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# Purpose and Power of the Group Tax Exemption in Health Care

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# PURPOSE AND POWER OF THE GROUP TAX EXEMPTION IN HEALTH CARE

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## I. INTRODUCTION

In 2011, many tax-exempt entities were losing their tax exemptions due to the fact that they had failed to file the required Form 990 not-for-profit returns for over a period of 3 consecutive tax years.[1] Shortly thereafter, an IRS advisory committee recommended the exclusion of some organizations from group rulings, and went even further to recommend the disallowance of group return filings.[2] The reasons noted were for transparency, accountability, and responsibility.[3]

With a focus on lessening the gap between health care organizations' executive staff and low-income populations, Congress mentioned various requirements and charity care thresholds supported specifically by Senator Grassley, which, while influential, did not result in a federal mandate nor a required charity care percentage.[4]

The IRS received comments and reviews emphasizing the benefits of consolidated returns.[5] Efficiency and limited resources were some of the benefits discussed in support of a continuing consolidated group tax exemption and return filing, which outweigh the added administrative burden.[6] In the health care arena, the Catholic Healthcare Association responded to the enactment of Health Care Reform and IRC 501(r) by creating Community Benefit and Charity Care

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[1] *See Is Your Tax Exempt Status in Jeopardy?*, MCGUIREWOODS LLP (June 21, 2011), http://www.mcguirewoods.com/Client-Resources/Alerts/2011/6/Is-Your-Tax-Exempt-Status-in-Jeopardy.aspx.

[2] *See id.*

[3] *See id.*

[4] *See generally* Robert Wolin et al., *Tax-Exempt Hospitals Under the Microscope – How Much Charity Care Are You Providing?*, BAKER HOSTELTER (July 26, 2007), http://www.bakerlaw.com/alerts/Tax-Exempt-Hospitals-Under-the-Microscope How-Much-Charity-Care-are-You-Providing-07-26-2007.

[5] *See, e.g.*, Lisa M. Hix, *Obtaining and Maintaining Tax-Exemption for Your Affiliates: The Mechanics, Pros and Cons of Group Exemption*, VENABLE LLP (Sept. 26, 2008), https://www.venable.com/obtaining-and-maintaining-tax-exemption-for-your-affiliates-the-mechanics-pros-and-cons-of-group-exemption-09-16-2008/.

[6] *Id.*

Standards to help not-for-profit health care organizations meet the new requirements.[7]

This article argues that the group tax exemption and consolidated group returns provide immense assistance to nonprofit healthcare organizations, because of simplicity, financial benefits and efficiency benefits. Part III will discuss what it means to be a tax-exempt entity and the legal basis for its existence, the historical basis of the exemption and its various rationales including relief of government burden, subsidy and income measurement theories. Part IV will explain the tax-exempt status in health care, the effects of the Affordable Care Act on the uninsured population, and key differences between for-profit entities and non-profit entities. Part V will both detail the consolidated reporting process from a financial accounting and tax perspective and also tie the group exemption rulings with industry concerns, benefits, and disadvantages.

## II. TAX EXEMPT STATUS

### *A. What it means*

"[T]here are three sectors. . . governmental, for-profit, and nonprofit".[8] Nonprofit organizations are not always tax-exempt organizations although almost all tax-exempt organizations are nonprofits. Interestingly enough, in the United States healthcare organizations exist in all three sectors.

Contrary to what one might assume, an organization being "nonprofit" does not mean that one of the goals of the organization is to not make money. The popular nun, Sister Irene Krause, is famous for saying to her staff, "no margin, no mission", and that adage remains true today.[9] Being a nonprofit organization means that the use of the organization's profits are put back into the community or organization whose purpose is more often than not for the support of a charitable mission.[10] In the for-profit context there are owners and stockholders

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[7] *See generally* CATHOLIC HEALTH ASS'N OF THE U.S., A GUIDE FOR PLANNING AND REPORTING COMMUNITY BENEFIT (2012) (implementing a detailed guide which hospitals nationwide utilize in creating Community Benefit programs and local Citizen Advisory Committees required under the Patient Protection Affordable Care Act).

[8] *See* THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS 6 (4th ed. 2013).

[9] Bruce Bryant-Friedland, *Sister Irene Kraus Remembered for Vision, Leadership*, THE FLORIDA TIMES-UNION (Aug. 25, 1998), http://jacksonville.com/tu-online/stories/082598/met_2a1Siste.html.

[10] *See* Marc J. Epstein & F. Warren McFarlan, *Nonprofit vs. For Profit Boards: Critical Differences*, STRATEGIC FINANCE, Mar. 2011, at 31, http://www.imanet.org/PDFs/Public/SF/2011_03/03_2011_epstein.pdf.

of the corporation who are looking for the profits to go into their pockets as dividends.[11] They are not as focused on a charitable mission and instead invest for different economic income reasons.[12]

No constitutional law states that healthcare or any other organization must receive a tax exemption. Therefore, the tax exemption comes solely from Congress, who may alter the law at any time.

### *B. Rationales*

#### 1. Historical

After the ratification of the Sixteenth Amendment to the U.S. Constitution came subsequent attempts to create a corporate income tax.[13] This resulted in the initial tax-exempt organizations such as churches and educational institutions.[14] Congress based its reasons for making the organizations exempt from taxation purely on the historical and unstated belief that these types of institutions should not be taxed.[15] The decision to not name them as a taxable organization resulted in the affirmative stance that these charitable institutions would not be taxed. Based on the societal norms in those times, one might have asked how can we tax the workers of God?

#### 2. Relief of Government Burden

An older argument in favor of tax exemptions for charitable organizations is that these organizations in fact relieve government burden from having to pay for the charitable services provided by these organizations.[16] Whereas the government may not pay for churches, they would pay for relief to the poor in the areas of provision of food, health care, and housing.[17] In an interesting case in regard to a tax exemption for a religious organization, the court upheld the constitutionality of the exemption for churches noting that the State, "consid-

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[11] *See id.*

[12] *See id.*

[13] *See generally* Erik Nelson, Comment, *Two Stories of Taxation of Capital,* 16 LEWIS & CLARK L. REV. 1049, 1054-55 (2012) (discussing the Revenue Act of 1916 and the movement toward more progressive corporate income taxation following the ratification of the 16th Amendment).

