COVER STORY

Tax Issues Facing Healthcare Internal Auditors

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In today's complex legal, tax, and financial environments, healthcare Internal auditors regularly address many difficult issues impacting the organization. These include financial reporting, internal controls, compliance with bond covenants, and satisfaction of governmental regulations. Each of these issues requires close monitoring and strict compliance. This article focuses on the tax issues that tax-exempt healthcare organizations are currently facing.

Over the last few years, scrutiny by both the general public and all levels of government on the activities of tax-exempt healthcare organizations has increased. Accordingly, it is imperative that the Board of Directors, Audit Committee and management group ensure that their internal auditors appropriately consider those activities which could potentially create unrelated business taxable income (UBTI) and/or otherwise impact the tax-exempt status. Organizations must be cautious not to impair their Internal Revenue Code (IRC) section 501(c) designation because such status results not only in federal income tax exemption, but also in Federal Unemployment Tax Act tax exemption, the ability to issue tax-exempt bonds to investors, and the ability to receive contributions which donors can deduct as charitable contributions for federal income tax purposes.

Audit Tip:

Organizations . . . be cautious not to impair IRC section 501(c) designation.

The following summarizes several tax-related issues that may be addressed by an Internal Revenue Service (IRS) agent during a review of the organization's Form 990, Return of Organization Exempt From Income Tax. If internal auditors regularly address these issues and monitor compliance, subsequent problems with the IRS may be reduced or avoided.

Descriptions of current and historical tax rules included in this article are meant to be very general in nature and are always subject to legislative, administrative and judicial change. They are current as of November 12, 2003. Application of these rules to a healthcare organization's unique fact patterns requires consultation with the organization's tax adviser.

Income From Joint Ventures

In the late 1970's and early 1980's, based on the holding in GCM 36293, May 30, 1975, an exempt organization generally lost its tax-exempt status under IRC section 501(c)(3) when it served as a general partner in a partnership that included private investor limited partners or otherwise shared net profits. Later, the IRS began using a two-prong test, based on the holdings in GCM 39005, June 28, 1983, ***Plumstead Theatre Society, Inc.***, 74 TC 1324 (1980), ***aff'd***, 675 F. 2d 244, (CA-9 1982) and ***Housing Pioneers***, TCM 1993-120, ***aff'd***, 49 F.3d 1395 (CA-9 1995), ***amended by***, 58 F. 3d 401 CA-9 1995), to make determinations of whether participation in a joint venture with a for-profit entity would impair the exempt status of a not-for-profit organization. The test requires that:

1. The partnership's activities further the organization's tax-exempt purpose; and
2. The partnership agreement is structured such that the organization exercises full control over the activities of the partnership, acts exclusively in furtherance of its exempt purpose, and receives no private benefit as a result of its participation in the partnership.

The IRS later issued Rev. Rul. 98-15, which provided specific guidance for joint ventures between exempt healthcare organizations and for-profit entities. It held that the activities of the joint venture (structured as a Limited Liability Corporation (LLC) and treated as a partnership for federal income tax purposes in this instance) are considered to be the activities of the nonprofit member when evaluating the member's exempt status under IRC section 501(c)(3).

Then, in ***Redlands Surgical Services***, 113 TC 47 (1999), ***aff'd***, 242 F.3d 904 (CA-9 2001), ***petition for reh'g den'd***, 5/30/01, the Tax Court noted that, through its investment in an existing ambulatory surgery center owned by physicians, a tax-exempt member of a hospital system did not have control over the operations of the partnership. The Tax Court concluded that the operations of the surgery center did not advance the interests of the exempt partner which, through its participation in the joint venture, impermissibly served private interests.

