More rules and regulations police not-for-profit hospitals

By Cameron R. Monti
Cameron R. Monti is an attorney with Howard & Howard who concentrates his practice in taxation, business and employment law. He can be reached at (312) 456-3574 or cmonti@howardandhoward.com.

For nearly a decade, the federal government has closely scrutinized hospitals that hold 501(c)(3) not-for-profit status and enjoy exemption from income, property and sales taxes. Yet many of those hospitals have difficulty demonstrating a clearly established charitable purpose or substantiating the clear charitable benefits provided to their surrounding communities.

An organization may qualify for exemption from federal income tax if it is organized and operated exclusively for one of several qualifying purposes: religious, charitable, scientific, public safety, literary, educational, amateur sports or preventing cruelty to children or animals.

Most hospitals qualify for not-for-profit status under the charitable purpose, and community benefit is the legal standard applied when determining whether a not-for-profit hospital is, or should be, exempt from federal income tax.

The standard comprises of five factors:

• The operation of an emergency room open to all members of the community without regard to ability to pay.

• A governance board composed of community members.

• The use of surplus revenue for facilities improvement, patient care, medical training, education and research.

• The provision of inpatient care for all persons in the community able to pay, including those covered by Medicare and Medicaid.

• An open medical staff with privileges available to all qualifying physicians.

At the state and local level, some hospitals have had their property-tax exemptions challenged or revoked on the basis that the community benefits they provide are inadequate.
A 2013 study published in the New England Journal of Medicine found that, on a national basis, hospitals devoted an average of 7.5 percent of their operating expenditures to community benefits. However, hospitals on the low end of the spectrum devoted approximately 1 percent of their operating expenditures.

To qualify for tax exemption, a hospital must show that it provides charitable benefits to a class of people broad enough to benefit a community and the hospital must be operated in furtherance of a public, rather than a private, interest. Nonetheless, frequent criticism of hospitals’ genuine purposes has led to closer scrutiny by the IRS and Congress over the past decade.

A February 2009 executive summary of an IRS study of more than 500 not-for-profit hospitals found that the average and median total compensation paid to the top manager was $490,000 and $377,000, respectively. Similar studies have supported the criticism that some “not-profit profit” hospitals provided very limited charitable benefits to their communities.

As a result, the federal government over the past five or six years has adopted rules and regulations to encourage compliance by hospitals that operate as nonprofit organizations under section 501(c)(3) of the Internal Revenue Code, in an effort to ensure they are earning the right to tax exemption.

For example, Section 9007 of the Patient Protection and Affordable Care Act imposes implementation and reporting requirements pursuant to Revenue Code Section 501(r) on nonprofit hospitals to (a) establish financial assistance and emergency medical care policies including policies that specify eligibility criteria, qualifications for assistance and medical debt collection practices; (b) limit costs leveled to patients for necessary emergency medical treatment who are eligible for assistance under the hospital’s financial assistance policy prior to pursuing aggressive collection actions against patients; (c) make reasonable efforts to assess whether a patient may be eligible under the hospital’s financial assistance policy and provide a patient a minimum of 120 days before pursuing “extraordinary” actions such as reporting unpaid medical debts to credit report bureaus or referring a debt to a collection agency; and (d) assess community health needs and adopt a strategy to implement the assessment policies every three years.

Not-for-profit hospitals that fail or refuse to comply with the rules and regulations, or fail to satisfy the reporting requirements, may be subject to an excise tax of $50,000 under section 4959 of the Revenue Code. Treasury regulations mandate that a hospital liable for the excise tax file IRS Form 4720 by the 15th day of the fifth month after the end of the organization’s taxable year during which the Section 4959 liability was incurred.

The federal government’s efforts to foster accountability also can be found in IRS Form 990, the federal tax return for not-for-profit hospitals. Form 990 has been evolving since 2009, beginning with changes to encourage reporting, accountability and transparency and to ensure hospitals are following the Patient Protection and Affordable Care Act and conducting themselves as not-for-profit organizations.

Schedule H of IRS Form 990, which pertains specifically to hospitals, requires them to report expenditures for activities and services that the IRS has classified as community benefits.

In 1969, the IRS effectively eliminated the mandate that not-for-profit hospitals provide charity health care “to the extent of [their] financial capability.” Since then, however, critics...
continue to question whether the genuine level of charitable and community benefits that 501(c)(3) hospitals provide is great enough to justify the tax benefits and not-for-profit status.