New Guidance for Tax-Exempt Hospitals on Community Health Needs Assessment and Other Section 501(r) Requirements

On April 5, the Treasury Department released proposed regulations that provide guidance on the community health needs assessment ("CHNA") and other requirements for tax-exempt hospitals under section 501(r) of the Internal Revenue Code, enacted as part of the Patient Protection and Affordable Care Act (the "Affordable Care Act") in 2010. The requirement to conduct a CHNA applies to taxable years beginning after March 23, 2012. As such, all tax-exempt hospitals are now subject to this requirement and must have either already conducted a CHNA pursuant to preliminary guidance issued by the IRS in 2011 or must act promptly in order to comply. Although the regulations prescribe a number of very detailed requirements for the conduct of a CHNA, and threaten the imposition of substantial taxes and/or loss of tax-exempt status for noncompliant hospitals, they provide various relief provisions for hospitals that make a reasonable effort to comply with these rules.

Section 501(r) requires all tax-exempt "hospital organizations" to have certain policies and procedures in place for each "hospital facility" they operate, with failure to comply potentially resulting in loss of tax-exempt status. A hospital facility is defined to include a facility that is required by a state to be licensed, registered, or similarly recognized as a hospital. Proposed regulations released last year (the "2012 proposed regulations") address the requirement that each hospital facility establish financial assistance and emergency care policies, and meet certain requirements with respect to limitations on charges and billing and collections activities (for a summary of the 2012 proposed regulations, see our prior Alert). The new proposed regulations address the remaining component of section 501(r) not covered by the 2012 proposed regulations, namely the requirement that for each of their hospital facilities, hospital organizations conduct a CHNA, prepare and make publicly available a corresponding CHNA report, and adopt an implementation strategy to address the community health needs identified in the CHNA. The new proposed regulations also make important changes to the definitions of "hospital organization" and "hospital facility" and provide guidance on the consequences of failing to comply with section 501(r).

Changes to Key Definitions

Hospitals Operated Through LLCs and Partnerships. The 2012 proposed regulations defined a hospital organization as a tax-exempt organization under section 501(c)(3) that operates one or more hospital facilities, including organizations that operate a hospital through a so-called "disregarded entity" (e.g., a single member limited liability company). The new proposed regulations provide that "operating a hospital facility" includes not only operation through a disregarded entity, but also through a joint venture, limited liability company, or other entity treated as a partnership for federal income tax purposes, except in the following limited circumstances: (1) the organization does not have control over the hospital facility sufficient to ensure that its operation furthers an exempt purpose under section 501(c)(3), and consequently the organization treats the operation of the hospital facility as an unrelated trade or business, or (2) the partnership is operated pursuant to certain grandfathering rules for arrangements entered into prior to March 23, 2010. Seeking analytical consistency, the IRS thereby tied the standard for exemption from section 501(r) to the standard used for determining whether a joint venture gives rise to unrelated business taxable income ("UBTI") to a participating tax-exempt organization (a standard first clearly enunciated by the IRS in Revenue Ruling 2004-51).

Hospitals with Multiple Buildings. The 2012 proposed regulations permitted, but did not require, a hospital organization to treat multiple buildings or divisions as a single hospital facility, as long as they were operated under a single state license. In order to increase consistency in how hospital organizations designate hospital facilities, the new proposed regulations make such treatment mandatory.

Consequences of Failing to Satisfy Section 501(r)

Ultimate Penalty - Revocation of Tax-Exempt Status. A hospital organization's failure to comply with section 501(r) with respect to one or more hospital facilities that it operates may result in the hospital organization's section 501(c)(3) status being revoked as of the first day of the taxable year in which the failure occurs. In considering whether to revoke a noncompliant hospital organization's section 501(c)(3) status, the IRS will consider all the facts and circumstances surrounding the failure, including, among other factors, whether the organization has had previous failures to comply; the size, scope, nature and significance of the failure; the reasons for the failure; and whether the organization has implemented safeguards designed to prevent similar failures from occurring in the future.

Income Tax Imposed for Single Noncompliant Hospital Facility. If a hospital organization operating more than one hospital facility fails to meet one or more of the requirements of section 501(r) with respect to a particular hospital facility, the net income from the noncompliant hospital facility will be subject to tax at regular corporate rates (or at rates for trusts in the case of certain hospital organizations formed as trusts). The IRS will impose tax if, assuming the noncompliant hospital facility were the organization's only hospital facility, the hospital organization would not continue to be described in section 501(c)(3) after applying the facts and circumstances test described above. Although the income giving rise to the tax is to be reported on Form 990-T, it is not treated as UBTI. Gross income and deductions from a noncompliant hospital facility cannot be aggregated with the gross income and deductions from the hospital organization's other noncompliant hospital facilities or from its unrelated trade or business activities. Importantly, however, the proposed regulations provide that a hospital organization operating a noncompliant hospital facility subject to tax will continue to be treated as a section 501(c)(3) organization for all purposes of the Code, including, for example, with respect to tax-exempt bonds issued to finance the noncompliant hospital facility.

