The New Environment for Exempt Healthcare Providers: What Should Exempt Hospitals Do?

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The last several years have seen a significant increase in the scrutiny by regulators and consumer groups of tax exempt hospitals, challenging whether the tax exemption granted these facilities is warranted. Consistent with the increased scrutiny, the Internal Revenue Service ("IRS") published a new Form 990, Return of Organization Exempt From Income Tax, in December of 2007. The new form is more like an SEC filing than a tax return asking for information that goes beyond what is required by law or previously reported by the organization to the organization's polices, practices and procedures for dealing with such critical issues as charity care, community benefit and executive compensation. Although exempt providers are not required to report using the new Form 990 until 2009 (for 2008 tax year), there are a number of things they can do to prepare for the initial new Form 990 filing. In addition to the new form, the general environment for exempt organizations has shifted significantly in the last several years, with an endless barrage of surveys, studies and congressional committee hearings assessing whether exempt facilities provide adequate benefit to their communities to justify the tax benefit bestowed on them. It seems clear that in the current environment, federal, state and local governments, consumer groups and other constituents will continue to question and challenge whether the exemption is warranted. This Memorandum is provided as a guide to various actions that should be taken now to refocus your organization, to prepare for the initial filing on the new Form 990, and to address current public interest concerns.

I. GOVERNANCE.

The IRS views good corporate governance as the key to the proper operation of exempt entities. The acting commissioner recently noted that the IRS remains "convinced that an independent, empowered, and engaged board of directors is the key to insuring that a tax-exempt organization serves public purposes, and does not misuse or squander the resources in its trust".[1] Generally the IRS believes that good governance and accountability practices provide valuable safeguards insuring that the organization's assets and resources are used in a manner consistent with its exempt purpose. A "well-governed" organization is more likely to be transparent with regard to its "operations, finances, fundraising, and use of assets."[2] In the new Form 990, the IRS has added a number of questions requiring the organization to "provide certain information regarding the composition of its board . . ., certain of its governance policies and practices, and the means by which it is held accountable to the public by making governance and financial information publically available."[3] Thus exempt hospitals should review their governance generally and consider taking the specific actions set forth below.

1. Review and Revise Your Mission Statement.

Your mission statement is the lense through which the various corporate decisions of the organization are evaluated and made. A well written mission statement "serves to explain and popularize" the entity's "purpose and guide its work."[4] Make sure your mission statement clearly articulates a mission consistent with your exempt status. Consider statement of a clear commitment to improved quality of care in the community, access to care by normally disenfranchised persons, and enhanced community health all in addition to the common statement of desire to be a "leader" or "health care provider of choice" in the community. We recommend specific references to (i) commitment to access for all members of the community, (ii) improved community health, and (iii) meeting needs of low income and vulnerable persons. A well drafted mission statement that is consistent with the entity's exempt purpose becomes the filter through which all other decisions must pass when leadership asks: "is this consistent with, or does it advance, our mission?" Finally the mission statement is a constant reminder to executive staff, board members and physicians that the focus of the hospital is on the objectives set forth in the mission statement.

2. Review, Revise or Develop Other Governance Policies.

a) Charity Care Policy.

In discussing charity care it is best to agree first on what charity care is. Although debated for some years, it appears that the definition developed by the Catholic Health Association has gained traction with both the Senate Finance Committee and the IRS: "Free care and discounted care given to persons deemed unable to pay based on established financial assistance policies"[5] This definition of charity care specifically excludes bad debt. Your charity care policy should utilize the Federal Poverty Guidelines (or other established guideline) to determine eligibility under the policy. The policy should be easily understood, and prominently posted in the Emergency and Admitting Departments and on your web page.

Once you have developed your policy, budget each year and plan for a certain level of charity care. The Senate Finance Committee, Minority Staff Proposal (July 2007) suggested a required minimum level of charity care equal to 5% of the greater of 1) annual operating expenses, or 2) annual operating revenue. The Proposal suggested that a) eligibility under the policy be determined after the care is provided, but before any billing for the service, b) the Federal Poverty Guidelines be used in determining eligibility, and c) bad debts not be included in computation of charity care.[6] Although the Proposal has not been introduced as legislation it does provide insight to the leaning of the Finance Committee if it determines that such legislation is necessary in order to coerce exempt organizations into adequately addressing community needs.

b) Conflict of Interest Policy.

