

THE IRS LOOKS CLOSELY AT HOMES FOR THE AGING

*Organizations Must Be Prepared to Face
Increased Scrutiny on Tax-exempt Status and Financing*

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Because of the current vigorous enforcement of federal tax laws, not-for-profit corporations that seek or wish to preserve tax-exempt status for retirement housing and long-term care facilities must become familiar with the Internal Revenue Service's (IRS's) specific exemption requirements.

Tax-exempt status has long been perceived as appropriate for the traditional retirement home (i.e., congregate housing and life-care facility), which serves the elderly and typically experiences low profit margins. However, since 1987, Congress and the IRS have become particularly concerned with the potential for tax abuse by owners of "luxurious" tax-exempt retirement housing facilities for the "wealthy elderly" (particularly those facilities financed with tax-exempt bonds). In addition, the IRS has increased its scrutiny of organizations having or applying for tax-exempt status. Furthermore, Congress is considering two

separate legislative proposals to allow the IRS to impose "intermediate" tax sanctions, short of revocation of tax-exempt status, to penalize tax-exempt organizations that fail to comply with the federal tax code and associated regulations.¹

FUNDAMENTALS OF EXEMPTION

Section 501(a) of the Internal Revenue Code exempts organizations described in section 501(c)(3) from federal income tax. An organization that is both *organized* and *operated* exclusively for religious, charitable, scientific, literary, or educational purposes or for testing for public safety may qualify for tax-exempt status under section 501(c)(3).² The theory is that the federal government is compensated for lost tax revenue because it does not have to finance such activities.

To qualify for section 501(c)(3) status, an organization must be both organized and operated for one or more exempt purposes.³ An organization will be considered as *organized exclusively*

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The Internal Revenue Service uses the generic term "homes for the aging" to include all forms of retirement housing facilities (except nursing homes that solely provide the highest level of nursing care). A home for the aging that qualifies under section 501(c)(3) (through satisfaction of the organizational and operational tests) will qualify for

charitable status for federal tax purposes if it operates to satisfy the following basic needs of aged persons: suitable housing, healthcare, and financial security.

In general, not-for-profit organizations recognized as exempt under code section 501(c)(3) may be eligible for tax-exempt financing to develop a home for the aging through the issuance of tax-exempt bonds. Effective tax-exemption planning is a necessary part of the business planning process by sophisticated not-for-profit organizations that own and operate (or desire to own and operate) charitable homes for the aging and similar housing facilities serving the elderly. The benefits of exempt status remain attractive for many such organizations. The challenge of obtaining and maintaining that status is becoming far more burdensome.

for exempt purposes only if its articles of incorporation:

- Limit its corporate purposes to one or more exempt purposes
- Do not expressly empower the organization to (1) devote more than an insubstantial part of its activities to influencing legislation through propaganda or otherwise, (2) participate or intervene (directly or indirectly) in any political campaign, or (3) engage in activities associated with an "action" organization (as defined in the Treasury Regulations)

- Allow distribution of its assets on dissolution only to other section 501(c)(3) entities or to the federal, state, or local government⁴

An organization will be regarded as *operated exclusively* for one or more exempt purposes only if it engages primarily in activities that accomplish one or more exempt purposes. An organization will *not* be so regarded if more than an insubstantial part of its activities is *not* in furtherance of an exempt purpose and if (1) its net earnings inure in whole or in part to the benefit of private shareholders or individuals or (2) it serves a private rather than a public interest.⁵

SPECIFIC CRITERIA FOR HOMES FOR THE AGING

The IRS uses the generic term "homes for the aging" for all retirement housing facilities (except nursing homes that solely provide the highest level of nursing care [i.e., skilled care]). The IRS recognizes the elderly are susceptible to physical and financial distress and have special needs such as suitable housing; physical and mental healthcare; civic, cultural, and recreational activities; and an environment conducive to dignity and independence. According to section 501(c)(3), fulfilling these needs may constitute "charitable purposes" even though direct charitable assistance may not be provided.⁶

A home for the aging that qualifies under section 501(c)(3) (through satisfaction of the organizational and operational tests) will qualify for charitable status for federal tax purposes if it operates to satisfy the following basic needs of aged persons:

- Suitable housing
- Healthcare
- Financial security⁷

Suitable Housing An organization satisfies the suit-

Congress is considering allowing the IRS to impose "intermediate tax sanctions."

able housing criterion if it provides residential facilities that are specifically designed to meet some combination of the physical, emotional, recreational, social, religious, or similar needs of aged persons.

The IRS has cited the following factors as evidence that housing was designed to meet the needs of the aged: fire-resistant construction materials; safety features such as bathroom grab-

bars; wide doorways, ramps, and elevators for wheelchair access; slip-resistant floors; convenient electrical outlets and cabinets; windows at eye level for residents in wheelchairs; 24-hour emergency alarm service; and lounges and indoor and outdoor recreational areas.

