(a), and Treas. Reg. § 1.513-1(b).

(2) At least one U.S. Supreme Court case has held that the organization’s primary purpose for engaging in the activity must be for the production of income or profit. United States v. American Bar Endowment, 477 U.S. 105 (1986).

b. The activity is “regularly carried on.”

(1) A question of the frequency and continuity with which the organization conducts this activity. Essentially asks whether the activity is conducted in a manner comparable to that of competing for-profit taxable entities. See § 512(a) and Treas. Reg. § 1.513-1(c).

(2) IRS generally will concede that an activity that is conducted only once a year is not “regularly carried on.” More risk if planning and preparation for the event occur at various times throughout the year. See Treas. Reg. § 1.513-1(c)(2).

c. The trade or business is “not substantially related” to the organization’s exempt purposes.

(1) To be “substantially related,” activity must “contribute importantly” and have a “substantial causal relationship” to the achievement of exempt purposes. See Treas. Reg. § 1.513-1(d).

(2) Standard is difficult to apply – look to the purpose for the activity and the means by which it is conducted.

(3) Fact that an activity may serve as a source of funding for the organization’s other exempt activities is not, in itself, sufficient to show “substantial relatedness.” See Treas. Reg. § 1.513-1(d)(1).

2. Deductions. An organization’s gross unrelated business taxable income (UBTI) can be reduced or offset by deductions for expenses “directly connected” with the production of such income. See § 512(a)(1).

3. Reporting. Organization must report its UBTI and pay UBIT by filing IRS Form 990-T annually, in addition to its Form 990 information return. UBTI is taxed at regular corporate tax rates. § 511(a) and § 11(b). Under the Pension Protection Act of 2006 (H.R. 4), effective for returns filed after the date of enactment (August 17, 2006), Form 990-T is subject to the same public disclosure requirements as the Form 990 information return.

4. Impact of Substantial UBTI. Excessive UBTI could lead to loss of tax-exempt status, since it may suggest that the organization is no longer

a. How much UBTI is too much? Entirely a facts-and-circumstances determination. Generally practitioners look to “rule of thumb” of between 25% and 30%, but see Rev. Rul. 64-182 in which (apparently) 100% of rental activity is unrelated but charitable grantmaking is commensurate in scope with its financial resources. See TAM 9521004 where more time is spent on exempt purposes; unrelated activity is not primary purpose.

C. Modifications and Exclusions.

1. UBTI rules are subject to both “modifications” and “exclusions.” While both concepts result in a reduction on UBIT liability, the distinction between the two terms is generally relevant for tax-exempt bond financing purposes.

2. Modifications. Pursuant to § 512, a healthcare organization’s UBTI does not include:

   a. Dividends. § 512(b)(1).
   b. Interest. § 512(b)(1).
   c. Royalties. § 512(b)(2).
   d. Rents from real property, subject to various limitations. § 512(b)(3).
   e. Gain/loss from sale of property (other than stock in trade or inventory). § 512(b)(5).
   f. Research income. § 512(b)(7)-(9).

Notwithstanding the above, if the assets producing such income were debt-financed, such amounts may constitute “unrelated debt-financed income” under § 514 (which is taxed as UBTI). See §§ 512(b)(4) and 514; see also PLR 200320026 (involving a medical college facility) and PLR 200717019 (controlled entity’s medical office building financed with acquisition indebtedness was not “debt-financed property” because entity leased building for outpatient surgical and other healthcare services substantially related to the controlling hospital’s exempt purposes).

Under § 512(b)(13), the exempt organization must include as UBTI certain rents, royalties, and interest derived from a controlled (generally, more than 50% ownership) subsidiary, including a controlled partnership. See Treas. Reg. § 1.512(b)-1(j); see, e.g., PLR 200716034 (Hospital controlled a beneficial interest in employed physician professional
corporations (PCs). Physicians were merely acting as the Hospital’s nominees pursuant to various employment, shareholder and affiliation agreements. Medical service income from controlled PCs was unrelated business income because services were rendered to patients of physicians, not patients of hospital). The controlled subsidiary rules do not apply to dividends. This provision is intended to prevent exempt groups from using the exempt organization to shield taxable income of taxable subsidiaries, or shielding UBTI of exempt subsidiaries by creating deductible items within the group. Under the Pension Protection Act of 2006 (H.R. 4), the controlled subsidiary rules were changed to apply only to amounts exceeding an arm’s-length payment as determined under § 482 principles. See § 513(b)(12)(D). However, the scope of this change was generally limited to contracts in effect as of August 17, 2006 and payments only until December 31, 2013. (Up until 2013, the latter date was extended annually since original expiration date of December 31, 2007). The American Taxpayer Relief Act of 2012, which extended the provision for excess payments to payments received or accrued before January 1, 2014, was the last extension. (§319(b), PL 112-240, 1/2/2013.)

3. Exclusions. Pursuant to § 513, the term “unrelated trade or business” does not include amounts derived from:

a. A trade or business in which substantially all of the work is performed by volunteers (e.g., gift shops operated by hospital auxiliaries). § 513(a)(1).

b. A trade or business carried on for the convenience of an organization’s members, students, patients, officers, or employees. § 513(a)(2). See also Rev. Rul. 69-267, 1969-1 C.B. 160 (gift shop); Rev. Rul. 69-268, 1969-1 C.B. 160 (cafeteria and coffee shop); Rev. Rul. 69-269, 1969-1 C.B. 160 (parking lot operated by hospital for patients and visitors).

c. The sale of goods, substantially all of which have been received by the organization as gifts or contributions (e.g., a thrift shop). § 513(a)(3).

d. Qualified public entertainment activities, and certain convention and trade show activities. § 513(d).

e. “100 Bed Rule” In limited circumstances, the provision of certain types of services by one tax-exempt hospital to another. See §§ 513(e) and 501(e) (providing for the exemption of “cooperative hospital service organizations”); see also Treas. Reg. § 1.513-6.

(1) Services are of a specific type (data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, records center, or personnel) and must
be ones that the recipient hospital could perform for itself as part of its own activities.

(2) Must be provided only to facilities serving less than 100 inpatients.

(3) Services must be provided at cost.

f. The distribution of low-cost articles incident to the solicitation of charitable contributions. § 513(h)(1)(A).

g. The rental or exchange of mailing lists. § 513(h)(1)(B).

D. Application to Typical Health Care Organizations.

1. Pharmacy Sales. Sales to “patients” are substantially related to exempt purposes, while sales to non-patients are not. See Treas. Reg. § 1.513-1(c)(2)(ii). Six categories of “patients”:
   a. Persons admitted as inpatients.
   b. Persons receiving care from hospital’s outpatient facilities.
   c. Persons referred to an outpatient facility for diagnosis or treatment.
   d. Person refilling prescription received during treatment as a patient.
   e. Person receiving medical services as part of a hospital-administered home care program.
   f. Person receiving medical services in hospital-affiliated extended care facility.


2. Laboratory Testing. Subject to same “patient” vs. “non-patient” analysis as for pharmaceutical sales. See Rev. Rul. 85-110, 1985-2 C.B. 166, and PLRs 9739043, 9323035, 9023041, 8941082, 8921091, 8809092, 8736046, 8721103 and 8246018. See also TAM 201428030 (finding that unique circumstances justified not imposing UBIT on income from the provision of laboratory services to patients of private physicians by a rural hospital in a medically underserved area where there were no full-service laboratories available in the community served by the hospital and the other laboratories that could conduct testing needed by the hospital’s non-patients could not do so adequately.)

4. **Sales of Blood and Blood Products.** In certain circumstances, the IRS views the sale of blood and blood products as substantially related to exempt purposes. See Rev. Rul. 78-145, 1978-1 C.B. 169.

5. **Fitness Centers.** Various factors must be examined to determine whether a fitness center is substantially related to exempt purposes, including fee structure, nature of programs, composition of membership, comparability to operations of commercial counterparts, etc. See TAMs 8505002 and 9803001 and PLRs 201123045, 200203070, 200051049, 9736047, 9732032, 9329041, 9226055 and 9110042.


8. **Parking Facilities.** Income from parking lots or structures for patients and visitors generally does not constitute UBTI. See Rev. Rul. 69-269, 1969-1 C.B. 160, and PLRs 9739042, 9739041, 9315021 and 8815031.

9. **Transportation Services.** The provision of transportation services for patients, visitors, and others in need generally is not an unrelated trade or business. See PLR 200247055.

10. **Lease of Medical Office Building Space.** The lease of space to hospital-affiliated physicians in a medical office building adjacent to the hospital generally will be treated as substantially related to the hospital’s exempt purposes. See Rev. Rul. 69-463, 1969-2 C.B. 131, Rev. Rul. 69-464, 1969-2 C.B. 132, and PLR 8452099; see also PLRs 200314031 and 200717019 (lease of hospital space to unrelated institution); PLR 200404057 (lease of nursing home to nonprofit operator). However, medical office building rental income attributable to unrelated commercial businesses will be UBTI if debt-financed.

11. **Management and Other Support Services.** Consulting and managerial services provided to unrelated entities generally will result in UBTI. See B.S.W Group, Inc. v. Commissioner, 70 T.C. 352 (1978); Rev. Rul. 72-369, 1972-2 C.B. 245; TAMs 200218037 and 9822004. See IRC § 513(e) services performed for hospital facilities serving 100 or less inpatients. Income from billing services may or may not be UBTI depending on the facts. See PLRs 8404076 (billing and collection services for hospital-based radiologists did not generate UBTI); PLR 8736046 (income from billing services for unrelated hospital and medical group was UBTI). Also of interest: PLR 201128028 (7/15/11) (the provision of consulting and educational services for a fee to foreign hospitals and governments operating healthcare facilities is not an inherently charitable activity); PLR 9021050 (imaging services income of partnership interest owned by tax-
exempt health care organization is not UBTI) and PLR 8139014 (payroll data processing for unrelated hospital was held as UBTI).

