N. HOSPITAL FINANCING ISSUES
(Adopted From a Speech by E. D. Coleman to the National Health Lawyers Association - Toronto, Canada, November 1984)

1. Introduction

The National Office continues to see large numbers of applications for exemption and ruling requests from hospitals proposing to reorganize. A typical reorganization involves the creation of new entitles that will serve as taxable and nontaxable affiliates of an existing hospital. Such reorganizations generally give rise to three types of issues: (1) exemption issues, (2) foundation classification issues, and (3) unrelated business income tax issues.

Our review of hospital reorganization cases indicates that the reorganizations occur for a number of reasons, many of which are related in some way to the rapidly changing health care environment. Caught between escalating costs, federal medicare reimbursement policy, and increasing competition from both the public and private sectors, hospitals are undergoing a dramatic transformation.

In addition to reorganizing, hospitals are attempting in other ways to raise funds and to finance certain projects. Many hospitals utilize the partnership format either to invest funds or to obtain financing for certain projects they wish to be involved in. In addition to discussing hospital reorganizations this topic will also discuss the use of partnerships.

2. Hospital Reorganization in General

This subject was previously discussed in the 1983 CPE Text in the article on Health Care Organizations on pages 22-28 and to a large extent the problems remain the same.

Structurally, we still see a parent organization being created which, on an organizational chart, is over the hospital and other entities within the system. The parent formulates policy and provides overall management to the affiliated group of organizations. It may also allocate funds raised by a fund-raising affiliate. Certain services, formerly performed by the hospital, such as fund-raising and radiology, are placed in new organizations. In addition one or more taxable subsidiaries may be formed to conduct activities that would normally generate income subject to unrelated business income tax if conducted by an exempt

organization. Examples of such activities might include the sale of laboratory services to the general public and the construction, with borrowed funds, or a regular commercial (non-medical) office building on hospital property.

We also occasionally see a second type of reorganization in which several existing hospitals merge. As in the first type of reorganization, endowment funds and services are placed in newly created entities and a common parent is formed.

Some of the more specific reasons we have seen for hospital reorganizations include a desire to insulate the hospital's assets from malpractice liability claims by moving endowment funds to separate foundations or fund-raising affiliates, and placing real property under the control of a title-holding organization described in IRC 501(c)(2). In the case of merged hospitals, a reorganization may allow the hospitals to share services and thereby cut costs without incurring unrelated business income tax liability. It is also possible to develop new profit centers located in revenue generating subsidiaries which engage in such activities as management consulting.

Two reasons previously given for reorganizations (see pages 24 and 25 of the 1983 CPE Text) are no longer applicable because of amendments to the Social Security Act.

Section 102 of the Social Security Act Amendments of 1983, P.L. 98-21, extended social security coverage (FICA) on a mandatory basis to employees of all exempt organizations effective January 1, 1984. Previously reorganizations provided hospitals a means of opting out of existing FICA coverage of their employees. (The Deficit Reduction Act, P.L. 98-369, created an exception to mandatory social security coverage. Certain churches as well as church related organizations may elect not to be covered. In all likelihood, however, church related hospitals are not eligible to make this election.)

In addition, section 601 of the Act changed the manner in which payments under Medicare would be computed by introducing a system of prospective payments based on those of a regionally adjusted "diagnostic related group". A "diagnostically related group" is a medical procedure, e.g. an appendectomy, where costs are assumed to be similar. Previously the amount of payments were determined based upon a hospital's reimbursable costs. Reorganization could affect a hospital's costs under this system and thus in many cases increase reimbursements.

3. Exemption Issues

A primary exemption issue is whether the activities of the newly created entities are ones that could be performed directly by the hospital for its own benefit.

The general rule is set forth in Rev. Rul. 78-41, 1978-1 C.B. 148. This revenue ruling states that a trust created by an exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the hospital, and from which the hospital directs the bank-trustee to make payments to claimants, is operated exclusively for charitable purposes and qualifies for exemption from tax under IRC 501(c)(3). Rev. Rul. 78-41 holds that the fund is an "integral part" of the tax-exempt hospital and that the trust is performing a function that the hospital could do directly. Thus, an insurance trust could provide insurance to hospitals that have a parent in common with it.