[14] *See* Paul Arnsberger et al., *A History of the Tax-Exempt Sector: An SOI Perspective,* STATISTICS OF INCOME BULLETIN, Winter 2008, at 105, http://www.irs.gov/pub/irs-soi/tehistory.pdf.

[15] *See generally* HYATT & HOPKINS, *supra* note 8, at 5 (discussing Congress's power to enact healthcare legislation and the historical context of wanting some things to be free from government).

[16] *See* St. Louis Union Trust Co. v. United States, 374 F.2d 427, 432 (8th Cir. 1967).

[17] *See supra* note 14.

ers these groups as beneficial and stabilizing influences in community life and finds this classification useful, desirable, and in the public interest."[18]

3. Subsidy and Income Measurement Theories

The modern day rationale's for exemptions have been set forth into two theories: subsidy theory and income measurement theory.[19] While some fellow legal professionals adopt the subsidy theory approach, I believe, specifically in the nonprofit health care sector, that the mutual benefit received by community health care consumers more than meets the tax exemption of the nonprofit entities.[20]

Virginia requires each hospital, in order to retain their state exemption, to file an annual Certificate of Public Need report declaring how much uncompensated care the hospital provided to the indigent community in the last taxable year.[21] The majority of organizations in Virginia exceeded the state requirements.[22] In particular, Mary Washington Healthcare, a nonprofit integrated health care system with two hospitals serving the Stafford and Fredericksburg regions, noted the importance of community benefits in maintaining their tax-exempt status.[23] The money it had saved by not paying federal and state income taxes had also provided threefold in uncompensated and subsidized health care for the community.[24] Not only did the community

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[18] Walz v. Tax Comm'n of New York, 397 U.S. 664, 673 (1970).

[19] *See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 66-71 (1981) (discussing subsidy theory); Rob Atkinson, *Theories of The Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses,* 27 STETSON L. REV. 395, 408 (1997) (describing income measurement theory).

[20] *See* Philip T. Hackney, *What We Talk About When We Talk About Tax Exemption*, 33 VA. TAX REV. 115, 126 (2013).

[21] VIRGINIA DEP'T OF HEALTH, VIRGINIA MEDICAL CARE FACILITIES CERTIFICATE OF PUBLIC NEED RULES AND REGULATIONS 35 (2011), http://www.vdh.virginia.gov/OLC/Laws/documents/2011/pdfs/COPN%20regs%202011.pdf.

[22] *VHHA Annual Report on Community Benefit*, VIRGINIA HOSPITAL AND HEALTHCARE ASS'N, http://www.vhha.com/research/community-benefit/ (last visited Sept. 28, 2015).

[23] *Community Benefit*, MARY WASHINGTON HEALTHCARE, http://www.marywashingtonhealthcare.com/community-benefit (last visited Sept. 28, 2015).

[24] *See* Kelsey Brimmer, *Virginia Hospitals and Health Systems Provide $2.2B in Community Support*, HEALTHCARE FINANCE NEWS (Feb. 10, 2012), http://www.healthcarefinancenews.com/news/virginia-hospitals-and-health-systems-provide-over-22-billion-community-support; *see also* MARY WASHINGTON HEALTHCARE, COMMUNITY BENEFIT REPORT 2012, http://www.marywashingtonhealthcare.com/images/stories/documents/CommBenefits/2012commbenefitreport_4pg_may2013.pdf (2013).

members receive a mutual benefit, but they also received a more substantial benefit.[25]

Another factor not always considered when looking into the benefits that nonprofits provide their communities is the access to care within a short distance from one's own home. Very often people will have to travel an hour or more to receive rare treatments that are not profitable, which nonprofits provide at a loss.[26] Although the loss is captured in unsubsidized care, the mileage expense and the time it takes to travel outside their region to obtain care is not calculated and included in benefits.

In 2011, Ernst & Young LLP (EY) completed an unprecedented report in collaboration with the American Hospital Association (AHA) that reviewed over 900 member hospitals' Form 990 Schedule H's, which are nonprofit tax returns that report hospitals' community benefit dollars.[27] The report found that over an average 12.3% of all expenses of hospitals went to community benefits, e.g. free health care or subsidized services.[28] Hospitals also spent 1% on bad debt expense, which commonly represents the indigent population unable to pay.[29] The report noted that nonprofit hospitals "not only provide charity care and make up for underpayments by Medicaid and other means-tested government programs, but also cover for losses due to unreimbursed Medicare and bad debt expense attributable to charity care."[30]

While 12.3% of total expenses are deemed to qualify as a community benefit, a more liberal way of looking at hospital expenses are that 100% of expenses go towards the promotion of health in the community.[31] As noted in a 1970 Catholic University Law Review article:

> If one accepts the thesis that promotion of health is a charitable purpose and that all receipts must be applied to that charitable purpose of the hospital, there would seem to be no logical reason why a hospital could not accept only paying patients, charge each the full cost of

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[25] *See* Brimmer, *supra* note 24.

[26] *See, e.g.*, CATHOLIC HEALTH ASSOCIATION, A GUIDE FOR PLANNING & REPORTING COMMUNITY BENEFIT: SUPPLEMENTAL CHAPTER 7 (2012), https://www.chausa.org/docs/default-source/community-benefit/social-accountability-and-the-long-term-care-continuum.pdf?sfvrsn=2 (discussing a community benefit framework for social accountability and accessibility of charitable organizations).

[27] *See* ERNST & YOUNG LLP, RESULTS FROM 2011 TAX-EXEMPT HOSPITALS' SCHEDULE H COMMUNITY BENEFIT REPORTING 1 (2014), http://www.aha.org/content/14/schedhreport.pdf.

[28] *Id.* at 1, 5.

[29] *Id.* at 5, 8.

[30] *Id.* at 10.

[31] *See id.* at 5.