For some time now the IRS has encouraged the adoption by the board of a Conflict of Interest Policy as a means to avoid situations (whether intentional or inadvertent) that benefit the hopital's staff, officers or board members personally thus violating the statutory requirement that the exempt facility operate for the benefit of the community rather than any individual private interests. A sample policy was published by the IRS in 1997 and revised in 1999 (a copy is available on our web site under Healthcare Practice Group - Additional Resources). Although the proposed IRS policy is not required and should be modified to fit the particular situation of each facility, it does provide a good initial guide.

If you already have a policy in place we suggest that you review it and review its application to make sure that it covers necessary elements and functions effectively. Remember that aside from avoiding the "appearance of impropriety", an effective conflict of interest policy is intended to assure that the facility and its board review and analyze opportunities and make relevant decisions without distraction from the facility's obligation to operate for public benefit. Absence of such a policy does not automatically result in action by the IRS although approval of an arrangement or transaction that improperly benefits a hospital insider might. The new Form 990 asks specifically if the hospital has such a policy and if it is followed effectively.[7] Failure to follow an existing policy may subject some or all of the participants in a transaction (officers and board members) to the excise taxes applicable to excess benefit transactions and may ultimately jeopardize the exempt status of your hospital.

c) Compliance Plan ("Whistleblower Policy").

The purpose and need for an effective compliance plan is beyond the scope of this memorandum and is generally well understood within the healthcare industry. However, some compliance plans developed and dutifully implemented in the 1990s have not been seriously revised or reviewed since. The Office of Inspector General (OIG) has made numerous statements that a plan that collects dust and is not continually reviewed and revised is equivalent to no plan at all. We mention the need to review (and if necessary revise) the hospital compliance plan, because the new Form 990 asks a specific question about whether the facility has a "whistle-blower policy". Given that most healthcare "whistleblower policies" are an integral part of a comprehensive compliance plan, we suggest that as part of your effort to review your compliance with the other matters in this memorandum, that you check the status of the compliance plan as well and particularly the portion dealing with internal reporting of possible wrong doing or violations.

d) Executive Compensation Policy.

Compensation paid by exempt hospitals to officers, directors, and key employees is of primary concern to the Senate Finance Committee and the IRS. As a result of the Senator Grassley's persistent inquiries, the IRS reported last year on its Executive Compensation Compliance Initiative[8] and added specific questions to the new Form 990 on how executive computation is determined and reviewed.[9] We have previously recommended to our clients that they establish a compensation committee (sometimes also responsible for physician recruiting) and delegate to it specific authority to deal with compensation

and related matters. The committee should be comprised of independent board members. If such committee is to have final authority on compensation matters, the board should clearly delegate such authority by board resolution in establishing the committee. Moreover, the deliberation and decisions of the committee should be conducted consistent with objectively reasonable internal controls and procedures, such as the procedures for establishing a rebuttable presumption of reasonableness under the IRS regulations on excess benefit transactions.[10] Basically such procedures should include: 1) approval of the compensation by the board or a committee properly authorized by the board; 2) review by the determining body of appropriate comparability data indicating the compensation arrangement is (in its entirety) reasonable; and 3) adequate and contemporaneous documentation of the decision (indicating the terms of the arrangement, the date approved, the members of the determining body present and voting, the comparability data relied upon, and any action or discussion by member with a conflict of interest with respect to the arrangement). In light of the particular interest of the IRS and others in compensation arrangements for exempt hospitals, we strongly suggest that the organizations adopt a carefully drafted executive and physician compensation policy setting forth the authority of the determining body (if other than the board) and the process for determining and reviewing compensation inclusive of the elements summarized above.

e) Joint Venture Policy.

Ancillary joint ventures between exempt hospitals and for profit third parities (including members of the hospital's medical staff) are becoming more and more common. These ventures are usually structured very carefully with significant input from legal counsel to comply with applicable law and suggested "best practices". We have recommended previously that exempt entities adopt a policy on joint ventures, but few exempt organizations have done so. The new Form 990 asks specifically if the organization has such a policy[11] as well as specific information (in the case of hospitals) about each joint venture.[12] Thus we encourage exempt providers, and hospital's in particular, to develop such a policy setting forth at a minimum the elements outlined in the Senate Finance Committee Minority Staff Discussion Draft (July 18, 2007): 1) the venture must adopt a charity care policy similar to the hospital's policy, 2) the venture advances the exempt purpose and mission of the hospital, 3) the hospital has control over the charity care, community benefit and other elements key to furthering the charitable purposes of the hospital. The hospital may want to provide other requirements beyond this short list. Although the policy may be adopted to apply to "future" arrangements, the hospital will want to review all current ventures to assess their compliance with the policy, its objectives, and applicable law and current "best practices".

f) Record Retention.