E. IRS TE/GE Advisory Committee 2014 Report Recommendations

In June 2014, the IRS’ Advisory Committee on Tax Exempt and Government Entities (ACT) released its 2014 Report of Recommendations, which included an extensive analysis of and recommendations regarding UBIT. While colleges and universities were the focus of the report’s UBIT discussion, the UBIT-related recommendations nonetheless are of interest to all exempt organizations. The recommendations included:

- Opening a regulation project to formalize the commensurate test set forth in Revenue Ruling 64-182 which articulates the principle that profits from a substantial commercial activity will not preclude exemption as long as a tax-exempt organization’s income and financial resources are used commensurate in scope with its charitable programs;

- Providing formal guidance regarding allocation of indirect costs between exempt activities and unrelated business activities which includes the incorporation of a safe harbor element and clearly identifying allocation methods that would be per se unreasonable;

- Issuance of a comprehensive revenue ruling on a range of UBTI issues including facility rentals, dual use of property, catering/food service, bookstore operations, technology transfers, and categorizing activities as unrelated businesses;

- Adoption of a new web-based Form 990-T, Exempt Organization Business Income Tax Return, which requires activity-by-activity reporting; and

- Continued education and outreach by improving public access to IRS materials and information through the IRS website.

The ACT Report is available at:

V. ADDITIONAL TAXES.

A. Employment Tax.

A tax-exempt organization is generally required to pay the employer portion of Social Security and Medicare taxes (FICA). FUTA tax exemption applies to organizations described in IRC §501(c)(3). (§ 3306(c)(8)) Exempt organizations are generally liable for state unemployment taxes.

B. Foreign Withholding Tax.

1. If an organization makes a payment of U.S. source income to a foreign person, the organization must withhold and report the proper amount of tax. The payment must be reported on Form 1042-S and the organization
must file a Form 1042 by March 15 of the year following the payment. § 1441.

2. Most foreign countries require that payers of certain amounts, especially interest, dividends, and royalties, to U.S. payees withhold foreign income tax from such payment and pay it to the foreign government. Foreign withholding rates are sometimes modified by tax treaties between the U.S. and the foreign government. As a result, U.S. tax-exempt entities receiving interest, dividends and certain other payments from foreign countries may be subject to foreign withholding tax.

C. Medical Device Excise Tax.

§ 4191 imposes an excise tax of 2.3% on sales price of taxable medical devices by the manufacturer, producer, or importer after Dec. 31, 2012. The medical device excise tax is reported on Form 720, which is to be filed quarterly. Eyeglasses, contact lenses, hearing aids and any other medical devices determined by the Secretary to be of a type which is generally purchased by the general public at retail for individual use are exempt.

D. State Taxes.

Organizations may be subject to property, income, gross receipts, or other taxes varying in accordance with state laws.

E. Patient Centered Outcomes Research Trust Fund Fee.

1. The Patient Centered Outcomes Research Trust Fund fee applies to issuers of specified health insurance policies and plan sponsors of applicable self-insured health plans. It helps to fund the Patient Centered Outcomes Research Institute (PCORI). § 4376 imposes a fee on the plan sponsor of an applicable self-insured health plan. The fee applies to policy or plan years ending on or after Oct. 1, 2012, and before Oct. 1, 2019. The PCORI fee is to be reported on Form 720, which is to be filed annually. See §§ 4375, 4376, and 4377. Additional information about the fee may be found on the IRS website at http://www.irs.gov/uac/Newsroom/Patient-Centered-Outcomes-Research-Institute-Fee.

F. Transitional Reinsurance Fee.

1. Among other things, PPACA provides that each state must establish a transitional reinsurance program to help stabilize premiums for coverage in the individual market during the first three years of insurance exchange operation (2014-2016). PPACA directs health insurance issuers and self-insured group health plans to make reinsurance contributions. Under § 1341(b)(3)(B)(i) of the Affordable Care Act, contribution amounts for reinsurance are to reflect, in part, an issuer’s “fully insured commercial book of business for all major medical products.” The total contribution amount to be collected from contributing entities for 2014 is $12 billion plus administrative expenses. It is estimated that a $63 annual ($5.25
monthly) per capita contribution rate for benefit year 2014 will sum to this amount. (45 CFR Parts 153, 155, 156, 157 and 158).

G. Community Health Needs Assessment (CHNA) Excise Tax.

1. If a hospital facility fails to meet the Community Health Needs Assessment requirements of § 501(r)(3), § 4959 imposes an excise tax equal to $50,000 to the organization. The tax is imposed on the hospital organization separately for each hospital facility’s failure. The tax may be imposed for each taxable year that a hospital facility fails to meet the CHNA requirements. (Prop. Treas. Reg. §53.4959-1). This excise tax was imposed by the Affordable Care Act, enacted March 23, 2010; this particular tax is based on the CHNA effective date, which is for years beginning after March 23, 2012.

H. Health Insurance Providers Fee.

1. REG-118315-12, 78 Fed. Reg. 14034 (Mar. 4, 2013), contains proposed regulations regarding the annual fee imposed on covered entities engaged in the business of providing health insurance for United States health risks. This annual fee is imposed by § 9010 of the Patient Protection Affordable Care Act (PPACA) and is payable annually on September 30th. Under § 9010(e)(1) of PPACA, the aggregate fee amount for all covered entities is $8 billion for calendar year 2014. The fee is then allocated to all covered entities based on its proportionate share using a specified formula set in § 9010(b)(1) of PPACA.

I. Excise Tax on Certain Tax-Exempt Entities Entering into Prohibited Tax Shelter Transactions.

§ 4965 imposes an excise tax on certain tax-exempt entities and knowing managers entering into prohibited tax shelter transactions such as transactions of a type which the Secretary specifically identifies or determines as having a potential for tax avoidance or evasion. For example, accommodating the overvaluation of a noncash contribution of more than $250 by providing a receipt for the contribution.

VI. INTERMEDIATE SANCTIONS.

A. Law and Regulations.

1. § 4958; Treas. Reg. § 53.4958.

B. General Concepts.

1. **Purpose.** Intermediate sanctions serve as an enforcement mechanism short of revocation of tax-exempt status.

2. **Substance.** Sanctions are in the form of penalty excise taxes, imposed not on the organization but rather on the insiders ("disqualified persons") who receive excess benefits in a transaction or arrangement involving the organization, and on the organization’s leaders ("organization managers") who knowingly approved the transaction or arrangement.

C. Imposition of Taxes.

1. **Disqualified Person Taxes.** A disqualified person receiving an excess benefit is subject to a first tier tax of 25% of the amount of the excess benefit, and a second tier tax of 200% of the amount of the excess benefit if the transaction is not corrected in a specified time period.

   **Example:** An insider physician receives compensation of $300,000 in a year when reasonable compensation would only be $200,000. The physician would be assessed a tax of $25,000 (25% of the $100,000 excess benefit). If he did not also make arrangements to repay the $100,000 excess benefit, he would owe an additional tax of $200,000 (200% of the $100,000 excess benefit).

2. **Organization Manager Tax.** An organization manager (defined to include any officer, director, trustee, or other person having powers similar to those of officers, directors, or employees) knowingly approving an excess benefit transaction is subject to a tax of 10% of the amount of the excess benefit, up to the maximum of $20,000. [The maximum tax was increased from $10,000 to $20,000 by the Pension Protection Act of 2006 (H.R. 4), signed into law August 17, 2006.]

   a. All participating organization managers are jointly and severally liable.

   b. There is no second tier tax.

   c. The tax applies on an organization manager who participated in the excess benefit transaction, knowing that it was such a transaction, unless such participation is not willful and is due to reasonable cause.

      **Example:** In the example above, the organization manager pays a tax of $10,000 (10% of the $100,000 excess benefit).

D. Excess Benefit Transactions.

Three types of transactions result in such tax:

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1. **Non-FMV Transactions.** A disqualified person receives an economic benefit in a transaction with the organization that exceeds the value of the consideration (including the performance of services) received for providing such benefit – this includes a non-fair market value transaction or the receipt of unreasonable compensation.

2. **Prohibited Revenue-Sharing Transactions.** A disqualified person receives payment based on the income of the organization in an arrangement that violates the private inurement proscription (e.g., payment based on a percentage of net income). The 2002 final regulations do not address these types of transactions. Until final regulations are published regarding revenue-sharing transactions, the IRS says that these transactions should be evaluated under the general rules defining excess benefit transactions (see Regs. § 53.4958-4), which apply to all transactions with disqualified persons regardless of whether the person’s compensation is computed by reference to revenues of the organization. IRM § 7.27.30.7.

3. **Prohibited Transactions Involving Supporting Organizations.** A supporting organization makes either:

   a. A grant, loan, payment of compensation, or similar payment to a substantial contributor (defined as someone who contributed more than $5,000 to the organization, if such amount is more than 2% of the total contributions received by the organization in the taxable year), a family member of such substantial contributor (if an individual), or a 35% controlled entity; or

   b. Any loan to a disqualified person, other than an organization described in § 509(a)(1), (2) or (4).

The foregoing provisions were added by the Pension Protection Act of 2006 (H.R. 4), signed into law August 17, 2006.

**E. Disqualified Persons.**

1. Defined to include any individual in a position to exercise substantial influence over the affairs of the organization.

2. Certain individuals are per se disqualified persons (e.g., directors, CEO, CFO, COO), while others are subject to a facts-and-circumstances test.

3. Also includes certain family members, businesses in which a disqualified person owns 35% or more interest, and any person who has been a disqualified person at any time in the last 5 years. Physicians can be (but are not necessarily) disqualified persons.

4. For transactions occurring after 7/25/06, also includes persons in a position to exercise substantial influence over the affairs of a supporting organization. [This change was part of the Pension Protection Act of 2006 (H.R. 4), signed into law August 17, 2006.]
F. **Rebuttable Presumption of Reasonableness.**

1. The Regulations provide that the parties to a transaction or arrangement will be entitled to “a rebuttable presumption of reasonableness” if the arrangement was approved by an authorized body (board of directors, committee, or others authorized by Board) that:
   
   a. Is composed entirely of persons not related to or controlled by the disqualified person(s);
   
   b. Retained and relied upon appropriate data as to comparability; and
   
   c. Adequately and contemporaneously documented the basis for its determination.