> care, remain entirely self- supporting, and still qualify as a charitable institution.[32]

## III. Tax Exempt Status in Health Care

Tax-exempt health care organizations normally have as their mission the promotion of health in their local and surrounding communities. This mission, in addition to the traditional mission of serving those unable to pay, is the initial reason for their tax exemption. Health care entities include not only hospitals but also home health and hospice agencies, physician practices, free standing emergency departments, ambulatory surgery centers, and medical research laboratories affiliated with a hospital.[33] As the years progressed, the IRS prescribed additional Revenue Rulings to further define the charitable hospital definition and, in 2000, the IRS placed a key focus on uncompensated care that would come to be known as "Charity Care" under the Community Benefit Standard.[34]

Lord MacNaghten originally defined "charity" in the context of charitable trusts in England as comprising four principle divisions of "relief of poverty", "advancement of education", "advancement of religion", and "trusts for other purposes beneficial to the community."[35] For a period of time, American law ignored the various principles and instead chose to focus solely on the "relief of poverty" provision.[36] In 1956, the IRS issued a revenue ruling and subsequent regulations suggesting "charitable" was not meant to be narrowly construed to this scope of assistance but in fact was represented by various ways and means constituting a public benefit.[37] Now, the "promotion of health" alone is a substantive rationale for applying charitable status for hospitals based upon the premise that a hospital is allowed to accept paying patients, be self-supporting, and still maintain its charitable mission.[38]

It is important to note that while the focus of this article on charitable hospitals views tax exemptions from a federal income tax perspective, state and local property tax laws exemptions also apply and hold much power over the nonprofit sector. In fact, as a result of the focus on federal tax exemption in 2000, states began to give more

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[32] Robert S. Bromberg, *The Charitable Hospital*, 20 Cath. U. L. Rev. 237, 247 (1970).
[33] *See* I.R.C. § 170(b)(1)(A)(iii) (2014).
[34] *See* Rev. Rul. 69-545, 1969-2 C.B. 117.
[35] Commissioners for Special Purposes of Income Tax v. Pemsel, [1891] A.C. 531 (H.L.) 583 (appeal taken from Eng.).
[36] *See* Hyatt & Hopkins, *supra* note 8, at 16.
[37] *See* Rev. Rul. 56-185, 1956-1 C.B. 202.
[38] *See* Hyatt & Hopkins, *supra* note 8, at 17.

attention to the charitable giving of hospitals and began to more closely monitor the state requirements.

### A. *Affordable Care Act means everyone is insured, right? So no more need for Charity Care?*

In 2012, the United States Supreme Court decided *National Federation of Independent Business v. Sebelius,* upholding the individual mandate portion of the Affordable Care Act.[39] With the provision of health care to uninsured Americans at an entirely new level, this brought into question the need for tax-exempt nonprofit hospitals whose basis for exemption relied upon their provision of significant charitable care to those who could not afford health care insurance.

While Health Care Reform has drastically increased the percentage of the population with insurance, there still is and will always be people who opt out of the system and choose to either pay the tax penalty or simply not file a tax return at all.[40] In 2013, about 42 million people lacked health insurance coverage of any type, and according to the Tax Foundation, already 43.4 million Americans do not pay any income tax.[41] This does not include the people who do not even file returns. According to the U.S. Census Bureau there are 316 million people in the United States, of which 23% are children, leaving about 243 million adult taxpayers.[42] 51.2% (about 128.2 million) of Americans were single in its monthly job market report in August 2014.[43] Therefore, we can estimate 126 million single taxpayers and about 120 million married persons. If we assume that each of these married persons files a joint return, or would file a joint return, that leaves a total of 60 million returns for married persons and 126 million returns for single taxpayers for a grand total of 186 million returns. The IRS re-

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[39] Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2608 (2012).

[40] *See* Table A-1, *infra* note 96.

[41] JESSICA C. SMITH & CARLA MEDALIA, U.S. CENSUS BUREAU, HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2013, at 3 (2013); Scott A. Hodge, *Number of Americans Paying Zero Federal Income Tax Grows to 43.4 Million*, TAX FOUNDATION (March 30, 2006), http://taxfoundation.org/article/number-americans-paying-zero-federal-income-tax-grows-434-million (last visited Sept. 30, 2015).

[42] POPULATION DIVISION, U.S. CENSUS BUREAU, ANNUAL ESTIMATES OF THE RESIDENT POPULATION FOR SELECTED AGE GROUPS BY SEX FOR THE UNITED STATES, STATES, COUNTIES, AND PUERTO RICO COMMONWEALTH AND MUNICIPIOS: APRIL 1, 2010 TO JULY 1, 2013 (2014).

[43] Richard Florida, *Singles Now Make Up More Than Half the U.S. Adult Population: Here's Where They All Live,* THE ATLANTIC CITYLAB, (Sept. 15, 2014), http://www.citylab.com/housing/2014/09/singles-now-make-up-more-than-half-the-us-adult-population-heres-where-they-all-live/380137/.

ported in a 2012 report that the total returns filed were 145 million.[44] Therefore, we have a shortage of roughly 41 million returns. So if that is equivalent to 45 million people that refuse to file individual returns – either because their income is too low or they just think the law doesn't apply to them – that is about 45 million people who will feel no consequences if and when they refuse to obtain health insurance. That is a little less than 1 million taxpayers per state.[45]

The Federal Emergency Medical Treatment and Labor Act (EMTALA), enacted in response to "patient dumping" of the uninsured still applies to hospitals that accept Medicare and operate emergency departments.[46] It is important to note that nearly all tax-exempt hospitals accept Medicare and the Medicare Conditions of Participation require that all hospitals have the ability to provide initial treatment in emergency situations.[47] Therefore, those who remain uninsured will still require treatment, which leaves ample people in need of financial assistance.

### *B. Not-for-Profit v. For-Profit*

Hospitals have traditionally been tasked with caring for the sick and, up until the 1920's, acted as full charities in the sense that they only survived on voluntary charitable donations since they were not paid for their services. Hospitals gain their income from Medicare, other government subsidies (Medicaid, CHIP, etc.), and patient and insurance fees.[48] This has caused some state courts to argue that there is no longer a distinction between nonprofit and for-profit hospitals and their operations.[49] However, as the dissent in *Utah County v. Intermountain Health Care, Inc.* notes, these state courts could not be more misguided.[50] The distinction in many underserved geographical regions is not whether hospitals are either for-profit or nonprofit – rather they are either a nonprofit hospital or there is not a hospital at

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[44] BRETT COLLINS, I.R.S., PROJECTIONS OF FEDERAL TAX RETURN FILINGS: CALENDAR YEARS 2011-2018, at 182 (2012), http://www.irs.gov/pub/irs-soi/12rswinbulreturnfilings.pdf.

