Is your Hospital’s Tax-Exempt Status at Risk?
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At a Glance
The IRS has proposed changes to Section 501(c)(3) of the Internal Revenue Code that could affect the tax-exempt status of not-for-profit healthcare organizations. Healthcare financial managers should ensure that their organizations maintain compliance with the tax-exempt requirements and remain above reproach, particularly in the areas of:
> An organization’s intent for public service
> Implications of Section 4958 on the organization’s tax-exempt status
> Political activities
> Operating an affiliated business

The tax-exempt status of many not-for-profit hospitals may soon be called into question. And it’s not the recent spate of class action lawsuits that pose the threat—it’s the IRS.

Not-for-profit hospitals are being forced to take a hard look at the justification of their tax-exempt status. They have faced high-profile challenges of their tax exemption from numerous quarters for an alleged failure to provide sufficient charitable care to fulfill their obligation under tax exemption. Familiar examples include the highly publicized attempts by attorney Richard Scruggs to bring class action lawsuits and by Illinois Attorney General Lisa Madigan to introduce legislation that would require hospitals to spend at least 8 percent of their operating costs annually on charity care.

But a much less publicized challenge by the federal government may have a much more immediate impact on not-for-profit providers.

The IRS has quietly voiced its own concerns that the line has become increasingly blurred between organizations operating as true altruistic public charities serving the needs of the community and not-for-profit health systems thriving under quasi-corporate leadership and structure disguised as entities serving the public good. On Sept. 9, 2005, the IRS introduced proposed changes to clarify qualification of tax exemption under Section 501(c)(3) of the Internal Revenue Code. These proposed regulation clarifications pose significant financial implications in the event an organization’s tax-exempt status is revoked. Is your hospital system at risk?

What’s It All About?
The IRS tax-exempt provision was established to shelter religious, charitable, and educational organizations from the burden of federal income tax. In essence, to qualify under Section 501(c)(3), the organization is prohibited from providing economic benefit to a private individual or shareholder. Also, primary activities of the qualifying entity may not be involved in attempts to influence legislation or foster the advancement of an individual seeking political office.

Charitable organizations fall under two categories: public charities and private foundations. To be classified as public charity, at least one of the following criteria must be satisfied:
> Organization and operation as a church, hospital, school, or similar type of institution established for religious, healthcare, or educational intent
> Receipt of contributions from numerous sources
> Generation of income for the purpose of the tax-exempt status
> Support of one or more existing public charities

Private foundations, by contrast, operate by soliciting donations and contributions from one primary benefactor and operate by distributing grant funding to other organizations or individuals rather than directly managing the program activities.

On July 30, 1996, Section 4958 was added to the IRS code to levy excise taxes on disqualified persons who were provided excessive economic benefit by a public charity or social welfare organization. These sanctions apply only to the disqualified individual, not the tax-exempt organization. Excessive benefit is defined as remuneration that exceeds the fair market value of the services rendered by the disqualified individual (i.e., a person who is empowered to exercise control or influence over the tax-exempt organization). Section 4958 does not directly affect the determination of tax-exempt status for applicable organizations.

Although compliance with Section 4958 and Section 501(c)(3) are evaluated independently, violations of Section 4958 by an individual may affect the IRS interpretation of continued adherence with the requirements for a tax-exempt organization to maintain its status. In fact, if a disqualified person is determined to have obtained economic consideration in excess of fair market value, it would stand to reason that the basic principle of private inurement is at issue. Therefore, in reality, the organization is de facto at risk for revocation of its Section 501(c)(3) tax-exempt status via sanction of a disqualified individual under Section 4958. A Section 501(c)(3) organization is at risk of jeopardizing its tax-exempt status if more than an insubstantial portion of its activities violate its exempt purpose, specifically relating to the following:
> Participating in political campaigns of elected officials
> Lobbying activities
> Allocating earnings to the private inurement of an individual or shareholder
> Operating a business that is not for the primary tax-exempt purpose
> Benefiting the organization’s founder or the founder’s family
> Engaging in illegal activities or violations of public policy

Proposed Changes to the Regulations
The proposed changes to the regulations regarding the recognition of tax-exempt status will become effective upon publication of a final rule, taking into account public comments, in the Federal Register. Public comments to the proposed rulemaking were accepted through Dec. 8, 2005.

IRS code Section 501(c)(3) proposed revisions are presented in the form of a series of examples to clarify the intent and application of the regulations. These changes mark the first substantial revisions to the regulations specifically related directly to the determination of eligibility for tax-exempt status for applicable organizations since the inception of the code section in 1959.

In general, the examples provided in the proposed changes imply that each situation is unique and will be evaluated independently regarding a determination as to possible violations of the regulations. One violation alone, unless it is particularly egregious, would probably not jeopardize the tax-exempt status. However, a pattern of offenses or unacceptable activities that have a material impact on the organization's operations may be interpreted as reason for revocation. The examples provided by the IRS offer concrete illustrations of what behaviors are disallowable in an effort to assist organizations in assessing and correcting questionable practices.

What Can Healthcare Financial Managers Do?

In response to the clarifications provided by the examples illustrated in the IRS Section 501(c)(3) code changes, healthcare financial managers can perform the following action steps to ensure their organizations maintain compliance with the tax-exempt requirements and remain above reproach.