2. If presumption is obtained, this essentially shifts the burden of proof to the IRS to prove that an arrangement was *not* reasonable and *not* at fair market value. See PLR 200413014 (ruling that aspects of bond financing process would meet criteria to obtain rebuttable presumption).

G. **Protection for Organization Managers.**

Even if a transaction or arrangement is later determined to have resulted in an excess benefit, an organization manager will be deemed to have not acted “knowingly” (and therefore may avoid the penalty taxes) if either:

1. Steps were taken so as to achieve the rebuttable presumption; or

2. The organization manager, after full disclosure of the factual situation to an appropriate professional, relied on a reasoned written opinion of legal counsel, an accountant with appropriate expertise, or an independent valuation expert. The opinion must address the facts and the applicable standards.

H. **Payments Through Affiliates.**

Excess benefits include excessive compensation paid through a 50%-or-more controlled entity.

I. **“Automatic” Excess Benefit Transactions.**

1. **Concept.** An economic benefit will be treated as compensation for purposes of § 4958 only if the organization providing the benefit clearly indicated its intent to treat the benefit as compensation for services when the benefit was paid. If amounts are not appropriately processed and reported as compensation, they will not be considered compensation for services rendered.

2. **Result.** In these cases, if the payment is received by a disqualified person, the payment will be deemed an “automatic” excess benefit
transaction, regardless of whether there otherwise may have been an argument that the payment was reasonable compensation for services rendered.

J. Revocation Still a Risk.

1. In circumstances where penalty taxes may be an inadequate remedy, the IRS may revoke an organization’s tax-exempt status. See Treas. Reg. § 1.501(c)(3)-1(f).

2. Considerations:
   a. Size and scope of exempt activities.
   b. Size and scope of excess benefit transactions.
   c. Whether there have been repeated violations.
   d. Whether safeguards have been implemented to prevent future violations.
   e. Whether the violations have been corrected, or the organization has taken good faith efforts to seek correction.

K. Resources Regarding Intermediate Sanctions.

1. CPE Texts.

2. Other IRS Documents.
   a. TAM 200244028 (6/21/02)
   b. TAM 200243057 (7/2/02)
   c. PLR 200247055 (11/22/02)
   d. Information Letter 2002-14 (12/23/02)
   e. PLR 200332018 (5/13/03)
f. PLR 200335037 (6/2/03)

g. PLR 200421010 (5/21/04)

h. TAM 200435018 through 200435022 (5/5/04)

3. Cases.


b. *But see* Sta-Home Health Agency, et al. v. Commissioner, 456 F.3d 444 (5th Cir. 2006). The Fifth Circuit Court of Appeals reversed the Caracci decision without remand, based on determinations that the Tax Court:

   (1) Erred as a matter of law in affirming the IRS’s imposition of penalty taxes after the IRS failed to meet its burden of proving that the taxes were correctly assessed;

   (2) Erred as a matter of law in selecting the valuation method; and

   (3) Made clearly erroneous factual findings in applying the valuation method.

VII. EVOLUTION OF EXEMPTION.

A. Early Challenges. There are several early litigated cases in which hospitals were denied tax exemption principally due to the hospitals' net earnings inuring to the benefit of physicians in a position to exert significant control over the hospital.

1. Harding Hospital, Inc. v. Commissioner, 505 F.2d 1068 (6th Cir. 1974) (a small group of doctors who possessed a “virtual monopoly” on the patients treated by the hospital received office space, equipment and business office services from the hospital at less than FMV).

2. Kenner v. Commissioner, 20 T.C.M. 185 (1961), aff’d, 318 F. 2d 623 (7th Cir. 1963) (hospital funds used to pay founder/director’s personal expenses, hospital funds used to purchase property for founder/director’s wholly-owned corporation and hospital funds commingled with founder/director’s funds).

founder/director without charge and paid operating expenses of founder/director’s private medical practice).

4. Sonora Community Hospital v. Commissioner, 397 F.2d 814 (9th Cir. 1968), aff’g 46 T.C. 519 (1966) (founding physicians were source of 90 percent of hospital’s patients and indirectly received at least one-third of gross receipts from certain hospital activities).

5. Lowry Hospital Ass’n. v. Commissioner, 66 T.C. 850 (1976) (commingling of expenses and receipts, sharing of employees and facilities, joint occupancy of space and unified billing procedures under joint letterhead).


B. More Current Challenges.


   a. **Facts.** Anclote Psychiatric Hospital exemption revoked in 1991 retroactive to 1983 due to prohibited private inurement in the 1983 sale of hospital assets to a corporation formed by its directors, despite receipt of favorable PLR 8234084 (May 27, 1982), which earlier ruling was predicated on the sale price being equal to fair market value.

   b. **Findings.** The Tax Court upheld the revocation, agreeing that the sale price was excessively below fair market value and resulted in private inurement.


   a. **Facts.** By letter dated June 16, 1994, the IRS revoked the exemption of LAC Facilities, Inc. (formerly Modern Health Care Services, Inc.) retroactive to 1985 based on its violation of the inurement and private benefit proscriptions. From 1960 until 1984, the organization owned and operated North Miami General Hospital, a 359-bed acute care teaching hospital. In 1984, it sold its operating assets to a for-profit company for approximately $57 million after obtaining certain rulings from the Service, including a ruling that it would continue to be described in §§ 501(c)(3), 509(a)(1), and 170(b)(1)(A)(iii). In its request for rulings, the organization stated that it would concentrate its efforts on providing alternative delivery systems, such as free-standing diagnostic centers. In 1986 and 1987, the organization purchased seven existing private medical practices at a total cost of approximately $17.4 million and entered into service agreements with the physicians who previously owned the practices. By 1988,
the organization had a primary building with seven medical specialties, various rehabilitative services and an ambulatory surgery suite, as well as 11 satellite offices. In 1992, the organization sold its remaining assets, including the medical practices and its interest in six other health care centers, to a group 70 percent owned by physicians who worked for the organization in exchange for a promissory note in the amount of $4.5 million. The promissory note subsequently was written down to $253,614 due to doubtful collectability.

b. Findings. Evidence of prohibited inurement and private benefit fell into these main categories: (1) excessive amounts paid in the 1986 and 1987 acquisition of the physician practices; (2) excessive compensation paid to the selling physicians for operating the practices; (3) sale of the organization’s assets in 1992 at substantially less than fair market value; (4) excessive compensation paid to certain officers and trustees by the organization and related entities; (5) payment of various expenses by the organization that benefited insiders or their spouses; (6) amending the organization’s retirement plan to allow certain officers and trustees to receive significant lump-sum distributions; and (7) excessive payments by the organization to related entities. For example, it is alleged by the Service that one of the physician practices that the organization bought for $6 million had only $170,093 in tangible assets and was worth $2 million. Similarly, the Service finds that the $400,000 per year compensation paid to each of five physicians in the first full year after their practices were purchased was, in the aggregate, 50 percent higher than the physicians’ compensation in the last full year prior to the sale, and that reasonable compensation was $265,000 per physician. According to the Service, even the organization’s own accounting firm determined that the organization’s assets in 1992 were worth over $7.3 million when the organization sold them to insiders for a $4.5 million promissory note, later written down to $253,614. The Service also finds excessive the 1988 compensation of the chief executive officer, president, and trustee, which compensation included a salary of $266,667, a lump sum distribution of over $1.8 million from the organization’s executive staff retirement plan, and $120,000 from a related taxable insurance company. On July 23, 1998, LAC Facilities voluntarily dismissed its legal challenge to the revocation of its exemption. The IRS notified donors that LAC Facilities was no longer described in § 501(c)(3) on December 28, 1998. See “Organization Not Exempt,” 98 TNT 248-10 (December 29, 1998) (available in LEXIS; Fedtax library; tnt file).

3. Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), aff’d per curiam, 242 F.3d 904 (9th Cir. 2001).

a. Facts. The IRS denied exemption to Redlands Surgical Services (“Redlands”). Redlands is a wholly owned nonprofit subsidiary of
RHS Corp., a § 501(c)(3) organization and the parent of a typical reorganized hospital system located in California. Redlands’ sole purpose and activity is to hold a 46% partnership interest in a partnership that is the sole general partner of another partnership that operates a freestanding ambulatory surgery center.

b. Findings. The Tax Court upheld the IRS’ denial of Redlands’ exemption and the Ninth Circuit affirmed. Redlands sole activity was its participation in an ambulatory surgery center joint venture with a for-profit entity and this did not qualify it for tax-exempt status. In concluding that the IRS had properly denied Redlands’ request for exemption, the Court reasoned that, to the extent Redlands ceded control over its only activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, Redlands could not ensure that the joint venture operated in furtherance of exempt purposes.

4. Baptist Health System.

a. Facts. On December 8, 1997, the IRS sent a 30-day letter to Baptist Health System in Birmingham, Alabama, proposing revocation of the § 501(c)(3) status of the 11-hospital group. See 97 TNT 244-3 (Dec. 19, 1997) (IRS alleges that the amount paid by BHS to purchase physician practices exceeded fair market value).

b. Findings. The case was settled in June, 1999 pursuant to a confidentiality agreement. Media reports disclose a settlement payment of almost $500,000.


a. Facts. In 1996, St. David’s, a tax-exempt hospital in Austin, Texas, and Round Rock Hospital, Inc., a for-profit corporation and an affiliate of Columbia/HCA Healthcare Corporation (“HCA”), entered into a whole-hospital joint venture. In the arrangement, each party contributed hospital systems in the Austin area to a newly-formed partnership. HCA had a slightly larger percentage interest (54.1% to 45.9%) for St. David’s) in the partnership for economic purposes (distributions, liquidation, etc.), but St. David’s and HCA had equal representation on the partnership’s board of governors. Another affiliate of HCA managed the operations under a management agreement with a 50-year term. The organizational documents of the partnership provided a binding obligation that all hospitals operated by the joint venture meet the community benefit standard. Pursuant to an audit, the IRS retroactively revoked St. David’s exemption under § 501(c)(3), claiming that the lack of control resulted in the venture operated more than incidentally for private benefit and not exclusively in
furtherance of its charitable purposes. The district court agreed with St. David’s stating “it is difficult to imagine a corporate structure more protective of an organization’s charitable purpose than the one at issue in this case.” It awarded summary judgment to St. David’s, and in a separate motion granted attorney’s fees and costs to St. David’s of approximately $950,000.

b. Findings. In vacating the district court’s ruling, the Fifth Circuit held that the central issue was not whether the partnership met the community benefit standard, which St. David’s argued it met through the partnership’s activities. The court agreed that the community benefit standard was likely met. Rather, similar to the holdings in Revenue Ruling 98-15 and the Redlands case, the court stated that control was necessary for St. David’s to maintain its exemption. The court determined that the issue of whether the requisite control was present was a question of fact that could not be decided on summary judgment. On remand to the district court, the jury summarily determined that the requisite control was present. See 2004 WL555095 (W.D. Tex. March 18, 2004). See also Rev. Rul. 2004-51, 2004-22 I.R.B. 974 (guidelines for ancillary joint ventures involving exempt organizations issued, but outside healthcare context).