[45] *See* Table A-1, *infra* note 96.

[46] *See* 42 U.S.C. § 1395dd (2014).

[47] *See*CENTERS FOR MEDICARE & MEDICAIDSERVICES, DEP'T OF HEALTH & HUM. SERVS., CMS MANUAL SYSTEM (2009), https://www.cms.gov/Regulations-and-Guidance/Guidance/Transmittals/downloads/R46SOMA.pdf.

[48] *See generally* BARRY R. FURROW ET AL., HEALTH LAW: CASES, MATERIALS, AND PROBLEMS 414, 452, 472 (7th ed. 2008) (explaining how different government systems can contribute to hospital's income).

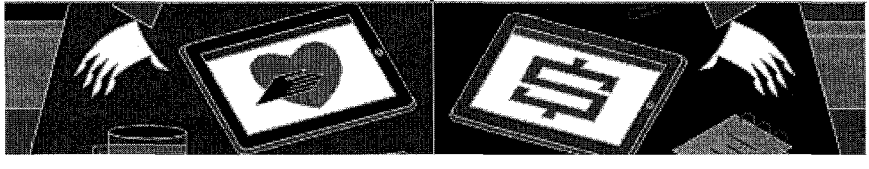
[49] *See, e.g., Utah County v. Intermountain Health Care, Inc.*, 709, P.2d 265, 271 (Utah 1985)

[50] *Id.* at 279-280.

all.[51] Significant differences exist between the two; non-profit hospitals identify charity patients *after* admission rather than *at* admission, as for-profit hospitals normally do.[52] Non-profit hospitals are there to help people regardless of their ability to pay, and do not look at patients with dollar signs over their heads.

In an Institute of Management Accountants Strategic Finance article, Marc Epstein and F. Warren McFarlan created a Table to outline key differences between for-profit and nonprofit governance sectors in an effort to educate Board members.

| FOR-PROFITS | NONPROFITS |
|---|---|
| **MISSION** | |
| Mission important | Mission very important |
| Financial results | Cash-loss generator may be the key service |
| Nonfinancial metrics important | Nonfinancial metrics of mission performance very important |
| **FINANCE** | |
| Financial metrics of performance P&L, stock price, and cash flow very important | Financial metrics of meeting budget and cash flow projections also important |
| Funds come from operations and financial capital markets | Funds come from operations, debt, grants, and philanthropy |
| Short-term goals very important | Deep focus on long-term goals (as long as cash is there) |
| **EXECUTIVE** | |
| Small board—paid governance | Often large board—volunteer governance |
| Few board committees | Often many board committees |
| Combined chair/CEO plus lead director | Nonexecutive volunteer chair, plus CEO |



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In conclusion, and as best described by Thomas K. Hyatt and Bruce R. Hopkins themselves, "Congress is not merely 'giving' eligible nonprofit organizations 'benefits'; this exemption from taxation. . . is not a 'loop-hole,' a 'preference,' or a 'subsidy.'"[54] The exemption is earned by factors such as a charitable purpose, a mission to promote health to the community and underserved, a location in areas that most profitable organizations would not service, providing subsidized

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[51] *Id.* at 289.

[52] *See Id.* at 284.

[53] Marc J. Epstein & F. Warren McFarlan, *Nonprofit v. For Profit Boards: Critical Differences*, 92 STRATEGIC FIN., 28, 30 (2011).

[54] THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS 13 (Wiley ed., 4th ed. 2013).

health services in which most profitable institutions would not, and treating anyone regardless of their ability to pay.

## IV. MODERN NON-PROFIT HEALTH LAW CHANGES

Since the passage of the principles established in 1969, various stakeholders in the health care community have taken the challenge to define and provide guidance to explain community benefit requirements for non-profit hospitals. The Catholic Health Association in particular has been instrumental in providing guidance to the Senate Finance Committee; particularly when the redesign of the Form 990's Schedule H occurred, which required non-profit hospitals to report and categorize community benefit dollars spent in a taxable year.[55] Outreach was a significant component in the 1990's ideal mission of hospitals, and was key in the expansion of the community benefit standard subsequent to national health reform and the inclusion of the I.R.C. 501(r) requirements.[56]

At the end of the 2014 calendar year, the Treasury issued Final Regulations for Tax Exempt Hospitals.[57] On the U.S. Department of Treasury's website in the Treasury Notes section, the government admitted to altering regulations in response to the number of stakeholder comments it received.[58] Key changes included a decrease in financial assistance policy translations based upon the community served, and individual notification of financial assistance policies only required when "extraordinary collections actions" are intended.[59]

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[55] *See generally,* Press Release, Catholic Health Association of the United States, Sr. Carol Keehan Emphasizes Catholic Health Ministry's Longstanding Commitment to Community Benefits in Testimony Before U.S. Senate Finance Committee (Sept. 13, 2006) (on file with PR Newswire). *See also* Julie J. Trocchio, *Something old something new: CHA's updated Guide for Planning and Reporting Community Benefit*, 89 HEALTH PROGRESS 6 (2008) (discussing Catholic Health Associations revision of its community benefit resource *Guide for Planning and reporting Community Benefit* in line with the new IRS Form 990 Schedule H). *See generally* BRUCE R. HOPKINS ET AL., THE NEW FORM 990: LAW POLICY, AND PREPARATION 375–420 (Wiley ed., 2009).

[56] *See* Martha Somerville, et al., *Hospital Community Benefits After the ACA: The State Law Landscape*, THE HILLTOP INSTITUTE, March 2013, at 1; *see also* Paul Hattis, *Retooling for Community Benefit*, 74 HEALTH PROGRESS 38, 38 (1993). *See generally* I.R.C § 501(r) (2014).

