ACCESS TO CAPITAL

Final Section 501(r) Regulations: Implications for Tax-Exempt Bonds and Other Transactions of Nonprofit Hospital Organizations

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- General Overview of Section 501(r)
  - Enacted in the Affordable Care Act
  - Community Health Needs Assessment requirements, financial assistance policy requirements, requirements relating to limitations on charges and billing and collection requirements
  - Generally effective for tax years beginning after March 23, 2010
  - Interim guidance includes proposed regulations published on June 26, 2012 and on April 5, 2013, and IRS notices, which effectively provide safe harbors until final regulations apply
  - IRS Rev. Proc. 2015-21 provides procedures for correcting and disclosing noncompliance

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- General Overview of the Final Regulations
  - Published December 31, 2014
  - Generally apply to taxable years beginning after December 29, 2015
  - Contain very detailed requirements that generally are not safe harbors
  - Requirements include not only conducting Community Health Needs Assessments and adopting policies, but also actual implementation

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- Consequences of Noncompliance with Section 501(r)
  - Four levels of noncompliance addressed in detail in the final regulations:
    - Revocation of section 501(c)(3) status
    - Taxation of noncompliant hospital facilities and section 4959 excise tax
    - Correction and disclosure of noncompliance not willful or egregious
    - Correction of "minor errors and omissions"

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- Revocation of Section 501(c)(3) Status
  - Generally indicates a high threshold for revocation of 501(c)(3) status
  - Applies on an organization by organization basis
  - Suggests, but does not expressly provide, that revocation will ordinarily be limited to cases of "willful" or "egregious" noncompliance
  - Revocation may apply as of the first day of the taxable year in which the failure occurs
  - Provides for an "all the facts" and circumstances test that is very similar to the test for revocation of 501(c)(3) status because of excess benefit transactions (transactions with "disqualified persons") set forth in section 1.501(c)(3)-1(f)
  - "Minor omissions and errors" generally excused if corrected
  - Other noncompliance not "willful" or "egregious" excused if corrected and disclosed

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- Revocation of Section 501(c)(3) Status – Facts and Circumstances Test
  - Whether the organization has previously failed to meet the requirements and, is so, whether the same type of failure has previously occurred
  - The size, scope, nature and significance of the organization's failures
  - In the case of an organization that operates more than one hospital facility, the number, size and significance of the organization's failure(s)
  - The reason for the failure(s)
  - Whether the organization had, prior to the failure(s), established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the requirements
  - Whether practices and procedures had been routinely followed and the failure(s) occurred through an oversight or mistake in applying them
  - Whether the organization has implemented safeguards that are reasonably calculated to prevent similar failures from occurring in the future
  - Whether the organization corrected the failure(s) as promptly after discovery as is reasonable given the nature of the failure(s)
  - Whether the organization took the measures to implement safeguards and make corrections described above

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- Revocation "Facts and Circumstances" Test – Observations
  - Suggestion that "willful" noncompliance and a pattern of noncompliance would be particularly problematic
  - Adopting a process for making refinements to policies and procedures if noncompliance is discovered may be prudent
  - Organizations that had been subject to taxation of noncompliant hospital facilities could be more at risk for revocation for future noncompliance

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- Taxation of Noncompliant Hospital Facilities – Nature of the Tax
  - In addition to the section 4959 excise tax for failure to meet Community Health Needs Assessment requirements
  - Applies on a hospital facility by hospital facility basis
  - An income tax different than unrelated business income tax (UBIT) but in some respects similar to UBIT
  - The final regulations contain provisions to avoid "double counting" items relating to 501(r) noncompliance tax and UBIT
  - Tax could apply to one or more hospital facilities and not all the hospital facilities of an organization
  - Effectively an "intermediate sanction" similar to the excise benefit transactions income tax of section 4958
  - Taxation would apply to entire taxable year in which noncompliance occurs

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- Taxation of Noncompliant Hospital Facilities – Standards for Imposition
  - Implication that "willful" or "egregious" noncompliance would generally at least subject a hospital facility to taxation, but the tax could be imposed because of other instances of noncompliance
  - "Minor omissions and errors" generally excused if corrected
  - Implication that other noncompliance would generally subject a hospital facility to tax unless corrected and disclosed
  - Tax could be imposed because of noncompliance, even if corrected and disclosed, if the IRS determined the noncompliance was "willful" or "egregious"

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- The "Willful" or "Egregious" Standard
  - A "willful" failure includes a failure due to gross negligence, reckless disregard, or willful neglect
  - An "egregious" failure includes only very serious failures, taking into account the severity of the impact and the number of affected persons
  - Both are vague "facts and circumstances" tests