C. Coordinated Examination Program and Hospital Audit Guidelines.

1. Coordinated Examination Program. In 1990, the IRS announced the beginning of a coordinated examination program (CEP) of hospital systems that would review exempt hospitals and all of their affiliates, exempt and for-profit, by a team that included EO specialists and IRS specialists outside of the EO area from the field and National Office. One purpose was to give the IRS a better handle on the scope and nature of hospital activities. The CEP program in the hospital area has continued as an IRS priority, although it has been renamed (“Team Examination Program”) and has evolved somewhat in its focus areas.

2. IRS Audit Guidelines for Hospitals. Reissued in 1992, these materials can be found at Manual Transmittal 7(10)69-38, Exempt Organizations Examination Guidelines Handbook (March 27, 1992), and reflect the increased sophistication of the IRS in the healthcare area. While they can take aggressive positions on certain subjects, they are a useful tool for practitioners. See IRS Announcement 92-83.

D. IRS Focus on Documentation and Conflicts of Interest Policy.

1. Documentation. The IRS focus on the importance of contemporaneous documentation in support of decisions made (e.g., incentive compensation, recruitment incentives, joint ventures, etc.) is reflected in Revenue Ruling 97-21, the rebuttable presumption of reasonableness standard in § 4958, and IRS emphasis on conflicts of interest policies.
2. **Conflicts of Interest Policy.** The IRS views a conflicts of interest policy as serving a number of purposes, including allowing the board to make decisions in an objective manner without undue influence by persons with a private interest and helping to assure that an exempt health care organization fulfills its charitable purposes, properly oversees the activities of its directors and principal officers, and pays no more than reasonable compensation to physicians and other highly compensated employees. The IRS expects the conflicts of interest policy to be substantial, be adopted by all exempt organizations in a hospital system, and apply to any transaction with an interested person. The IRS advises that a substantial conflicts of interest policy should include the following: disclosure by interested persons of financial interests and all material facts relating thereto; procedures for determining whether the financial interest of the interested person may result in a conflict of interest; procedures for addressing the conflict of interest after determining that there is a conflict; and appropriate disciplinary and corrective action with respect to an interested person who violates the conflicts of interest policy. There also should be procedures ensuring that the policy is distributed to all trustees, principal officers, and members of committees with board-delegated powers and each such person should sign an annual conflict statement. The IRS published a model conflicts of interest policy in 1997 and updated it in 1999. See FY 1997 CPE Text (1997-C) and FY 2000 CPE Text (2000-E). Go to [http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Continuing-Professional-Education-Technical-Instruction-Program](http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Continuing-Professional-Education-Technical-Instruction-Program) and click on “Exempt Organizations CPE Topical Index”. “Conflicts of Interests” is listed alphabetically. The IRS has also published the IRS model conflict of interest policy in the instructions to Form 1023.

E. **Recent Congressional and IRS Scrutiny.**

1. **Interested Bodies.** Beginning in 2003, Congressional leaders on both sides of the aisle began to express interest/concern regarding the nonprofit sector and, in particular, nonprofit hospitals. Ultimately, via hearings conducted by the House Ways and Means Committee, the Senate Finance Committee, the House Energy and Commerce Committee, and various subcommittees of the above, Congress undertook a full-fledged inquiry as to whether nonprofit hospitals continue to “deserve” tax-exempt status.

2. **Areas of Inquiry.** Collectively, the various hearings covered a wide range of issues, including:

   a. Basis for tax-exempt status.

   b. Charitable giving practices.

   c. Enforcement and accountability.

   d. Governance and oversight.
e. Executive compensation.

f. Charity care and community benefit.

g. Pricing, billing and collection practices.

3. **Proposed Reforms.** Various sources offered proposals as to legislative reforms for the nonprofit sector, including the staff of the Senate Finance Committee, the staff of the Joint Committee on Taxation, industry groups, state charity and tax officials, the Panel on the Nonprofit Sector, and the minority staff of the Senate Finance Committee (July 18, 2007). Areas targeted for reforms included:

   a. Federal and state enforcement.

   b. IRS 990 reporting.

   c. Financial oversight and disclosure.

   d. Governance/boards of directors.

   e. Executive compensation.

   f. Charity care/community benefit.

   g. Joint ventures.

   h. Billing and collection practices.

   i. Nonprofit/for-profit conversions.

4. **Information Requests.**

   a. **Community Benefit.**

      (1) **Grassley Letter.** In May 2005, Senate Finance Committee Chairman Charles Grassley (R-IA) sent a letter to 10 nonprofit hospitals and hospital systems asking them to account for their charitable activities by responding to a list of 46 questions on a wide range of areas. In a press release, Senator Grassley stated, “It’s my duty to make sure charitable donations actually help those in need . . . . By gathering information from nonprofit hospitals, I hope to learn whether the benefits they provide to the needy justify the tax breaks they receive.”

      (2) **GAO Report.** In response to a request from Sen. Grassley, on September 12, 2008, the General Accounting Office (GAO) issued a report entitled “Nonprofit Hospitals: Variation in Standards and Guidance Limits Comparison of How Hospitals Meet Community Benefit Requirements.”
The report concluded that the community benefit standard gives hospitals broad latitude to determine what services and activities constitute community benefit, while state requirements vary substantially. The report is available at www.gao.gov/new.items/d08880.pdf.

b. Executive Compensation.

(1) GAO Survey. As the result of a request from Congress, on July 28, 2006, the GAO published a survey entitled “Nonprofit Hospital Systems: Survey on Executive Compensation Policies.” The GAO sampled 100 tax-exempt hospital systems, which commonly reported practices such as: (i) having an executive compensation committee or entire board with primary responsibility for approving executives’ base salary, bonuses, and perquisites; (ii) having a conflict of interest policy that covers members of the executive compensation committee and compensation consultants; and (iii) relying upon comparable market data of total compensation and benefits prior to making compensation determinations. The report is available at www.gao.gov/new.items/d06907r.pdf.

(2) Grassley. Senator Grassley issued comments criticizing deficiencies in the GAO survey data, including 35 hospitals’ failure to respond, evidence of deficiencies in the compensation approval process, and perceived excessive retirement benefits.

5. IRS Initiatives.

a. Executive Compensation. As part of the Tax-Exempt Compensation Enforcement Project, in 2004 and 2005, the IRS contacted nearly 2,000 charities and foundations to seek more information about their executive compensation practices and procedures. The enforcement project consisted of examinations as well as these information requests.

b. Hospitals and Community Benefit. In June 2006, the IRS sent questionnaires to 544 tax-exempt hospitals requesting detailed information on community benefit statistics and programs, charity care practices and executive compensation practices to identify how such hospitals meet the community benefit standard for exemption under § 501(c)(3). This was a wide-ranging investigation of nonprofit hospitals by the IRS, intended to determine whether they are following standards for tax-exempt status, whether they deny care to people without insurance, and whether they provide significant amounts of charity care. The purpose of the questionnaires was to generate data for possible legislative reform with respect to the standards for nonprofit
hospitals. The questionnaires also led to IRS audits of certain nonprofit hospitals. The IRS issued the following reports:


c. **Tax-Exempt Bond Compliance Check.** In August 2007, the IRS issued another compliance check questionnaire on Form 13907 entitled “Tax-Exempt Bond Financings Compliance Check Questionnaire.” The IRS sent the questionnaire to more than 200 nonprofit organizations that have outstanding tax-exempt financing. Thus, nonprofit hospitals can expect increased scrutiny of their post-issuance compliance posture from the IRS relative to their tax-exempt financing practices; likely will be facilitated by Schedule K of the revised Form 990 (addressed below).

d. **Governance.** Since early 2007, the IRS has emphasized the need for tax-exempt organizations to adopt and implement effective governance practices. The IRS position is that, although tax laws do not directly regulate governance, effective governance is directly correlated with tax law compliance. The IRS has developed extensive governance training materials for its agents, and more recently has adopted a governance checksheet for use in audits of exempt organizations. Form 990, Part VI also reflects this emphasis. For more information, see: http://www.irs.gov/pub/irs-tege/governance_training_presentation.pdf and http://www.irs.gov/pub/irs-tege/eo_determ_gov_cpe_ppt.pdf

e. **Colleges and Universities Compliance Project.** In 2008, the IRS distributed detailed questionnaires to 400 randomly-selected colleges and universities in order to examine potential noncompliance in the areas of unrelated business taxable income and executive compensation. The Final Report of this Project was posted on April 25, 2013. The UBTI component focused on expenses not connected to the unrelated business activities, lack of profit motive, improper expense allocation, errors in computation or substantiation, and reclassifying exempt activities as unrelated. This component of examinations resulted in increases in UBTI for 90% of the examined organizations totaling about $90 million and disallowance of more than $170 million in losses and NOLs. The executive compensation component focused mostly on compliance with § 4958 requiring that organizations not pay more than reasonable compensation to their disqualified persons. About 20% of the examined organizations failed to meet the rebuttable presumption standard. For more information, see: http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf.
f. National Research Program. FY 2013 was the third and final year of this IRS-wide research project on employment tax compliance. This was the first comprehensive examination of employment tax compliance since 1984. In this project, EO revenue agents examined employment tax forms filed by exempt organizations for the tax years 2008, 2009 and 2010.

g. § 501(c)(4),(5) and (6) “Self Declarers”.

