JOURNAL OF HEALTH CARE FINANCE

Winter 2018

COMMENTARY

Not-for-Profit Tax-Exempt Hospitals:

Is it Time to Start Paying Taxes?

Barbara Yasmin Lodge, MJ Health Law

Loyola University Chicago

I. INTRODUCTION

Using IRS data from the Centers for Medicare and Medicaid Services (CMS), it has been estimated that the value of the tax benefits received by not-for-profit tax-exempt hospitals increased from $12.6 billion in 2002 to $24.6 billion in 2011.[1] This jump can be attributed to forgone taxes, public contributions, and the value of tax-exempt bond financing.[2] $7 billion of this is gained from federal and state corporate income tax benefits, $3 billion from the benefit received from tax-exempt bonds, and $10 billion is attributed to state and local sales and property tax exemptions. By allowing people to reduce their tax liability by donating to tax-exempt organizations, this also benefitted tax-exempt hospitals to the tune of more than $10.5 billion in donations.[3] Not-for-profit organizations that meet the requirements of Internal Revenue Code 501(c)(3) receive substantial advantages that are not given to for-profit corporations and organizations, the most significant being the favorable treatment under the tax code.[4] Qualified not-for-profit organizations will be exempt from federal income tax, state and local taxes as well as property, income and sales tax. Donations that they receive are tax-deductible to the donor and these organizations also qualify for tax-exempt bond issues.[5] Hence, the tax-exemption reduces the cost of capital for not-for-profit organizations compared to similar for-profits.[6] The questions that immediately spring to mind are: do not-for-profit hospitals truly need or deserve these tax breaks, what net benefit do we as a society receive from non-profit tax-exempt hospitals and, could this forgone money, if collected, be better spent in our communities?

---

[1] Rosenbaum, S., Kindig, D. A., Bao, J., Byrnes, M. K., & O'Laughlin, C. (2015). The value of the nonprofit hospital tax exemption was $24.6 billion in 2011. Health Affairs, 34(7), 1225-1233I. doi:http://dx.doi.org/10.1377/hlthaff.2014.1424

[2] *Id.* at 1228

[3] *Id.* at 1228

[4] National Health Law Program (NHeLP) Nonprofit Hospitals and Community Benefit: Corey Davis, July 01, 2011_07_08_Nonprofit_Hospitals_and_Community_Benefit.pdf. 1-18.

[5] *Id*.

[6] *Id*.

Another question that one might also ask is why we allow hospitals to enjoy such lucrative tax breaks? Historically around the early 1900s, nonprofit hospitals were run by nuns and volunteers to care for the poor, and the tax exemptions were crucial for these institutions to maintain their charitable services.[7] Supporters of the tax exemption claim that this is still relevant and necessary as non-profit hospitals today continue to benefit the community by operating 24/7 emergency rooms, funding numerous health-related outreach programs and treating the uninsured while frequently not getting paid for a substantial part of the care they provide.[8] "Nonprofit organization" is an older and somewhat misleading term because it implies that these organizations do not operate at a profit; however, the correct terminology today should be "not-for-profit." The majority of not-for-profit organizations make money, but the intent is to reinvest the profits to enhance operations or to be used for charity work.[9] The fact is that most not-for-profit hospital systems are run today essentially like for-profit businesses, emphasizing revenue and market share over improvements to health care.[10] Seven of the 10 most-profitable hospitals and hospital systems in the United States are not-for-profits, each earning more than $160 million from patient care services, according to a study in Health Affairs.[11]

Starting in the mid-1950s, and extending until 1969 Internal Revenue Ruling 56-185 required a hospital seeking tax exemption to be ''operated to the extent of its financial ability for those unable to pay for the services rendered."[12] Hospitals had previously justified providing charity care as the basis for receiving tax-emption, but with the introduction of federally funded healthcare programs Medicare and Medicaid, which provided healthcare for those unable to pay along with employee provided insurance plans for workers, that need changed.[13]

In 1969, Revenue Ruling 69–545, introduced the much broader ''community benefit standard" in which ''promotion of health'' for the general benefit of the community would now be considered a charitable purpose.[14] Almost all not-for-profit hospitals are exempt from income, property, and sales taxes because they qualify as charitable organizations.[15] Although federal, state and local definitions of what defines a charitable organization might vary, there is a general expectation that tax-exempt hospitals will benefit their communities, by providing services and engaging in activities that they subsidize.[16] The IRS instructions for reporting what constitutes

---

[7] Brennan, D, (2016). *Do not-for-profit hospitals deserve their tax exemptions?* Retrieved from: http://www.truthinhealthcare.org/do-not-for-profit-hospitals-deserve-their-tax-exemptions

Cafardi, N. P., & Cherry, J. F. (2012). Understanding nonprofit and tax exempt organizations. New Providence, NJ: LexisNexis. p. 150

[9] *Id*. at 2.

[10] Kassab, B. *Orlando Sentinel Series: Beth Kassab writes about taxes for Central Florida's nonprofit hospitals. Part 2: Do Central Florida's nonprofit hospitals give enough to earn their tax breaks?* February 1st, 2016. Retrieved from: http://www.orlandosentinel.com/opinion/os-hospital-tax-community-benefit-beth-kassab-20160201-column.html

A More Detailed Understanding Of Factors Associated With Hospital Profitability. Ge Bai and Gerard F. Anderson
Health Affairs 2016 35:5, 889-897. https://doi.org/10.1377/hlthaff.2015.1193

[12] Revenue Ruling 56-185

[13] See Cafardi *supra* note 4.

[14] Provision of Community Benefits by Tax-Exempt U.S. Hospitals Gary J. Young, J.D., Ph.D., Chia-Hung Chou, Ph.D., Jeffrey Alexander, Ph.D., Shoou-Yih Daniel Lee, Ph.D., and Eli Raver N Engl J Med 2013; 368:1519-1527April 18, 2013DOI: 10.1056/NEJMsa1210239

[15] *Id*.

[16] *Id*.

"community benefit" expenditures are somewhat vague and broad and essentially allow hospitals to claim a variety of activities including such items as training medical students and nurses to become the hospitals' own future workforce.[17] Tax-exempt hospitals can purchase property mainly for investment, and are supported in building of large new facilities to provide more revenue. They also benefit from issuing tax-exempt bonds and by being able to promote tax deductible gift donations.[18] Top executives at not-for-profit hospitals are well rewarded, but the growth of these behemoths has done nothing to reduce the cost of health care for patients.[19]

A report commissioned by Ernst & Young and released by the American Hospital Association (AHA) 2012, reviewed community benefits of not-for-profit hospitals for tax year 2009.[20] The level of benefits provided varied widely among the hospitals. Hospitals in the top decile devoted approximately 20 percent of operating expenses to community benefits; hospitals in the bottom decile devoted approximately 1 percent; the average was 7.5 percent. This variation was not explained by indicators of community need.[21] A report to Congress which looked at community benefit spending by hospitals concluded that private tax-exempt hospitals reported net expenditures of $62.4 billion of total operating expenses spent on community benefit activities in 2011."[22] However, of the $62.4 billion of community benefit spending, the IRS reported that hospitals allocated more than half to offset losses from means-tested government programs: Medicaid at 32 percent and financial assistance for indigent patients at 24 percent. Additionally, 36 percent of community benefit spending went to health professions education, research, and certain subsidized health services. Hospitals allocated just $2.7 billion or 4 percent, to community health improvement and about $2 billion or 3 percent to cash and "cash in-kind" contributions to community groups.[23] In reality less than 8 percent of community benefit spending was allocated to community health improvement.[24]

Not-for-profit hospitals claim that they still need the tax-exemptions to remain economically viable[25] and executives complain about bad debts along with the fact that Medicare, Medicaid and private insurance companies are not in line with rising healthcare costs.[26] The fact is that not-for-profit hospitals today look and operate more like for-profit corporations rather than charities and, therefore, no longer deserve to receive state and federal

---

[17] Folkerts, L. (2009). Do Nonprofit Hospitals Provide Community Benefit? A Critique of the Standards for Proving Deservedness of Federal Tax Exemptions, 34 Iowa J. Corp. L. 611-640.

