Summer Months Bring Developments For Tax-Exempt Hospitals

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In a time span of just over a month, tax-exempt hospitals have been handed a series of new developments that may change many aspects of the manner in which they conduct and report their charitable activities.

1. Revised Draft Form 990.

On June 14th, the Internal Revenue Service issued a draft revision of the Form 990 annual information return that must be filed by tax-exempt organizations, including hospitals. With the most comprehensive changes in over twenty-five years, the revised form dramatically increases the amount and scope of information that must be reported by tax-exempt organizations, including both financial and non-financial matters. Of particular interest to the healthcare sector, the form now requires the reporting of substantial details regarding board governance, charity care and community benefit, compensation, tax-exempt bond financing and compliance with rules against private business use, and dealings with affiliated organizations (including exempt affiliates, taxable affiliates, disregarded entities, and joint ventures). The breadth of the required reporting is, to some minds, staggering. The IRS is soliciting comments on the revised Form 990 through September 14, 2007, with the intent that the form will be required for tax filings made in 2009 with respect to the 2008 tax year. If the final form does not vary dramatically from the draft now under review, hospitals and health systems will need to devote substantially greater resources to completing the Form 990. More urgently, because the new form will be used to report events beginning as early as January 2008 (i.e., only a few months from now), hospitals and healthcare systems would be well-advised to study the revised form and evaluate changes that may be appropriate in their governance, management, compensation, bond compliance, and other aspects of their activities. We would be pleased to meet with senior leadership and finance staff of DBGC's healthcare clients to review the revised draft form and explore its implications.

2. Senate Finance Committee Minority Staff Discussion Draft.

On July 17th, Senator Charles Grassley, Ranking Member of the Senate Finance Committee, released a discussion draft prepared by his staff, offering a panoply of recommended changes in the standards to be applied to tax-exempt hospitals. The draft proposes that many hospitals currently classified as Section 501(c)(3) organizations be re-classified as Section 501(c)(4) entities. Such a change would hold many repercussions, not the least of which would be an inability of such organizations to receive tax-deductible charitable contributions or to utilize tax-exempt bond financing. The wide-ranging recommendations cover topics such as minimum charity care standards (e.g., Section 501(c)(3) organizations would be required to dedicate a minimum of 5% of their annual patient operating expenses or revenues, whichever is greater, to charity care), other measures of community benefit, billing and collection practices, governance standards, certain types of "lavish" perquisites provided to executives, and expanded imposition of intermediate sanctions penalty taxes under Section 4958. In light of Senator Grassley's status as the Ranking Member, rather than the Chair of the Committee, it is unclear whether these recommendations will make their way into proposed legislation. Nonetheless, they are sure to be the topic of substantial discussion and debate in the continuing climate of heightened scrutiny of tax-exempt nonprofit hospitals.

3. IRS Interim Report on Hospital Community Benefit Initiative.

On July 19th, the Internal Revenue Service released its interim report on the hospital community benefit initiative undertaken in 2006. That initiative involved sending an extensive ques-

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tionnaire to 544 hospitals across the country, with diverse inquiries regarding free and discounted care to the indigent and uninsured, emergency room services, other types of community benefits, governance, and executive compensation. The interim report provides preliminary analysis of the above, with the exception of executive compensation matters (which are currently being addressed by an audit initiative). Noting "considerable variation" in the tracking and reporting of uncompensated care (including the treatment of bad debt, charity care, discounted care, and shortfalls associated with care of patients covered by Medicare and/or Medicaid), the report reaches no conclusions but does offer some initial observations, including:

- Uncompensated care accounted for 56% of the total community benefit expenditures reported by respondents.
- 97% of hospitals reported having a written uncompensated care policy, but there was no uniform definition of the term "uncompensated care."
- The types of community benefit undertaken by respondents included uncompensated care (97% of respondents), medical education and training (76%), community education programs and other outreach (75%), programs to improve access to healthcare (54%), immunization programs (40%), other health promotion programs (32%), community needs assessments (28%), and medical research (21%).
- The average community benefit expenditure (using the diverse definitions applied by respondents), as a percentage of total revenues, was 9%.

The IRS plans to issue a final report by fall 2008. During the interim period, the IRS will be conducting further analysis of the reported data. The interim report indicates that the IRS will be conducting compliance checks or examinations of individual hospitals to test the reported results. On Friday, July 20th, an IRS representative spearheading the project indicated in informal statements that, for now, the compliance checks and examinations are likely to be focused on the "outlier" organizations, i.e., those whose responses were outside the norms (although not foreclosing the possibility of a broader audit initiative regarding community benefits provided by tax-exempt hospitals).