In FY 2012, EO developed a project focusing on § 501(c)(4),(5) and (6) organizations. These entities, which include social welfare organizations; labor, agricultural and horticultural groups; and trade associations, can declare themselves tax-exempt without seeking a determination from the IRS. EO wants to learn more about whether such organizations have classified themselves correctly and are complying with applicable rules.

In FY 2013, EO sent a questionnaire to more than 1,000 § 501(c)(4), (c)(5) and (c)(6) organizations that claimed tax-exempt status without being recognized by the IRS as exempt (i.e., that “self-declared”) and that filed Form 990 for tax year 2010 or 2011. The purpose of the questionnaire was to help the IRS better understand organizations that have self-declared and to learn how they satisfy their exemption requirements. See http://www.irs.gov/Charities-&-Non-Profits/Other-Non-Profits/Self-declarers-questionnaire-for-section-501-c-4-5-and-6-organizations.

h. The FY 2013 Annual Workplan stated that EO would examine a statistically valid sample of organizations reporting substantial gross unrelated business income for three consecutive tax years, but reporting no income tax due for any of those years. EO’s concern is whether these organizations are accurately reporting their sources of unrelated business income and correctly allocating and deducting expenses associated with it.

i. Priority Guidance Plan – Treasury has included the following initiatives in its 2014-2015 Priority Guidance Plan:

1. Revenue Procedures updating grantor and contributor reliance criteria under §§ 170 and 509.

2. Revenue Procedure to update Revenue Procedure 2011-33 for EO Select Check.

3. Proposed regulations under § 501(c) relating to political campaign intervention.

4. Final regulations on application for recognition of tax exemption as a qualified nonprofit health insurer under § 501(c)(29) as added by § 1322 of the ACA. (Temporary
and proposed regulations were published on February 7, 2012.)

(5) Final regulations under §§ 501(r) and 6033 on additional requirements for charitable hospitals as added by §9007 of the ACA. (Proposed regulations were published on June 26, 2012 and April 5, 2013.)

(6) Additional guidance regarding § 509(a)(3) supporting organizations.

(7) Guidance under § 512 regarding methods of allocating expenses relating to dual use facilities.

(8) Guidance under § 4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners.

(9) Final regulations under §§ 4942 and 4945 on reliance standards for making good faith determinations. (Proposed regulations were published on September 24, 2012.)

(10) Final regulations under § 4944 on program-related investments and other related guidance. (Proposed regulations were published on April 19, 2012.)

(11) Guidance regarding the excise taxes on donor advised funds and fund management.

(12) Guidance under § 6033 relating to the reporting of contributions.

(13) Final regulations under § 6104(c). (Proposed regulations were published on March 15, 2011.)

F. Legislation.

1. There have been various proposals in recent years, mostly from Sen. Charles Grassley and Sen. Max Baucus. The focus primarily has been differences between tax-exempt and for-profit hospitals, minimum charity care and community benefit standards, and executive compensation (including, e.g., eliminating any taxpayer protection from the rebuttable presumption, making its three prongs mandatory, and requiring organizations to report in Form 990 the specific comparability data relied upon in setting executive compensation).

2. Led to inclusion of various reforms in Patient Protection and Affordable Care Act of 2010 (H.R. 3590), enacted March 23, 2010 – see §§ 9007 and 10903 of PPACA.
3. New § 501(r), imposing additional requirements for hospitals to obtain/maintain exemption under § 501(c)(3) (see prior discussion).

4. Other requirements of PPACA:

   a. Hospitals must file a copy of their audited financial statements (separate or consolidated) along with Form 990.

      (1) Results in audited financials becoming subject to public disclosure requirements of IRC § 6104.

   b. IRS is to review every hospital’s community benefit activities at least once every three years.

   c. IRS is to report annually on charity care, bad debt, and government program shortfalls for exempt, taxable and governmental hospitals; and on community benefit costs incurred by exempt hospitals.

   d. Based on the above information, IRS is to provide a five-year report on trends.

G. Other Recent Congressional Interest.

1. In October 2011, Rep. Charles Boustany, chairman of the House Ways and Means Subcommittee on Oversight, wrote a letter to IRS Commissioner Douglas Shulman asking for information regarding the Service’s administration and oversight of exempt entities. The request followed an April 2011 Oversight Subcommittee hearing on the activities of AARP (a § 501(c)(4) organization) and whether those activities are consistent with the organization’s exempt purpose. The letter requested detailed information on compliance, unrelated business income, audits, and current tax-exempt enforcement initiatives. It also specifically asked about new reporting requirements for tax-exempt hospitals and requested a status update on the 2008 Colleges and University Compliance Project.

2. In April 2012, Rep. Boustany announced a subcommittee hearing to examine the operations and oversight of tax-exempt organizations for consideration as part of overall tax reform. Boustany announced that the May 16 Subcommittee hearing on exempt organizations operations and oversight will be the first in a series directed at the tax-exempt sector and the Service’s oversight of it. In announcing the hearing, Boustany declared that oversight of the tax-exempt sector is an important priority for the Subcommittee. He added that he had a chance to hear from the IRS in response to his October 2011 information request. He stated that this hearing is a chance to hear from members of the tax-exempt community. Boustany noted that the Committee’s goal in looking at the tax-exempt sector as part of comprehensive tax reform is to ensure that the sector is operating efficiently and that the laws governing it are being applied fairly and evenly.
3. Section 340B of the Public Health Service Act, 42 U.S.C. 256(b), created a prescription drug discount program, known as the 340B program. The 340B program requires drug manufacturers to provide outpatient drugs to eligible health care organizations/covered entities at reduced prices. Covered entities are permitted to contract with a retail pharmacy to facilitate the program.

Senator Grassley made the following comment about 340B eligibility and hospital executive bonuses: “Hospitals eligible for the 340B program are supposed to have a high indigent patient population. If some 340B-eligible hospitals have significant money available for executive bonuses, that raises questions about how they allocate their resources.” See June 18, 2013 Grassley Memorandum Re: Discount prescription drug program. (http://www.grassley.senate.gov/news/news-releases/discount-drug-program-hospital-executive-bonuses).

In July 2013, Senator Charles Grassley, Ranking Member of the Committee of the Judiciary, sent a letter to Walgreen’s president and CEO, Greg Wasson, regarding the growing profits generated from the 340B drug discount program. Contract pharmacies are the focus of inquiry regarding the sale of discounted drugs intended for 340B program patients at a markup to those insured through Medicare. Senator Grassley concluded his letter to Walgreens inquiring about the 340B programs and profits by noting that maintaining the integrity of the 340B program is of the utmost importance.

4. On June 13, 2013, in the ninth of a series of papers on tax reform, the Senate Finance Committee proposed ideas to amend the Internal Revenue Code. The ideas include limiting political activities of § 501(c)(4) organizations to 10% of expenditures and creating a new tax category for groups engaging in political activity. See http://www.finance.senate.gov/issue/?id=046ec1ca-5a13-4dc2-83ee-30a92cafbd73.

VIII. § 501(c)(4) QUALIFICATION.

A. **Exemption.** To be exempt under § 501(c)(4), an organization must not be organized for profit and must be operated exclusively for the promotion of social welfare.

B. **Promotion of Social Welfare.** Requires an organization to operate primarily to further in some way the common good and general welfare of the people of the community. Operation of a social club is not the promotion of social welfare.

C. **Private Inurement.** The 1996 Taxpayer Bill of Rights 2 (which enacted intermediate sanctions) extended the private inurement prohibition to organizations described in § 501(c)(4).

D. **Lobbying.** An organization that furthers its social welfare purposes primarily through lobbying can qualify for exemption. However, an organization that loses its exemption under § 501(c)(3) because it engages in more than insubstantial

E. **Electioneering.** An organization may engage in some political activities, so long as it is not its primary activity, and qualify under § 501(c)(4). Political expenditures may, however, be subject to tax under § 527(f). See, e.g., PLR 201128035 (07/15/11) (denying exemption where an organization’s activities were primarily for the benefit of a particular political party and private groups of individuals, rather than the community as a whole).

F. **Tax Disadvantages/Advantages.** § 501(c)(4) organizations are not eligible to receive tax-deductible contributions or to obtain tax-exempt financing. There is no public charity/private foundation distinction in § 501(c)(4) and, therefore, the private foundation rules are inapplicable.

G. **Application Process.** A § 501(c)(4) organization may apply for recognition on IRS Form 1024 (Application for Recognition of Exemption under Code § 501(a)).

H. **Proposed Regulations.** On November 29, 2013, Treasury and the IRS issued proposed regulations affecting the activities of organizations exempt under § 501(c)(4). See “Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities,” 78 Fed. Reg. 71535 (Nov. 29, 2013). The goal of the proposed regulations is to provide more definitive rules regarding a § 501(c)(4) organization’s political activities that would “provide greater certainty” and “reduce the need for detailed factual analysis” or “fact-intensive determinations.” The proposed regulations would define a new category of activity, “candidate-related political activity,” that would not be considered to promote “social welfare,” the exempt function of many § 501(c)(4) organizations.


J. **Enforcement Activity.** In May 2011, the IRS confirmed that it had begun examinations of 5 donors to (c)(4) organizations, to determine whether their donations instead should have been reported as taxable gifts. These efforts represented the first time the IRS had pursued the question of gift taxes on donations to non-(c)(3) exempt organizations since the early 1980s (when it had issued Rev. Rul. 82-216). Per an internal IRS memorandum dated July 7, 2011, IRS leadership directed agents to drop these cases, given the “significant legal, administrative and policy implications” at issue, combined with the near absence of enforcement history. Not surprisingly, much political gamesmanship accompanied the entire brouhaha, although the IRS steadfastly denied any political influences.