[57] *See* Emily McMahon, *Treasury Finalizes Patient Protection Regulations for Tax-Exempt Hospitals*, TREASURY.GOV (Dec. 29, 2014), http://www.treasury.gov/connect/blog/Pages/Treasury-Finalizes-Patient-Protection-Regulations-for-Tax-Exempt-Hospitals.aspx.

[58] *Id.*

[59] *Id.*

The Treasury also enacted IRC 501(r), which requires hospitals to perform a community health needs assessment every three years to determine specific health related needs in its service area.[60] The assessment should drive the hospital's community benefit towards the health area identified.

## V. CONSOLIDATED RETURNS

Consolidated return benefits ultimately provide non-profits with several advantages, such as efficiency of resources and time. They also provide the community with more transparency to see the company's profits, expenses, contributions, and community benefits as a whole. Because most persons in the community lack the expertise to understand complicated corporate structures with multiple parent and subordinate organizations, it is easier for them to look at one return that lays out all of the information they need to understand. For the IRS, the benefits are plentiful in the area of efficiency., The IRS would be unable to handle the increase in volume if the group return option were to be disallowed because the IRS and many government agencies at this time are understaffed and underfunded. Tax-exempt entities are not areas the IRS can target to provide high return on investment for audits, and therefore it would be an unworthy use of their limited time and resources.

### *A. Financial Accounting Guidelines*

Consolidation occurs when financial statements of a parent organization are combined with its subsidiaries to produce one single comprehensive financial statement.[61] Consolidations are useful for management, auditors, and creditors to better determine income and expenses. The U.S. Generally Accepted Accounting Principles (US GAAP) consolidation rules provide several different models with guidance on how to consolidate financial statements of controlling and subsidiary companies.[62] The rules for the different models differ in

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[60] I.R.C § 501(r)(3) (2014).

[61] It is important to note that the degree and percentage of ownership will depend upon the type of inclusion the subsidiary is given into the consolidated financial statement. If a majority interest of more than 50% is held the parent is required to include the subsidiary in its consolidated return. If the parent only holds a substantial non-majority interest in the subsidiary it may still be required to be reflected as an investment on the financial statement.

[62] Ernst & Young, *Financial Reporting Developments: A Comprehensive Guide, Consolidated and other financial statements Noncontrolling interests, combined financial statements, parent company financial statements and consolidating financial statements, 1* (July 2014), http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CCMQFjAA&url=http%3A%2F%2Fwww.ey.com%2Fpu

their basis on control, risk, or rewards.[63] Each model makes a concerted effort to eliminate intercompany transactions so that revenues and expenses are not counted twice, and to ensure financial statements are not erroneously inflated.[64]

*B. Treasury Guidelines*

26 U.S. Code § 1501 and § 1.6033-2(d) permit affiliated group corporations to file a consolidated return for income tax in lieu of the usual requirements of a separate return for each entity.[65] In order to obtain such privilege, all entities must consent prior to the last day of the taxable year. Treasury Regulation § 1.1502-75 details extensively the privilege of filing consolidated returns.[66]

One of the advantages of filing consolidated returns is that losses incurred by one member of the consolidated group are allowed to offset gains from another member.[67] In addition, transfers of property that would otherwise be deemed sales are classified as intercompany transfers and therefore escape immediate taxation.[68] This advantage is key because the delay in payment of taxes due to the time value of money is always a beneficial goal in tax planning,.

Disadvantages also exist with the consolidated return, and some argue that the disadvantages offset the advantages. Consolidated return regulations are extremely complex and although more often than not deferral of gain can be a positive thing it can also hurt a company that is on the verge of having a Net Operating Loss expire, which could have been utilized to offset these gains.[69] Furthermore in the loss arena the rules have issued consolidated loss limitations under Section 382.[70]

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[63] *Id at 23.*

[64] *Id at 47.*

[65] I.R.C. § 1501 92014); 26 C.F.R. § 1.6033-2(d) (2015). Affiliated group means one or more includable corporations connected through stock ownership with a common parent. I.R.C. §1504(a)(1) (2014).

[66] 26 C.F.R. 1.1502-27 (2015).

[67] *See generally id* at 80.

[68] *See generally id* at 20.

[69] *See* Amie T. Whittington, *Back to Basics: Consolidated Tax Returns,* Executive's Tax & Management Report, Nov. 2007, at 2, tax.cchgroup.com/images/FOT/BacktoBasics.pdf. *See generally,* I.R.C. §. 172 (2014).

[70] *See generally,* I.R.C. § 382(b) (2014).

## VI. GROUP TAX RULINGS AND EXEMPTIONS

### A. *History*

The group ruling originally came into creation over 75 years ago.[71] Its main purpose was to create administrative convenience and efficiency for the IRS.[72] The thought was that it would also create efficiencies for central organizations that controlled subsidiary organizations allowing them to complete one combined tax return covering all of its entities.[73]

### B. *How the Group Exemption Ruling is Obtained*

The IRS defines a group exemption as, "a recogni[tion] on a group basis [of] the exemption under section 501(c) of the Code of subordinate organizations on whose behalf the central organization has applied for recognition of exemption."[74] A "parent" or central organization generally has "subordinate" organization(s) underneath of it, which it controls or is affiliated.[75]

In order to receive a group ruling from the IRS, the central organization, in most circumstances, must first receive its tax exemption recognition from the IRS before it may request to establish a group. In addition, six requisites through various listed documentation must be established before the parent may ask for its subsidiaries to be included in a group exemption ruling.[76] The requirements include: 1) affiliation, 2) subject to control of the parent, 3) exempt purpose under IRC 501(c), 4) ineligibility for private foundation status, 5) identical accounting period, and 6) certain formation date requirements for backdating.[77] The subordinate organization must consent and certify that it wishes to be considered as a part of the group. The ruling generally takes the IRS 12 months to complete.

### C. *Group Ruling Benefits and Difficulties*

In practice, the group exemption combined with the consolidated return has provided significant benefits – one of them being of a

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[71] Paul Arnsberger et al., *A History of the Tax-Exempt Sector: An SOI Prespective,* http://www.irs.gov/pub/irs-soi/tehistory.pdf.

[72] DEPARTMENT OF THE TREASURY, I.R.S., PUBLICATION 4573, GROUP EXEMPTIONS: TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION (2007), http://www.irs.gov/pub/irs-pdf/p4573.pdf.

