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## **Grassley Releases Staff Report Proposing Hospital Reforms in Response to IRS Community Benefit Interim Report**

On July 19, 2007, the Internal Revenue Service (the "IRS") released their Interim Report on Tax-Exempt Hospitals and Community Benefit Project (the "IRS Report") containing preliminary information on the way nonprofit hospitals provide community benefit. On the same day, Sen. Grassley, ranking member of the Senate Finance Committee, released a staff report (the "Staff Report") outlining various reform proposals geared toward ensuring nonprofit hospitals provide an adequate level of charity care. Although the IRS Report is merely a reporting of collected data, the IRS is expected to issue a final report on the community benefit compliance check in September of 2008. The IRS Report and the Staff Report come on the heels of the IRS' request for public comment regarding the release of a draft of a completely redesigned Form 990. The IRS Report, the Staff Report, and the redesigned Form 990 are part of the ever increasing scrutiny on the activities of tax-exempt organizations and particularly tax-exempt healthcare organizations.

### **IRS Interim Report on Tax-Exempt Hospitals and Community Benefit**

Although the IRS is still in the process of analyzing the reported data, the IRS Report made three basic findings: (1) nearly all hospitals reported providing various types of community benefit; (2) no uniform definition of uncompensated care emerged from various hospital responses; and (3) there appear to be significant differences in the way other components of community benefit are reported. In response, the IRS' hospital project team recommended developing a separate Form 990 schedule for hospitals as a vehicle for addressing the lack of definitional and reporting uniformity. The IRS responded with the new Schedule H, Hospitals, as part of the recently released discussion draft of the redesigned Form 990.

While Sen. Grassley believes the IRS Report paves the way for legislation which defines common terms and measurements for charity care (as proposed in his Staff Report), the American Hospital Association's Senior Vice President and General Counsel, Mindy Hatton stated, "Today's IRS report shows that hospitals provide a broad range of benefits to their community. The IRS is vetting new reporting schedules that will provide the public with greater and more consistent information about hospitals' service to the community. With this significant work going on, the proposals in the minority staff's draft report are not needed."

### **Staff Report**

The Staff Report includes a wide range of reform proposals aimed primarily at 501(c)(3) hospitals. The proposals would affect nonprofit/for-profit healthcare joint ventures, corporate governance standards, possible conversion of 501(c)(3) hospitals to 501(c)(4) status, certain executive perquisites (e.g., spousal travel), hospital billing and collection practices,

minimum charity care standards, and higher excise taxes (25% with no cap) for hospital managers participating in the approval of excess benefit transactions with fewer defenses (no more initial contract exception or rebuttable presumption of reasonableness).

The Staff Report invites specific comments on a wide range of sensitive topics, including the need for transition rules, how a "hospital" should be defined and how the new rules should apply to multi-hospital systems, whether the Sarbanes Oxley Act should be applied to large nonprofit hospitals, whether certain payments should be subtracted out of the calculation of whether hospitals meet minimum charity care standards, implications of the proposals on bond financing in healthcare, and whether various subsidized low margin healthcare service should count toward the charity care standard. Comments are due by August 24, 2007.

Although the Staff Report is not legislation, if it is transformed into legislation and enacted as proposed, or even with minor modifications, it could represent the most significant set of changes in exemption standards for hospitals in over 30 to 40 years.

The following summarize some of the key provisions of the Staff Report and its potential impact of tax-exempt hospitals and healthcare systems.

Charity Care. The charity care standard would be divided into three components: (1) free care to all patients at a specified multiplier (the Staff Report suggests no less than 100% percent of the Federal Poverty Level ("FPL")); (2) a minimum of 5% of the greater of operating expenses or operating revenues spent on charity care; and (3) a formula for computing minimum charity care percentages for joint ventures. With respect to free care, the Staff Report did not provide the option of basing charity care determinations on a patient's means, such as their net worth. Charity care would be defined as: (i) medically necessary in-patient or out-patient hospital services provided without payment from those persons who are at a certain level of the FPL; (ii) the amount of revenue, less any payments received for patient care, which is expected to be written off as a result of a designation (prior to billing) that the patient is unable to pay for medically necessary services.