[18] *Id*.

[19] *Id*.

[20] McPherson, B. (2012). Hospital Tax Exemption: How Did We Get Here? INQUIRY: The Journal of Health Care Organization, Provision, and Financing, 49(3), 191-196.

Provision of Community Benefits by Tax-Exempt U.S. Hospitals Gary J. Young, J.D., Ph.D., Chia-Hung Chou, Ph.D., Jeffrey Alexander, Ph.D., Shoou-Yih Daniel Lee, Ph.D., and Eli Raver N Engl J Med 2013; 368:1519-1527April 18, 2013DOI: 10.1056/NEJMsa1210239

[22] See Rosenbaum *supra* note 2.

[23] Schirra, J. J. (2011). A Veil of Tax Exemption: A Proposal for the Continuation of Federal Tax-exempt status for Nonprofit Hospitals. *Health Matrix: Journal Of Law-Medicine*, *21*(1), 231-277 at 232

[24] See Rosenbaum *supra* note 2.

[25] Nation George A., III. (2010). Non-profit charitable tax-exempt hospitals - wolves in sheep's clothing: To increase fairness and enhance competition in health care all hospitals should be for-profit and taxable. Rutgers Law Journal, 42(1), 141-211

PricewaterhouseCoopers' Health Research Institute, Acts of Charity: Charity Care Strategies for Hospitals in a Changing Landscape 6 (2005), 1-39,6.

tax-exemption status. Hospitals might be providing community benefits but they are basically operating in the same manner as their commercial counterparts; they make large profits, pay high executive salaries, have uncharitable billing practices and, in general, do not provide significant charity care or community benefits. This calls into question the value of the tax-exempt advantage they receive.

Part II of this paper will provide background on why hospitals were originally given tax-exempt status and explain why historically it was necessary to maintain their viability; this section will also review current State and Federal tax laws. Part III examines the IRS tests which a non-profit has to meet to maintain its exempt status; this section also discusses why these tests are inadequate and lack justification for a hospital organization to be exempt from all taxes, specifically the organizational test, which defines the organization's purpose, and the operational test. This section looks at how the IRS monitors private benefit and reviews how the community benefit standard remains vague and inadequate. Part IV explains the changes to tax exemption requirements that came about with the Affordable Care Act (ACA), and asserts that fair pricing policies and financial assistance are not routinely offered and fail to support indigent people. Part V discusses the private inurement test and how excessive compensation can be misused by tax-exempt hospitals. Part VI describes the fourth IRS test, the political activities test. Part VII examines joint ventures and mergers and looks at various hospital joint venture opportunities, pointing out how hospitals with non-profit tax-exempt status can abuse this benefit to help increase profits of for-profit organizations. Part VIII discusses the property tax exemption and alternatives to complete property tax-exemption, looking at how States are losing huge amounts of tax dollars from tax-exempt hospitals. The paper concludes in Part IX, summing up the current non-profit tax-exempt criteria and looking at alternatives for the future, covering financial implications for hospitals but also the government's potential for increased tax dollars.

II. BACKGROUND

Why do hospitals enjoy such lucrative tax breaks? Back in the early 1900s, when hospitals were run by nuns and volunteers as religious charities, governments viewed the tax exemptions as necessary for institutions to keep their doors open.[27] From the eighteenth through the late nineteenth centuries in the United States, hospitals functioned to take care of the sick, insane and those in extreme poverty.[28] Hospitals were often viewed as a last resting place rather than a place of care as the risk of infection and death were significant.[29] Physicians did not expect to earn their livelihood from hospital-related work; patients were treated in the hospital because they could not pay a private practitioner to treat them at home.[30] Training was usually an apprenticeship with a local practitioner and credentials were not required.[31] Many hospitals originated from very modest means. At one Massachusetts hospital, "one man donated a pig of an uncommonly fine breed, while another donated an Egyptian mummy."[32] At another, "prisoners quarried the granite blocks used for the walls of the building and, after several years, advocates of the hospital collected enough charitable gifts from the wealthy to finish

[27] See Brennan *supra note 8.*

[28] *Id*.

[29] McGregor, C. (2007). The community benefit standard for non-profit hospitals: Which community, and for whose benefit? *The Journal of Contemporary Health Law and Policy, 23*(2), 302-40

[30] Charles Rosenberg, The Care of Strangers: The Rise of America's Hospital System 18, 98-99 (1987)

[31] *Id.*

[32] See Schirra *supra* note 24, at 270.

constructing the hospital."[33] During this time there were no government subsidies or patient fees and hospitals relied on donations of money and property from the wealthy.[34]

Advances in medicine and medical education began in the 1870s and 1880s. Hospitals were evolving because of developments in medical science and technology which would forever change the medical landscape.[35] American physicians returning from study trips abroad brought back the belief that medical research and medical education had a place in the hospital.[36] In this way, the interests of the medical profession began to shape the institution of the hospital.[37] As a result, hospitals started to become more attractive to paying patients and by the beginning of the twentieth century, hospitals emerged as places of, "efficiency and scientific excellence."[38] The affluent became aware that hospitals were the best providers of medical procedures because of their superior equipment, postoperative nursing, and medical care, so the stigma of the previous century and a half faded and it became socially acceptable to be treated in hospitals.[39] Starting in the late 1900's, no longer strictly for the poor, hospitals became increasingly capital-intensive organizations. Hospital growth progressed as paying patients were able to cover the vast majority of hospital expenses, providing hospitals with a new source of capital.[40] By the 1930s, hospitals derived two-thirds their income from patient fees.[41] The paying patient would be taken care of in a private room, while the poor received less comfort or privacy in large wards.[42]

In 1913, with the ratification of the Sixteenth Amendment to the Constitution, Federal income tax in the United States was initiated along with the premise that through tax exemption private citizens would be able to solve society's problems on a non-governmental basis."[43] The federal income tax law that Congress passed in 1894 allowed certain "charitable" organizations to be exempt from tax because of the expenses that were incurred from various projects aimed at helping poor people.[44] At the time, hospitals, many which had their roots in almshouses, served as refuges for the poor.[45] The 1894 statute and its successor, the 1913 income tax statute, made it standard IRS practice to treat hospitals as charities which consequently made them eligible for tax exemption.[46] The rationale was justified that the Government would gain compensation for the loss of tax revenue, by receiving relief from financial burdens which would ordinarily have been met by use of public funds.[47] From 1956 until 1969, the Internal Revenue Service (IRS) has

---

[33] *Id.*
[34] *See* McGregor *supra* note 30.
[35] See Rosenberg *supra* note 2.
[36] *Id*.
[37] *Id.*
[38] *See* Schirra *supra* note 24, at 238
[39] *Id.*
[40] See Rosenberg *supra* note 2.
[41] In Sickness and in Wealth: American Hospitals in the Twentieth Century by Rosemary Stevens (Basic Books, New York, 1989), pp. xii + 432, $US 24.95, ISBN 0-465-03223-0
[42] *See* Schirra *supra* note 24.
[43] *See* Schirra *supra* note 24, at 241.
[44] Tahk, S. C. (2015, February 26). Tax-Exempt Hospitals and Their Communities. Retrieved October 31, 2017, from https://taxlawjournal.columbia.edu/article/tax-exempt-hospitals-and-their-communities/
[45] *Id*.
[46] *Id*.
[47] 338 F. Supp.448 (D.D.C. 1972), in, Cafardi, N. P., & Cherry, J. F. (2012). Understanding nonprofit and tax exempt organizations. New Providence, NJ: LexisNexis. 51

made it a requirement that in order to qualify for tax-exempt status a hospital should operate, "to the extent of its financial ability for those not able to pay for services rendered and not exclusively for those who are able and expected to pay".[48] Today a hospital does not have to support indigent care in order to qualify for a tax exemption. If it can show that it organized and operated for a charitable purpose and provides a "community benefit" it will qualify as a tax-exempt organization under 501(c)(3) of the IRC.[49]

