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IRS Weighs In On Community Benefit Standard

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In the midst of the healthcare reform debate, serious discussion continues with respect to changes to the current "community benefit" standard (Standard) for hospital tax exempt status. In January 2009, the Commissioner of Tax Exempt and Government Entities of the Internal Revenue Service (IRS) spoke on hospital standards for exemption and concluded with: "[t]he existing community benefit standard, after a long and serviceable career, may be outdated. It may need a tune up; it may need a new engine; it may need a new vehicle."[\[1\]](#)

In a recent speech, a senior IRS Exempt Organizations official outlined a possible approach for an IRS revision to this standard. This follows a previous proposal presented by the Senate Finance Committee to dramatically revise the standard, as a means of helping finance healthcare reform. While they approach the topic from materially different perspectives, the actions of the IRS and Senate Finance Committee increase the likelihood that the 40-year old Standard may be subject to substantial revision.

The Standard has been the principal means by which hospitals obtain tax exempt status since it was introduced by the IRS in 1969 through the revenue ruling process.[\[2\]](#) The Standard articulates a multi-factor test (applied on a facts-and-circumstances basis) to determine whether a hospital operates to benefit the community. Relevant factors include:

1. Whether the governing board of the hospital is comprised of a majority of independent members who are representative of the community (as opposed to practicing physicians and other persons with financial interests in the hospital);

2. Whether medical staff privileges in the hospital are available to all qualified physicians in the area, consistent with the size and nature of the hospital facilities;
3. Whether the hospital maintains a full-time emergency room open to all patients regardless of their ability to pay for emergency services;
4. Whether the hospital admits as patients those persons able to pay for medical care, either directly by themselves or through third-party payment programs such as private health insurance or governmental plans such as Medicare or Medicaid; and
5. Whether the hospital's excess funds are invested in patient care and facility improvement and medical training, education, and research.

In applying the Standard, the IRS has also historically considered other factors such as community outreach/health education programs, but has viewed the most significant factors as those relating to emergency room availability and non-discrimination against Medicare and Medicaid beneficiaries.[\[3\]](#) These are not the only factors considered by the IRS and, of course, hospitals must also meet the general requirements for income tax exemption under IRC 501(c)(3), including the prohibitions against private inurement, payment of excess compensation, and impermissible private benefit.

On May 18, 2009, the Senate Finance Committee included a proposal to change the Standard as one of a series of policy options presented as a means of financing forthcoming health reform initiatives.[\[4\]](#) A principal portion of the Committee's (essentially bare-bones) proposal was a minimum charity care expenditure requirement, enforced in part by an intermediate sanctions penalty mechanism.

The most recent development in this "conversation" was the June 11 presentation of Ronald Schultz, Senior Technical Adviser in the Tax Exempt and Government Entities Division, to the American Institute of Certified Public Accountants Not-for-Profit Industry Conference.[\[5\]](#) Mr. Schultz is well-respected in the exempt organization sector for his knowledge, sensitivity to sector concerns, and accessibility. In his presentation, Mr. Schultz repeated concerns about the Standard previously expressed by other IRS officials, namely, that several of the five factors set forth in the Standard may be obsolete, given the evolution in healthcare since 1969, and that the Standard fails to effectively clarify the differences between nonprofit and for-profit hospitals.

In support of his comments, Mr. Schultz referenced the data contained in the recent IRS Hospital Report,[\[6\]](#) which suggested a material diversity in the types of nonprofit hospital providers. He indicated that this diversity was relevant to whether the exemption test continues to be based on a "facts and circumstances" analysis or more of a "bright line" test.[\[7\]](#) Along those lines, Mr. Schultz noted that some nonprofit hospitals (e.g., critical access hospitals and academic medical centers) may be exempt because they are the only hospital resource in the community or because of their teaching or research activities, while other types of nonprofit hospitals might remain subject to the Standard.

This diversity is supported by data from the Hospital Report. For example, 59% of reporting critical access hospitals provided uncompensated care equal to 3% of their revenues, compared with 52% of rural non-critical access hospitals, 33% of high population area hospitals, and 39% of other hospitals.^[8] Research expenditures were concentrated in a few hospitals; out of the hundreds of hospitals surveyed, 93% of research expenditures were concentrated in 15 hospitals.^[9] This same group of 15 hospitals reported 58% of the aggregate reported medical education and training expenditures.^[10]

Mr. Schultz also observed that while a "bright line standard" for exemption would be easier to apply than the Standard, application of the former might prove to have significant consequences for the nonprofit sector (i.e., some "winners and losers").^[11] Mr. Schultz underscored in his comments that he was not promoting either approach.

In previous public comments, Mr. Schultz has suggested any future exemption standard might possibly need to consider at least three other criteria:

- the nature of a hospital's decision-making process and structure;
- the amount of accountability that a hospital has to the community it serves; and
- the nature of the activities and services that the hospital provides.^[12]

Mr. Schultz' comments are significant in several ways. First, they serve to confirm the IRS' ongoing interest in revisiting the Standard, rather than waiting for standards for hospital exemption to be codified. Second, it appears that the approach that the IRS may take to revising exemption standards is materially different from the approach proposed by the Senate Finance Committee. Third, they underscore the need for nonprofit, tax exempt hospitals to continue to emphasize precisely how they are different from their for-profit counterparts, especially with respect to the manner in which they are governed and accountable to the community, and the nature of the services they provide.

The somewhat competing approaches of the IRS and the Senate Finance Committee, respectively, to the revision of the standard bear watching, particularly as developments in the larger spectrum of healthcare reform take center stage. Health lawyers may thus wish to advise their tax exempt, nonprofit hospital clients to prepare for the possibility of some form of change, ultimately, to the standards by which the organization receives its federal tax exemption.

^[1] Statement by Steven T. Miller in Austin, Texas, January 12, 2009, available at http://www.irs.gov/pub/irs-tege/miller_speech_011209.pdf.

[2] See Rev. Rul. 69-545, 1969-2 117; see also *Eastern Kentucky Welfare Rights Org. v Simon*, 506 F.2d 1278 (D.C. Cir. 1974), *vacated on other grounds*, 426 U.S. 26 (1975).

[3] See, Internal Revenue Service Corporate Education, *Introduction to the Healthcare Industry*, Training 33-3-102 (1-95) TADS 83846E at p. 64.

[4] Peregrine and Mills, "New Challenge to Federal Tax Exemption," *Health Lawyers Weekly* May 22, 2009; Peregrine and Mills, "Community Benefit Standard in Play – Again," *Tax and Finance Practice Group Executive Summary*, June 2009.

[5] Diane Freda, "IRS May Revise Community Benefit Standard, Exempt Critical Access, Teaching Hospitals", *BNA's Health Care Daily Report*, June 15, 2009; Fred Stokeld, "IRS Will Look to Hospital Study When Considering Exemption Standards, Official Says", 2009 EOTT 110-5 (June 11, 2009).

[6] IRS Exempt Organizations (TE/GE) Hospital Compliance Project Final Report, February 20, 2009, <http://www.irs.gov/charities/charitable/article/0,,id=203109,00.html> (Hospital Report).

[7] Hospital Report, http://www.irs.gov/pub/irs-tege/miller_speech_011209.pdf.

[8] Figure 32 of Hospital Report.

[9] Hospital Report, page 50.

[10] Hospital Report, page 52.

[11] *Id.*

[12] Simon Brown, "IRS Considering Bright Line Standards for Hospital Tax Exemption" (Doc. 2009-10524 Tax Analysts May 2009).