

GREAT BOARDS

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Tax-exempt status: Next battleground for non-profits?

By Barry S. Bader

“Why is it we’re providing these huge tax subsidies to these organizations?”

John Colombo, professor of law at the University of Illinois at Urbana-Champaign

Taking your hospital’s tax exemption for granted could be risky. Local taxing authorities, the Internal Revenue Service, Congress and some state attorneys general are raising tough questions about whether hospitals and other not-for-profit organizations are meeting the obligations that come with a tax exemption.

The current wave of class action lawsuits challenging charity care policies at some 400 hospitals is adding fuel to the fire and triggering media attention. The New York Times opened a major story with this statement: “Nonprofit hospitals with tax exemptions for serving the poor are quietly charging indigent patients and even suing over unpaid bills. How did an arrangement to serve the poor become so unhealthy?”

Challenges on Multiple Fronts

News stories like that provoke the ire of hospital leaders straining to meet their mission and fulfill unfunded mandates with limited financial resources. In fact, the same governments that criticize hospital charity care policies are increasing hospitals’ charity care burden by reducing provider payments.

Nonetheless, the reality is that the tax status of not-for-profit hospitals is undergoing challenges from multiple quarters, including:

Local tax authorities. Financially strapped local governments in search of tax revenues have challenged the local property tax exemption of some hospitals and their subsidiaries in Pennsylvania, Massachusetts, Utah and Illinois. Some hospitals make contributions to local governments in lieu of tax payments.

Elsewhere, hospitals have staved off tax authorities in return for community benefit laws. A Texas law requires hospitals to devote a specific percentage of hospital revenues to charity care and other community benefits. Hospital boards in New York must file Community Service Plans every three years and an implementation plan annually. Indiana requires annual reporting of community benefits, and Massachusetts and Missouri have voluntary reporting programs.

State government. In Minnesota, Attorney General Mike Hatch has targeted three large health systems over their executive compensation practices. The latest investigation, of Fairview Health Services, broadened the inquiry to include Fairview’s billing and charity care policies.

Internal Revenue Service. “We will

Tools of the Trade

Tool for Documenting Community Benefit

Documenting what a hospital does to benefit the community is a complex undertaking. In 2004, VHA, the Catholic Health Association of the United States and Lyon Software collaborated to create standardized community benefit categories, definitions and reporting guidelines in an effort to standardized an approach for not-for-profit health care organizations.

A free copy of a 44-page document, *Community Benefit Reporting: Guidelines and Standard Definitions for the Community Benefit Inventory for Social Accountability*, can be downloaded from The Catholic Health Association Web site at www.chausa.org. Complementary software is available from Lyons Software at www.lyonsoftware.com.

discourage and deter non-compliance within tax-exempt and government entities,” Mark W. Everson, an IRS commissioner, said in a speech at the National Press Club in March 2004. “Non-compliance involving tax-exempt entities is especially disturbing because it involves organizations that are supposed to be carrying out some special or beneficial public purpose.”

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involving exempt organizations, the IRS has launched a major study of executive compensation practices in not-for-profit organizations. Some 2,000 organizations are being contacted, including many hospitals and health systems. Some will have routine compliance checks, but others can expect more detailed examinations and penalties if “excess benefit transactions” or other violations are found.

“If we don’t act to guarantee the integrity of our charities, there is a risk that Americans will lose faith in [them] and reduce their support.”

Mark W. Everson, commissioner of Internal Revenue

RS also has broadened the information it requests on its Form 1023, the application for tax-exempt status, and the Form 990, the annual disclosure form a non-profit must file. A comprehensive revision of the Form 990 is underway, with the expectation that disclosure requirements will be expanded and enforcement strengthened. Although an IRS spokesperson wouldn’t comment because no decisions have been made, the agency is considering expanding the number of individuals whose compensation is disclosed, the methods by which compensation is set, and the organization’s conflict-of-interest policies and implementation.

House Ways and Means Committee. Following up on hearings last year, the Subcommittee on

Oversight plans more work on “the appropriate role of tax-exempt organizations,” according to the committee’s work plan for 2005. Last year, Nancy Kane, a Harvard professor and national expert on tax exemption, told the oversight subcommittee, “The quantifiable value of hospital tax exemptions greatly exceeds the average cost of charity care provided.” She cited research from 1995 showing that 75 percent of hospitals enjoyed tax benefits in excess of the average cost (not charges) of the charity care they provided.

Ways and Means Chairman Rep. William M. Thomas, R-Calif., has suggested that the basis upon which the government first determined to grant tax-exempt status to hospitals may no longer exist, as non-profits emulate their commercial competitors. Thomas grilled several hospital executives about their compensation and charity care practices. Signaling possible legislation, he said, “We might be more specific in outlining responsibilities or duties of [not-for-profit] institutions.” (To review the hearing testimony, go to <http://waysandmeans.house.gov/hearings.asp?comm=3>.)