III. IRS Tests

There are three definitions that the Internal Revenue Service (IRS) uses for a hospital. The Medicare Act contains the most traditional definition used by the IRS and Congress. In summary, it states that the term "hospital" means an institution which, "is primarily engaged in providing, by or under the supervision of physicians, to inpatients diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons, or rehabilitation".[50] A second definition is used for entities that qualify as public charities' and receive tax deductions, "the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if the organization is a hospital".[51] Under this definition an organization qualifies if it is a hospital and its principal purpose is to provide medical or hospital care, medical education, or medical research.[52] A third definition applies to organizations that are not hospitals per se, but are Cooperative Hospital Service Organizations (CHSOs), service organizations that carry out services for tax-exempt hospitals.[53] Services may include rehabilitation, data processing, purchasing, warehousing, billing and collection, food, outpatient clinical, industrial engineering, laboratory, printing, communications, record centers, and personnel.[54] The organization that provides services to the tax-exempt hospital can qualify for tax-exemption also if the services it provides are considered in furtherance of the first organization's tax exempt purpose.[55] To qualify for tax-exemption they must also pass the "integral part" test. The integral part test requires the supported hospital organization to maintain a significant involvement in the operations of the CHSO.[56] This third category goes to show how broad the definition of a hospital is in reference to tax exemption.[57]

Exemption purposes defined by the IRC section 501(c)(3) state that, "religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international sports competition, and preventing cruelty to children or animals are exempt purposes".[58] Health care organizations do not, however, automatically receive tax-exempt status.

---

[48] Tax-Exempt Hospitals: Renewed Focus on Indigent Care. Vol. 4, No. 1, J. Health & Life Sci. L. 142.

[49] Joint Committee on Taxation, Present Law and Background Relating to the Tax-Exempt Status of Charitable Hospitals (JCX-40-06), September 12, 2006.

[50] Hyatt, T. K., & Hopkins, B. R. (2017). The law of tax-exempt healthcare organizations. Hoboken, NJ: John Wiley & Sons.1-1106.

[51] I.R.C. § 170(b)(l)(A)(iii)

[52] I.R.C. § 170(b)(l)(A)(iii)

[53] See Hyatt & Hopkins, *supra* note 51.

[54] *Id.*

[55] See Cafardi *supra* note 9.

[56] §1.509(a)-4(i)(3)(i)

[57] *See* Schirra *supra* note 24.

[58] I.R.C. § 1.501(c)(3)

They can achieve that status if they qualify as 'charitable' organizations under the Internal Revenue Code. Tax exemptions for charitable institutions are justified by the public benefit the institutions provide to the community and society. To qualify for tax-exemption by the Internal Revenue Service (IRS) under section 501(c)(3) of the Internal Revenue Code (IRC) an organization must meet four tests. These are: the organizational test, the operational test, the private inurement test and the political activities test.[59] To initially determine if an organization provides a public benefit, the organization must first satisfy the organizational test and the operational test.[60]

The organizational test requires that the organization's purpose be expressly limited in its "governing instrument" to at least one of the specific purposes under I.R.C. § 501(c)(3).[61] The organizational test is written in the creating document, sometimes referred to as the "founding document" of the organization. The organizational test is the easier test to satisfy, achieved through careful drafting of the governing instrument. [62] In order for a hospital to meet the organizational test in its founding document it must state the exempt purpose of the organization and specify that the organization will perform, unless they are insubstantial, only exempt activities.

The operational test examines the organization's activities and requires that it must be engaged primarily in the activities that it has identified as its exempt purpose.[63] The IRS is highly concerned with hidden factors of private benefit and commerciality when assessing an organization for tax-exempt. The commerciality question seeks to determine if the organization is a "business" or a "charity" based on its relatively subjective criteria.[64] Operating a commercial business, however, does not automatically preclude an organization from tax-exempt status but the operational test does require that the business activities are in furtherance of the organization's exempt purpose. The wording in I.R.C. § 1.501(c)(3) states that an organization must be operated "exclusively" for exempt purposes; however, in interpreting the term "exclusive" the IRS has determined that an organization must be operated "primarily" for exempt purposes. This is sometimes referred to as the "primary purpose test."[65] Under the primary purpose test, a tax-exempt organization must make sure that its primary activity is in furtherance of its exempt purpose and that it may only undertake insubstantial activities that are not in furtherance of this.[66]

In its evaluation of an organization, one of the IRS's main concerns is that the organization's primary activity provides a public benefit rather than benefitting a private interest. Even one non-exempt activity, if considered substantial, will fail the operational test.[67] The private benefit question seeks to determine if private individuals are receiving a substantial

[59] See Cafardi *supra* note 9.
[60] See Hyatt & Hopkins, *supra* note 51.
[61] 26 CFR 1.501(c)(3) (2006)
[62] McGregor, C. (2007). The community benefit standard for non-profit hospitals: Which community, and for whose benefit? The Journal of Contemporary Health Law and Policy, 23(2), 302-40, 312
[63] 26 CFR 1.501(c)(3) -1(c)(2005)
[64]See Cafardi *supra* note 9.
[65] *Id*. at 66.
[66] *Id*.
[67] *Id*.

benefit from the organization, which is not permitted under the regulations.[68] "Private benefit" does not refer to insiders in the organization—that is "private inurement"—but, rather, looks at whether the organization serves a public and not a private interest. In determining if the organization is operating for a private benefit the court will look to see if the persons benefitting from activities of the organization are, " too narrow, too small, or too limited a group."[69] Proponents advocate that not-for-profit commercial activity is a good thing as it helps organizations to be more self-reliant, resilient, and enhances their opportunities to expand programs which could make the difference between an organization that merely survives and one that is successful.[70] The statue that governs tax-exemption is more concerned with the destination of the income, rather than the source of the income, and that it is furthering the claimed charitable purpose, which is the ultimate test for exemption.[71] When the business activities are considered too commercial above and beyond furtherance of the tax-exempt purpose, they will fail the operational test.[72] Recent closer scrutiny of private benefit is a sign that the IRS has increasingly become distrustful of the use of not-for-profits and charities as vehicles to operate a commercial business and that they have found organizations operating a profitable business using the charity status to further the private interest of individuals.[73]

Since 1969, to be federally tax-exempt hospitals were no longer required to provide free or low cost service to patients unable to pay.[74] In addition to the tests outlined above, a crucial stipulation that a non-profit tax-exempt health care organization must also prove is that its services are for the benefit of the community. This test, known as the "community benefit standard," is a subpart of the operational test specifically applied to not-for-profit health care organizations.[75] To prove that they function for a community benefit the IRS Revenue Ruling 69-545 made significant changes to the rules that govern what hospitals must do to qualify and maintain tax exemption status:[76] an emergency room (ER) must be operated which is open to all; there must be a board of directors drawn from the community; an open medical staff policy must be in place; the hospital must offer treatment of Medicare, Medicaid and other government program patients; and, "the use of surplus funds must be to improve facilities, equipment, patient care, and provision of medical training, education and research."[77] One modification, Revenue Ruling 83–157, states that "although the operation of an ER open to all patients is a strong indicator of community benefit", the presence of other significant factors could justify tax exemption if it can be determined that an ER is not necessary or a duplicative service.[78] There appear to be no clear guidelines in law or regulation to determine what activities qualify as community benefit.[79] It is, therefore, not surprising to find that activities vary across hospitals

[68] *Id*.

[69] *Id*. at 69.

