

## Tax-Exempt Hospitals Face Increasing Tax Scrutiny

In recent years, nonprofit hospitals have been facing increasing regulatory scrutiny as federal, state, and local/regional taxing authorities are challenging whether some tax-exempt hospitals are providing sufficient charity care to warrant their tax-exempt status.<sup>1</sup> Generally, nonprofit hospitals that qualify for a tax-exempt status are excused from paying most income taxes, property taxes, and other taxes.<sup>2</sup> In return, these hospitals are expected to provide a charitable benefit to the community in which they serve, including, for example, charity care for the poor.<sup>3</sup>

A nonprofit hospital seeking tax exemption under *Internal Revenue Code* (IRC) Section 501(c)(3) must meet three requirements, which are somewhat akin to a “three-legged stool,” i.e., a tax exempt provider must meet all three requirements, or the hospital cannot stand:

- (1) Comply with the proscription against *excess benefit transactions* and the *inurement of private benefit*, which prohibits the “*income or beneficial interest*” of a hospital from “*inur[ing] to the benefit of any private shareholder or individual*”;<sup>4</sup>
- (2) Meet its *charitable purpose*; and,
- (3) The hospital must be operated for a legal purpose.<sup>5</sup>

Further, the *Patient Protection and Affordable Care Act* (ACA) imposes the following additional conditions for hospitals attempting to achieve or maintain tax-exempt status:

- (1) Establish written financial assistance and emergency medical care policies;
- (2) Limit the amounts charged for emergency or other medically necessary care to individuals eligible for assistance under the hospital’s financial assistance policy; and,
- (3) Conduct a *Community Health Needs Assessment* (CHNA) at least once every three years to evaluate and prioritize the health needs of the community that the hospital serves.<sup>6</sup>

The ACA’s imposition of these additional requirements on hospitals seeking to achieve and maintain tax-exempt status reflects a growing concern of the federal government, as well as state and local/regional taxing authorities, that nonprofit, tax-exempt hospitals are not

providing sufficient charitable care to the communities they serve, and that these hospitals are adopting practices and policies aligned with those of their for-profit counterparts, limiting their charitable efforts.<sup>7</sup> This is not a novel concern, as the IRS has extended reporting requirements for tax-exempt organizations a number of times in the past. In July 2009, the IRS released new guidance to its agents concerning key issues to scrutinize when reviewing the governance of nonprofit hospitals and other exempt organizations by their controlling groups (e.g. boards of directors or boards of trustees).<sup>8</sup> Additionally, as discussed in the March 2012 issue of *Health Capital Topics*,<sup>9</sup> the IRS revised its Form 990, the tax document exempt organizations are required to file with the IRS each fiscal year.<sup>10</sup> The updated form made significant changes with respect to organizations’ financial reporting and governance requirements, as well as to the hospital reporting process.<sup>11</sup>

A number of operations of tax-exempt hospitals have been critically scrutinized by federal, state, and local/regional taxing authorities, including the provision of charitable care. For example, the *Internal Revenue Service* (IRS) has launched investigations into whether executives at nonprofit hospitals are being paid salaries that are too high, in violation of their tax-exempt status.<sup>12</sup>

Presented with a potential opportunity to increase tax revenues, federal, state, and local/regional taxing authorities, struggling amid the current economic downturn, are more frequently challenging the property tax exemptions of nonprofit hospitals, arguing that these hospitals have failed to fulfill their charitable mission and, as a result, should not be entitled to lucrative tax exemptions.

Illinois has long been one of the more aggressive states in challenging the tax-exempt status of nonprofit hospitals. The *Illinois Department of Revenue* (IDOR) was locked in litigation with *Provena Medical Center* (Provena), a Catholic hospital in Urbana, Illinois, for over five years.<sup>13</sup> In its lawsuit, the IDOR alleged that Provena failed to meet its charitable mission, by providing charity to only one-half of one percent of its patients.<sup>14</sup> Further, local Illinois tax officials stripped Provena of its property tax exemption in 2010, as Provena spent only \$831,724 in charitable activities,

falling short of the \$1.1 million the medical center would owe in property taxes.<sup>15</sup> Since then, Provena has been required to pay approximately \$1 million in property taxes annually.<sup>16</sup> Following Provena, the IDOR has rescinded the tax-exempt status of several hospitals, including: Northwestern Memorial Hospital's Prentice Women's Hospital in Chicago; Edward Hospital in Naperville; and, Decatur Memorial Hospital in Decatur.<sup>17</sup>

Similarly, the City of Pittsburgh is challenging the tax-exempt status of the *University of Pittsburgh Medical Center* (UPMC), a nonprofit, academically affiliated medical center, seeking the removal of UPMC's tax-exempt status and six years of back payroll taxes.<sup>18</sup> In support of its lawsuit, the City of Pittsburgh noted that UPMC, the largest healthcare provider in the region with net patient revenues of approximately \$5.7 billion, donates less than two percent of its revenue to charity care.<sup>19</sup> Pittsburgh's mayor, Luke Ravenstahl, cited: (1) the city's need for money in the face of burgeoning pension obligations; and, (2) rising healthcare costs, as the primary reasons behind the decision to review the nonprofit hospital's tax status, an increasingly common decision among municipalities across the U.S.<sup>20</sup>

In response to the critique of their tax-exempt status, nonprofit hospitals are employing a variety of strategies to protect their tax exemptions. One such strategy is to proactively sell the nonprofit hospitals to private investors and public companies before the hospital's tax status is scrutinized. Hospitals in Detroit, Miami, Scranton, and outside Boston have employed this method.<sup>21</sup> Additionally, some hospitals have elected to work with their local and state governments to establish *Community Benefit Standards* for providers, outside of simply providing free care to uninsured patients, e.g., free preventative health services; funding biomedical research; and, other charitable endeavors which support the nonprofit's mission of caring for its community.<sup>22</sup>

Tax-exempt hospitals will continue to face increasing levels of regulatory scrutiny as state and local governments seek to ensure that the tax exemptions received by these hospitals are warranted by the amount of community benefit they provide. Nonprofit hospitals that do not provide for, and document, the community benefit, e.g. care for uninsured individuals, may jeopardize their tax-exemptions, placing an additional strain on these hospitals' financial resources.

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3 St. Louis Post Dispatch, February 22, 2014.

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