[73] Rev. Proc. 80-27, 1980-1 I.R.B. 677 (discussing the rule for applying for group exemption).

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *Id.*

financial and efficiency nature. In the public sector, when an accountant files a return, a set fee is normally allocated to each return. If a company has ten subsidiaries and one parent, they would pay $3,000 per return. Thus, if they can minimize this to one return, they have saved the equivalent of ten returns and $30,000. Thus, according to the illustrated example, the IRS has now cut down its workload from reviewing eleven returns to only one. Even if the returns are done in house, utilizing software programs (for example the Lacerte Professional Suite) will also result in a savings based on the estimated costs of the example above. To access a return (i.e. to input data and send it electronically to the IRS) it costs a minimum of about $100 each, not including licensing fees of about $500, filing fees of about $25, and accountant time of about $30/hour.[78] If a company has 19 subsidiaries and one parent, allowing a consolidated return it saves the company an average of $200/return, not including internal accountant fees, which could easily be more than $50,000 a year! Although, this number appears small, costs can quickly add up for organizations and the IRS who must store and pay to receive all of these electronic returns.

### *D. Governmental Agency Confusion*

Unfortunately, the group ruling has also created some confusion for persons who are unaware of its existence, including government agencies. According to the Author, one such instance occurred while working for a large health care system and applying for hospital funding for the Electronic Health Record (HER) Incentive Meaningful Use funds from the government.[79] The task proved to be difficult, as unforeseen issues were encountered relative to the IRS Employer Identification Number (EIN) verification letters while attempting to register the hospital with the Centers for Medicaid and Medicare Services (CMS).[80] The top of each subsidiaries EIN verification letter lists the parent corporation, as this is how the IRS sends out correspondence.[81] CMS did not understand how group exemptions function, and denied the organization funding due to this technicality.[82] After considerable efforts, the IRS and CMS escalated the matter and finally

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[78] Calculated using Intuit Accountants, ProSeries® Professional Tax Software, http://accountants.intuit.com/tax/proseries/professional/.

[79] Centers for Medicare and Medicaid Services, Electronic Health Care Record Incentive Programs, http://www.cms.gov/Regulations-and-Guidance/Legislation/EHRIncentivePrograms/index.html.

[80] Internal Revenue Service, Publication 557 – Tax-Exempt Status for Your Organization, 8, (Oct. 2013), http://taxmap.ntis.gov/taxmap/pubs/p557-004.htm.

[81] No written account of this policy available to the public has been found. The Author learned of this procedure by an IRS representative in 2013 via telephone.

[82] This account is provided by the Author, Marie Yascko-Rosado while working at Mary Washington Healthcare as a Tax Specialist.

resolved the discrepancies between their systems. It is clear that the agencies do not speak to one another, and it is critical that taxpayers and professionals educate CMS and other agencies about the processes of the IRS.

### *E. IRS Advisory Council Concerns*

A 2011 IRS ACT report stated that group returns are uninformative and lack transparency.[83] The parent is not part of the consolidated return and is reported separately. The Advisory Council also noted that the accounting transactions such as intercompany transfers in the group were not required to be netted, as in normal corporate consolidated financial statements based upon Generally Accepted Accounting Principles.[84] Therefore, they argued that determining financial operations of each subordinate member of the group was impossible without viewing unconsolidated financial statements.[85] However, this is arguably not a significant issue, as most states (and now federal law) have required nonprofits to publish their Audited Financial Statements on their websites.[86] The Audited Financial Statements often separate out the companies and their income and expenses so that bond investors and community stakeholders can see a transparent view of the parent and its subsidiaries.

As mentioned above, public disclosure of regulatory filings is expected of non-profits, which is why the Advisory Committee had concerns.[87] Nonprofits must annually file Form 990's, which report the compensation of executives, board members, and key employees, fundraising amounts earned, categorized expenses, and community benefit dollars spent.[88] In addition, unrelated business activity returns are also to be supplied to the public by the Pension Protection Act of

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[83] Advisory Committee on Tax Exempt and Government Entities (ACT), Exempt Organizations: Group Exemptions-Creating a Higher Degree of Transparency, Accountability, and Responsibility (June 15, 2011) at 35, http://www.irs.gov/pub/irs-tege/tege act rpt10.pdf.

[84] *Id.* at 19-26.

[85] *Id.* at 25

[86] *See* I.R.S. Publ'n 4221-PC (Rev. 7), (2014), *https://www.irs.gov/pub/irs-pdf/p4221pc.pdf*; Tiffany C. Wright, *Does the IRS Require Audited Statements for Nonprofits?*, AZCENTRAL, yourbusiness.azcentral.com/irs-require-audited-statements-nonprofits-21631.html; *see, e.g.*, Mary Washington Healthcare, IRS 990 Reports, http://www.marywashingtonhealthcare.com/about-mary-washington-healthcare/irs-990-reports.

[87] *See* Advisory Committee on Tax Exempt and Government Entities (ACT), Exempt Organizations: Group Exemptions-Creating a Higher Degree of Transparency, Accountability, and Responsibility (June 15, 2011) at 1, http://www.irs.gov/pub/irs-tege/tege act rpt10.pdf.

[88] I.R.C. 501(c)(3) (2014).

2006.[89] This tells the community the profitable businesses or sometimes non-profitable business that are unrelated to the organization's mission.[90] Since the non-profit is "owned by the community" transparency is important between the community and the nonprofit organization.

From a hospital perspective, when multiple subordinates can file one 990, the hospital must report only a combined set of the top highest five persons paid income.[91] Often, hospital management dislikes having its compensation publically posted, as they often receive criticism.[92] Also, the way that the Form 990: Schedule J is organized tends to provide inflated compensation numbers.[93] A valuation of benefits not generally includable in income must be valued and included in compensation. Such items any health insurance benefits and other Section 125 Fringe Benefits are not generally includable in income. Total compensation also requires a valuation and inclusion of bonuses and deferred compensation, as well as total Medicare wages. This essentially makes the Schedule J report an economic Haigs-Simmons reporting type of income rather than our present day federal taxation system of recognizing income.[94]

## VII. CONCLUSION

"For the United States and other democratic nations, the community of nonprofit organizations is a necessary ingredient of a civil society."[95] The provision of a group tax exemption provides both the Internal Revenue Service and the public and private accounting, and legal sectors with efficiency and benefits well beyond any transparency concerns. In a time of a steadily shrinking government workforce and

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[89] Evelyn Brody, *Sunshine and Shadows on Charity Governance: Public Disclosure As a Regulatory Tool*, 12 Fla. Tax Rev. 183, 207.