The new Form 990 asks whether the hospital has a current document retention and distribution policy.[13] This is a carry over from the public corporation arena by way of Sarbanes-Oxley. Such a policy would be separate from any policies dealing with patient medical records.

g) Summary of Policies.

Inquiry is made on the new Form 990 as to the existence and the application of each of the policies discussed above. Therefore it is important to review your facility's policies on charity care, conflicts of interest, compliance, executive compensation and joint ventures; revise or draft new policies where necessary; and assess their application and effectiveness. There is no statutory requirement for exempt entities to develop such management policies, but the IRS has stated that it will review the 990s to determine whether such policies have been implemented. The IRS governance guidelines issued February 2008, also suggest consideration of policies on the handling of investments, fund-raising and documentation of meetings and decisions.[14]

3. Review the Composition and Role of the Board of Directors.

The IRS encourages active and engaged boards "believing that it is important to the success of a charity and to its compliance with applicable tax law requirements."[15] The board should be composed of informed individuals who are active in overseeing the entity's operations and finances. Board composition should include independent members of the community that bring various talents and abilities to the board. Every effort should be made to avoid domination of the board by employees or others "who are not, by their very nature, independent individuals because of family or business relationships."[16] The IRS reviews the information filings to determine if the board represents a broad public interest, whether it is comprised of independent members, and to what extent there is potential for insider transactions resulting in misuse of entity assets. The organization should review the make up of its board to insure that the board is comprised of independent community members and not dominated by insiders or employees. The IRS defines an "independent " director as a director that is 1) not compensated as an officer or other employee of the organization or related entity, 2) receiving less than $10,000 per year from the organization or related entity as an independent contractor, 3) not otherwise receiving, directly or indirectly, material financial benefits from the organization or from a related entity, and 4) not having a family member receiving any of the items in 1-3.[17] Although the IRS did not address members of the medical staff per se, it is important to note that any physician with an employment arrangement or independent contractor arrangement (exceeding $10,000 per year) would not be independent.

Although the role of the board remains that of oversight, and not daily operations, the IRS clearly is encouraging active and engaged boards.[18] The new Form 990, for example, inquires whether the board has reviewed the 990 before it is filed. As discussed below there are a number of actions that should be taken in preparation of the initial new Form 990 filing, including review of the form by the board prior to its filing. Review other functions of your board and determine if a more active role or involvement is advisable to assure an open, responsive and transparent atmosphere. To assist with your review we recommend for your further consideration *Governance and Related Topics - 501(c)(3) Organizations* published on the web by the IRS in February of 2008 updating its recommended best practices for governance of tax exempt entities (available on our web page under Healthcare Practice Group - Additional Resources).

II. COMMUNITY BENEFIT.

Although some provision of community benefit has been a key element in determining the tax exemption of charitable hospitals since 1969, clarity as to the meaning of the term "community benefit" has been illusive.[19] Through its significant efforts over several years to articulate a common means for reporting and discussing community benefit, the Catholic Health Association ("CHA") has developed a definition that appears to be the evolving standard:

> Community benefits are programs or activities that provide treatment and/or promote health and healing as a response to identified community needs. They are not provided for marketing purposes. A community benefit must meet at least one of the following criteria:
>
> -Generates a low or negative margin
> -Responds to needs of special populations such as minorities, older persons and persons with disabilities who are living in poverty, persons with chronic mental illness, and other disenfranchised persons
> -Supplies services or programs that would likely be discontinued – or would need to be provided by another not-for-profit or government provider- if the decision was made on a purely financial basis.
> -Responds to public health needs
> -Involves education or research that improves overall community health.[20]

Schedule H, Hospitals, to the new Form 990 requests significant information on the efforts of the hospital to identify and assess the health care needs of the community and the hospital's specific efforts to met those identified needs. In order to assess the health needs of your community and evaluate how effective your organization is at identifying such needs and systematically addressing them, you should consider the following actions:

1. Implement a Community Health Assessment.

In conjunction with other community providers, community leaders, and public agencies, the hospital should assess the health needs of its community. Include persons knowledgeable about the community, its needs and resources. The basic approach would include, forming the assessment group, defining the community, reviewing and analyzing the available information, collecting new information, assessing community strengths, determining problems and gaps, and prioritizing the needs.[21] You should document the process and the structure used in the process in order to explain the process on the Form 990. The Senate Finance Committee Minority Staff *Tax-Exempt Hospitals: Discussion Draft* suggests that such assessments be conducted at least every 3 years.[22]