Relief from Penalties for Certain Corrected Errors. In the least serious situation, when a hospital facility omits required information from a policy or report or makes an error with respect to the implementation or operational requirements of section 501(r), such error or omission will not be considered a section 501(r) violation if it is minor, inadvertent, due to reasonable cause, and the hospital facility corrects such omission or error as promptly after discovery as is reasonable. Additionally, the IRS intends to publish further guidance providing for correction and disclosure of omissions or errors that rise above the level of minor and inadvertent but that are neither willful nor egregious in order to encourage prompt discovery and correction by hospital facilities. Failures corrected pursuant to that forthcoming guidance will be excused upon correction and disclosure.

$50,000 Excise Tax. The proposed regulations also address the $50,000 excise tax imposed on hospital organizations with respect to each hospital facility that has failed to satisfy the CHNA requirements in any three-year period. The proposed regulations make clear that the hospital organization will continue to be subject to the excise tax in each successive year in which the respective hospital facility remains noncompliant.

Community Health Needs Assessment

Among the most significant new obligations imposed on tax-exempt hospital organizations by the Affordable Care Act are those surrounding the CHNA requirement. For any taxable year, a hospital organization meets the CHNA requirement with respect to a hospital facility it operates only if the facility has conducted a CHNA in such taxable year or in either of the two immediately preceding taxable years and an authorized body of the hospital facility has adopted, by the end of the taxable year in which the hospital facility conducts the CHNA, an implementation strategy to meet the community health needs identified through the CHNA. The proposed regulations build off of preliminary guidance issued in IRS Notice 2011-52 and set forth a detailed framework for conducting a CHNA and adopting an implementation strategy. Within that framework, however, hospital organizations are given some discretion in meeting their CHNA requirements. It is worth noting that while a number of states have similarly adopted CHNA-type requirements as a condition of hospital licensure, the proposed regulations do not address interactions with these state level requirements.

Conducting a CHNA and preparing a CHNA report. In conducting a CHNA, a hospital facility must complete each of five steps. The hospital facility must (1) define the community it serves, (2) assess the heath needs of that community, (3) in assessing the community's health needs, take into account input from persons who represent the broad interests of its community, including those with special knowledge of or expertise in public health, (4) document the CHNA in a written report that is adopted by an authorized body of the hospital facility, and (5) make the CHNA report widely available to the public. The proposed regulations include details about each of these five steps, including how to define "community" (especially which groups may not be excluded), the categories of individuals who must provide input on the CHNA, and specific steps a hospital facility must take to meet the requirement that the CHNA report be made widely available.

While the proposed regulations require that each hospital facility document its CHNA in its own separate CHNA report, the proposed regulations make certain allowances for joint and collaborative reports.

Developing an implementation strategy. In connection with a hospital facility's implementation strategy, the proposed regulations require that for each significant health need identified through the CHNA, the implementation strategy must either (1) describe how the facility plans to address the health need or (2) identify the health need as one the facility does not intend to address and explain why the facility does not intend to address it. As with the CHNA report, generally each hospital facility must adopt its own implementation strategy, although the proposed regulations make certain allowances for joint and collaborative implementation strategies.

A hospital organization must attach to its Form 990 a copy of the most recently adopted implementation strategy for each hospital facility it operates or provide the website where the implementation strategy has been made widely available to the public. In addition, a hospital organization must report annually on its Form 990 actions taken during the taxable year to address the significant health needs identified through its most recent CHNA report for each of its hospital facilities or, if no action was taken, the reason for not taking any action.

Effective Date and Transition Relief

A hospital organization must, with respect to each hospital facility that it operates, conduct a CHNA and adopt an implementation strategy by the end of its first taxable year beginning after March 23, 2012. The proposed regulations provide transition relief with respect to the requirement that an implementation strategy

be adopted in the same year the CHNA is conducted. This transition relief applies to hospital facilities that have already conducted a CHNA in one of their first two taxable years beginning after March 23, 2010 and to facilities that have conducted a CHNA in their first taxable year beginning after March 23, 2012. Under the transition relief, a hospital facility will be treated as satisfying the implementation strategy adoption requirement if the strategy is adopted by an authorized body of the hospital facility on or before the 15th day of the fifth month following the close of its first taxable year beginning after March 23, 2012 (that is, the due date for filing the hospital organization's Form 990, without extension).

The new proposed regulations will be effective, with respect to the requirements under section 501(r), as of the date they are published in final or temporary form and, with respect to any filing requirements, will be effective for returns filed on or after the date the rules are published in final or temporary form. The effective date for the 2012 proposed regulations has also been changed to the date those regulations are published in final or temporary form. Hospital organizations can rely upon the proposed regulations for any CHNA conducted or implementation strategy adopted on or before the date that is six months after the proposed regulations are published in final or temporary form, and may continue to rely upon the guidance in Notice 2011-52 until October 5, 2013.

For more information on any of the regulations discussed above, please contact Lorry Spitzer, Kendi Ozmon, Morey Ward, Gil Ghatan or another member of Ropes & Gray's tax or health care groups

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IRS Circular 230 Notice

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