[90] Unfortunately, Guidestar.com, the electronic storage bank of all 990's, does not have the 990T's uploaded and it would have to be requested directly from the organization.

[91] I.R.S., *Instructions for Form 990,* Cat. No. 11283J (Nov. 10 2014).

[92] *See, e.g.,* Naomi Freundlich, *High CEO Salaries at Nonprofit Hospitals Under Scruitiny. . . Once Again*, HEALTHBLOG (Mar. 24, 2011) www.healthblog.com/2011/03/high-ceo-salaries-at-nonprofit-hospitas-under-scrutinyonce-again/.

[93] *See generally, e.g.* Edmund B. Ura, *Reviewing the Compensation Information in Your Form 990- A Brief Guide for Board Members*, MERCES FQHC HUMAN RESOURCES CONSULTING (March 14, 2013), http://merceschcconsulting.com/2013/03/14/fqhcreviewing-compensation-form-990-a-brief-guide-for-board-members/.

[94] *See* Jonathan Barry Forman, *The Income Tax Treatment of Social Welfare Benefits*, 26 U. MICH. J.L. REFORM 785, 799-800 (1994). (The classic economic definition of income, also known as the Haig-Simons definition of income in footnote 130).

[95] Hyatt, Thomas K. and Hopkins, Bruce R, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS §1.3 (4th Ed. 2013)

budgets the IRS is already struggling to keep up with the growing number of tax-exempt entities. Efficiency and budgetary concerns demand that we continue the rule of the group exemption.

(Numbers in thousands. Civilian noninstitutionalized population. For information on confidentiality protection, sampling error, nonsampling error, and definitions, see *www.census.gov/acs/www/Downloads/data_documentation/Accuracy/ACS_Accuracy_of_Data_2013.pdf*) 96