[70] IRS 7.25.3 Religious, Charitable, Educational, Etc., Organizations Retrieved from: https://www.irs.gov/irm/part7/irm_07-025-003.html

[71] Sico Foundation v. United States, 295 F.2d 924 (Ct. Cl. 1962).

[72] See Cafardi *supra* note 9.

[73] See IRS *supra* note 71.

[74] See McGregor *supra* note 30.

[75] *Id.*

[76] Rev. Rul. 56-185, 1956-1 C.B. 202.

[77] See McPherson *supra* note 21.

[78] *Id*.

[79] Hospital Tax Exemption: Where Do We Go from Here? (2012). Inquiry: The Journal of Health Care Organization, Provision, and Financing, 49(3), 197-201.

and hospital organizations and that there is no consistency in the measurement of community benefits. At a state level there is also variation in the standards set in determining if hospitals qualify for not-for-profit preferential treatment under state the law.[80] There have been some private efforts to standardize and quantify the benefits that nonprofit hospitals provide to the community, but they are largely voluntary and unenforceable and there remains "broad latitude" in determining what constitutes community benefit.[81]

An organization can meet the organizational test but fail the operational test as was the case in B.S.W. Group, Inc. vs Commissioner.[82] The group's purpose was providing consulting services to customers primarily in the area of health, housing, vocational skills, and cooperative management.[83] All of B.S.W.'s consulting clients were to be tax-exempt organizations and/or not-for-profit organizations, some of which were not tax-exempt.[84] These services met the organizational test, but it was determined that they did not meet the operational test because they were found to be operating in a manner and charging clients as would a for-profit organization.[85] In this case the Commissioner did not dispute that they were organized exclusively for the required purposes, see sec. 1.501(c)(3)-1(b), but found that they did not meet the operational test because they were "primarily engaged in an activity which is characteristic of a trade or business."[86]

IV. Changes under the Affordable Care Act

Beginning in tax years after March 23, 2010, the Affordable Care Act (ACA) added new requirements that nonprofit hospitals must meet as a condition of retaining their tax-exempt status.[87] The ACA created Section 501(r) in the Internal Revenue Code which primarily governs how hospitals can bill patients for medically necessary emergency care and has four main components: 501(r)(3) which establishes the requirement to conduct a Community Health Needs Assessment (CHNA); 501(r)(4) governs financial assistance policies (FAP); 501(r)(5) sets limits on charges and defines average general billing (AGB) and methodologies for calculating the limitations and; 501(r)(6) sets communication requirements, timetables and restrictions for billing and collections. [88]

In 1969, the IRS eliminated the requirement that a "nonprofit" healthcare organization had to, "operate to the extent of its financial ability for those not able to pay for services rendered."[89] In doing this they eliminated the requirement that not-for-profit hospitals provide charity care for those unable to pay. Under Revenue Ruling 69-545 the requirement that

---

[80] See NHeLP *supra note* 5.

[81] See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-08-880, Variation in Standards and Guidance Limits Comparisons of How Hospitals Meet Community Benefit Requirements 8 (2008) at 19.

70 T.C. 352 (1978) *B.S.W. Group Incorporated, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT*

[83] *Id*.

[84] *Id*.

[85] See Cafardi supra note 9.

[86] See B.S.W. GROUP *supra* note 83 at 356.

[87] See NHeLP *supra note* 5.

[88] Wells, J., & McFadden, G. (2011). Tax-Exempt Hospitals and New Reporting Requirements. Journal of Accountancy, 212(5), 54-57.

[89] Revenue Ruling 56-185, 1956-1 C.B. 202

charitable hospitals provide care to patients without charge or at rates below cost was removed.[90] It was assumed that Medicare and Medicaid would now provide adequate access to medical care for the poor and indigent.[91] It has become obvious over time that this is not what happened and neither Congress nor the IRS provide adequate guidance on how to determine if a patient qualifies for charity care. Patients that need assistance to pay healthcare bills are not necessarily uninsured and not all those that are uninsured are unemployed.[92] The community benefit standard was addressed in a class action lawsuit when healthcare advocates challenged the validity of Revenue Ruling 69-545 in Eastern Kentucky Welfare Rights Organization v. Simon.[93] In this case the district court agreed that Congress had intended for the term charitable to mean "relief of the poor".[94] The appeal court reversed the ruling with the explanation that Revenue Ruling 69-545 provided alternative opportunities for hospitals to meet the tax-exemption requirements as charities apart from the financial obligations.[95]

To address this shortfall, one of the criteria that tax exempt hospitals must meet as part of 501(r) is to establish a written Financial Assistance Policy (FAP) that includes eligibility criteria and the method for applying for financial assistance.[96] There must also be a written Emergency Medical Care Policy (EMCP) that requires the provision of care to individuals for emergency medical conditions regardless of their eligibility for financial assistance.[97] The financial assistance policy must include: (a) eligibility criteria when free or discounted care is available to low income individuals, (b) how charges to patients are calculated and (c) the process for applying for financial assistance. The policy must be widely publicized and, if the hospital organization does not have a separate billing and collections policy, explain the actions it may take in the event of nonpayment."[98] They must limit amounts charged for emergency or other medically necessary care provided to individuals eligible for financial assistance to not more than amounts generally billed (AGB) to insured patients and refrain from engaging in extraordinary collection actions (ECAs) before making "reasonable efforts" to determine whether individuals are eligible for financial assistance. [99] This requirement was put in place to fill an important gap. A recent study conducted by two non-governmental organizations (NGOs) found that, among 99 hospitals surveyed, fewer than half provided application forms for charity care, only about a quarter provided information regarding eligibility, and only about one third

[90] Rev. Rul. 69-545, 1969-2 C.B. 117.

[91] Nation George A., III. (2010). Non-profit charitable tax-exempt hospitals - wolves in sheep's clothing: To increase fairness and enhance competition in health care all hospitals should be for-profit and taxable. Rutgers Law Journal, 42(1), 141-21.,

[92] *See* PriceWaterhouseCoopers *supra* note 27.

[93] 370 F. Supp. 325, 338 (D.D.C. 1973), rev'd, 506 F.2d 1278 (D.C. Cir. 1974), vacated on other grounds, 426 U.S. 26 (1976).

Joint Committee on Taxation, Present Law and Background Relating to the Tax-Exempt Status of Charitable Hospitals (JCX-40-06), 1-27, 6, September 12, 2006

[95] *Id.* at 7.

[96] 26 CFR 1.501(r)-4 - Financial assistance policy and emergency medical care policy.

[97] *Id*.

[98] Hearle, K. (2015). Responding to final 501(r) regulations for tax-exempt hospitals. Healthcare Financial Management, 69(4), 84-90. 84

[99] *Id.*

provided information in a language other than English.[100] Organizations also need to revise their pricing, billing and other business practices that raise concerns regarding their charitable purpose.[101] Hospitals need to better communicate and advertise financial assistance policies more widely with the goal of encouraging and increasing access for the uninsured and underinsured to help with financial assistance while maintaining fair and transparent billing practices.[102] In recent years, nonprofit hospitals have been the subject of more than 45 class-action lawsuits challenging their tax-exempt status on the basis of their billing practices and treatment of low-income uninsured individuals.[103]

V. Private Inurement and Compensation

Private inurement is the third of the IRS's test requirements that organizations need to meet to qualify for tax exempt status. It prohibits persons that have any control in the organization, however limited that might be, from benefiting from the organization's activities.[104] The test states that an organization will not qualify for tax exemption if its "net earnings inure, in whole or in part, to the benefit of private shareholders or individuals."[105] Private shareholders and individuals are those that are considered insiders in an organization.[106] Whenever there appears to be an overlap of control and benefit in an organization private inurement could possibly be happening.[107] Private inurement is not always obvious and can be hidden.[108] For example it can occur when tax exempt organizations have business relations with insiders or their families, and pay them, inflated prices for goods or services.[109] As was put by one court, a charity does not operate, "to siphon its earnings to its founder, members of the board, their families or anyone else fairly described as an insider."[110] When business arrangements between the organization and insiders occurs, the transactions must occur at arm's length and be able to be considered reasonable as would compare to any other similar transaction in the marketplace.[111] If an organization does not keep satisfactory supporting records of

---

[100] Pryor, C. Best Kept Secrets: Are Non-Profit Hospitals Informing Patients About Charity Care Programs?, (Community Catalyst; The Access Project; May 2010), http://www.communitycatalyst.org/doc_store/publications/Best_Kept_Secrets_May_2010.pdf

Mason T. Is your property tax-exempt status at risk? Hfm (Healthcare Financial Management) [serial online]. September 2010;64(9):104-110. Available from: OmniFile Full Text Select (H.W. Wilson), Ipswich, MA. Accessed.