2. Develop a Community Benefits Plan.

After assessing the health needs of your community, you should develop a Community Benefit Plan detailing how the hospital plans to fulfill its mission and meet the needs of the community. The Community Benefit Plan should be produced (or revised) annually in conjunction with the facility's strategic and financial plans, and should describe priorities, programs, resources and anticipated impact of the activities described in the plan. The CHA Guide suggests in more detail that the facility consider including the following in their plan:

a. A statement of the hospital's mission and its commitment to access, community health improvement, and the needs of those living in poverty;
b. The geographic area and target populations;
c. Any major trends, needs, problems, and assets in the community;
d. The goals and objectives that each program seeks to accomplish;
e. The various issues the facility intends to address directly, as well as those it plans to address in conjunction with others;
f. Problems and needs not addressed by the plan which are expected to be a continuing concern in the community, and explain the reason(s) for not addressing the concerns in the plan;
g. A description of how the plan was developed (this is also requested on the new Form 990); and
h. An invitation for those reviewing the plan to comment on it.[23]

3. Produce an Annual Community Benefit Report.

In conjunction with other coordinated efforts to describe the hospital efforts to provide various community benefits to the community, the hospital should produce an annual Community Benefit Report ("Report") demonstrating the various resources applied to meet identified community needs. The Report should be quantitative and narrative in describing efforts to meet the health needs of the community, should demonstrate the facility's leadership in improving community health, and should be publically available (for example on the hospital website). The CHA Guide suggests including the following components in the Report:

a. An executive summary and one page community benefit summary;
b. A description of the "core values and social teaching that guide" the facility;
c. A history of the hospital's commitment to the community and the development of the that commitment;
d. A description of community needs and resources available to address those needs;
e. Set forth objective measures of community benefit including dollars spent, number of individuals served, and the resulting impact on the community; and
f. Finally, a narrative report explaining the value of the services provided beyond just dollars spent and numbers served.[24]

Although the hospital will use any number of other public relations efforts to tell its story, the annual Community Benefit Report can and should be an effective and dramatic tool in the effort to justify

the exemption provided to the facility and to demonstrate the extensive "good" that the facility provides in the community. Moreover, community benefit is the key element in the justification of the hospital's exempt status under current law, and thus what may seem like a significant expenditure of time, energy and resources is necessary to demonstrate the hospital's commitment to the exempt mission and purpose.

III. EXEMPT BOND COMPLIANCE.

On August 21, 2007, the IRS initiated an internal effort to evaluate the policies and procedures used by exempt organizations to ensure their compliance with respect to the hospital's debt obligations. Compliance questionnaires were sent to over 200 exempt entities showing an outstanding balance on tax-exempt obligations on their Form 990 for tax year 2005. The questionnaire addressed the following: 1) record retention, 2) qualified use of bond-financed property, 3) arbitrage yield restrictions and rebate requirements, 4) debt management polices and procedures, and 5) awareness of voluntary compliance and education. Similarly, the new Form 990 implements a new Schedule K with a number of specific questions on outstanding obligations relating to use of the proceeds, private business use, and arbitrage compliance. We recommend that the hospital establish post-issuance compliance procedures and policies, including annual arbitrage analysis and assessment of percentage of bond-financed property actually used in private business use.

IV. PREPARE FOR THE FORM 990.

As mentioned above, the new Form 990 is a radical change from the straight forward financial information reporting forms of the past. The new Form 990 is more like a Securities Exchange Commission reporting form for publically held corporations than an income tax reporting form. The core form is 11 pages with up to as many as 18 possible additional schedules. Some health systems may have

to file all the schedules while others may be able to report on as few as 3 or 4. Of particular note is the new Schedule H, Hospitals, which asks specific questions about charity care including whether there is a written charity care policy, what eligibility criteria are used in the policy, whether the policy addresses "medically indigent" patients, and the charity care budget for the hospital. The schedule also asks about the hospital's Community Benefit Report and its community building activities; bad debt expenses and collection practices; and various joint ventures and management relationships. Finally the new schedule asks for a specific explanation of how the hospital assesses the health care needs of the community, how it informs patients of the charity care policy, geographic and demographic information on the community the hospital serves, how the hospital's community benefit efforts actually address community needs, and finally any other information "describing how the ... (hospital)...furthers its exempt purpose by promoting the health of the community." Other relevant new schedules in the form include Schedule J, Compensation Information; Schedule K, Supplemental Information on Tax Exempt Bonds; Schedule L, Transactions with Interested Persons; and Schedule R, Related Organizations and Unrelated Partnerships. To prepare for the initial filing of the expansive new Form 990 we recommend the following actions:

1. Review the Governance Issues.

Review each of the issues raised under the Governance section of this memorandum and make sure you have a strong Mission Statement which clearly substantiates your exempt status, well written and implemented policies on charity care, conflicts of interest, compliance, executive compensation and joint ventures.