K. **Continued Congressional Interest.** In April 2011, the House Ways and Means Oversight Subcommittee held a hearing on the activities of the AARP and its exempt purpose. § 501(c)(4)s have continued to be a hot topic, with allegations on both sides of the aisle that (c)(4)s are in fact disguised political entities doing the bidding of certain candidates or political parties. See, e.g., September 17, 2012 response of U.S. Sen. Orrin Hatch (Ranking Member, Senate Finance
Committee) and U.S. Rep. Dave Camp (Chairman, House Ways and Means Committee) to New York Attorney General Eric Schneiderman’s inquiry into perceived politically-active § 501(c)(4) organizations, asserting that Schneiderman should adhere to established IRS processes for states to obtain tax return information (http://www.finance.senate.gov/newsroom/ranking/release/?id=bac6d9e9-ddcd-4d6a-b8b2-20b691ff5162).

In 2013, an IRS scandal broke regarding increased scrutiny of tea party groups applying for § 501(c)(4) status. The Determinations Unit of the IRS, based out of Cincinnati, was criticized for the alleged targeting of particular applications for § 501(c)(4) status. The IRS was accused of using a filtering process that identified certain terms in the entity name, such as “tea party” for additional scrutiny into their activities, in particular whether inappropriate political activity was occurring.

In the aftermath, § 501(c)(4) reform is trending, yet lawmakers on either side have differing views. One point of convergence is the statutory requirement that a social welfare organization be “operated exclusively for the promotion of social welfare” (IRC § 501(c)(4)(A)) and whether there should be a strict interpretation of “exclusively.” The regulations describe a qualifying § 501(c)(4) as one that is “operated primarily for the purpose of bringing about civic betterments and social improvements.” (Comments from various sources made to BNA reporters. Lorenzo, A., Heller, M. “Tax Management Weekly Report”; 32 TMWR 773; (6/10/2013)).

In June 2014, the U.S. House of Representatives Committee on Appropriations released a Fiscal Year 2015 Financial Services Bill. According to a press release that cites “inappropriate actions by the IRS in targeting groups that hold certain political beliefs, as well as its previous improper use of taxpayer funds,” the bill would significantly decreasing funding for the IRS and also includes the following provisions:

- A prohibition on a proposed regulation related to political activities and the tax-exempt status of § 501(c)(4) organizations (on the basis that “the proposed regulation could jeopardize the tax-exempt status of many non-profit organizations and inhibit citizens from exercising their right to freedom of speech, simply because they may be involved in political activity”).

- A prohibition on funds for bonuses or awards unless employee conduct and tax compliance is given consideration.

- A prohibition on funds for the IRS to target groups for regulatory scrutiny based on their ideological beliefs.

- A prohibition on funds for the IRS to target individuals for exercising their First Amendment rights.

- A prohibition on funding for the production of inappropriate videos and conferences.
• A prohibition on funding for the White House to order the IRS to determine the tax-exempt status of an organization.

• A requirement for extensive reporting on IRS spending.


L. Limited Time Expedited Review Process and Self-Certification Option for § 501(c)(4) Applicants. Following a review of internal procedures to reduce the backlog of tax-exempt applications, the IRS in 2013 offered certain organizations that had applied for § 501(c)(4) status a faster, optional method to gain tax-exempt status. If an organization’s application had been pending for more than 120 days as of May 28, 2013, and the organization’s activities involved possible political campaign intervention or issue advocacy, it may have received a Letter 5228 (Optional Expedited Process for Certain Exemption Applications Under Section 501(c)(4)). Under the program, IRS would send the organization a favorable determination letter within two weeks after it received the organization’s signed representations that the organization devoted 60% or more of both spending and time to activities that promote social welfare as defined by § 501(c)(4) and the organization devoted less than 40% of both spending and time to political campaign intervention. The organization was required to ensure the above thresholds apply for past, current and future activities. See FS 2013-8 (June 2013) http://www.irs.gov/uac/Newsroom/IRS-Offers-New-Streamlined-Option-to-Certain-501c4-Groups-Caught-in-Application-Backlog. This expedited processing program is no longer available for new applicants, however. See http://www.irs.gov/Charities-&-Non-Profits/New-Review-Process-and-Expedited-Self-Certification-Option.

IX. INTERACTION WITH THE IRS.

A. Exemption Application.

1. Overview. Organizations seeking § 501(c)(3) status must obtain IRS recognition of such status by filing an exemption application. See § 508(a).

Prior to July 2014, there was only one form of application, the Form 1023. In July 2014, however, the IRS introduced a new, shorter application form (the Form 1023-EZ) for use by certain (but not all) small charities. The Form 1023-EZ is three pages long, compared to the standard 26-page Form 1023. Most organizations with annual gross receipts of $50,000 or less and assets of $250,000 or less are eligible to use the Form 1023-EZ.

In trimming the application, the IRS removed the requirement to provide a narrative description of the organization’s activities and financial information. The list of officers, directors, trustees and employees is limited to five individuals (in an order prescribed by the instructions), and the organization merely attests to and represents certain facts about its operations rather than providing long narrative explanations. The current
user fee for the Form 1023-EZ is $400 (as compared to $850 for the Form 1023). The Form 1023-EZ is filed electronically through the government’s Pay.gov website.

The new form is intended to speed the IRS’ approval process for smaller groups and free up resources to review applications from larger, more complex organizations while reducing the application backlog. At the time the Form 1023-EZ was released, the IRS had more than 60,000 § 501(c)(3) applications in its backlog, with many of them pending for nine or more months. The IRS anticipates that as many as 70% of all applicants will qualify to use the new streamlined form.

2. **Form 1023.** The standard IRS Form 1023 must be filed by applicants who do not qualify to file the IRS Form 1023-EZ.

   a. Form 1023 requires that the organization provide IRS with extensive information about either its past and current activities (if the organization has existed for some time) or its expected activities (if a newly-formed organization).

   b. Schedule C of Form 1023 contains special questions and information the IRS will review in the exemption determination process for a requesting hospital, including information regarding participation in healthcare joint ventures and relationships with physicians on its medical staff.

   c. All exemption applications are sent to Covington, KY processing center. Applications are either processed there, or are sent from Covington to another regional office.

   d. **Recommended reading:**

3. Interactive Form 1023 (Form i1023). The IRS recently developed an online interactive guide to help applicants correctly complete and submit the Form 1023. The Interactive Form 1023 (i1023) features pop-up information boxes for most lines of the form. These boxes contain explanations and links to related information on www.IRS.gov and www.StayExempt.irs.gov, EO’s educational website. The Form i1023 is available at: http://www.stayexempt.irs.gov/StartingOut/InteractiveForm1023Application.aspx.

4. Form 1023-EZ. Most (but not all) organizations with actual and anticipated annual gross receipts of $50,000 or less and assets of $250,000 or less are eligible to file the new, shorter Form 1023-EZ. To determine an organization’s eligibility to use Form 1023-EZ, one may use the Eligibility Worksheet provided in the Instructions for Form 1023-EZ. Although an organization may be eligible to file Form 1023-EZ, it may choose to file Form 1023 instead.

The Form 1023-EZ must be filed online. Further details about the new Form 1023-EZ application process may be found in Rev. Proc. 2014-40. See also new final and temporary regulations published at 79 Fed. Reg. 37630 (July 2, 2014).

Pursuant to Rev. Proc. 2014-40, Section 4.06, an organization eligible to file a Form 1023-EZ with a pending Form 1023 may submit a Form 1023-EZ if the Form 1023 has not yet been assigned for review. The application will be treated as a written request for withdrawal of the Form 1023. (Accordingly, the user fee for the Form 1023-EZ must be submitted, and the Form 1023 user fee generally will not be refunded.)

5. Effective Date. The effective date of an organization’s tax-exempt status depends on when its exemption application was filed.

a. If an organization files Form 1023 within 27 months from the date of formation, exemption may be granted retroactively to date of formation. See Treas. Reg. § 601.201(n)(3)(i); see also Rev. Proc. 84-47, 1984-1 C.B. 545.


b. If organization files Form 1023 more than 27 months from the date of formation, exemption may be retroactive only to the date of filing. See Rev. Rul. 77-208, 1977-1 C.B. 153; Rev. Rul. 77-469, 1977-2 C.B. 196. See also Schedule H to Form 1023, listing certain questions and exceptions for tardy filers, including the
possibility of § 501(c)(4) status for periods prior to the filing of Form 1023. A § 501(c)(3) applicant organization that files its Form 1023 more than 27 months after formation may still qualify for § 501(c)(4) status retroactive to its formation, but will not receive a determination letter confirming retroactive § 501(c)(4) exemption if it files for exemption outside of the first 27 months from the end of the month in which it was organized. See Rev. Proc. 2014-9.

6. **Retroactive Recognition of Exemption.** For organizations other than § 501(c)(3), (9), (17) and (29), Rev. Proc. 2013-9 created new requirements for retroactive recognition of exemption. Prior to 2013, and back to 1962, when such organizations applied for recognition, the IRS usually would recognize such organizations as tax-exempt from the date of formation, no matter how long the interval between the date of formation and the date of application. In addition to the practical difficulties of ascertaining an organization’s purposes and activities for this period, such recognition is now potentially inconsistent with the provisions of § 6033(j), which automatically revokes the exempt status of an organization that fails to file required Form 990 series returns or notices for three consecutive years. The new procedure adopts a practice similar to the rule for § 501(c)(3) organizations for these organizations, generally permitting recognition from the date of formation if the organization has always met the requirements for exemption, has applied within 27 months from the end of the month in which it was organized, and has not failed to file required Form 990 series returns or notices for three consecutive years.

7. **Determination Letter.** IRS approval comes in the form of a “determination letter.” This is a standard form letter, which summarizes the consequences of exemption. All exempt organizations should retain their determination letter as part of their permanent files.