Healthcare An organization satisfies the healthcare criterion if it provides some form of healthcare or maintains a continuing agreement with other organizations, facilities, or healthcare personnel to maintain its residents' physical and, if necessary, mental well-being.

Substantial on-site nursing or healthcare facilities are not a prerequisite for satisfying the criterion. Rev. Rul. 72-124 requires only "limited nursing care." Also acceptable is a facility that provides transportation for medical examination and follow-up treatment and that provides an employee on 24-hour call to give temporary aid in emergencies, contact healthcare professionals, and ensure that the steps necessary to render care are implemented. When an organization is restricted by state certificate-of-need laws from developing a healthcare component for its new home for the aging, such transfer agreements and similar arrangements might satisfy this criterion.

Financial Security The IRS has stated that an organization meets the financial security criterion if it satisfies three conditions:

- **A Policy of Financial Assistance.** The organization must establish a policy of maintaining in residence residents who become unable to pay regular charges. The organization may accomplish this by applying its reserves, seeking funds from local and federal welfare units, soliciting funds from its sponsoring organizations or its members, or applying some combination thereof.⁸

Rev. Rul. 72-124 sanctions a selective admission policy: Organizations can admit only those persons able to pay the established rates. The IRS has not definitively addressed whether there are

limits to the responsibility of a home for the aging in carrying out such a policy. It is submitted that it would be an inappropriate application of the financial security test to require an organization to place itself in financial distress in order to implement such a policy.

- **Lowest Feasible Cost.** The organization must provide services to its elderly residents at the lowest feasible cost, taking into consideration such expenses as the payment of indebtedness, maintenance of adequate reserves to ensure the life care of each resident, and reserves for the facility's physical expansion commensurate with its resources and the community's needs.⁹

By its nature, lowest feasible cost is a relative criterion. The IRS requires that services be provided at the least possible expense. Any entrance fee or monthly fee charged will not be per se determinative of operation at the lowest feasible cost, but is to be considered in relation to all expenses. Although "wasteful expenditures" are a strong indication that an organization is not charging the lowest feasible cost, using commercial services rather than volunteers or obtaining aid from other charitable organizations or government is not inconsistent with operations at lowest feasible cost.¹⁰

- **Financial Accessibility.** An organization's payment structure must be set at a level that is within the financial reach of a "significant segment" of the community's elderly persons.¹¹ The IRS has not provided any specific guidelines for defining what constitutes a "significant segment" or how to document financial accessibility. In a recent ruling, the IRS extended section 501(c)(3) status to a home for the aging whose charges were allegedly affordable to approximately 75 percent of its community's aged persons.¹² However, there is no precedent to suggest that the 75 percent level is a standard to be applied in determining compliance with this condition.

A home for the aging developed as a "luxury" facility should not automatically be prohibited from qualifying for section 501(c)(3) status. The IRS general counsel has stated that a facility's luxurious nature is not a determinative factor.¹³ Rather, the financial accessibility test is the proper test (assuming the other criteria apply). However, the significant increase in so-called luxury homes for the aging that has occurred since the IRS last addressed the issue may create some risk in continued reliance on this position.¹⁴

Related Rulings The IRS has applied the three-condition test to grant tax-exempt status to homes for the aging corporations involved in:

- Expansion of an existing charitable organization to include an apartment complex for the elderly¹⁵

- Development of a "rest facility in the country" providing poor elderly persons with a two-week vacation¹⁶

- An exempt home for the aging's acquisition of a building with a swimming pool, restaurant, and commercial and residential tenants

- Development of a meals on wheels program for the elderly¹⁷

- Development of a home outreach program for the elderly¹⁸

A particularly significant development in this regard was the 1993 action of the IRS in granting tax-exempt status to an equity-based continuing care retirement community (CCRC) owned and operated by Pacific LifeCare Corporation of Santa Rosa, CA.¹⁹ The CCRC featured a unique cooperative membership option, as well as a traditional entrance fee option. Prices ranged from \$175,000 to \$400,000, depending on the specific option and type of unit. The CCRC was able to overcome the obstacles to exemption presented by its equity model and pricing schedule and receive exemption after a two-and-a-half year review.

QUALIFICATION BY NURSING FACILITY

To qualify for section 501(c)(3) status, a nursing home, unless it is organized and operated primarily for the "promotion of health" (the term used in Rev. Rul. 69-545),²⁰ must satisfy the three-part criteria established in Rev. Ruls. 72-124 and 79-18. In Rev. Rul. 69-545, the IRS determined generally that the promotion of health is a charitable purpose adequate to maintain the section 501(c)(3) status of hospitals that do not violate the private inurement/private benefit restrictions and that provide healthcare services to the community at large without discrimination.