| State | 2013 uninsured | | | | 2012 uninsured | | | | Difference in uninsured | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Number | Margin of error[1] (±) | Percent | Margin of error[1] (±) | Number | Margin of error[1] (±) | Percent | Margin of error[1] (±) | Number | Margin of error[1] (±) | Percent | Margin of error[1] (±) |
| **United States** | **45,181** | **200** | **14.5** | **0.1** | **45,615** | **195** | **14.8** | **0.1** | ***–434** | **279** | ***–0.2** | **0.1** |
| Alabama | 645 | 17 | 13.6 | 0.4 | 632 | 17 | 13.3 | 0.4 | 13 | 24 | 0.2 | 0.5 |
| Alaska | 132 | 7 | 18.5 | 1.0 | 145 | 7 | 20.5 | 1.0 | *–13 | 10 | *–2.0 | 1.4 |
| Arizona | 1,118 | 24 | 17.1 | 0.4 | 1,131 | 27 | 17.6 | 0.4 | –13 | 36 | –0.4 | 0.6 |
| Arkansas | 465 | 14 | 16.0 | 0.5 | 476 | 11 | 16.4 | 0.4 | –11 | 17 | –0.5 | 0.6 |
| California | 6,500 | 57 | 17.2 | 0.2 | 6,710 | 52 | 17.9 | 0.1 | *–209 | 77 | *–0.7 | 0.2 |
| Colorado | 729 | 18 | 14.1 | 0.3 | 751 | 20 | 14.7 | 0.4 | –22 | 26 | *–0.7 | 0.5 |
| Connecticut | 333 | 14 | 9.4 | 0.4 | 322 | 11 | 9.1 | 0.3 | 11 | 18 | 0.3 | 0.5 |
| Delaware | 83 | 6 | 9.1 | 0.7 | 80 | 6 | 8.8 | 0.7 | 3 | 8 | 0.3 | 0.9 |
| District of Columbia | 42 | 4 | 6.7 | 0.6 | 37 | 3 | 5.9 | 0.5 | *5 | 5 | 0.7 | 0.8 |
| Florida | 3,853 | 43 | 20.0 | 0.2 | 3,816 | 36 | 20.1 | 0.2 | 37 | 56 | –0.1 | 0.3 |
| Georgia | 1,846 | 30 | 18.8 | 0.3 | 1,792 | 30 | 18.4 | 0.3 | *54 | 42 | 0.4 | 0.4 |
| Hawaii | 91 | 6 | 6.7 | 0.4 | 92 | 6 | 6.9 | 0.4 | –2 | 8 | –0.1 | 0.6 |
| Idaho | 257 | 12 | 16.2 | 0.8 | 255 | 9 | 16.2 | 0.6 | 3 | 15 | Z | 1.0 |
| Illinois | 1,618 | 27 | 12.7 | 0.2 | 1,622 | 22 | 12.8 | 0.2 | –4 | 34 | Z | 0.3 |
| Indiana | 903 | 19 | 14.0 | 0.3 | 920 | 20 | 14.3 | 0.3 | –17 | 27 | –0.3 | 0.4 |
| Iowa | 248 | 9 | 8.1 | 0.3 | 254 | 10 | 8.4 | 0.3 | –7 | 13 | –0.3 | 0.4 |
| Kansas | 348 | 12 | 12.3 | 0.4 | 356 | 10 | 12.6 | 0.4 | –7 | 15 | –0.3 | 0.5 |
| Kentucky | 616 | 14 | 14.3 | 0.3 | 595 | 14 | 13.9 | 0.3 | *21 | 20 | 0.4 | 0.5 |
| Louisiana | 751 | 17 | 16.6 | 0.4 | 760 | 16 | 16.9 | 0.4 | –8 | 23 | –0.3 | 0.5 |
| Maine | 147 | 7 | 11.2 | 0.5 | 135 | 7 | 10.2 | 0.5 | *12 | 10 | *0.9 | 0.8 |
| Maryland | 593 | 17 | 10.2 | 0.3 | 598 | 16 | 10.3 | 0.3 | –4 | 23 | –0.2 | 0.4 |
| Massachusetts | 247 | 10 | 3.7 | 0.2 | 254 | 11 | 3.9 | 0.2 | –8 | 15 | –0.1 | 0.2 |
| Michigan | 1,072 | 19 | 11.0 | 0.2 | 1,114 | 15 | 11.4 | 0.2 | *–43 | 24 | *–0.5 | 0.2 |
| Minnesota | 440 | 14 | 8.2 | 0.3 | 425 | 11 | 8.0 | 0.2 | 15 | 18 | 0.2 | 0.3 |
| Mississippi | 500 | 16 | 17.1 | 0.5 | 498 | 11 | 17.0 | 0.4 | 2 | 19 | Z | 0.7 |
| Missouri | 773 | 18 | 13.0 | 0.3 | 801 | 19 | 13.6 | 0.3 | *–29 | 26 | *–0.5 | 0.4 |
| Montana | 165 | 8 | 16.5 | 0.8 | 178 | 6 | 18.0 | 0.6 | *–14 | 10 | *–1.6 | 1.0 |
| Nebraska | 209 | 9 | 11.3 | 0.5 | 206 | 8 | 11.3 | 0.5 | 3 | 12 | 0.1 | 0.7 |
| Nevada | 570 | 17 | 20.7 | 0.6 | 603 | 17 | 22.2 | 0.6 | *–33 | 24 | *–1.5 | 0.9 |
| New Hampshire | 140 | 7 | 10.7 | 0.5 | 139 | 8 | 10.6 | 0.6 | 1 | 11 | 0.1 | 0.8 |
| New Jersey | 1,160 | 22 | 13.2 | 0.2 | 1,113 | 27 | 12.7 | 0.3 | *47 | 35 | *0.5 | 0.4 |
| New Mexico | 382 | 13 | 18.6 | 0.6 | 378 | 10 | 18.4 | 0.5 | 4 | 17 | 0.2 | 0.8 |
| New York | 2,070 | 30 | 10.7 | 0.2 | 2,103 | 30 | 10.9 | 0.2 | –33 | 43 | –0.2 | 0.2 |
| North Carolina | 1,509 | 26 | 15.6 | 0.3 | 1,582 | 26 | 16.6 | 0.3 | *–73 | 37 | *–0.9 | 0.4 |
| North Dakota | 73 | 6 | 10.4 | 0.8 | 69 | 5 | 10.0 | 0.7 | 5 | 7 | 0.3 | 1.0 |
| Ohio | 1,258 | 21 | 11.0 | 0.2 | 1,304 | 22 | 11.5 | 0.2 | *–47 | 30 | *–0.4 | 0.3 |
| Oklahoma | 666 | 13 | 17.7 | 0.3 | 685 | 12 | 18.4 | 0.3 | *–19 | 17 | *–0.7 | 0.5 |
| Oregon | 571 | 15 | 14.7 | 0.4 | 576 | 17 | 14.9 | 0.4 | –5 | 23 | –0.3 | 0.6 |
| Pennsylvania | 1,222 | 22 | 9.7 | 0.2 | 1,225 | 20 | 9.8 | 0.2 | –2 | 30 | Z | 0.2 |
| Rhode Island | 120 | 7 | 11.6 | 0.7 | 115 | 6 | 11.1 | 0.6 | 6 | 9 | 0.5 | 0.9 |
| South Carolina | 739 | 18 | 15.8 | 0.4 | 778 | 19 | 16.8 | 0.4 | *–39 | 26 | *–1.0 | 0.6 |
| South Dakota | 93 | 5 | 11.3 | 0.7 | 94 | 5 | 11.5 | 0.6 | –1 | 7 | –0.2 | 0.9 |
| Tennessee | 887 | 20 | 13.9 | 0.3 | 882 | 20 | 13.9 | 0.3 | 5 | 28 | Z | 0.4 |
| Texas | 5,748 | 55 | 22.1 | 0.2 | 5,762 | 54 | 22.5 | 0.2 | –14 | 77 | *–0.4 | 0.3 |
| Utah | 402 | 13 | 14.0 | 0.5 | 409 | 14 | 14.5 | 0.5 | –7 | 19 | –0.5 | 0.7 |
| Vermont | 45 | 4 | 7.2 | 0.6 | 40 | 3 | 6.5 | 0.5 | 5 | 5 | 0.8 | 0.8 |
| Virginia | 991 | 22 | 12.3 | 0.3 | 1,000 | 21 | 12.5 | 0.3 | –9 | 31 | –0.2 | 0.4 |
| Washington | 960 | 22 | 14.0 | 0.3 | 945 | 21 | 13.9 | 0.3 | 15 | 30 | 0.1 | 0.4 |
| West Virginia | 255 | 10 | 14.0 | 0.5 | 264 | 9 | 14.4 | 0.5 | –9 | 13 | –0.5 | 0.7 |
| Wisconsin | 518 | 14 | 9.1 | 0.2 | 506 | 13 | 9.0 | 0.2 | 12 | 19 | 0.2 | 0.3 |
| Wyoming | 77 | 5 | 13.4 | 0.9 | 87 | 6 | 15.4 | 1.0 | *–10 | 8 | *–1.9 | 1.3 |

*Statistically different from zero at the 90 percent confidence level.

Z Represents or rounds to zero.

[1]Data are based on a sample and are subject to sampling variability. A margin of error is a measure of an estimate's variability. The larger the margin of error is in relation to the size of the estimate, the less reliable the estimate. This number when added to and subtracted from the estimate forms the 90 percent confidence interval.

Note: Differences are calculated with unrounded numbers, which may produce different results from using the rounded values in the table.

Source: U.S. Census Bureau, 2012 and 2013 1-year American Community Surveys.

96 Jessica C. Smith and Carla Medalia, *Health Insurance Coverage in the United States: 2013*, U.S. CENSUS BUREAU, CURRENT POPULATION REPORTS, at 18, (Washington, DC, 2014). (Utilized for total population without health insurance by state), https://www.census.gov/content/dam/Census/library/publications/2014/demo/p60-250.pdf.