8. **Group Rulings.** Certain organizations may avoid the need to file IRS Form 1023 if they instead qualify for inclusion in a group exemption ruling. For example, many Catholic hospitals are included in the group exemption granted to the Catholic Church throughout the United States. However, the IRS may decline to issue a group exemption letter when appropriate in the interest of sound tax administration under Rev. Proc. 2013-9. (See PLR 201330043). See Rev. Proc. 80-27, 1980-1 C.B. 677 (setting for the criteria for obtaining and maintaining a group exemption ruling). (See also Group Exemptions and Group Returns: http://www.irs.gov/Charities-&-Non-Profits/Group-Exemption-Rulings-and-Group-Returns.)

In FY 2012, EO developed the Group Rulings Questionnaire for completion by 2,000 randomly selected central organizations holding group rulings. The impetus for this questionnaire was the 2011 report on group exemptions by the Advisory Committee to TE/GE (ACT), together with the large number of subordinates whose exemption was automatically revoked for failing to file a Form 990-series return for three consecutive years. EO hopes to learn about the relationship between
central organizations and their subordinates and the ways in which central organizations and their subordinates satisfy their filing requirements.

a. See Bartlett and Jones, Operating Under a Group Exemption, Taxation of Exempts (WG&L), Jan/Feb 2011.


9. Advance Ruling Process. Until September 2008, newly formed organizations seeking IRS recognition of public charity status based on sources of public support (i.e., under §§ 509(a)(1) and 509(a)(2)) were required to accept an “advance ruling” of their publicly supported status in connection with receipt of their determination letters. Then, after five years, the organizations could obtain a final ruling as to public charity status by submitting Form 8734 to the IRS, demonstrating their actual sources of public support over the five-year period. Effective in September 2008, the advance ruling process was eliminated. IRS is now able to capture the required information via organizations’ annual Form 990 information returns. Organizations retain public charity status during first five years, regardless of actual sources of support. For more information, see:

B. Annual Information Returns (IRS Form 990).

1. Filing Requirement. Even though § 501(c)(3) organizations may not pay income taxes, they must file annual information returns (IRS Form 990). See § 6033. Certain types of organizations (e.g., churches) may avoid the need to file.

2. Overview.

a. Scope. Form 990 calls for reporting of detailed information regarding the exempt organization’s activities, directors and officers, and results of operations, including its income and expenses, as well as its balance sheet and changes in financial position.

b. Revision for Tax Years Beginning January 1, 2008 and After. On December 20, 2007, the IRS issued a significantly redesigned Form 990 in final form. Referred to by IRS TE/GE leadership as “the biggest thing in 30 years.”

c. Schedule H. Schedule H to the redesigned Form 990 requires extensive data concerning how exempt hospitals satisfy the IRS’s community benefit standard, such as charity care and Medicaid cost data, charity care policies and emergency room policies.
3. **Small Organizations.** Most organizations having annual gross receipts that normally average $50,000 or less ($25,000 or less for tax years ended prior to 12/31/2010) must file an online, shortened version of the Form 990, via Form 990-N (the “e-Postcard”), unless they choose to file a complete Form 990 or Form 990-EZ instead. See http://www.irs.gov/Charities-&-Non-Profits/Annual-Electronic-Filing-Requirement-for-Small-Exempt-Organizations-Form-990-N-(e-Postcard).

4. **Automatic Exemption Revocation for Non-Filing.** Per the Pension Protection Act of 2006, any exempt organization required to file an annual return or to submit an annual electronic notice is subject to automatic revocation of exemption for failure to file for three consecutive years. See http://www.irs.gov/pub/irs-tege/auto_rev_faqs.pdf
   

b. Exempt Organization Select Check is an online search tool which allows users to select an exempt organization and check certain information about its federal tax status and filings. Users have access to: (1) Publication 78, used to determine organizations eligible to receive tax-deductible charitable contributions, (2) tax-exemption auto revocations, and (3) 990-N filers. See http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check.

5. **Due Date.** Form 990 is due no later than the 15th day of the 5th month following the close of the organization’s taxable year. Extensions may be granted for up to six months. See § 6081. The IRS grants a three-month automatic extension. Upon IRS approval, an additional three-month extension may be granted.

6. **Public Disclosure.**
   
a. **Generally.** § 501(c)(3) organizations must make their exemption applications (Form 1023), three most recent information returns (Forms 990), and three most recent UBTI returns (Forms 990-T) available to the public. See § 6104 and Treas. Reg. § 301.6104(d). As a result of PPACA, now includes audited financial statements too.

b. **Exclusions.** All portions of Form 990 are subject to disclosure, other than the names and addresses of the organization’s contributors. All portions of Form 990-T are subject to disclosure.

c. **Inspection.** Must make available for inspection at principal office and regional and district offices.
d. **Copies.** Must provide copies upon request, either immediately for a request in person, or within 30 days for written requests.

   (1) May charge a reasonable fee for copying and postage.

   (2) If forms are “widely available” (e.g., on Internet), need not provide copies.

7. **Additional Resources.**


C. **Confirming Continued Exempt Status.**

   1. **Reliance on Determination Letter.** Once an organization obtains a determination letter, if the organization later undergoes a material change in its character, purposes or methods of operation (in comparison to as described in exemption application), the organization may be unable to rely on its prior determination letter. See Treas. Reg. § 601.201(n)(3)(ii).

   2. **How to Handle.**

      a. Organization must check the appropriate boxes on next annual information return (see Part III, Line 3 and Part VI.A. Line 4 on revised Form 990), and provide supplemental information describing the changes.

      b. Depending on the level of risk, the organization also may wish to seek informal advice from the IRS (either by telephone or through an in-person conference) or a formal redetermination through Cincinnati TE/GE or the filing of a private letter ruling request with the IRS National Office.

      c. Form 8940, *Request for Miscellaneous Determination* may be used for the following types of requests:

         (1) Advance approval of certain private foundation set-asides;

         (2) Advance approval of private foundation voter registration activities;

         (3) Advance approval of private foundation scholarship procedures;

         (4) Exemption from Form 990 filing requirements;
(5) Advance determination that a potential grant or contribution is an “unusual” grant, excluded from certain public support calculations;

(6) Change in (or initial determination of) type of § 509(a)(3) supporting organization;

(7) Reclassification of foundation status (includes voluntary request for private foundation classification);

(8) IRC 507(b)(1)(B) termination of private foundation status – advance ruling request; or

(9) IRC 507(b)(1)(B) termination of private foundation status – 60-month period ended.

For further guidance, see Rev. Proc. 2011-10, 2011-2 IRB 294 (consolidating various prior revenue procedures and announcements regarding public charity and private foundation classification). This Revenue Procedure is now updated annually, with the most recent being Rev. Proc. 2014-10.

3. Change in Foundation Status. Organizations that are seeking to change their foundation status, including requests from public charities for private foundation status and requests from public charities to change from one public charity classification to another public charity classification, or seeking a determination or a change as to supporting organization type or functionally integrated status, or seeking operating foundation or exempt operating foundation status, must submit Form 8940, as well as the appropriate user fee pursuant to Rev. Proc. 2014-8 or its successor revenue procedures. See Rev. Proc. 2014-10. Entities also retain the option to present self-classification on the Form 990, although this will not result in an updated determination letter or update in the IRS business master file.

D. Enforcement.

1. Historically, examination activity in the exempt organizations taxpayer community has been somewhat limited in recent years.

2. However, since approximately 2005, IRS has placed a new emphasis on enforcement via:

a. Examinations (i.e., audits).

   (1) Defined as a review of an organization’s books and records to determine tax liability for a particular period. In the case of an exempt organization, also includes continued qualification for exempt status.

   (2) Two types:
(a) **Correspondence audits.**

(i) Limited in scope, generally to only one or two items on a return.

(ii) Generally conducted by an EO specialist.

(iii) Accomplished via letters and phone calls.

(b) **Field examinations.**

(i) Broader in scope.

(ii) Conducted by one or more revenue agents.

(iii) Work occurs on-site at organization’s place of business.

(iv) Two types:

(a) Team Examination Program (TEP) – A large, complex organization is audited by a team of specialized revenue agents; may include coordination between IRS and other government agencies.

(b) General Program – Individual revenue agent handles.

b. **Compliance checks.**

(1) Defined as a review to determine whether an organization is adhering to recordkeeping and information reporting requirements.

(2) Not an “audit,” since process does not directly relate to determining an organization’s tax liability for a particular period.

(3) Handled by an EO specialist.

(4) Conducted via telephone or written correspondence.

(5) Technically, participation (response) by an organization is “voluntary.” However, failure to participate may result in IRS opening a formal examination.

3. In June 2014, the U.S. House of Representatives Committee on Appropriations released the Fiscal Year 2015 Financial Services Bill. Included in the bill is $10.95 billion for the IRS – which would be a cut of
$341 million below the fiscal year 2014 enacted level and $1.5 billion below the President’s budget request. This would bring IRS’ budget below the sequester level and below the level that was in place in fiscal year 2008. The trend of large budget cuts may hamper the IRS’ capacity for compliance audits.

