

Top Three Current Revenue Stream Considerations for Tax-Exempt Organizations Providing Elder Care

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Current economic conditions have put additional strain on organizations across the health care spectrum in unprecedented ways. However, along with new challenges, both market conditions and new guidance from the Internal Revenue Service (IRS) bring fresh opportunities for tax-exempt senior services and other elder care organizations to consider new efficiencies, maximize revenues, and even expand operations. In particular, organizations in acquisitive periods and large health care systems looking to expand their spectrum of elder care services may find significant opportunities in the current market.

1. **Evaluating related versus unrelated revenue streams and associated expenses.**

Under Sections 511 through 514 of the Internal Revenue Code of 1986, as amended (IRC), tax-exempt organizations are required to pay unrelated business income tax (UBIT) on income from activities that are unrelated to their charitable, educational, scientific, religious or other exempt (or “related”) purposes. The unrelated business income (UBI) rules are complex, and such complexity can deter tax-exempt organizations from taking a comprehensive analysis relating to revenue sources and expense allocations for UBI calculation purposes. Changes to methodology for categorizing related versus unrelated revenue and expenses have implications across an organization’s financial reporting, to include tax returns and other compliance filings in both future and prior years.

In May 2020, the IRS issued proposed regulations to give guidance for tax-exempt organizations calculating UBTI on separate unrelated trades or businesses (commonly referred to “siloeing” such revenue and expenses) under IRC Section 512(a)(6), which was added by the 2017 Tax Cuts and Jobs Act (TCJA). The proposed regulations provide organizations guidance on how to identify and calculate UBTI from separate trades or businesses for purposes of IRC Section 512(a)(6), which generally requires

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organizations operating more than one unrelated trade or business to compute UBTI separately for each siloed trade or business. Once the businesses are broken into separate silos, an organization must determine how to allocate expenses that may apply to more than one activity to each silo. The preamble to the Section 512(a)(6) proposed regulations indicates that the IRS intends to publish a separate notice of proposed rulemaking to provide further guidance on expense allocation in calculating UBTI. In the interim, tax-exempt organizations may allocate such expenses using any reasonable method.

Shifting models of care and new payment models across the health care spectrum provide not only cost efficiencies but also opportunities to analyze whether a tax-exempt organization's activities (and associated revenues and expenses) are actually patient revenue related to such organization's exempt purposes. And, if any activities are deemed unrelated to a tax-exempt organization's exempt purposes, the new Section 512(a)(6) guidance provides a new benchmark to analyze such revenues and make good faith determinations relating to expense allocations.

2. Acquiring assets out of bankruptcy proceedings. Economic downturns are painful, but for organizations with an acquisitive mindset, such market events can provide opportunities to expand existing and add activities through purchasing assets or businesses out of bankruptcy proceedings. If a tax-exempt organization is merely purchasing assets out of bankruptcy, the tax status of the former owner is typically not relevant. However, if the tax-exempt organization is purchasing the shares or equivalent ownership units of a taxable entity, it may still be a good fit for the acquiring tax-exempt organization but such transactions will require proper planning to protect the acquirer's tax-exempt status.

3. Acquiring for-profit entities or operations. Whether acquired through bankruptcy proceedings or by a straight equity purchase, acquiring existing operations or ownership of a for-profit organization may present beneficial opportunities to tax-exempt organizations to enhance or expand their elder care service spectrum.

While many senior housing organizations operate as for-profit enterprises, converting to a tax-exempt organization as a stand-alone organization or by acquisition by a tax-exempt organization may be a win-win for both organizations with proper planning. Additional considerations include the applicability of IRC Section 337(d), which requires certain corporations that transfer all or substantially all of their assets to a tax-exempt entity or convert from a taxable corporation to an exempt entity to recognize gain or loss as if it had sold the assets at fair market value. Also, the IRS has recently stated that organizations formerly operated as for-profit entities prior to their conversion to Section 501(c)(3) entities are one of the issues included on the annual compliance strategy list, and therefore may have a higher chance of future examination. However, if the converted organization files a new application for tax-exempt status by filing a Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, that is approved by the IRS the examination would seem fairly straightforward so long as the Form 1023 is an accurate representation of the entity's activities.

Despite the additional due diligence and planning required, the last several years have shown several high-profile mergers and acquisitions of both tax-exempt and taxable skilled nursing facilities by tax-exempt organizations. Tax-exempt organizations, especially those looking to expand operations geographically or to encompass a more comprehensive spectrum of care should not discount opportunities to acquire an existing enterprise based solely on its taxable status.

If you want to review your organization's current senior services activities and/or evaluate expansion of elder care, please contact the authors or your regular Dorsey attorney.