[102] *Id.*

[103] Lunder E, Liu EC. Tax-exempt section 501(c)(3) hospitals: community benefit standard and schedule H, CRS report for Congress. 2008 Jul 31

Emerson, Montgomery, McCracken, Walker & Rhoads, LLP Guidestar. (2009). The Private Inurement Prohibition, Excess Compensation, Intermediate Sanctions, and the IRS's Rebuttable Presumption. A Basic Primer for 501(c)(3) Public Charities. guidestar_excess_compensation_whitepaper.pdf

[105] See Cafardi *supra* note 9, at 70.

[106] Sec.1.501 (a)-1(c), Income Tax Regs.

[107] See Cafardi *supra* note 9.

[108] *Id.*

[109] *Id.*

[110] United Cancer Council, Inc., Petitioner-appellant, v. Commissioner of Internal Revenue, Respondent-appellee, 165 F.3d 1173 (7th Cir. 1999).

[112] World Family Corporation, Petitioner v. Commissioner Of Internal Revenue, Respondent 81 T.C. 958 (1983)

business transactions, the IRS may determine that an organization cannot prove that private inurement has not occurred. This will cause it to fail to qualify for tax-exempt status.[112]

Excessive compensation is the most common type of private inurement.[113] The IRS closely scrutinizes compensation arrangements between hospitals, physicians and others to look for incidence of private inurement or excess benefits.[114] Tax exempt hospitals that have business or financial dealings with physicians or have them as board members have been declared as not operating as charity when there is a prohibited inurement of earnings which benefits an individual or group. Excessive compensation may occur in the form of a salary, wage or bonus incentive to an employee, or in payment to a vendor, contractor or independent contractor.[115] As one court stated, "the law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts".[116] The determination of incidence of private inurement will be based on whether the compensation is "reasonable."[117] In the determination of reasonableness is a facts-and-circumstance test, the principle criteria being the element of comparability.[118] Evaluation of compensation packages then need to be compared to similar organizations that are tax-exempt and taxable. Compensation may take into account the location of the organization, or an individual's expertise.[119] An example would be the board of governors being required to review similar compensation by other hospitals when reviewing the CEO salary.[120] Independent review bodies may be hired to assess for reasonable compensation packages. The direction on the IRS Form 990 is that, "reasonable compensation is the value that would ordinarily be paid for like services, by like enterprises, under like circumstances." [121]

Employees are persons who are not independent contractors and are compensated in return for their service.[122] Compensation can be paid to employees in current payments or deferred payments such as retirement plans.[123] However the compensation is paid, (salary, wages, bonus payments, commission, or deferred compensation), tax-exempt healthcare organizations are constrained by the private inurement doctrine, and all reimbursements to employees must also be considered "reasonable".[124] Physician compensation arrangements can vary and are subject to state laws. The IRS keeps a close eye on these arrangements with regards to potential for unreasonable compensation or other forms of inurement; however, there is little direction on how that is measured.[125] If the physician is an employee, a fixed compensation agreement can be paid and in this situation the hospital has control over patient charges and

[112] See Cafardi *supra* note 9.
[113] See Emerson *supra* note 105.
[114] See Hyatt, T. K., & Hopkins *supra* note 51.
[115] *Id*.
[116] See World Family Corp. *supra* note 112.
[117] *Id*.
[118] See Hyatt, T. K., & Hopkins *supra* note 51.
[119] *Id.*
[120] *Id.*
[121] I.R.C. § 1.501(c)(3)
[122] See Hyatt, T. K., & Hopkins *supra* note 51.
[123] *Id.*
[124] *Id.*
[125] Executive Compensation: A Primer for Establishing Reasonable Compensation 1-12, 8. http://www.trusteemag.com/ext/resources/inc-ru/pdfs/2011PDFs/08ExecCompPrimer.pdf

physician compensation.[126] In contrast when a physician remains as an independent contractor, an income guarantee arrangement might take place.[127] Independent contractors may also be receiving fixed compensation for administrative duties.[128] These types of arrangements are expected to come under greater scrutiny from the IRS for possible private inurement.[129]

When considering hospital recruitment of physicians, under Revenue Ruling 73-313 guarantee of private practice income may be acceptable to the IRS if a physician is relocating to an area where there is significant proof that: (a) there is a need for the physician in the community, (b) the level of guaranteed income is considered reasonable and (c) there is a ceiling on the outlay by the hospital.[130] In such circumstances, personal benefit to the physician will not affect the public benefit purpose of the organization if it can be shown that the physician income can be proven to relate back to community benefit.[131] In 2002 the IRS issued a letter detailing factors to be considered when assessing for private inurement. Concerns were that the compensation arrangement would reduce the charitable benefits that the organization provides and that the compensation arrangement might be used to transfer part of the organization's profits to those who have some control in the organization.[132] IRS guidelines sought to address some of the issues. For example, the hospital may provide office space to the physician but if the physician uses the office space for their private practice in whole or part, it must be rented at a rate considered to be at fair market value.[133] The hospital may also provide the physician with support staff but if the staff is used in whole or part to operate their private practice, this must be provided at a reasonable rate.[134] Other compensation items might include unfunded deferred compensation arrangements, loans or rental or use of equipment.[135] When considering if compensation is excessive, the IRS has generally been more forgiving in respect to compensation for work done that the physician performs or supervises others to perform. However, they have suggested that a cap could be appropriate.[136]

The IRS, Congress, state regulators, and charity watchdog groups continue to be concerned about excessive executive compensation packages.[137] Tax-exempt organizations need to find the right balance in compensation agreements that reward executives fairly for their work and time but stand up to federal tax law.[138] Two significant studies, the IRS Executive Compensation Compliance Project in 2004 and the U.S. Government Accountability Office (GOA) report in 2006, shed light on some of the areas of concern in executive compensation arrangements. Then in 2010 the IRS also launched a payroll audit of tax-exempt organizations to scrutinize executive compensation.[139] Executive incentive compensation is deemed acceptable

[126] See Hyatt, T. K., & Hopkins supra note 51.
[127] *Id.*
[128] *Id*.
[129] Hospital Audit Guidelines, at § 333.3(6)(c).
[130] IRS Rev. Rul. 73-313, 1973-2 C.B. 174
[131] See Executive Compensation *supra* note 80, 8.
[132] *Id* at 9.
[133] See Hospital Audit Guidelines supra note 121.
[134] *Id*.
[135] *Id.*
[136] See Hyatt, T. K., & Hopkins supra note 51.
[137] *Id*.
[138] *Id*.
[139] See Executive Compensation *supra* note 126.

and will not affect the not-for-profit's charitable designation as long as financial incentives remain within reasonable compensation limits.[140] One example would be that loans to executives as part of a compensation or recruitment package are not prohibited by the IRS. The IRS, in interpreting the Internal Revenue Code, will consider loans to executives or employees reasonable when they are intended to help a person transition to a new area and are treated an arm's-length transaction between the parties.[141] The reason for some distrust by the IRS is that these loans can be abused by organizations who used them to offer compensation which they never intend to be repaid or they were offering them interest free or below market rate.[142]