With such a large reduction in funds, focused audits may become a regular practice. Similar to the Colleges and Universities Compliance Project and the Employment Tax National Research Project, focused audits begin with distribution of detailed questionnaires to a randomly-selected population that meet certain parameters in order to examine potential noncompliance in various areas. These focused audits are more efficient and may become more common with growing demands and a slashed budget.
<table>
<thead>
<tr>
<th>Statute §501(r)(3)</th>
<th>Proposed Regs. §1.501(r)-3</th>
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| 1. Conducts a CHNA every three years. | • Define the community it serves  
| | • Assess the health needs of that community (i.e., identify “significant” health needs of the community, prioritize those health needs, and identify potential measures and resources (such as programs, organizations, and facilities in the community) available to address the health needs  
| | • Document the CHNA in a written report (“CHNA report”) that is adopted for the hospital facility by an authorized body of the hospital facility  
| | | o A definition of the community served by the hospital facility and a description of how the community was determined  
| | | o A description of the process and methods used to conduct the CHNA  
| | | o A description of how the hospital facility took into account input from persons who represent the broad interests of the community it serves  
| | | o A prioritized description of the significant health needs of the community identified through the CHNA, along with a description of the process and criteria used in identifying certain health needs as significant and prioritizing such significant health needs; and  
| | | o A description of the potential measures and resources identified through the CHNA to address the significant health needs.  
| | • Hospitals facilities collaborating with other hospital facilities may issue a joint CHNA report. |
| 2. Adopts an implementation strategy to meet the needs identified through CHNA. | • Describes how the hospital facility plans to address the health need.  
| | • Identifies the health need as one the hospital facility does not intend to address and explains why the hospital facility does not intend to address the health need.  
| | • Adopted in the same taxable year the CHNA has been conducted. |
3. CHNA takes into account input from persons who represent the broad interests of the community served by the hospital facility, including those with special knowledge of or expertise in public health,

- At least one state, local, tribal, or regional governmental public health department (or equivalent department or agency) with knowledge, information, or expertise relevant to the health needs of that community
- Members of medically underserved, low-income, and minority populations in the community served by the hospital facility, or individuals or organizations serving or representing the interests of such populations
- Written comments received on the hospital facility’s most recently conducted CHNA and most recently adopted implementation strategy.

4. CHNA is made widely available to the public.

- Available on website (until two subsequent CHNAs have been posted), or
- Paper copy

5. § 4959 imposes a $50,000 excise tax for failure to meet the requirements of §501(r)(3).

- For organizations with multiple facilities the $50,000 tax is imposed on the hospital organization separately for each hospital facility’s failure.

<table>
<thead>
<tr>
<th>Statute §501(r)(4)</th>
<th>Proposed Regs. §1.501(r)-4</th>
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<tbody>
<tr>
<td>1. Eligibility criteria for financial assistance, and whether such assistance includes free or discounted care.</td>
<td>Specify all financial assistance available under the FAP, including all discount(s) and free care and, if applicable, the amount(s) (for example, gross charges) to which any discount percentages will be applied</td>
</tr>
<tr>
<td>2. The basis for calculating amounts charged to patients.</td>
<td>Specify all of the eligibility criteria that an individual must satisfy to receive each such discount, free care, or other level of assistance;</td>
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<td></td>
<td>State that following a determination of FAP-eligibility, a FAP-eligible individual will not be charged more for emergency or other medically necessary care than the amounts generally billed to individuals who have insurance covering such care (AGB);</td>
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<td>Describe which method the hospital facility uses to determine AGB</td>
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<tr>
<td><strong>3. The method for applying for financial assistance.</strong></td>
<td><strong>If the hospital facility uses the look-back method to determine AGB, either state the hospital facility's AGB percentage(s) and describe how the hospital facility calculated such percentage(s) or explain how members of the public may readily obtain this information in writing and free of charge.</strong></td>
</tr>
<tr>
<td><strong>4. In the case of an organization which does not have a separate billing and collections policy, the actions the organization may take in the event of non-payment, including collections action and reporting to credit agencies.</strong></td>
<td><strong>a hospital facility's FAP must describe how an individual applies for financial assistance under the FAP.</strong></td>
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<td><strong>Whether contained in a hospital facility's FAP or a separate written billing and collections policy established by the hospital, facility must describe:</strong></td>
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<td></td>
<td>o Any actions that the hospital facility (or other authorized party) may take relating to obtaining payment of a bill for medical care, including, but not limited to, any extraordinary collection actions</td>
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<td></td>
<td>o The process and time frames the hospital facility (or other authorized party) uses in taking the actions, including, but not limited to, the reasonable efforts it will make to determine whether an individual is FAP-eligible before engaging in any extraordinary collection actions and</td>
</tr>
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<td></td>
<td>o The office, department, committee, or other body with the final authority or responsibility for determining that the hospital facility has made reasonable efforts to determine whether an individual is FAP-eligible and may therefore engage in extraordinary collection actions against the individual</td>
</tr>
<tr>
<td><strong>5. Measures to widely publicize the policy within the community to be served by the organization.</strong></td>
<td><strong>FAP must include, or explain how members of the public may readily obtain a free written description of, measures taken by the hospital facility to:</strong></td>
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<td></td>
<td>o Make the FAP, FAP application form, and a plain language summary of the FAP (as defined in §1.501(r)-1(b)(19)) widely available on a Web site, as described in paragraph (b)(5)(iv) of this section</td>
</tr>
</tbody>
</table>
|   | o Make paper copies of the FAP, FAP application form, and plain language summary of the FAP available upon request and without charge, both in public locations in the hospital facility and by mail, in English and in the primary language of
any populations with limited proficiency in English that constitute more than 10 percent of the residents of the community served by the hospital facility

- Inform and notify visitors to the hospital facility about the FAP through conspicuous public displays or other measures reasonably calculated to attract visitors’ attention; and
- Inform and notify residents of the community served by the hospital facility about the FAP in a manner reasonably calculated to reach those members of the community who are most likely to require financial assistance.

6. A written policy requiring the organization to provide, without discrimination, care for emergency medical conditions (within the meaning of section 1867 of the Social Security Act (42 U.S.C. 1395dd)) to individuals regardless of their eligibility under the financial assistance policy.

- Hospital facility must establish a written policy that requires the hospital facility to provide, without discrimination, care for emergency medical conditions to individuals regardless of whether they are FAP-eligible
- Provides for care pursuant to EMTALA
- **Interference with provision of emergency medical care.** Policy must prohibit the hospital facility from engaging in actions that discourage individuals from seeking emergency medical care, such as by demanding that emergency department patients pay before receiving treatment for emergency medical conditions or by permitting debt collection activities in the emergency department or in other areas of the hospital facility where such activities could interfere with the provision, without discrimination, of emergency medical care.
  - Example: F’s emergency medical care policy also states that F prohibits any actions that would discourage individuals from seeking emergency medical care, such as by demanding that emergency department patients pay before receiving treatment for emergency medical conditions or permitting debt collection activities in the emergency department or in other areas of the hospital facility. See Prop. Reg. § 1.501(r)-4(c)(4).

<table>
<thead>
<tr>
<th>Statute §501(r)(5)</th>
<th>Proposed Regs. §1.501(r)-5</th>
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<tbody>
<tr>
<td>1. Limits amounts charged for emergency or other medically necessary care provided to individuals eligible for care, not more than the amounts generally billed to individuals who have insurance covering such care (AGB)</td>
<td>In the case of emergency or other medically necessary care, not more than the amounts generally billed to individuals who have insurance covering such care (AGB)</td>
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<td>AGB- determined by one of two methods which must</td>
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assistance under the financial assistance policy to not more than the amounts generally billed to individuals who have insurance covering such care, and continue to be used once adopted.

- Look-back method
  - Determine AGB by multiplying the gross charges by one or more percentages of gross charges (“AGB percentages”).
  - AGB percentages are calculated at least annually by dividing the sum of all fully paid claims during a prior 12-month period for emergency and other medically necessary care using either:
    - Claims paid by Medicare fee-for-service as the primary payer, including any associated portions of the claims paid by Medicare beneficiaries in the form of co-insurance or deductibles; or
    - Claims paid by both Medicare fee-for-service and all private health insurers as primary payers, together with any associated portions of these claims paid by Medicare beneficiaries or insured individuals in the form of co-payments, co-insurance, or deductibles.

  by the sum of gross charges for those claimed.

- One or multiple AGB % can be used. For example, one AGB % of gross charges for all care or multiple AGB % based on categories of care (such as inpatient or outpatient services).

- Must be calculated within 45 days of the end of 12 month period the percentage was used

- Prospective Medicare Method
  - Determine AGB by using the billing and coding process the hospital facility would use if the FAP-eligible individual were a
Medicare fee-for-service beneficiary and setting AGB for the care at the amount the hospital facility determines would be the amount Medicare and the Medicare beneficiary together would be expected to pay for the care.

- Hospitals facilities collaborating with other hospital facilities may issue a joint CHNA report.

| 2. Prohibits the use of gross charges. | • In the case of all other medical care, less than the gross charges for such care.  
• Safe Harbor if individual did not submit a complete FAP application by the time of charge and facility continues to make reasonable efforts that an individual is FAP eligible through the end of the application period and is corrected if determined to be FAP eligible. |

<table>
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<th>Statute §501(r)(6)</th>
<th>Proposed Regs. §1.501(r)-6</th>
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| 1. An organization meets the requirement of this paragraph only if the organization does not engage in extraordinary collection actions before the organization has made reasonable efforts to determine whether the individual is eligible for assistance under the financial assistance policy. | • A hospital organization meets the requirements of section 501(r)(6) with respect to a hospital facility it operates if the hospital facility (or third-party designee) does not engage in extraordinary collection actions (ECAs), against an individual (or designee of individual) before the hospital facility has made reasonable efforts to determine whether the individual is eligible for assistance under its financial assistance policy (FA).  
• ECAs are actions taken by a hospital facility against an individual related to obtaining payment of a bill for care covered under the hospital facility’s FAP that require a legal or judicial process or involve selling an individuals’ debt to another party or reporting adverse information about the individual to consumer credit reporting agencies or credit bureaus, including, but not limited to:  
  o Property liens  
  o Foreclosure on real property  
  o Attachment or seizure of bank account or other personal property  
  o Commencement of civil action  
  o Cause arrest |
- Cause individual to be subject to a writ of body attachment
- Wage garnishment

- **Reasonable efforts** means notifying the individual about the FAP during the notification period. “Notification” requirements pursuant to the proposed regulations are onerous. They include, notification of financial assistance policy by providing a plain language summary and offering a FAP application before discharge, including a summary of the FAP in at least three billing statements and in all other written communication and informing the individual of the FAP and in all oral communications with the patient regarding the care during the notification period.

- Facility can engage in ECAs after the notification period but must suspend ECAs when a FAP application is submitted prior to a longer application period. The proposed regulations define the application period as beginning on the first date care is provided and ending 240 days from the day the hospital provides the first billing statement for such care. The proposed regulations define the notification period as beginning on the first date care is provided and ending 120 days from the day the hospital provides the first billing statement for such care.