The Staff Report also recommends a mandatory community needs assessment every three years with consultation from local advocates or representatives of the Department of Health and Human Services ("HHS"), without providing any further definition of "consultation" or "advocate." In addition, the Staff Report anticipates some hospital conversions from 501(c)(3) to 501(c)(4) status, including discussion of the need to adopt conversion procedures for the anticipated changes in status. For 501(c)(4) hospitals, the charity care standard would be changed to a community benefit standard for exemption (e.g., 5% minimum on community benefit). In other words, the current 501(c)(3) test of community benefit would no longer suffice for 501(c)(3) status but could qualify a hospital for 501(c)(4) status. What counts as "community benefit," however, would be strictly prescribed and limited to charity care, an ER open to all, burn units, trauma centers, health professional education and training, health research, and activities designed to respond to a community needs assessment. Critical access hospitals

would be exempt from the 5% standards whether treated as 501(c)(3) or 501(c)(4) organizations. It is unclear whether transition rules would make satisfactory accommodation for bonds and charitable contributions because under current law, Section 501(c)(4) organizations cannot finance projects with tax-exempt bond proceeds or benefit from charitable contributions. Such hospitals may find it difficult, if not impossible to maintain state or local property tax exemption.

Governance. Corporate governance is also targeted in the Staff Report, including requiring a community board with no more than 25% insiders on any nonprofit hospital board (whether a Section 501(c)(3) or 501(c)(4) organization). For this purpose, an "insider" would include management, employees, physicians, and anyone deriving financial gain from the hospital by contract or otherwise, directly or indirectly, with the exception for "reasonable directors' fees." Other governance recommendations include mandating a detailed conflict of interest policy, requiring hospital boards be responsible for charity care and billing practices, and noting hospital boards should review the Form 990 annually. The Staff Report proposes nonprofit and government hospitals be held to mandated annual reporting requirements to ensure "transparency," which would include a variety of information that in part mirrors the expanded disclosure on the redesigned Form 990, including new Schedule H for Hospitals. Like the Redesigned Form 990, the Staff Report's transparency disclosures for nonprofit and government hospitals would include community benefit and charity care expenditures and offsetting funding, and details of joint ventures and their charity care or community benefit policies.

Excise Tax. The Staff Report also suggests an excise tax on all 501(c)(3) and 501(c)(4) hospitals that fail to meet the proposed quantitative standards for exemption (5% charity care or community benefit test). The tax would be twice the amount of the shortfall. Thus, if the 5% amount is calculated to be \$15 million and a hospital only provides \$8 million, the tax would be \$14 million (twice the difference of \$15 million - \$8 million), with IRS discretion to reduce the tax to the amount of the shortfall if the hospital has a favorable track record (e.g., in compliance 4 of 5 years). The Staff Report also suggests a recapture of prior tax benefits if exemption is revoked, and even suggests the HHS consider revocation or repeated failure to meet quantitative exemption standards when determining whether or not to revoke Medicare provider status.

Billing and Collection. The Staff Report recommends maximum charges for the medically indigent uninsured (not more than the lower of the amount paid by Medicare or Medicaid or actual hospital cost for such services). This would apply at up to 100% - 200% or more of the FPL. The Staff Report also recommends amending the Federal Debt Collection Practices Act and applying it to both nonprofit and government hospitals' internal billing and debt collection functions.

Joint Ventures. The Staff Report proposes a mandatory charity care standard, and neither the initial contract exception nor the rebuttable presumption of fair market value would apply. This would mean more joint ventures could result in excess benefits under Section 4958 if they involve disqualified persons and may lead to more joint venture audits. In addition, the Staff Report recommends expanding the definition of

"disqualified person" to include any party who "participates" in a nonprofit/for-profit joint venture where that person receives "an excess financial benefit" or the tax-exempt hospital "receives a disproportionate financial detriment" without defining the term "participates." The Staff Report also proposes that any hospital manager approving a deal with knowledge of an excess benefit could be taxed at 25% of the excess benefit (potentially without a cap on total liability instead of the current 10% tax rate capped at \$20,000 per transaction).

Executive Compensation. The Staff Report discusses executive compensation, and recommends prohibiting payment of country club fees, spousal travel, private air transport, loans to executives, and severely limiting payment for first class travel. The Staff Report also recommends eliminating the initial contract exception currently available for all employment contracts.

### **Conclusion**

As Sen. Grassley has stated, the Staff Report itself is not legislation. It is, however, a menu of potential tax-exempt hospital reforms now open for debate in Congress and may be a springboard for significant hospital tax legislation. In light of the redesigned Form 990 and the anticipated release of the IRS' final community benefit report analyzing the data from the compliance check questionnaire, tax-exempt healthcare organizations should continue to anticipate further developments in the scrutiny of the tax-exempt sector.



A copy of the Report can be found at:

<http://grassley.senate.gov/releases/2007/07182007.pdf>

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