In 2005, the Panel on the Nonprofit Sector in its Final Report, discouraged charitable organizations from payment of compensation to board members.[143] Traditionally, directors serving on governing boards for not-for-profit organizations have, in the past, done so without receiving any compensation.[144] The Panel recommended that charitable organizations maintain the tradition of board directors serving on a voluntary basis.[145] As healthcare not-for-profits have grown into billion dollar businesses, many feel they are able to justify paying board members because they need to recruit skilled directors to serve.[146] The practice of paying board directors is criticized, because directors are disqualified persons under the immediate sanctions rule and it can diminish their independence. Plus, boards can decide their own level of compensation, which can be a conflict of interest.[147] Congress continues to closely monitor compensation and an increase in IRS monitoring has resulted in some cases of litigation against non-profit organizations.[148]

VI. Political Activities Test

The IRS political activities test is the fourth measure that not-for-profits must meet to qualify for tax-exemption. Organizations that are exempt from income tax under section 501(a) of the Internal Revenue Code described in section 501(c)(3) may not participate or intervene in any political campaign on behalf of, or in opposition to, any candidate for public office.[149] These restrictions come from the wording in the statute which states that, "no substantial part of the activities of a 501(c)(3) organization can consist of carrying on propaganda, or otherwise attempting to influence legislation".[150] The organizational definition in IRC § 501(c)(3) restricts the ability of these organizations to participate in political activity. They may only conduct an insubstantial amount of lobbying and they may not intervene in political campaigns' electioneering.[151] The distinction between lobbying and electioneering is important to tax-exempt organizations because although electioneering is completely prohibited, lobbying is

[140] See Hyatt, T. K., & Hopkins supra note 51.

[141] *Id*.

[142] *Id*.

[143] Panel on the Non-Profit Sector Final Report: Strengthening Transparency Governance Accountability of Charitable Organizations, (June 2005), at 64. https://www.neh.gov/files/divisions/fedstate/panel_final_report.pdf

[144] *Id*.

[145] *Id*.

[146] *Id*.

[147] See Hyatt, T. K., & Hopkins supra note 51, 792

[148] See Executive Compensation *supra note* 126.

[149] IRB 2007-25 (Rev. June 18, 2007)

[150] I.R.C. § 1.501(c)(3)

[151] See Lunder *supra* note 104.

allowed to an insubstantial degree.[152] Congress introduced Section 501(h) of the IRC in 1976 in order to clarify what is considered not "substantial lobbying" and allows tax-exempt organizations, except churches, a safe harbor with an expenditure formula that can be used to assess the degree of lobbying.[153] A 501(c) (3) reports its lobbying expenses to the IRS annually as part of Form 990 filing.[154] Organizations that violate either restriction may lose their tax-exempt status and the eligibility to receive deductible contributions. Additionally, the organization may, either in addition or as an alternative to the loss of tax-exempt status, be required to pay an excise tax on its political or lobbying expenditures, be enjoined from making further expenditures, and receive a termination assessment of all taxes owed.[155] In March of 2010, the IRS began more closely scrutinizing certain organizations applying for tax-exempt status under sections 501(c)(3) and 501(c)(4) of the Internal Revenue Code.[156] Campaign finance watchdogs believed that tax exemptions were being abused by groups whose primary purpose was to influence elections, not to promote "social welfare," as tax-exempt status mandates.[157] Lisa Gilbert, the director of Public Citizen's Congress Watch division, stated, that while "the I.R.S. should not be targeting any particular political ideology, questioning applicants for tax exemption to determine whether they were primarily political was entirely proper and should be more widely pursued."[158]

VII. Joint Ventures

Over the past 30 years there has been an explosion in joint ventures between tax-exempt health care organizations and for-profit entities.[159] Although there is no exact legal definition of the term "joint venture," the term is often used to refer to arrangements in which a tax-exempt health care organization, such as a hospital, clinic, or managed care organization and one or more taxable, for-profit parties agree to provide capital or services together, and to share in some capacity the income or losses.[160] There are two types of joint ventures. The first is the "whole-entity" joint venture in which a tax-exempt organization contributes all or a major part of its assets and operations in partnership with a for-profit entity. The second and most common joint ventures involving tax-exempt health care organizations are "ancillary" joint ventures.[161] Ancillary joint ventures involve a portion of the exempt entity's assets and activities, for example to create ambulatory surgery centers or to purchase and operate medical equipment.[162] Under Revenue Ruling 98-15, joint ventures between a tax-exempt organization and a for-profit organization or person can only occur if they can show that the primary purpose for the joint

[152] See Cafardi *supra* note 9.
[153] *Id*.
[154] *Id*.
[155] See Lunder *supra* note 104.
[156] See Emerson *supra* note 105.
[157] The New York Times. I.R.S. Apologizes to Tea Party Groups Over Audits of Applications for Tax Exemption. Jonathan Weiseman. May 10, 2013. http://www.nytimes.com/2013/05/11/us/politics/irs-apologizes-to-conservative-groups-over-application-audits.html
[159] *Id.* (A version of this article appears in print on May 11, 2013, on Page A11 of the New York edition with the headline: I.R.S. Apologizes to Tea Party Groups over Audits of Applications for Tax Exemption).
[160] Woods, L & Schroeder, T.C. Healthcare Regulatory and Compliance Insight. *Joint Ventures Between Tax-Exempt Health Care Organizations and For-Profit Parties: Avoiding Federal Tax Law Traps*. (2010).21-29.
[160] *Id*.
[161] *Id*.
[162] *Id*.

venture is in advancement of the tax-exempt purpose of promoting health in the community.[163] Certain indicia of community benefit are, "creation of a new provider of healthcare services; expansion of community healthcare services; improvement in treatment modalities; reduction in healthcare costs; and, improved patient convenience and access to physicians".[164] If this initial test is sufficiently proven, then the joint venture will also be examined for potential private inurement or private benefit issues.[165]

Hospital joint ventures with physicians occur because hospitals need patients and need physicians to admit patients to their hospitals; hence, there is a self-interest by the hospital to support physicians.[166] Integrated delivery systems are a way that hospitals have found to bring physician practices under the tax-exempt umbrella of the hospital without jeopardizing their own tax-exempt status.[167] In an effort to avoid scrutiny under anti-kickback laws and ensure that hospitals continue to receive patients from physician practices, hospitals engage in purchasing physician practices. The physician becomes an employee of the hospital and continues to see the patients who are now secured customers under the hospital-based practice.[168] They justify this practice as continuing to benefit the community through health promotion.[169] Legal cases in this area have dictated that hospital-physician joint ventures are possible if the purpose is to benefit the community, but are not appropriate in collaborations where they are just a way to allow the physicians to benefit from the non-profit partnership[170] hidden under a "joint venture cloak."[171]

Whereas historically hospitals were usually independent operations that served a specific local community, today the number of tax-exempt hospitals that operate as stand-alone organizations is, relatively, much less and many hospitals now are more often part of a multi-corporate healthcare system.[172] Tax-exempt hospitals are joining together with for-profit hospitals, usually large for-profit chains as partners in the current highly competitive healthcare market.[173] The non-profit, tax-exempt hospital has considerable tax advantages over the for-profits, which make it the preferred situation for most healthcare organizations.[174] Typically, not-for-profit hospitals and clinics and some not-for-profit insurers will be incorporated under state laws as "public benefit corporations." Public benefit corporations are organized as not-for-profits, that fall within section 501(c)(3) or 501(c)(4) of the Internal Revenue Code and are exempt from payment of federal income taxes.[175] In whole-entity joint ventures the tax-exempt entity contributes all or a substantial portion of its assets and operations to a joint venture in partnership with a for-profit entity that will contribute cash or assets.[176] This can result in greater