An organization's intent for public service. Healthcare organizations often conduct, or are directly affiliated with clinical research institutions that conduct, a variety of research activities. This practice in itself is perfectly acceptable. However, each research protocol should be evaluated to ensure that the results of the clinical trials or basic science experiments benefit society at large rather than a specific individual or entity. For example, if research funding is provided by a corporation to study drug interactions of a drug family (e.g., antibiotics) rather than a specific product manufactured exclusively by one pharmaceutical company, the results would benefit the public at large, thereby meeting the public service criterion.

In times of shortage of healthcare professionals, many hospital systems partner with educational institutions for the common good of both organizations. Healthcare financial managers should evaluate all relationships between the hospital organization and educational institutions, particularly for-profit trade schools. For example, if the hospital routinely pays tuition or offers scholarships for students to complete a two-year radiology program, the hospital's Section 501(c)(3) tax-exempt status may be at risk because the privately owned radiology school receives economic benefits from the hospital organization.

The composition of the board of directors for the healthcare organization is another area that should be considered. Many hospital organizations appoint members of the medical staff to the board. If decisions are made at the board level that directly benefit a physician serving in a governance capacity, private inurement may result. To avoid a potential conflict of interest, members of the medical staff actively practicing at facilities owned

and operated by the hospital organization should be prohibited from serving on the board of directors or any corresponding committees of the board.

Implications of Section 4958 on the organization's tax-exempt status. As stated above, a violation of Section 4958 may jeopardize an organization's tax-exempt status under Section 501(c)(3). Although one or two isolated incidents may not place the continued recognition of an organization's tax-exempt status at risk per se, a pattern of offenses, the size of a particular excess benefit transaction, a lack of measures to prevent future occurrences, and an absence of corrective action by the organization may result in the revocation of the tax-exempt status.

In a hospital setting, this situation can be illustrated by a prominent physician routinely obtaining economic favors such as inflated fees for clinical services rendered, excessive payments for administrative medical director services, waived rent for office space owned by the hospital system, and/or lavish gifts for continued patient referrals. If the hospital organization is located in a rural area and depends on one dominant physician group for patient referrals, this condition may be increasingly prevalent.

The external environment is a condition that every healthcare organization must consider in the operation of its facilities. In a highly competitive market, hospitals must become attractive to patients and physicians to ensure success. This circumstance may invite questionable marketing strategies that result in disqualified persons receiving excess benefit from the organization. Healthcare financial managers have the responsibility to evaluate the operating environment and recognize whether a threat exists related to unacceptable business practices.

Executive compensation may also be a source of potential private inurement. A market salary study should be performed to ensure the compensation packages, including salaries, bonuses, and fringe benefits, are reasonable and justifiable. Perks such as housing and automobile allowances, paid memberships to country clubs, and exorbitant expense accounts should be identified and curtailed. Paid travel expenses, especially spousal travel above reasonable and customary amounts, may also be viewed by the IRS as a form of excessive benefit. The organization should ensure these excessive perks are included as income on the individual's W-2 statement.

Political activities. For any not-for-profit hospital, financial success often is determined by government agencies. Depending on the patient mix, changes to Medicare or Medicaid regulations could significantly hamper a health system's bottom line. In an era of rising costs, reductions in payment could be devastating. Consequently, it is in the best interest for healthcare organizations to lobby for favorable laws and regulations. Similarly, the election or appointment of a particular individual could affect the outcome of government policy changes on the federal and state levels. The degree to which an organization participates in such political activities, particularly lobbying and campaign contributions, may place its tax-exempt status at risk. A simple matter of the display of a political sign on hospital grounds or campaign pins worn by employees could be suspect. Clear

organizational policies should be established and enforced prohibiting such activities by all hospital employees and medical staff.

Operating an affiliated business. Many health systems own and operate affiliated businesses that support the primary mission of the organization. Examples include schools, collection agencies, joint ventures, and even hotels to house traveling nurses and the family members of patients. Healthcare financial managers should assess the overall size and scope of the business units and subsidiaries in which the organization has ownership or substantial controlling interests. The IRS may determine a violation of the Section 501(c)(3) requirements exists if the majority percentage of the total organization is deemed to be businesses outside the realm of the purpose for which the tax-exempt status was established.

Reduce Your Organization's Risk Exposure

In the 46-year history of the tax-exempt requirements mandated in Section 501(c)(3) of the Internal Revenue Code, the regulations have remained relatively unchanged. The proposed changes drafted in 2005 send a clear message to the not-for-profit business community that concerns have been raised regarding violations in the tax-exempt status privilege. Charitable organizations, including health systems, have evolved from institutions that operate purely to serve the needs of the community to organizations resembling corporations. Healthcare financial managers should step back and realistically assess the components of the organization and its business objectives and governance structure, and ensure that, from a macro perspective, the business environment meets the spirit of the fundamental purpose behind the tax-exempt status. For example, does your organization utilize fund accounting, or is the financial accounting system designed as a for-profit entity? Was a surplus (i.e., profit) realized at fiscal year-end? How were these monies used?

Also, a detailed evaluation of specific transactions and events should be performed to verify compliance with the individual requirements of the tax-exempt regulations. Continuation of the designation of tax-exempt status is of vital importance to all not-for-profit hospital organizations as the consequences of revocation by the IRS would result in substantial additional costs to the organization in the form of federal income taxes.

Is your organization truly a not-for-profit charitable organization worthy of tax-exempt status? Are key members of executive management, prominent physicians, or organizational founders excessively benefiting from the operation of the hospital and its affiliates? How well do you think your organization would fare in an audit conducted by the IRS? What would be the financial impact if the exemption were revoked? These are the types of questions you may want to answer in an effort to reduce risk exposure in your organization.

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