There is a dearth of authority under the code, regulations, IRS rulings, and court decisions, however, regarding the basis on which homes for the aging and nursing facilities could be treated as hospitals engaged primarily in the promotion of health.

In a 1982 private letter ruling, the IRS determined that a skilled nursing facility, providing a high level of nursing care (with hospital and physician support), should be considered a hospital, but that "health care facilities provided by convalescent homes for the aged and infirm are as a rule limited in nature and do not provide extensive medical care."²¹

The IRS also determined that an intermediate care facility whose principal function was to house aged or infirm persons requiring nursing care but not immediate medical attention was *not* a hospital.²² In a 1978 private letter ruling, the IRS determined that a geriatric home providing its residents

with skilled nursing beds and having a full staff of physicians and inpatient medical services (except surgery) did not qualify as a hospital because its primary purpose was not caring for the sick or injured but housing the aged.²³

This suggests that, for a nursing facility to be regarded as organized and operated primarily for the promotion of health and obtain recognition of exempt status as a hospital, rather than under the three-part test, it is well advised to provide high-level nursing care with hospital and physician support. Nursing facilities providing less urgent nursing care (such as intermediate or sheltered care) are well advised to qualify for exemption under the three-part test.

TAX-EXEMPT FINANCING

In general, not-for-profit organizations recognized as exempt under code section 501(c)(3) may be eligible for tax-exempt financing to develop a home for the aging through the issuance of tax-exempt bonds. In addition to the general restrictions associated with the issuance of such bonds, interested tax-exempt organizations should consider other specific restrictions associated with homes for the aging.

In mid-1988, then-Rep. Brian J. Donnelly, D-MA, proposed dramatic new restrictions on the ability to finance certain types of homes for the aging with "Qualified Section 501(c)(3)" bonds—the most popular tax-exempt bond vehicle for developing new facilities. Donnelly's concern was that some charitable organizations were using tax-exempt bonds to finance rental housing projects that served an affluent population. He said that tax-exempt bonds should be used to finance retirement housing only where legitimate governmental or charitable purposes are served.

Accordingly, the Technical and Miscellaneous Revenue Act of 1988 provided that a bond used directly or indirectly to provide residential rental housing would not qualify as a section 501(c)(3) bond unless it meets one of three criteria:

- Provides residential rental property as the first use of such property (i.e., new construction)
- Meets the low-income targeting rules of code section 142(d)—that is, at least 40 percent of rental housing units built with bond proceeds are

IRS examiners will closely examine potentially "abusive" transactions.

occupied by tenants having incomes of 60 percent or less of the area's median gross income, or at least 20 percent or less of those housing units are occupied by tenants having incomes of 50 percent or less than the region's median income

- Provides certain substantially rehabilitated property

CONCERN WITH "ABUSIVE" TRANSACTIONS

The IRS has announced

that its examiners will closely scrutinize potentially "abusive" transactions in which charitable organizations purchase or sell healthcare facilities (including homes for the aging) purchased with tax-exempt bonds. Transactions of this type may result in loss of exempt status. The release identifies three types of abusive transactions:

- A charitable organization acquires a nursing home or hospital with proceeds of tax-exempt bonds. For example, a developer may acquire a nursing home and resell it at a substantial profit to a new or existing charity over which the developer exercises control. The developer may also enter an agreement with the charitable organization to rehabilitate, manage, or operate the nursing home for an excessive fee.

- A charitable organization leases or sells healthcare or similar facilities that it financed with proceeds of tax-exempt bonds. The facilities are leased or sold to partnerships or other entities in which the physicians, medical staff, or charitable organization have a financial interest.

- A private healthcare corporation sells an unprofitable facility to a charitable organization. For example, a private corporation may set up a new charitable organization to issue tax-exempt bonds and use the proceeds along with purchase money debt to purchase the facility from the private corporation at an inflated price.²⁴

The IRS has also announced that it has issued new instructions to its examiners with respect to processing applications for recognition of section 501(c)(3) status submitted by nursing homes, old age homes, extended care facilities, hospitals, and other healthcare organizations. The instructions describe abusive situations that the IRS intends to curtail.²⁵ Indeed, the *Internal Revenue Manual* identifies the specific questions an IRS specialist may ask and documents he or she may request in connection with an application for

recognition of section 501(c)(3) status submitted by a not-for-profit organization wishing to issue tax-exempt bonds to support its (putative) tax-exempt purpose.²⁶ This substantial list underscores the degree of detail involved in applying for recognition of exemption for such a project.

A TIME OF SCRUTINY

An organization wishing to maintain or seek federal tax-exempt status for the ownership and operation of a home for the aging or to seek tax-exempt financing for the development of such a facility must commit to a thorough tax-planning effort.