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- Correction and Disclosure of Noncompliance
  - Noncompliance that is not "willful" or "egregious" is excused if correction and disclosure is made following IRS procedures (Rev. Proc. 2015-21)
  - Disclosure is a factor that tends to establish that noncompliance was not "willful" or "egregious", but does not in itself establish that the noncompliance was not "willful" or "egregious"

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- Correction and Disclosure of Noncompliance – IRS Rev. Proc. 2015-21
  - Requires disclosure in the organization's Form 990 "for the tax year in which the failure is discovered"
  - Requires detailed disclosure of the failure, including type, cause, the facility where it occurred, time period and, in the case of noncompliance relating to charges or billing or collection requirements, an estimate of the number of individuals affected and the dollar amount involved
  - Requires detailed disclosure of the correction and (except in the case of CHNA noncompliance) a description of how affected individuals were restored to the position they would have been had the failure not occurred.
  - Corrections must be made regardless of whether a prior year is a closed taxable year, but not for refunds of less than $5

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- Correction of "Minor Errors and Omissions"
  - An omission or error is not treated as a failure to comply if
    - it was "minor" and "either inadvertent or due to reasonable cause" and
    - the hospital facility corrects the omission or error a promptly after discovery as is reasonable
  - Omissions or errors are "minor" only if minor in the aggregate
  - Previous corrections of the same error or omission tend to show the error or omission was not inadvertent
  - Establishment of practices and procedures tends to establish an omission or error was due to reasonable cause

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- Tax-Exempt Bond Consequences of Revocation
  - Revocation would likely be treated as resulting from a "deliberate act" causing noncompliance with use-of-proceeds rules, and would cause bonds to be taxable from the date of issuance
  - Breach of bond document covenants
  - Possibly could apply to a portion of a bond issue with multiple users
  - IRS would likely enter into a closing agreement to preserve the tax-exempt status of bonds, but there are no existing settlement standards for such a violation, and a "penalty factor" could be applied in addition to "tax exposure" on nonqualified bonds

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- Tax-Exempt Bond Consequences of Taxation of Noncompliant Hospital Facilities
  - The final regulations provide that taxation because of section 501(r) noncompliance does *not* by itself result in noncompliance with tax-exempt bond use-of-proceeds requirements
  - Possibly could result in breach of bond document covenants, depending on how framed
  - Imposition of the tax likely would be a matter of much more concern than imposition of substantial UBIT
  - Disclosure of imposition of the tax may be required or advisable, even if not a "material tax event'" under SEC Rule 15c2-12 and continuing disclosure agreements
  - Rendering "unqualified" section 501(c)(3) opinions for the organization would be more difficult, and more rigorous due diligence for opinions would likely be required
  - Possible adverse effect on financing costs for outstanding variable rate bonds and future financings

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- Tax-Exempt Bond Consequences of Disclosure and Correction of 501(r) Noncompliance
  - In light of the extreme detail of the requirements in the final regulations, disclosure possibly will be common
  - Disclosure of noncompliance for federal tax purposes will ordinarily be significantly delayed, because the Form 990 for the tax year of noncompliance will ordinarily be filed long after the noncompliance is identified
  - Disclosure for securities law purposes will likely be a judgment call, weighing the facts and circumstances and materiality
  - Disclosure is more likely to be determined to be required or advisable in instances of noncompliance that possibly could be treated as "willful" or "egregious"

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- Tax-Exempt Bond Consequences of Correction of "Minor Omissions and Errors"
  - Ordinarily no adverse consequence
  - Due diligence to ensure that corrections are actually made

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- Highlighted Provisions of the Final Regulations – Community Health Needs Assessment ("CHNA")
  - The regulations require:
    - The conduct of a study, in which the community served is defined (without exclusion of underserved, low income or minority populations) and health needs identified and prioritized, with input from health agencies and members/representatives of protected groups
    - The preparation of a report with describes how the study was conducted and what conclusions were reached
    - The preparation of an implementation plan describing what needs will be addressed and how, and what needs will not be addressed and why.

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- Examples – Noncompliance with Technical Requirements for a Community Health Needs Assessment
  - A hospital facility adopts a CHNA report and implementation plan in 2015 and , in 2017, in the course of due diligence for a transaction, counsel discovers that the CHNA does not contain all of the elements required by Treas. Reg. §1.501(r)-3. Hospital Organization proposes to correct the failure by preparing and adopting a CHNA report containing all of the required elements and making the corrected CHNA report widely available to the public, but not before the transaction closes.
  - What if there are no technical violations but report is anemic and largely repeats reports from prior periods without change?