2. Review Hospital's Community Benefit.

Review the section of this memorandum dealing with Community Benefit and make sure you have assessed the needs of the community, developed a plan to address those needs and prepared a report on the needs, how they have been addressed and the resulting benefit to the health of the community.

3. Prepare a 990 for 2007.

Although the initial new Form 990 is not due to be filed until your 2008 tax year (filed in 2009), we suggest that you take hospital information for 2007 and complete the form as if it were being filed for 2007. This will accomplish a number of things. First, it will force several members of the administrative staff to actually review the form and recognize all the additional information being requested. Second, it will allow the organization's administrative staff to identify gaps and weaknesses in the hospital's information, and the way the information is collected or maintained. Finally, it will give the facility time to address the identified weaknesses, modify information collections, develop missing policies, and generally address short comings.

4. Multi-Disciplinary Team.

Create a multi-disciplinary team of administrative personnel (and possibly outside consultants or professionals) to assess the gaps and weaknesses identified with the 2007 mark up of the From 990 described above. This group may also be helpful in determining which individuals or departments will be responsible for collection of the information or maintenance of the data needed in various portions of the new form. Completion of the Form 990 is no longer just a function of the CFO and his staff. The vast array of questions and information requested will require input from a number of other departments, legal counsel, auditors, accountants and others.

5. Modify Data and Information Collection.

If necessary the organization may want to consider modification of the way in which it collects or retains certain data or information and how it "reports" it to administration, executive staff or the board so the information is more compatible with the new Form 990.

6. Educate the Board, Staff and Physicians.

It is important that all leadership of hospitals (board, staff and medical staff) and other exempt

providers understand the facility's mission and its efforts to fulfill the mission. In addition to reviewing many of the matters described in this memorandum with executive staff, and at board and medical staff meetings, it is important to remind all leadership that the organization has a commitment to improve the health of the community and meet certain identified health needs therein in furtherance of its exempt purpose and mission.

We also suggest that executive staff review the 2007 mark up of the Form 990 with the board both to educate the board on the gaps that need to be addressed and to give them an opportunity to review what the new From 990 requires. Education of the board on all matters related to the organization's tax exemption cannot be over emphasized. Such education opportunities include board orientation for new members, periodic education sessions on community need, charity care or executive compensation, as well as annual review of the Form 990.

IRS Circular 230 Disclosure:
To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Endnotes:

1. Letter from Kevin Brown, acting commissioner of IRS, to Senator Grassley, June 28, 2007.

2. Form 990 Redesign for Tax Year 2008 (filed in 2009) Frequently Asked Questions, February 8, 2008, A-5.

3. Id.

4. *Governance and Related Topics - 501(c)(3) Organizations*, issued by the IRS February 26, 2008.

5. *A Guide for Planning and Reporting Community Benefit*, by Catholic Health Association, page 138.

6. Minority Staff, *Tax-Exempt Hospitals: Discussion Draft*, pages 7-8.

7. Form 990, Part VI, Section B. Policies, questions 12a, 12b and 12c.

8. *Report on Exempt Organizations Executive Compensation Compliance Project - Parts I and II, March 2007*, issued by the Internal Revenue Service.

9. Form 990, Part VI, Section B. Policies, question 15a and 15b.

10. Comments to Final Regulations: *Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or if an Applicable Tax-exempt Organization Has Engaged in Excess Benefit Transaction(s)*, Vol. 73 Fed Reg No. 61, page 16520.

11. Form 990, Part VI, Section B. Policies, question 16a and 16b

12. Form 990, Schedule H, Part IV and Schedule R.

13. Form 990, Section B. Policies, question 14.

14. *Governance and Related Topics - 501(c)(3) Organizations*, Section 4, Governance and Management Policies.

15. *Governance and Related Topics - 501(c)(3) Organizations*, Section 3.

16. *Governance and Related Topics - 501(c)(3) Organizations*.

17. 2008 Form 990 Core (Parts VI) Instructions - Draft, April 7, 2008 Line 1b.

18. Id., Section 3.

19. Revenue Ruling 69-545 established the current standard. The facts included operating an open emergency room without regard to whether a patient could pay. With the advent of EMTALA all hospitals operate an open ER. So what constitutes community benefit has been shifting to other ways to provide access to healthcare by the disenfranchised.

20. *A Guide for Planning and Reporting Community Benefit*, page 138.

21. Id., pages 14-26.

22. Minority Staff, *Tax-Exempt Hospitals: Discussion Draft*, page 12.

23. Id., pages 21-22.

24. Id., page 67.