[163] Revenue Ruling 98-151998-1 C.B. 718.
[164] *Id* at, 163.
[165] *Id*.
[166] *Id*.
[167] See Cafardi *supra* note 9.
[168] *Id*.
[169] Griffith, G.M. Federal Law Update: Ancillary Joint Ventures after Redlands. (March 31, 1997) 1-44, 31. Retrieved from: https://www.honigman.com/media/site_files/174_imgimgGriffithB213287.pdf
[170] *Id.*
[171] I.R.S. Gen. Couns. Mem. 39863 (Nov. 22, 1991).
[172] *Id*.
[173] *Id*.
[174] *Id*.
[175] *Id.*
[176] See Woods & C Schroeder *supra* note 160.

efficiency of operations for the tax-exempt hospital. For the for-profit it is a way of "acquiring" the non-profit without actually purchasing it.[177] Revenue ruling 98-15 outlines the situations in which the IRS will allow this type of joint venture without jeopardizing the tax-exempt status of the non-profit hospital.[178] Such an entity is required to have: "majority hospital representation on the joint venture board; governing documents that require the board to satisfy the community benefit standard without regard to maximizing profitability; and joint venture management by an independent party."[179]

Complete sales of tax exempt hospital to for-profit organizations is becoming increasingly more common. Often the tax-exempt stand-alone hospital is losing money and can no longer survive in the competitive healthcare environment.[180] Conversions of a tax-exempt not-for-profit hospital to a non-exempt for-profit organization is a complicated situation. Issues arise because of the private inurement test which stipulates that "upon dissolution of a tax-exempt organization the profits must go to another tax-exempt organization".[181] Tax-exempt organizations that have used the profits from the sale of an exempt hospital to continue a community benefit such as operating a clinic or providing free healthcare funding can meet the requirement.[182] The sale must be for fair market value; otherwise, an impermissible private benefit has occurred and the proceeds from the sale must be used to continue the exempt purpose or else the operational test and the private inurement test are not met.[183] In Attorney General versus Hahnemann Hospital, the Hahnemann court added that charities may not amend their charter purposes to divert funds to new charitable purposes whenever the trustees decided to do so.[184] The tax-exempt purpose in any hospital joint venture arrangements must meet the private benefit and the private inurement tests, while satisfying the federal tax exemption and other legal and regulatory issues.[185]

Joint ventures almost invariably also raise significant legal issues with Anti-kickback laws, the Stark Law and Antitrust laws.[186] The transition must always be at arms-length, at market rates and in continuation of the hospital's exempt purpose. If these stipulations are not met they run the risk of intermediate sanctions or even losing their own tax-exempt status.[187] One of the most notable lessons learnt from joint ventures came from the court opinion in Redlands Surgical Services v Commissioner.[188] Redlands Surgical Services (RSS), a not-for-profit member corporation partnered with a for-profit business that operated a surgery center. RSS claimed it was entitled to tax-exempt status because its dealings with the for-profit partners had been at arms-length and because it had charitable goals.[189] The Internal Revenue Service denied tax-

[177] See Hyatt, T. K., & Hopkins *supra* note 51.
[178] 1998-1 C.B. 718
[179] See Woods & C Schroeder *supra* note 160 at 26.
[180] See Cafardi *supra* note 9.
[181] *Id,* 156.
[182] *Id*.
[183] *Id*.
[184] Attorney General v Hahnemann Hospital, 397 Mass.
[185] See Woods & C Schroeder *supra* note 160.
[186] *Id.*
[187] 26 U.S. Code § 4958 - Taxes on excess benefit transactions, Cafardi, 160
[188] Redlands Surgical Servs. v. Commissioner, 113 T.C. 47, 1999 U.S. Tax Ct. LEXIS 29, 113 T.C. No. 3 (T.C. July 19, 1999)
[189] *Id.*

exempt status, claiming that RSS had given up effective control over the operation of the surgery center to the for-profit partners and that this no longer supported its nonexempt purpose, and hence was benefitting private interests.[190]

VIII. Property Tax Exemption

Another benefit that not-for-profits that qualify for federal tax-exempt status receive is that they are nearly always exempt from paying property taxes in all 50 states.[191] Depending on the state, the power to issue a property-tax exemption is typically either granted to the legislature by that state's constitution, or mandated within the constitution itself.[192] The value of the exemption depends on the size and nature of the real estate that the not-for-profit owns.[193] Until recently, this charitable tax exemption had gone relatively unquestioned because of the perceived benefits that these not-for-profits provide to their local communities.[194] In response not-for-profit hospital chains have been making significant investments in facilities, property, plant and equipment, buying up property and businesses previously paying taxes and making them all exempt from taxation, which can be very costly for jurisdictions. "Property tax is the single largest component of local governments' own-source revenue."[195] Loss of potential property tax revenue from non-profit hospitals has been estimated at around $2 billion for local governments.[196] Proponents of the property tax exemption argue hospitals use these benefits to increase access to healthcare and, in particular, actually support healthcare for persons with publicly financed insurance like Medicare and Medicaid and indigent care.[197] However critics will suggest that this is no different than other companies such as Disney, which employs 74,000 people in Central Florida; has to absorb people's unpaid bills; spends a lot of money on new construction; and routinely provides substantial philanthropy; all while paying the largest tax bill in Orange County.[198] In these changing economic times state and local government agencies are beginning to revisit this benefit to not-for-profits and there is much debate as to whether it is still deserved or necessary.[199] Some states are requiring that non-profit tax-exempt hospitals meet additional metrics, independent of federal standards.[200] Three states, Pennsylvania, Texas and Utah have added wording to their statutes to define the standards that not-for-profits must meet to qualify for property tax exemption.[201] There have also been a number of notable cases where states have challenged the property tax exemption. In Provena Covenant Med. Ctr. v. Dep't of

[190] See Griffith *supra note* 171.

[191] Corcuera, D. (2013). Revisiting the Nonprofit Property-Tax Exemption: An Examination of the Need to Clarify Eligibility. Journal of Law and Commerce, 32(1), 154-172. At 155.

[192] *Id*.

[193] *Id*.

[194] Kassab, B. 4 Part Series: Beth Kassab writes about taxes for Central Florida's nonprofit hospitals. Part 2: *Do Central Florida's nonprofit hospitals give enough to earn their tax breaks?* February 1st, 2016. Retrieved from: http://www.orlandosentinel.com/opinion/os-hospital-tax-community-benefit-beth-kassab-20160201-column.html

[196] Calabrese T, Carroll D. *Nonprofit Exemptions and Homeowner Property Tax Burden*. Public Finance & Management [serial online]. March 2012;12(1):21-50. Available from: Business Source Complete, Ipswich, MA. Accessed June 8, 2017, 25.

[196] American Hospital Association. *AHA Hospital* Statistics, 2010 edition.

[197] *See* Calabrese *supra* note 196.

[198] *See* Kassab *supra* note 195, at Part 2.

[199] See Mason *supra* note 200.

[200] *Id*.