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- Highlighted Provisions of the Final Regulations – Financial Assistance Policy Requirements
  - Applicability to "substantially-related entities"
  - Requirement of a list of providers, and whether not the FAP applies to them
  - Flexibility to determine "medically necessary care"
  - Specific requirements for "widely publicize", including to limited English proficiency populations

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- Example – Noncompliance with Financial Assistance Policy Requirements
- In 2015 a Hospital Organization adopts a FAP for a hospital facility that relies on unrelated parties for patients to obtain assistance in applying for benefits under the FAP. By 2017 many of the government agencies and community organizations named in the FAP have ceased to provide the necessary assistance.

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- Example – Noncompliance with Financial Assistance Policy Requirements

- In 2015 Hospital Organization revises its Financial Assistance Policy for a hospital facility to conform with the final regulations. The revised FAP (1) provides that it applies to all emergency and medically necessary care provides by an "substantially-related entity" and (2) provides that the FAP will include a list of any providers, other than the hospital facility itself, delivering emergency or other medically necessary care in the hospital facility that specifies which providers are covered and which are not.
- In 2016 Hospital Organization acquires control over an limited liability company treated as a partnership for federal tax purposes that provides medically necessary care in the hospital facility. The Hospital Organization treats the partnership and furthering its exempt purpose, and does not report any income from the partnership as unrelated trade or business income. In addition, although the Hospital Organization initially maintained the required list of providers, it did not subsequently update the list. In 2018, in the course of due diligence for a transaction, counsel determines that Hospital Organization has failed to comply with the requirements of Treas. Reg. §1.501(r)-4 in these respects.
- Counsel proposes that the Hospital Organization disclose the failure in its next Form 990, and develop a plan to take corrective action.

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- Highlighted Provisions of the Final Regulations – Limitations on Charges Requirements
  - Retains two specified methods for determining "amounts generally billed" (AGB):
    - "12-month look-back" method based on Medicare fee for service and all private health insurers or
    - Prospective method
  - Limitation on "gross charges" for "all medical care covered under the financial assistance policy"

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- Examples – Noncompliance with Limitations on Charges Requirements
  - In 2016, a hospital facility has failed to meet the requirements of Treas. Reg. §1.501(r)-5 because, due to processing errors, it charged FAP-eligible individuals more than an amount permitted and discovers the errors during the month-end accounting period closing. The hospital facility proposes to correct the failure by providing all of the affected FAP-eligible individuals with an explanation of the error, a corrected billing statement, and a refund of any payments the individuals made in excess of the amounts owned after FAP discounts are applied (in cases in which the excess is $5 more more)
  - Suppose that the errors in billing are significant, and are not discovered until 2021?

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- Highlighted Provisions of the Final Regulations – Billing and Collection Requirements
  - Extremely detailed notification requirements to meet "reasonable efforts" to determine FAP eligibility
  - Detailed requirements to suspend or reverse extraordinary collection actions during application period
  - 240-day application period
  - Specific requirements for agreements with other persons relating to collection

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- Examples – Noncompliance with Billing and Collection Requirements
  - Hospital Organization maintains contracts with collection agencies. In 2015 Hospital Organization revises its Billing and Collections Policy to provide that it will not sell or refer an individual's debt related to care to another party only if meets the requirements under the final regulations.
  - In 2016, Hospital Organization enters into a new agreement with new collection agencies that do not include all of these required provisions. In addition, in 2016 and 2017, some of the contracting agencies do not in fact follow the required procedures. Certain personnel of the Hospital Organization learn of the failures in 2017, but take no corrective action other than to advise the collection agencies to comply going forward
  - In 2018, in the course of due diligence for a transaction, senior management of the Hospital Organization determines that Hospital Organization has failed to comply with the requirements of Treas. Reg. §1.501(r)-6 in these respects. In addition, senior management determines that certain of the agencies have continued to fail to meet the requirements of their contracts.

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- Bond Document Covenant Considerations
  - Borrowers and users typically covenant to maintain section 501(c)(3) status in loan agreements and similar financing documents and to limit unrelated trade or business use of bond-financed assets, but do not otherwise make covenants relating to UBIT
  - Accordingly, specific bond document covenants relating to section 501(r) may not be necessary, appropriate or customary, but it is unclear how practice will develop

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- Tax-Exempt Bond Certification Considerations
  - Borrowers and users of tax-exempt bond proceeds typically represent that they are section 501(c)(3) organizations
  - Practices for certifications relating to section 501(r) compliance are less uniform
  - In light of the extreme detail of the final regulations, borrowers and users may wish to frame such representations with care