In ***St. David's Health Care System, v. U.S.***, 2002-1 USTC ¶50,452 (W.D. Tex. 2002), ***rev'd***, No. 02-50959, 02-51312 (CA-5 2003), an acute-care hospital exempt from federal income taxation under IRC section 501(c)(3) entered into a joint venture limited partnership with for-profit HCA, Inc. The IRS revoked St. David's tax-exempt status retroactively to the date it entered into the partnership with HCA, based on the fact that St. David's participation in the partnership did not permit it to act exclusively for exempt purposes. The District Court focused on the control of the organization and held that St. David's operated in a charitable manner and that its corporate structure, including its board (which consisted of community members), allowed for adequate safeguards on the hospital achieving its charitable purpose of serving the community. On November 7, 2003, the Fifth Circuit reversed the District Court's holding, maintaining that even if St. David's performed important charitable functions, it cannot maintain its IRC section 501(c)(3) status so long as its participation in the joint venture with HCA furthers the private, profit-seeking interests of the for-profit partner. See ***St. David's Health Care System v. U.S.***, No. 02-50959, 02-51312 (CA-5 2003), ***rev'g***, 2002-1 USTC ¶50,452 (W.D. Tex. 2002). Further, it held that when an exempt organization in a joint venture cedes control over the partnership to its for-profit partner, it is assumed that the partnership's activities substantially further the for-profit entity's interests.

In PLR 200304041, January 29, 2003, a hospital affiliated exempt organization proposed a joint venture to develop and operate a cardiac catheterization laboratory with a cardiologist. The exempt organization would hold at least 52 percent of the membership interest. The venture's operating agreement provided that it would further charitable purposes by promoting health for a broad cross section of the community. It also specified that the furtherance of charitable purposes takes precedence over any profit-making motive. The IRS ruled that participation in the venture would not impair the exempt status of the organization or its parent. It also held that the organization's share of the venture's profit or loss would not be treated as UBTI. The holding was based on the finding that participation in the venture was consistent with the organization's governing documents, such participation furthered its charitable purposes, and that there was sufficient control to ensure that medical service will be provided by the participating exempt organization in a charitable manner.

The structuring of joint ventures with for-profit partners by exempt healthcare organizations continues to be an area of focus by the IRS. Some agents have recently taken the position that if the tax-exempt organization does not control the partnership, any income is per se UBTI. Agents have also recently argued that joint ventures that have consistently produced losses are not trades or businesses. Both the American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA) have submitted letters to the IRS suggesting proposed rulings regarding ancillary joint ventures. As evidenced by the analysis included in the cases and rulings cited above, the determination of whether or not a joint venture with a for-profit entity will impact the tax-exempt status of an exempt healthcare organization or produce UBTI is based directly on the particular facts and circumstances and the question of who exercises control over the operations of the joint venture. Accordingly, internal auditors should consider reviewing the documentation for joint ventures with physicians and for-profit entities to assure that support exists for the argument that the joint venture does not generate UBTI for the organization and does not impair its tax-exempt status.

Audit Tip:

Internal auditors . . . carefully review documentation for joint ventures with physicians and for-profit entities.

Intermediate Sanctions

Prior to the Taxpayer Bill of Rights 2, signed into law on July 30, 1996, the only remedy available to the IRS for issues of private inurement by a tax-exempt entity was revocation of the organization's exempt status. The exemption revocation, however, often penalized the organization rather than the insider who benefited from the improper transaction. Understandably, the IRS was hesitant to impose such an extreme and often disproportionate sanction.

In 1996, IRC section 4958 was added to remedy the situation. Instead of punishing the exempt entity, section 4958 assesses an excise tax against the disqualified person who benefited from an excess benefit transaction with an applicable tax-exempt organization. This taxation of excess benefits does not replace the prohibition of private inurement, i.e., the distribution of net earnings to those who control and/or financially support the organization. The ability to revoke exempt status for any amount of private inurement remains intact. However, as a practical matter, the imposition of intermediate sanctions, in most instances, is used in lieu of exemption revocation.

Audit Tip:

Internal auditors . . . attempt to identify disqualified persons and any excess benefit transactions.

A disqualified person is defined as anyone in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the transaction. Reg. section 53.4958-3. This includes, but is not limited to, members of the governing body, officers, founders, substantial contributors, etc.

An excess benefit transaction is any transaction, or series of transactions, in which the economic benefit to the disqualified person exceeds the value of the consideration received by the organization. Reg. section 53.4958-4. To determine whether an excess benefit has occurred, all consideration exchanged between the organization and the disqualified person must be considered. Compensatory benefits must also be included in the determination, including expense accounts, allowances, and reimbursements. Such accounts may be excluded only if the amounts paid qualify as an accountable plan that meets the requirements laid out by the Treasury in Reg. section 1.62-2(c).