[201] *Id.*

Revenue, the Illinois Department of Revenue determined that Provena was not entitled to a property tax exemption for charitable organizations based on analysis of the actual amount of "charity" it provided to the community.[202] This put into question what constitutes "charitable use of property" owned by charitable organizations in particular hospitals. In January of 2016, in a case known as *Carle*,[203] the Illinois Fourth District Appellate Court held that the hospital property tax exemption was unconstitutional. It challenged the constitutionality of Section 15-86, the 2012 legislation addressing hospital property tax exemption.[204] The reasoning was that the statute allowed for a mandatory exemption because the use of the word "shall," "a hospital applicant satisfies conditions for an exemption...and *shall* be issued a charitable exemption for that property."[205] On December 22, 2016, in Oswald v. Hamer, the Illinois First District Appellate Court held that the property tax exemption provided by Section 15-86 was constitutional.[206] They reasoned that the exemption would "only be given to a property that is used primarily for charitable purposes and must be given on a discretionary basis."[207] Then in Carle Foundation v. Cunningham Township, March 23, 2017, the Illinois Supreme Court vacated the previous Carle decision on the grounds that the Appellate Court lacked jurisdiction, and remanded the case to the trial court for further proceedings.[208] This means that currently the First District Appellate District Court decision in the Oswald case, which upholds the constitutionality of Section 15-86, is now the controlling case in Illinois. However this leaves uncertainty surrounding the constitutionality of the Illinois property tax exemption for hospitals and this matter could well affect other jurisdictions across the U.S. It appears that it is really only a matter of time before changing litigation will affect property tax exemption.[209]

The removal of the property tax exemption has implications for hospitals and communities and will significantly impact their planning and budgeting in the future.[210] Because of the importance and financial implications of property taxes to local government finance, some governments are looking at ways to limit the amount of property tax exemption not-for-profit organizations receive.[211] As a way to recoup lost taxes governments are looking at "payments in lieu of taxes," (PILOTS). Currently these PILOT programs are not statutorily regulated and are voluntary.[212] Organizations typically agree to pay a percentage of the tax that they would normally pay if they were not tax exempt but, because these programs are voluntary, they are inconsistent and there are limits to what the local government can exert on the organization.[213] Negotiations are often tense, especially in times of economic stress, and tax-exempt organizations may also fear that PILOTS are an admission of lack of charitable exemption

[202] Provena Covenant Med. Ctr. v. Dep't of Revenue, 236 Ill. 2d 368, 925 N.E.2d 1131, 2010 Ill. LEXIS 289, 339 Ill. Dec. 10 (Ill. Mar. 18, 2010)

[204] Carle Found. v. Cunningham Twp., 2016 IL App (4th) 140795, 45 N.E.3d 1173, 2016 Ill. App. LEXIS 1, 399 Ill. Dec. 183

[204] 35 ILCS 200/15-86

[205] *Id.*

[206] Oswald v. Hamer, 2016 IL App (1st) 152691, 2016 Ill. App. LEXIS 880 (Ill. App. Ct. 1st Dist. Dec. 22, 2016)

[207] ILL. CONST. art. IX, § 6.

[208] See Carle Found. v. Cunningham *supra note* 204.

[209] *See* Mason *supra* note 200.

[210] *Id.*

[211] Daniella Corcuera. (2013). Revisiting the Nonprofit Property-Tax Exemption: An Examination of the Need to Clarify Eligibility. Journal of Law and Commerce, 32(1), 154-172.

[212] *Id*.

[213] *Id*.

purpose, and a potential threat to their federal tax-exempt status.[214] Local governments still provide services to not-for-profits even though they don't pay property taxes. This leaves homeowners and for-profit businesses footing the bill for benefits such as streetlights and law enforcement provided to the not-for-profits in their community.[215] Another option is to have them to pay for government services that would normally be paid from their property taxes such as, fire protection, sewerage and road maintenance.[216] Municipal service fees are collected for use of these services after an assessment is made to determine the amount of benefit the property is receiving from these services.[217] Different solutions such as these have had varying success. The biggest flaw of these programs is lack of enforcement because they are mostly voluntary.[218] States that use federal not-for-profit exempt status to determine property tax exemption need criteria to be consistently applied and monitored[219] One solution may be for state legislatures to pass a stricter definition of the qualifications for charitable property tax exemption, but a long-term solution would necessitate collaboration between the state legislature, the state court system, the local municipalities, and the non-profits themselves.[220]

IX. CONCLUSION

Not-for-profit hospitals organizations account for around 59 percent of total hospital organizations in the United States with 68 percent of Medicare beds located in those hospitals.[221] As of today there is no agreement among states, local government units, the federal government, or among national and state hospital trade associations on what not-for-profit hospital activities and programs should be counted as community benefits.[222] There also remains a lack of agreement on how a quantitative floor, or threshold test, could be applied by government in order to determine which tax exemptions should be granted in full, in part, or at all.[223] The IRS has admitted that the standard is imperfect, and Federal agencies and officials have questioned whether this voluntary and seemingly arbitrary system is in need of reform.[224] The main problem identified is a lack of standards, accountability and transparency all of which make it difficult to distinguish between hospitals that provide substantial community benefits from those that do not.[225]

The debate around not-for-profit tax-exemption focuses on the hospitals and the amount of benefits they really provide to the community to earn this exemption.[226] The Schedule H, Form 990 Return of Organization Exempt from Income Tax is a start. [227] It requests financial

---

[214] *Id*.
[215] *See* Calabrese *supra* note 196.
[216] *Id.*
[217] *See* Corcuera *supra* note 212.
[218] *Id*.
[219] *See* Mason *supra* note 200.
[220] *See* Corcuera *supra* note 212.
[221] See NHeLP *supra* note 5.
[222] See Hospital Tax Exemption *supra note* 80.
[223] *Id.*
[224] See NHeLP *supra* note 5.
[225] *Id.*at 5.
[226] *See* PriceWaterhouseCoopers *supra* note 27.
[228] Form 990, Return of Organization Exempt From Income Tax. Retrieved from: https://www.irs.gov/uac/about-form-990

information regarding community benefits, including charitable care, unreimbursed costs and Medicaid payments as well as community health improvement services costs, health professional's education, subsidized health services, research and cash in-kind contributions to community groups.[228] Not-for-profit hospital organizations must continue to satisfy the requirements to meet tax-exemption status because Federal and State tax-exemption needs to be viewed as a privilege and not an entitlement.[229] However, not-for-profit hospitals claim that these new requirements are, "onerous and redundant."[230] Critics counter that the provisions to meet the tests are, "liberally construed,"[231] and that the allowance of deductions on account of charitable contributions and the reduction of the rate of tax on capital gains are weighed in the taxpayer's favor.[232] Despite the expectation that there is an apparent quid pro quo between the forgone taxes and the community benefits, it appears that the gains for the not-for-profit outweigh the charity care being provided to support healthcare for those unable to pay.[233]

Healthcare reform and recent court cases are signifying that to qualify for non-profit tax exemption, more stringent requirements are necessary, and such requirements may be on the way.[234] Committee staff describe the community benefit standard as an administrative failure and, in particular, lacking at providing benefits to low-income families.[235] Legislatures need to provide more oversight and set minimum standards as to the amount of "community benefit" that a tax-exempt hospital needs to provide.[236]

"Hospital charity care is uniquely American and serves as a safety net that is unnecessary in nations that have universal health coverage."[237] As said by Judge Vito Bianco, a New Jersey Tax Court judge in Morristown, when denying a property-tax appeal of Morristown Memorial Hospital in his decision issued on June 25, 2015, "modern non-profit hospitals are essentially legal fictions."[238]

---

[229] 1RS Schedule H (Form 990), Hospitals (OMB No. 1545-0047) (2009), available at http://www.irs.gov/pub/irs-pdf/f990sh.pdf. (Schirra, 245)

[229] See Hyatt, T. K., & Hopkins *supra note* 51.

[230] Letter from Melinda Reid Hatton, Senior Vice President & Gen. Counsel, American Hospital Association to Sarah Hall Ingram, Commissioner, Internal Revenue Service, Tax-Exempt & Government Entities Division (Apr. 20, 2011).

[231] *Id*. at 24.

[232] Helvering v. Bliss 293 U.S. 144 (1934).

[233] See McGregor *supra note* 30.

[234] *See* Mason *supra* note 200.

[235] Staff of S. Comm. on FIN.—Minority, 110th Cong. Tax-Exempt Hospitals: Discussion Draft (Comm. Print 2007), 5. *available at* http://www.senate.gov/~finance/press/Gpress/2007/prg071907a.pdf

[236] *See* Kassab *supra* note 195, Part 4.

[237] *See* PriceWaterhouseCoopers *supra* note 27, at 1.

[238] AHS Hosp. Corp. v. Town of Morristown, 28 N.J. Tax 456, 2015 N.J. Tax LEXIS 12, 133.