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- Tax-Exempt Bond Opinion Considerations
  - Borrower's counsel is typically required in tax-exempt bond financings to render opinions regarding the section 501(c)(3) status of borrowers and users of bond proceeds
  - Such opinions necessarily encompass 501(r) compliance, but only to the extent that an organization is compliant to the extent necessary to qualify as a 501(c)(3) organization (and not necessarily whether an organization is noncompliant hospital facilities are subject to tax)
  - Such opinions will require more rigorous due diligence in light of the final regulations; many counsel will likely require extremely detailed checklists matching specific requirements of the final regulations
  - Opinions specifically referencing 501(r) compliance are not currently the prevailing practice, but some opinions are drafted in a manner that implicitly address 501(r) compliance (e.g. that an organization is not subject to tax "except UBIT")
  - Counsel may discover noncompliance in the course of due diligence and require corrective action and disclosure; some disclosures *and corrections* may need to be made long after the tax year in which the noncompliance occurred
  - By comparison, it has been not uncommon for noncompliance related to "change of use" of bond-financed property in the course of due diligence for tax-exempt bond transactions, sometimes long after the noncompliance occurred

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- Tax-Exempt Bond Disclosure Considerations
  - Tax-exempt bond official statements typically contain a discussion of section 501(r) and may contain express statements regarding compliance
  - Practice regarding the exact form of such disclosure is developing
  - Official statement disclosures regarding tax disclosures will need to be considered more commonly in the future
  - Consideration of whether IRS enforcement actions regarding 501(r) will be disclosed in material event notices or other voluntary disclosures on EMMA will likely be more common in the future

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- Form 990 Schedule H
  - The current Schedule H to IRS Form 990 is effectively a checklist of the basic 501(r) requirements
  - Further revisions of Schedule H to reflect certain provisions of the final regulations and Rev. Proc. 2015-21 are likely
  - Disclosures made under Rev. Proc. 2015-21 will in the future need to be carefully reviewed in transactional contexts

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- Financial Accounting Considerations
  - FASB Interpretation No. 48 generally requires financial statement disclosure of "uncertain tax positions"
  - The extent to which 501(r) may raise financial accounting disclosure issues may be more of a concern in the future

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- Special Rules for Application to Acquisitions and Affiliations
  - Permitted compliance grace period for acquired and new hospital facilities for the Community Health Needs Assessment requirements
  - General requirement to meet CHNA requirements by the last day of the second taxable year beginning on the date acquired or the later of the date a determination letter is received and the date first licensed or registered
  - No similar compliance grace period applies to the other 501(r) requirements
  - Acquired facilities will be subject to the financial assistance policy, limitations on charges and billing and collection requirements immediately on the acquisition date

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- Considerations for Joint Venture Transactions
  - Section 501(r) generally applies to an organization that "operates" a hospital facility
  - An organization is generally treated as operating a hospital facility if it owns a capital or profits interest in an organization treated as a partnership for federal tax purposes, directly or indirectly through tiers of partnerships
  - An exception applies if the organization does not have control over the operation of the hospital facility operated by the partnership sufficient to ensure that the operation of the hospital facility furthers the exempt purposes of the organization and thus treats the operation as an unrelated trade or business
  - Another limited exception applies to certain partnership agreements entered into prior to the date of enactment of section 501(r) for organizations engaged primarily for educational or scientific purposes

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- Considerations for Transactions that Result in Control of Physician Groups
  - Depends on how treated for federal tax purposes
  - 501(r) requirements apply to a "substantially-related entity" (and entity treated as a partnership for federal tax purposes and the hospital organization owns a capital or profits interest) and that provides care that is not an unrelated trade or business
  - 501(r) requirements may apply to activities of Hospital Organization employees

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- Key Takeaways
  - Considering how failures to comply would play out can help to inform the approach taken to adopting policies and related practices and procedures
  - Practices and procedures relating to 501(r) compliance in addition to the minimum required policies may be advisable and may need to be "living documents"
  - In light of the extreme detail of the final regulations, bond document covenants, certifications and opinions regarding section 501(r) compliance need to be carefully framed, particularly because some degree of technical noncompliance may not be uncommon
  - Even if 501(r) noncompliance does not rise to the level of revocation of 501(c)(3) status, 501(r) noncompliance may raise difficult disclosure, bond document and financial issues
  - Correction and disclosure of noncompliance discovered in due diligence may become more common as a requirement to close transactions
  - To streamline and reduce the costs of due diligence for tax-exempt bond and other transactions, organizations may wish to consider incorporating detailed checklists into their internal compliance procedures
  - The "substantially-related entities" rules will be particularly important for treatment of partnership arrangements
  - Requirements relating to billing and collection possibly may receive the most IRS and public scrutiny

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