4. Reversal of Fortune for Provena Covenant.

On July 20th, an Illinois Circuit Court reversed a 2006 decision of the Illinois Department of Revenue, and held that Provena Covenant Medical Center of Urbana, Illinois was in fact entitled to property tax exemption. The case, involving a dispute as to the hospital's property tax status for 2002, has garnered widespread attention and is considered by many to be a harbinger of things to come for hospitals around the country. Provena Covenant initially was denied exemption in 2004 based on the determination of a local board of review. In late 2005, an administrative law judge reversed and found that the hospital should continue to be recognized (as it had for over 70 years) as a charitable, tax-exempt entity. A year later, in a decision that negatively characterized practices that are relatively common in the hospital industry, Illinois Department of Revenue Director Brian Hamer rejected the ALJ's opinion and concluded that the hospital did not provide enough charity care to justify property tax exemption as a charitable or religious organization. Director Hamer's position was summarily reversed by Judge Patrick Londrigan last Friday. Hospitals should not celebrate too quickly, however – given the stakes for both Provena Covenant and other Illinois hospitals, the Illinois Department of Revenue is anticipated to appeal the decision.

5. IRS Response to SFC Inquiry Regarding Charity Oversight.

Finally, on July 23rd, the Senate Finance Committee released a letter from IRS Acting Commissioner Kevin Brown responding to the Committee's March 2007 request for a report on current compliance problems and abuses in the nonprofit sector. Among the items cited in its 28-page letter, the IRS again observed that "many tax-exempt hospitals are difficult to distinguish meaningfully from for-profit hospitals." The IRS also reiterated its ongoing concerns about inadequate nonprofit governance, Section 509(a)(3) supporting organizations, excessive compensation arrangements, and involvement in political campaign activities.

The attorneys in DBGC's Health Law Department are actively assisting our clients to assess the significance of the events described above and other changes in the hospital enforcement and compliance arena. As always, we will be monitoring future federal and state developments in an effort to keep our clients informed and positioned to respond effectively.

Please contact Linda S. Moroney, TJ Sullivan, or any other member of Drinker Biddle's Health Law Practice Group if you have questions regarding these changes, would like to submit comments regarding these changes, or if we can be of assistance in any other matter.

Health Law Practice Group

Kendra M. Allaband
(312) 569-1328
Kendra.Allaband@dbr.com

Matthew P. Amodeo
(518) 862-7468
Matthew.Amodeo@dbr.com

Keith R. Anderson
(312) 569-1278
Keith.Anderson@dbr.com

James A. Barker
(202) 230-5166
James.Barker@dbr.com

Thomas Bartrum
(202) 230-5196
Thomas.Bartrum@dbr.com

Stephen S. Boochever
(518) 862-7461
Stephen.Boochever@dbr.com

Jennifer Breuer
(312) 569-1256
Jennifer. Breuer@dbr.com

Ed Bryant Jr.
(312) 569-1259
Edward.Bryant@dbr.com

Eileen M. Considine
(518) 862-7462
Eileen.Considine@dbr.com

John J. D'Andrea
(518) 862-7463
John.Dandrea@dbr.com

James H. Freis
(973) 549-7170
James.Freis@dbr.com

Jeffrey T. Ganiban
(202) 230-5150
Jeffrey.Ganiban@dbr.com

Stephanie Dodge Gournis
(312) 569-1327
Stephanie.DodgeGournis@dbr.com

Kelley Taylor Hearne
(202) 230-5127
Kelley.Hearne@dbr.com

Melissa A. January
(312) 569-1283
Melissa.January@dbr.com

Todd D. Johnston
(609) 716-6674
Todd.Johnston@dbr.com

Liliana Kalogjera
(414) 221-6053
Liliana.Kalogjera@dbr.com

Bridget C. Kevin
(312) 569-1282
Bridget.Kevin@dbr.com

Robert W. McCann
(202) 230-5149
Robert.McCann@dbr.com

Gerald McCartin
(202) 230-5113
Gerald.McCartin@dbr.com

Linda S. Moroney
(414) 221-6057
Linda.Moroney@dbr.com

Mark D. Nelson
(312) 569-1326
Mark.Nelson@dbr.com

Daniel O'Connell
(973) 549-7160
Daniel.OConnell@dbr.com

Neil S. Olderman
(312) 569-1279
Neil.Olderman@dbr.com

Colleen O. Patzer
(414) 221-6058
Colleen.Patzer@dbr.com

Julie M. Rusczek
(414) 221-6060
Julie.Rusczek@dbr.com

Robyn S. Shapiro
(414) 221-6056
Robyn.Shapiro@dbr.com

Brenda E. Stafford
(973) 549-7164
Brenda.Stafford@dbr.com

Elizabeth D. Stottlemyer
(202) 230-5156
Elizabeth.Stottlemyer@dbr.com

K. Bruce Stickler
(312) 569-1325
Bruce.Stickler@dbr.com

T.J. Sullivan
(202) 230-5157
TJ.Sullivan@dbr.com

Douglas B. Swill
(312) 569-1270
Douglas.Swill@dbr.com

Kelly Trahan
(312) 569-1284
Kelly.Trahan@dbr.com

Robert J. Waters
(202) 230-5152
Robert.Waters@dbr.com

Fatema Zanzi
(312) 569-1285
Fatema.Zanzi@dbr.com

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LAW OFFICES | CALIFORNIA | DELAWARE | ILLINOIS | NEW JERSEY
NEW YORK | PENNSYLVANIA | WASHINGTON DC | WISCONSIN