Do Tax-Exempt Hospitals Have a Future?

What activities cause a hospital to qualify as exempt under Section 501(c)(3) of the Internal Revenue Code? The IRS last wrestled with this question in 1969, when it issued its landmark community benefit revenue ruling. However, as Congress, the IRS, and the media subject exempt organizations as a group to greater scrutiny, hospitals in particular are finding that fundamental questions are being asked about their exempt status.

The convergence of several factors has decreased the distinction between taxable and tax-exempt hospitals. As a result of the enactment of Medicare and Medicaid, the federal government now pays for a portion of the services that previously had been provided for free. As a part of good marketing practices, for-profit hospitals have added community wellness, screening, and testing programs of the type provided by exempt hospitals. As a result of the need to compete to attract patients and operate in a business-like fashion, exempt hospitals pay executive compensation that is comparable to amounts paid by for-profit hospitals.

Because of the similarities between the activities of exempt and taxable hospitals, discussions about exemption standards tend to focus on whether the requirements for exemption should be made more strict or whether the tax code should continue to provide hospitals with the ability to qualify for exemption at all. Over the last few years, and more recently as part of the debate over an overhaul of the health care system, Congress has focused on the status of tax-exempt hospitals. At a May 2009 American Bar Association Tax Section meeting, Ms. Theresa Pattara, an aide to Sen. Charles Grassley (R-Iowa), stated that Sen. Grassley, chairman of the Senate Finance Committee, is working on a proposal to impose more rigorous requirements on hospitals seeking tax-exempt status.

Community Benefit Standard – Then and Now

Under current law, a hospital seeking to qualify for exempt status under Section 501(c)(3) must, among other things, make its services available to all members of the community and provide sufficient “community benefits.” Prior to 1969, the IRS required exempt hospitals to satisfy a charity care standard, which required hospitals to provide health care at a free or reduced cost. After the implementation of the Medicare and Medicaid programs, however, the federal government paid for a large portion of the services that had previously been provided for free. This decrease in free services caused exempt hospitals to be concerned that they would not satisfy the charity care standard. In response to these concerns, the IRS created the community benefit standard, which was intended to provide hospitals with a more flexible test for qualifying for exemption.

As noted in the 2006 Congressional Budget Office report, “Nonprofit Hospitals and the Provision of Community Benefits,” commentators have broadly defined the community benefit standard as requiring a hospital to conduct “those programs and services that are generally thought to be provided at low or negative margin and are intended to improve access by disadvantaged groups or to address important health care matters for a defined
The IRS has developed slightly more specific explanations of the community benefit standard. For example, Revenue Ruling 69-545, which announced the community benefit standard, stated that a hospital will be treated as providing community benefits if it promotes the health of any broad class of persons by conducting activities such as charity care, health screening, community education about health risks, emergency room services and basic research. In Revenue Ruling 83-157, the IRS loosened the guidelines for exemption even further by providing that a hospital could obtain exempt status even if it did not operate an emergency room. Since 1969, the community benefit standard has been discussed and applied to various situations in numerous IRS rulings and court opinions. In 2003 in IHC Health Plans, Inc. v. Commissioner, for example, the U.S. Court of Appeals for the 10th Circuit held that for a hospital to qualify for exemption under Section 501(c)(3) it must make its services available to everyone in the community “plus provide additional community or public benefits.” 325 F.3d 1188, 1198 (10th Cir. 2003) (emphasis in original). Further, the public benefit provided “must be sufficient to give rise to a strong inference that the organization operates primarily for the purpose of benefitting the community.” As noted by the 10th Circuit in this decision, courts find the following factors and activities relevant in analyzing whether a hospital or health-care provider operates primarily for the purpose of benefitting the community: (1) the size of the class it benefits, (2) the amount of free or below-cost products or services provided, (3) the number of persons treated who participate in government programs such as Medicare or Medicaid, (4) the use of surplus funds for education or research programs, and (5) a board of trustees reflecting the community to be benefited.

In the years since the community benefit standard was articulated in 1969, for-profit hospitals have continuously increased their provision of the type of services that form the basis of the community benefit standard. Due to the growing convergence of services provided by exempt and for-profit hospitals, Congress, the IRS and many commentators have begun to question whether the community benefit standard remains the appropriate test for granting tax-exemption to hospitals. For example, during 2003 the community benefit standard was the subject of joint hearings held by the U.S. Federal Trade Commission and the U.S. Department of Justice on whether nonprofit hospitals provided a discernibly different level or quality of community benefit when compared with for-profit hospitals. Similarly, the 2006 Congressional Budget Office report on the community benefit standard noted that, “there is little consensus on what constitutes a community benefit or how to measure community benefits.”

Congressional and Agency Actions

Sen. Grassley has been a vocal critic of exempt hospitals over the past few years and is leading the attempt to impose more severe restrictions and quantifiable measurements to obtain exempt status. Suggested among the many alternatives being considered, Congress is currently examining whether, and the extent to which, hospitals should retain their exemptions. On July 10, 2009, the Wall Street Journal reported that changes being suggested by Sens. Grassley and Max Baucus (D-Mont.) would require hospitals to offer a minimum amount of charity care, to limit charges to the uninsured, and to soften their collection practices.

In addition to the attention paid by Congress, a major focus of the exempt organization branch of the IRS over the last few years is the exempt status of hospitals. This focus arises in many different arenas. In conjunction with the newly released Form 990, for example, the IRS promulgated a separate schedule to be completed by hospitals. Schedule H requires a hospital to list the amount and type of its charity care, the amount of its community health improvements benefits, the guidelines that it follows to determine eligibility for providing free care to low-income persons, and significant other information about its community building activities, bad debt expenses, and collection practices. On account of the breadth of the new information required by Schedule H, completion of most of the Form 990 schedules was deferred until 2009.

