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IRS Issues Final Report on Nonprofit Hospital Study

Background

On February 12, 2009, the Internal Revenue Service ("IRS") issued a Final Report on its Nonprofit Hospital Study ("Final Report" or "Study"). In 2006, the IRS undertook the Study sending questionnaires to 544 tax-exempt hospitals inquiring about their community benefit activities and executive compensation. The Study was intended to give stakeholders a greater understanding of tax-exempt hospital activities. In 2007, the IRS released an interim report ("Interim Report") summarizing the reported community benefit information from the Study on an aggregate basis. The Final Report builds upon the Interim Report by providing a more detailed analysis broken down by various demographics, including the type of community in which the reporting hospital is located (community type) and the hospital's revenue size. Overall, the Final Report acknowledges that the community benefit and executive compensation standards are cumbersome, but cautions against any rapid changes to either standard until more information is gathered.

Community Benefit

According to the Final Report, community benefit activities of reporting hospitals were diverse among the different demographics studied. Specifically, hospital revenue size and location (urban or rural) were generally found to dictate the level of community benefit a reporting hospital provided, with urban tax-exempt hospitals engaging in more community benefit activities.

Uncompensated care was the largest reported community benefit expenditure for each of the demographics studied. On an aggregate basis, uncompensated care represented 56% of the aggregate community benefit expenditure reported by the hospitals studied. Medical research and training (23%), research (15%) and community programs (6%) comprised the remainder of the reporting hospitals' community benefit activities.

On a percentage of revenue basis, the Final Report found that the average and median percentage of total revenue spent by reporting hospitals on uncompensated care was 7% and 4%, respectively.

The Final Report showed, however, that the level of uncompensated care reported was distributed disproportionately among the reporting hospitals. Nine percent of the reporting hospitals shouldered 60% percent of the aggregate community benefit while 14% of the reporting hospitals provided 63% of the uncompensated care reported. Also, while the reporting hospitals' community benefit expenditures did not correlate with per capita income levels of such hospitals' surrounding areas, community benefit expenditures appeared to increase as the uninsured rates of reporting hospitals' surrounding areas increased.

Executive Compensation

According to the Final Report, the level of compensation reporting hospitals paid to top executives, which was not previously addressed in the Interim Report, indicated reporting hospitals across all demographics generally complied with the rebuttable presumption procedure provided under Section 4958 of the Internal Revenue Code to establish reasonableness of compensation paid. Under these rules, an organization may use disinterested persons to review comparability data to establish compensation. If proper procedures are followed and documented, then the rebuttable presumption procedure places the burden on the IRS to prove that compensation is unreasonable. According to the Final Report, average and median total compensation paid to top tax-exempt hospital executives of the reporting hospitals was \$490,000 and \$377,000, respectively, with urban and suburban reporting hospitals reporting higher levels of compensation paid to their executives than their rural counterparts. While these figures may seem high, the IRS explained in the Final Report that nearly all compensation amounts were deemed reasonable because the reporting hospitals utilized the rebuttable presumption procedures.

IRS Commentary and Conclusion

The Final Report does not present recommendations for reforming current community benefit and executive compensation standards. The IRS explained that any attempt to immediately revise the community benefit and executive benefit standards would jeopardize the tax-exempt hospital community given the various ways tax exempt hospitals report community benefit and their diverse financial capabilities. The IRS suggested that revisions to either standard should not be undertaken until the IRS has the opportunity to gather more information from tax-exempt hospitals as they begin to file the Schedule H that accompanies the new Form 990.

The IRS' neutral commentary is especially important in light of recent scrutiny of executive compensation in the financial sector

surrounding the Troubled Assets Relief Program ("TARP") and Senator Charles Grassley's efforts as recent as last week to amend the American Recovery and Reinvestment Tax Act of 2009 (Federal Economic Stimulus Bill) to replace the IRS' current approach to measuring community benefit with an approach rooted in measuring charity care. Nonprofit hospitals should examine the Final Report and monitor the IRS' continuing efforts to gather information on tax-exempt hospitals and its role in ongoing discussions to revise the community benefit and executive compensation standards.

The entire 191 page Final Report may be found at <http://www.irs.gov/charities/charitable/article/0,,id=203109,00.html> and Hall Render will provide additional updates as developments arise.

Should you have any questions, please do not hesitate to contact your regular Hall Render attorney, or Calvin R. Chambers at cchambers@hallrender.com or 317-338-2428 or Thomas M. Donohoe at tdonohoe@hallrender.com or 317-338-2289.

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