While Rev. Rul. 78-41 provides an example of the application of the general rule regarding related entities there are exceptions. For instance, if the primary purpose of the entity is to carry on a regular trade or business with unrelated organizations, the entity does not qualify under IRC 501(c)(3). An example of this exception, albeit not in the medical care area, is provided in Rev. Rul. 72-369, 1972-2 C.B. 245, which states that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations does not qualify for exemption. The revenue ruling distinguishes Rev. Rul. 71-259, 1971-2 C.B. 234, which states that a nonprofit organization providing assistance in the management of participating colleges' and universities' endowment or investment funds for a charge substantially below cost qualifies for exemption under IRC 501(c)(3). The term "substantially below cost" is described in Rev. Rul. 71-529 as being less than fifteen percent of the total cost of operation. Thus a subsidiary organization may provide services at cost to other subsidiaries in the hospital group. However, if it provided services to unrelated exempt entities it would have to provide them "substantially below cost".

A second exception to the general rule concerns cooperative services provided to unrelated exempt entities.

In HCSC Laundry v. U.S., 450 U.S. 1 (1981), the Supreme Court held that IRC 501(e), concerning hospital cooperative service organizations providing certain specified services, is the exclusive provision of the Code under which cooperative service organizations can qualify for exemption. Cooperative service

organizations are organizations that provide certain services (specified in IRC 501(e)) to unrelated IRC 501(c)(3) hospitals. Thus, under the HCSC case, an exempt subsidiary could not provide laundry services to unrelated exempt organizations on a cooperative basis. The HCSC case is discussed in greater detail in pages 3-6 of the 1982 CPE Text.

In hospital reorganizations where an affiliated group of both for-profit and nonprofit entities is created there is a potential for diversion of funds from exempt purposes. Common management, common ownership or mutual operational dependence between for-profit and nonprofit entities are situations where this can occur. The National Office has not yet seen a hospital reorganization case involving a diversion of hospital funds or assets. In the mid-1970s, however, Congressional hearings detailed cases where exempt HMO's and affiliated organizations were used as adjuncts of private medical practices. We think that the format being used in many hospital reorganizations could also be used in this manner.

4. Unrelated Business Income Tax Issues

The issue of the unrelated business activities of hospitals has been extensively discussed in previous CPE's. See, for example 1980 - 84 CPE Texts.

There is one issue unique to hospital reorganizations that arises in situations where a parent organization has both nonprofit and for-profit subsidiaries. As indicated previously, often certain activities likely to result in income that is subject to unrelated business income tax accruing to the hospital are spun-off into taxable subsidiaries in an attempt to better focus management resources. The critical issue is whether the nature of the parent/subsidiary relationship is such that the commercial activities of the for-profit subsidiaries should be attributed to the nonprofit parent.

In this regard the existence of the subsidiary generally will not be disregarded for tax purposes. Britt v. U.S., 431 F. 2d 227 (5th Cir. 1970). However, where the parent corporation so controls the affairs of the subsidiary that it is merely another activity of the parent, the corporate entity of the subsidiary may be disregarded. See Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F. 2d 1098 (5th Cir. 1973). Thus, the activities of a separately incorporated subsidiary ordinarily can only be attributed to its parent organization where the facts provide clear and convincing evidence that the activities of the subsidiary are inseparable from those of parent. Among the factors analyzed are:

(1) the existence of bona fide business purpose of the subsidiary,

(2) the degree to which the subsidiary is managed by an independent (outside) Board of Directors,

(3) the degree of involvement by a parent in day-to-day affairs of a subsidiary, and,

(4) whether transactions between a parent and a subsidiary are at arm's length.

Factors insufficient to warrant attribution are:

(1) the subsidiary's Board of Directors is being appointed by the parent,

(2) the chief executive of the parent sits on a subsidiary's board, and

(3) the parent owns 100 percent of the stock of a subsidiary and the subsidiary pays dividends to the parent.

5. Foundation Issues

It is typical for the parent in a hospital reorganization and perhaps some of the affiliates, to request classification under IRC 509(a)(3) as a "supporting organization." IRC 509(a)(3) describes organizations which, among other requirements, are:

(1) organized, and at all time thereafter, 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 IRC 509(a)(1) or (2), and

(2) operated, supervised, or controlled by or in connection with one or more organizations described in IRC 509(a)(1) or (2).