Unless the proposed facility is dedicated to serving low-income elderly, the principal tax issue will be the ability to develop or maintain a facility that is financially feasible yet satisfies the three-pronged IRS test for establishing tax-exempt status. This challenge is rendered difficult by the dearth of useful tax guidance on arrangements that satisfy the test. Particularly needed is guidance on the IRS financial security criterion with respect to lowest feasible cost, a rate structure affordable to a substantial segment of the area's elderly population, and limitations on the facility's obligation to maintain residents unable to make their payments. A newly formed corporation that seeks tax-exempt status to develop a home for the aging with the proceeds from tax-exempt bonds will have its exemption application closely scrutinized by the IRS.

This challenge is also made difficult by the fact that the IRS position on exempt status is based on a revenue ruling issued more than 20 years ago. The drafters of Rev. Rul. 72-124 could hardly have predicted the operational and financial structure and resident payment obligations of many of today's homes for the aging.

The IRS is in the process of restructuring the focus (to one based more on concepts of community benefit) of its circa-1969 standards for hospital tax-exempt status. The *Social Accountability Program: Continuing the Community Service Tradition of Not-for-Profit Homes and Services for the Aging* (Catholic Health Association, St. Louis, and American Association of Homes for the Aging, Washington, DC, 1993) describes how an organization can operate from a community benefit focus. It is conceivable that the homes-for-the-aging standards may be subject to such revision. If so, are they likely to be more (or less) flexible?

The prospect of federally mandated universal healthcare has caused some persons to question the value of continuing to grant tax-exempt status to hospitals. The Clinton healthcare reform proposal contemplates greater focus on hospitals providing community benefit as a condition to maintaining tax-exempt status. Although the fate

of healthcare reform is unclear, the prospect is for additional community benefit requirements for both hospitals and homes for the aging.

Furthermore, all exempt organizations are currently operating in an environment of unprecedented IRS scrutiny, with the possibilities of audits and the potential adoption of regulations providing for intermediate tax sanctions against organizations found not to be in compliance with tax-exemption standards.

Given these factors, effective tax-exemption planning is a necessary part of the business planning process by sophisticated not-for-profit organizations that own and operate (or desire to own and operate) charitable homes for the aging and similar housing facilities serving the elderly. The benefits of exempt status remain attractive for many such organizations. The challenge of obtaining and maintaining that status is becoming far more burdensome. □

NOTES

1. H.R. 3697 ("Exempt Organization Reform Act of 1993"); *Tax Notes*, March 21, 1994, at 1490, (a discussion of the Treasury Department's proposal introduced on March 16, 1994).
2. Treas. Reg. sections 1.501(c)(3)-1(a)(1).
3. Treas. Reg. sections 1.501(c)(3)-1(a)(1).
4. Treas. Reg. sections 1.501(c)(3)-1(b)(1),(2),(3), and (4).
5. Treas. Reg. sections 1.501(c)(3)-1(c)(1).
6. Rev. Rul. 72-124, 1972-1 C.B. 145.
7. Rev. Rul. 72-124, 1972-1 C.B. 145.
8. Rev. Rul. 72-124, 1972-1 C.B. 145; Rev. Rul. 79-18, 1979-1 C.B. 194.
9. Rev. Rul. 72-124, *supra*; Rev. Rul. 79-18, *supra*.
10. General Counsel Memorandum 37101 (April 26, 1977).
11. Rev. Rul. 79-18, *supra*.
12. Private Letter Ruling 8722082 (March 3, 1987); Private Letter Ruling 9001036 (October 11, 1989).
13. General Counsel Memorandum 37101, *supra*.
14. Private Letter Ruling 8022085 (March 6, 1980), involving a tax-exempt "Christian Home for the Aged," which was expanding to develop a new facility featuring entrance fees ranging from \$40,000 to \$100,000.
15. Private Letter Ruling 8117221 (January 31, 1981).
16. General Counsel Memorandum 36144 (January 27, 1975).
17. General Counsel Memorandum 36404 (September 8, 1975).
18. Private Letter Ruling 8637141 (June 20, 1986).
19. *Exempt Organization Tax Review*, vol. 9, no. 1 at 123.
20. 1969-2 C.B. 117.
21. Private Letter Ruling 880878 (December 3, 1987); Rev. Rul. 76-9, 1976-1 C.B. 348; Private Letter Ruling 9327090 (April 15, 1993).
22. Private Letter Ruling 7731041 (May 9, 1977).
23. Private Letter Ruling 7825023 (March 21, 1978).
24. Informational Release 90-60; *Daily Tax Report* (Bureau of National Affairs), April 4, 1990.
25. *Daily Tax Report*, August 22, 1990.
26. *Internal Revenue Manual*, section 7668-17).