Another aspect of the IRS’s concentration on health care organizations is the IRS’s recent study that focused on the executive compensation and community benefit of exempt hospitals. Its study culminated in a widely read report the IRS released in February 2009. Ronald J. Schultz, senior technical adviser to the Commissioner, Tax-Exempt and Government Entities Division, spoke recently about the hospital study. He said that the study is relevant to whether the IRS should continue to use the current facts and circumstances exemption standard or whether it should switch to a “bright-line” standard presumably based on the amount of free or low-cost services provided as a percentage of total services.
What Does It Mean For Tax-Exempt Hospitals?

It is impossible to predict the outcome of the spotlight being aimed at tax-exempt hospitals. The final result may hinge on the form of health care reform that is enacted. If every person receives subsidized health care from the government, the type of services that could be offered by an exempt hospital to satisfy the community benefit standard would need to be altered. Even if no program of this type is implemented, the IRS and some segments of Congress have expressed a desire to make changes, ranging from eliminating the exemption, requiring some mandated level of charity care, or moving to another type of facts and circumstances test. However, whether an agreement on the form of such change can be reached remains to be seen.

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HUD Notice Provides Relief for Hospital Borrowers

In its Notice H 09-05, issued July 1, 2009, the U.S. Department of Housing and Urban Development (HUD) announced an expansion of its Federal Housing Administration (FHA) hospital mortgage insurance program that may make it easier for non-profit hospitals to refinance tax-exempt debt on which the interest rate has, in some cases, risen dramatically as a result of problems in the credit markets.

Background

Non-profit hospitals qualified under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (Code), generally may have tax-exempt “qualified 501(c)(3) bonds” issued on their behalf by so-called “conduit issuers” (generally, governmental entities and qualified “authorities”). The issuer issues the bonds and loans the proceeds to the hospital, which, through its loan repayments to the issuer, effectively pays the debt service on the bonds. As the “true” borrower, the 501(c)(3) hospital enjoys the benefits of the relatively low rate of tax-exempt interest on the qualified 501(c)(3) bonds.

A common type of qualified 501(c)(3) bond issue in recent years has been variable rate demand bonds or some other form of variable rate debt, such as auction rate bonds. These bonds are designed to act as short-term debt, in that the interest rate is periodically reset – commonly, every seven days – the theory being to reduce the interest burden on the 501(c)(3) borrower. The variable rate obligations typically are backed by a variety of insurance and liquidity facility arrangements (credit enhancement). However, the recent turmoil in the credit markets adversely affected the financial strength of many credit enhancers, which has had the effect in numerous cases of dramatically driving up the interest rate on the variable rate obligations backed by those credit enhancers. The higher interest cost is borne by the 501(c)(3) borrowers.

HUD Notice

Generally, qualified 501(c)(3) bonds may not be federally guaranteed. However, there is an exception in the Code for a guarantee by the FHA.

FHA will exercise its authority to insure hospital debt used 100 percent to refinance existing “capital” debt. In some cases, this may permit a 501(c)(3) hospital to refinance high-interest tax-exempt debt with lower-interest tax-exempt debt backed by the federal government.
Until the issuance of the Notice, FHA would insure the debt, including qualified 501(c)(3) bonds, of certain qualified hospitals, but only if, among other requirements, at least 20 percent of the loan proceeds were spent on new construction or renovation and equipment. Now, pursuant to the Notice, FHA will exercise its authority under Sections 242 and 223(f) of the National Housing Act to insure hospital debt used 100 percent to refinance existing “capital” debt. In some cases, this may permit a 501(c)(3) hospital to refinance high-interest tax-exempt debt with lower-interest tax-exempt debt backed by the federal government.

To qualify for FHA insurance of 100 percent refinancing debt, the 501(c)(3) hospital must meet more stringent financial tests, including an aggregate operating margin of at least 0.33 percent and an average debt service coverage ratio of at least 1.8 for the last three years. Also, the hospital must show that the interest rate on its debt has increased by at least 1 percent since January 1, 2008, as a result of the credit crisis, or must show that such an increase is about to happen. In general, the maximum amount of the insured refinancing debt may not exceed the amount required to pay off the prior debt plus reasonable and customary legal, organization, title and recording expenses, and professional and inspection fees.

HUD has requested comment on the implementation of FHA's refinancing insurance authority as presented in the Notice, with a view toward adoption of final regulations. Such regulations, when published and effective, will supersede the Notice.

Conclusion

Borrowers experiencing or about to experience increased borrowing expenses due to the downgrading of credit supports should consider the new program announced in the Notice. Pepper finance attorneys can assist in determining the suitability of such an approach.

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WEBINAR: Final Breach Notification Provisions of the HITECH Act - The Compliance Countdown Begins!

Tuesday, August 25, 2009
2:00 - 3:00 P.M. Eastern

Included in the ARRA is the HITECH Act, a law supporting the development of a nationwide health information technology infrastructure for the use and exchange of health information for patient care.

On Wednesday, August 19, 2009, the U.S. Department of Health and Human Services issued the Breach Notification Rules. Entities covered under the HITECH Act have 30 days after publication in the Federal Register before the security breach notification requirements go into effect. Are you ready? Do you have a breach notification policy and procedures that comply with the HITECH Act?

Join Pepper partners Sharon R. Klein and M. Peter Adler as they discuss the final breach notification provisions and provide guidance on what organizations need to do to comply with them over the 30 day window to avoid fines and other penalties in the event of a breach.

Register online for Pepper's complimentary webinar at https://www.regonline.com/HITECH_Act.