The traditional IRC 509(a)(3) relationship involves a supporting organization that supports the activities of one or more organizations described in IRC 509(a)(1) or (2). However, in many reorganizations, the relationship is reversed in one or two ways. One way involves an IRC 509(a)(3) parent which supports one or more subsidiaries described in IRC 509(a)(1) or (2). The second involves an IRC 509(a)(3) parent with at least one subsidiary also claiming IRC 509(a)(3) status. Although the National Office has issued rulings concluding that IRC 509(a)(3) status is appropriate in the first situation, both issues are currently under study.

6. Partnerships

Another general category of ruling request involves the effect of participation by an exempt hospital in either a general or a limited partnership with for-profit entities.

The Service at first sought to preclude exempt organizations from being able to participate in partnerships. However, the current position followed by the Service is that partnership arrangements between exempt and nonexempt entities must be examined in light of the facts surrounding each case and if private benefit or inurement is found exemption can be denied.

In partnership situations, fiduciary principles are imposed on the general partner. The general partner must exercise prudent business judgment and maintain a basic profit orientation in furtherance of the interests of the limited partners. A conflict of interest could thus arise between the hospital's exempt purposes and its partnership responsibilities if it is the general partner. This conflict in purposes must be resolved in a manner that permits the hospital to act exclusively in furtherance of its exempt purposes, as, for instance, where the partnership is structured so that it furthers exempt purposes.

The general issue in these situations is inurement or other disqualifying private benefit. For instance, a hospital might loan a partnership funds for construction of a facility. In such case the loan agreement should be written, the interest rate charged should be specified, and the rate itself should be no less than the prevailing market rate. The rent charged to doctors who lease space in the building should also be set at fair market levels. Agreements that vary from these general principles should probably be given close scrutiny.

Furthermore, the provisions of the partnership agreement are also critical. Provisions that indicate that staff doctors or those in control are receiving undue benefit could jeopardize the hospital's tax exempt status. Examples include the disproportionate allocation of profits and/or losses in favor of the doctors, the existence of commercially unreasonable loans by the hospital to the partnership (e.g. unsecured or below prevailing interest rates), the sale or lease of land by the hospital at less than fair market rates, and the payment of inadequate compensation to the hospital for its services as general partner.

Where an exempt organization acts as a general partner, it often involves an exempt hospital participating with its staff doctors in a partnership for the purpose of constructing a medical office building adjacent to the hospital. The Service position is that benefits accrue to hospitals from the existence of nearby medical office buildings. The use of the hospital's diagnostic facilities is enhanced and patient admissions to the hospital are facilitated. The proximity of the building to the hospital also facilitates the carrying out of hospital duties by doctors. The overall effects are to increase hospital efficiency, encourage full utilization of facilities, and improve the overall quality of patient care. These benefits are described in Rev. Rul. 69-463, 1969-2 C.B. 131, and Rev. Rul. 69-464, 1969-2 C.B. 132, concerning the exclusion of certain medical office building income from the calculation of hospital's unrelated business income tax.

In addition to acting as general partners, hospitals could participate as limited partners in partnership agreements. This situation could arise when a hospital participates in a venture capital investment limited partnership to raise funds through investments with above average return. Typically, a for-profit general partner receives a management fee based on a percentage of committed capital. In such situations, the inquiry should focus on possible inurement or private benefit which could jeopardize exempt status. Factors considered favorable are:

(1) arm's-length contractual relationship with a general partner who does not participate in the management or control of the exempt organization;

(2) business purpose for the arrangement independent of any purpose to operate the exempt organization for the direct or indirect benefit of the general partner;

(3) amount of payments to the general partner not dependent principally upon incoming revenue of the exempt organization, but rather upon the accomplishment of the objective of the compensatory contract (linked to net asset value rather than exclusively focused on income);

(4) actual operating results evidencing no abuse or unwarranted benefits;

(5) safeguards against the possibility of a windfall benefit to the general partner based upon factors bearing no relationship to the level of service provided; and

(6) the percentage utilized in the fee agreement is not unreasonable in magnitude as judged by market standards.

Rev. Rul. 79-222, 1979-2 C.B. 236, and Rev. Rul. 79-349, 1979-2 C.B. 233, illustrate the application of the tax on unrelated business income when an exempt organization derives income from partnership interest. In essence, the rule is that income from such an interest is unrelated business income except to the extent that the income received by the partnership is specifically excluded as dividends, interest, royalties, and the like.