An applicable organization is any 501(c)(3) or (4) exempt entity that is currently, or was at any time during the last five years, exempt from tax under IRC section 501(a). Reg. section 53.4958-2.

The excise tax equals 25 percent of the excess benefit and is imposed on the disqualified person who directly or indirectly benefited from the transaction. If the transaction is not corrected within the taxable period, an additional excise tax of 200 percent of the excess benefit is imposed. Exempt organizations cannot hesitate to seek out and correct such transactions. Excess benefits not discovered until an IRS audit is performed can prove very costly.

In addition to the tax on the disqualified person, IRC section 4958 also imposes a tax of 10 percent of the excess benefit on managers who approved the transaction if they knew, or should have known, that the transaction conferred an excess benefit. The statutory maximum amount of tax collectible from all participating organization managers (who are jointly and severally liable) with respect to any one excess benefit transaction is $10,000.

The final regulations, issued in January 2003, provide a safeguard for organizations through a standard known as the "rebuttable presumption of reasonableness." Transactions that meet this standard are presumed reasonable. The IRS may refute the presumption only if it develops sufficient contrary evidence to rebut the probative value of the data relied upon by the authorized body. If the organization does not satisfy the requirements of the rebuttable presumption of reasonableness, a facts and circumstances approach will be followed using established rules for determining reasonableness.

Healthcare organization internal auditors should consider addressing disqualified persons and any excess benefit transactions involving these individuals so that the organization's management group can address the potential imposition of any intermediate sanction penalties.

Political Activities

As another election cycle approaches in 2004, a review of political activities by exempt organizations is in order. IRC section 501(c)(3) expressly forbids tax-exempt organizations from participating or intervening in any political campaign for public office. Reg. section 1.501(c)(3)-1(c)(3)(iii). The prohibition is absolute, regardless of whether the activity is for or against a candidate.

Prior to 1987, the IRS allowed a moderate amount of leeway for cases in which the violation was small, unintentional, and subsequently corrected by the organization. In 1987, Congress codified the position into IRC section 4955, which assesses tax penalties on both the organization and the managers who knowingly approved the activity. The legislation does not replace the prohibition on political activity, but offers an alternative resolution to the extreme measure of exemption revocation.

The ban on participating or intervening in a political campaign does not, however, extend to all election-related activities. If activities, such as the following, are conducted in a non-partisan manner, they may fall outside the scope of prohibited political activity:

- Candidates may be invited to debates and other such forums if the event is conducted on an impartial basis. If the candidate is speaking in a capacity other than as a candidate, equal access to other candidates is not required.
- "Get-out-the-vote" drives are allowable as long as they are not keyed toward any particular political party or candidate.
- Compilations of voting records are permissible as long as they do not reflect a bias toward a particular candidate. Evaluations of voting records are not allowed, even if the ratings are based upon neutral factors or qualifications.
- Newsletters containing voting records are allowable as long as they are sent to the periodical's regular readership and are not timed to coincide with an election.

These activities must be monitored carefully to ensure compliance with established rules to prevent inadvertent noncompliance.

An open issue still remains as to whether an organization's contribution of "soft money" or the bearing of certain administrative expenses of a political organization would be allowed.

The prohibition of political activities enumerated above should not be confused with restrictions on lobbying activities. Section 501(c)(3) allows an organization to carry on propaganda and attempts to influence legislation as long as such efforts are not a substantial part of its activities. Determinations of substantiality are made based upon either an expenditure test or upon the individual facts and circumstances of the case.

Public Disclosure

IRC section 6104(d) requires all tax-exempt organizations to make available for public inspection and copying their exemption applications and their annual information returns. Forms 990-T, Exempt Organization Business Income Tax Returns, are outside the scope of the disclosure requirement.

The application for exemption generally constitutes either Form 1023 or Form 1024, as prescribed by the IRS. All associated documents and attachments filed with the application are considered part of the application and must be included. Supplemental information submitted to the IRS as part of the application process, either in support of the application or upon written request of the IRS, is also considered to be part of the application.

The annual information return subject to the disclosure requirements of section 6104(d) is an exact copy of the submission to the IRS, including any supporting schedules, attachments, and amendments. The names and addresses of contributors to the organization may be withheld. However, compensation paid to board members, highly compensated employees, and independent contractors may not be excluded from disclosure.

The application for exemption and annual information returns must be available for public inspection, without charge, at the organization's principal, regional, and district offices during regular business hours for a three-year period beginning on the date the return is required to be filed, including extensions. Regional and district offices include any office that has three or more employees during regular business hours.

Requests for copies of the return, made either in person or in writing, must be provided without charge, other than a reasonable fee for reproduction and actual postage.

The only exceptions to the disclosure policy are if the requests for copies are found to be part of a harassment campaign, or if the organization has made the requested document widely available, such as on the Internet.

The penalties to the organization for non-compliance are $20 per day that the requirement is not satisfied, up to a maximum penalty of $10,000 for any one annual information return.

Internal auditors should consider conducting random, unannounced tests of compliance with the public disclosure requirements by making requests of the documents, which are subject to these rules.

Internal auditors should also keep in mind that, possibly in the near future, certain portions of the Sarbanes-Oxley Act may be applied to the not-for-profit healthcare industry. The Sarbanes-Oxley Act was passed by Congress on January 23, 2002, in order "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." It currently applies to public corporations listed on U.S. stock exchanges, including their significant subsidiaries, locations, and operating entities in foreign countries. However, the Charitable Giving Act of 2003, passed last year

Audit Tip:

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. . . remember: certain portions of Sarbanes-Oxley may be applied to the not-for-profit healthcare industry.

Audit Tip:

Internal auditors . . . become familiar with Sarbanes-Oxley; look for value-adding ways to implement requirements.

by the Senate, would have made certain provisions found in the Sarbanes-Oxley Act applicable to not-for-profit organizations.

Regardless of impending statutory mandate, many boards of exempt healthcare organizations are requiring Sarbanes-like disclosure and governance because these requirements represent "best practices" for doing business. Therefore, internal auditors of healthcare organizations should familiarize themselves with the Sarbanes-Oxley Act and look for value-adding ways to implement the requirements at their organizations. (For more information on the Sarbanes-Oxley Act, see Ruppert, ***Sarbanes-Oxley Act of 2002: Overview & Commentary From a Non-Profit Healthcare Internal Audit Perspective***, ***New Perspectives on Healthcare Auditing***, pages 13-17 (2002).)

Employee and Independent Contractor Issues

The proper classification of a person's employment status as either an independent contractor or employee is based upon the overall relationship between the individual and the organization. This issue is important to the IRS because it impacts whether or not compensation is subject to income tax withholding and other employment taxation. The 20 "common law" factors outlined in Revenue Ruling 87-41 continue to be the standard for determination of the service provider's treatment as an employee or independent contractor. No one factor is, by itself, determinative. All of the factors together are applied in this subjective determination to assess the level of control by the payor over the payee. Controlling power need not be exercised; the payor need only have the power to control. Greater levels of control equate to a greater likelihood that the individual will be considered an employee of the organization.

Audit Tip:

Internal auditors . . . conduct reviews of contracts between healthcare organizations and service providers being treated as independent contractors.

In the healthcare industry, determining whether a physician is an employee or an independent contractor can be difficult using the common law factors of Rev. Rul. 87-41 because the test is less efficient as the degree of independent judgment of the worker performing the services increases. The complexity of the determination also increases due to the number of additional parties involved, such as the hospital or the physician's own corporation. Of the 20 original factors referred to above, the IRS has generally focused on the following four:

1. The degree to which the physician has become integrated into the operation of the organization;
2. The substantial nature, regularity, and continuity of the physician's work for the hospital;
3. The authority reserved by the hospital or other organization to require compliance with its general policies; and
4. The degree to which the physician has been accorded the rights and privileges generally established for the hospital's employees. See Rev. Rul. 66-274, 1966-2 C.b. 446, citing Rev. Rul. 61-178, 1961-2 C.B. 153.

In addition to these four factors, the IRS has also noted that the existence of the following factors indicates that a physician is most likely an employee rather than an independent contractor:

1. The physician does not have a private practice.
2. The hospital pays a straight wage to the physician.
3. The hospital provides supplies and professional support staff.
4. The hospital bills for physician services.
5. A percentage of the physician's fees are split with the hospital.
6. Hospital regulation of, or right to control physician.
7. Physician on-duty at hospital during specified hours.
8. Physician's uniform bearing hospital name or insignia.

The IRS has generally taken the position that medical directors are employees rather than independent contractors.

Internal auditors should consider conducting reviews of contracts between healthcare organizations and service providers being treated as independent contractors in order to determine if documentation is sufficient to support the organization's position that independent contractor, rather than employee, status is appropriate.

Payments to Non-Resident Aliens

Payments relating to payroll, consulting fees, and miscellaneous remittances to independent contractors for consulting services made by healthcare organizations to non-resident alien physicians and other service providers are subject to federal excise and withholding tax regulations which mandate both payment and reporting of the taxes. It is clear that the IRS is currently emphasizing compliance with these regulations.

For example, the IRS has recently announced that it is beginning a major initiative directed at colleges and universities in an attempt to identify institutions which are not compliant with these regulations. This higher education industry initiative resulted from an unsuccessful voluntary compliance on alien withholding program (VCAP) previously offered by the IRS. Pursuant to the program, colleges and universities were given from February 2001 through February 2002 to comply voluntarily with the withholding and reporting regulations. Participants were not subject to interest and penalties, which would, if not for the special program, otherwise have applied to the late payments. VCAP was not deemed successful because only 12 submissions were received by the IRS under the voluntary program. As a second attempt to collect the excise and withholding taxes relating to payments made to non-resident aliens, the IRS initiated a compliance program in its fiscal year 2003 Business Plan to review educational institutions for the special purpose of checking compliance with the applicable regulations.

The IRS noted in its 2004 workplan that it will also scrutinize payments made by healthcare organizations to non-resident aliens and perhaps even create a formal program which is similar to the one now in place for colleges and universities, as described above. In anticipation of such a program being put in place by the IRS, healthcare organization internal auditors should consider examining the payments to non-resident aliens for compliance with the applicable excise and withholding tax regulations.

Tax-Exempt Bond Compliance

Interest from a private activity bond is not excludable from gross income under IRC section 103(a) unless certain statutory requirements are met. ***See IRC sections 141-150.*** Typically, bonds issued by IRC section 501(c)(3) healthcare organizations are structured to satisfy the requirements of IRC section 145. ***See generally Treas. Reg. section 1.145-1(a)***. However, the IRS has expressed increased concern regarding compliance with tax-exempt bond rules and has aggressively monitored such compliance as part of its examinations of exempt organizations that have issued exempt bonds. In particular, the IRS has focused on the "private use" test, which requires, with limited exceptions, that no more than 5 percent (10 percent in the case of a public institution) of the "proceeds of the bond" can be used directly or indirectly in a trade or business. See IRC sections 145(a)(2) and 141(b). Internal auditors should consider tracing any changes in the use of bond proceeds in order to assure that the organization continues to maintain compliance with the exempt bond rules.

Conclusion

A not-for-profit healthcare organization's tax-exempt status is critical to its success with respect to raising revenue from exempt bond financing and its avoiding the costly expense of income, property, sales and use, and certain payroll-related taxes. The organization's internal audit function can help the organization be proactive in its efforts to monitor and maintain the exempt status. Accordingly, in its periodic reviews of the organization's operations and related operating agreements, the internal audit team should be aware of the tax-related issues discussed above and others, to ensure that potential problems are appropriately addressed, with assistance from the organization's tax advisors, as needed. A proactive and helpful approach would be to request advance rulings from the IRS in order to eliminate any uncertainty regarding impact on exempt status or creation of UBTI. ▪

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Audit Tip:

Internal auditors . . . trace changes in the use of bond proceeds to assure the organization continues to maintain compliance with exempt bond rules.