Senate Finance Committee. Hearings are also likely on the Senate side. Independent Sector, a coalition group of organizations interested in philanthropy, is leading a study requested by the committee on ways to “strengthen governance, ethical conduct and accountability” of charitable organizations. In its interim report issued in March (available at www.independentsector.org), the study’s panel offered 14 recommendations reminiscent of the Sarbanes Oxley Act, including:

Business Note

Why Hospitals Look More Commercial

“There’s been pressure on hospitals since the 1980s over healthcare costs to conduct themselves in more businesslike ways and be more efficient,” explains AHA’s Rick Wade. “So hospitals began to use more business management techniques. Marketing and advertising came into the hospital field, which they hadn’t indulged in before.”

It was all done “in the belief that more business-like behavior contains costs and increases choices.”

Mergers and consolidations also made small, hometown hospitals look like big businesses.

“Although hospitals didn’t change what they did for the community all that much, in some places they looked very corporate,” says Wade. As a result, many people found it harder to distinguish them from competitors who didn’t provide much in the way of community benefit.

◆ **Attestation.** CEOs and CFOs should be required to sign, under penalties of perjury, the annual disclosure (Form 990) of a not-for-profit organization’s finances, governance, operations and programs.

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◆ **Disclosure.** Audited financial statements should be submitted to IRS with the Form 990.

◆ **Conflict of interest.** Non-profits should be required to adopt and enforce a conflict-of-interest policy consistent with several model policies to be included in the panel's final report.

◆ **Financial literacy.** Non-profit boards should include some members with financial literacy and should consider having a separate audit committee.

◆ **Organizational ethics.** Non-profits should establish policies and mechanisms to encourage staff to report wrong-doing and safeguard them from retaliation.

*"Governance
drives everything."
Susan Doria,
Banner Health*

Case in Point: Provena

In 2004, the Illinois Department of Revenue denied tax-exempt status for Provena Covenant hospital in Urbana. Provena paid \$1.1 million in property taxes as a result of the decision, which is under appeal to the state.

Why did a state review board fault Provena, a Catholic hospital whose core values include "stewardship," which it defines as, "We use our human and economic resources responsibly with a special concern for the poor and vulnerable?"

Picking up on charges leveled by a local consumer advocacy group, the agency claimed the hospital was in

many respects functioning like a commercial enterprise and therefore didn't merit special treatment. To hospital professionals, the allegations reflected a lack of understanding of how hospitals work. For example:

- The review board said much of the area inside of the hospital is used by outside, for-profit entities, such as physician contract groups for hospital-based services.

- Relying on the Illinois property tax code and existing case law, especially a 1968 case involving a nursing home, the board said a non-profit was not allowed to have capital. Since Provena had \$327 million in assets, it was ineligible for an exemption, the agency claimed.

- It also said a non-profit had to provide charity care to all who needed and applied for it. Because patients were suing Provena as part of a nationwide, charity care class action, and because Provena was pursuing aggressive collection efforts, the taxing authority concluded it wasn't providing charity care to everyone.

- Provena's Community Benefits Report didn't distinguish bad debt from true charity care and other community benefits, the board said.

- Finally, the board alleged that some of the hospital's operating margins were used to support Provena Ventures, a for-profit affiliate.

Even if Provena prevails on appeal at the state level (and William Foley, CEO of parent Provena Health, is hopeful, saying the hospital "made a strong case"), other organizations can learn from Provena's experience. The

local tax board's arguments frame the case that other jurisdictions may use to attack a hospital's tax exemption. The allegations reflect a combination of two factors: a lack of understanding of how hospitals work and a failure on Provena's part to clearly document and communicate its operations and the community benefits it provides.

For example, Foley explains that the review board said because Provena contracts with for-profit entities, namely physician groups, for such services as laboratory, radiology, anesthesiology and emergency medicine, it was like any other "business with for-profit activities. Our contention is that all hospitals outsource because it's more efficient, less costly and better for patients, and outsourcing doesn't address what we do for community benefit."

In saying a not-for-profit couldn't amass capital, the tax agency ignored the legitimate needs of any organization and particularly a hospital to invest in new equipment and facilities to meet community needs and provide up-to-date technology for patients.

All hospitals are paying more attention to collecting delinquent accounts as a matter of economic necessity, but the review board said Provena's collection practices looked more like a business strong-arming tardy payers than a charity providing public benefit.

Lessons Learned

What has Provena learned? "Philosophically we're not doing anything differently," says Foley. "Community benefit is part of our

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10 Board Strategies

1. Measure the *total* amount of community benefit services the hospital provides, not just charity care.

2. Compare the hospital's total community benefit to the value of its tax exemption—and respond accordingly.

3. Help to educate opinion leaders about how hospitals really work. Explain why outsourcing some services to efficient, for-profit firms is appropriate stewardship of community dollars.

4. Be sure the hospital communicates its good works to community leaders, donors, government officials, regulators and the public.

5. Make sure the hospital's charity care policy and collection procedures conform to the organization's core values, mission and legal obligations. AHA's model charity care policy is a good starting point.

6. Be sure the hospital is effectively communicating its charity care policy to the community.

7. Monitor the implementation of the charity care policy.

8. Clean up patient bills so patients and their families can understand them.

9. Consider making contributions to other organizations that promote community health or serve needy populations.

10. At least once a year, devote a significant amount of time at a board meeting to discussion of community benefit activities.

mission.” But tactically, Provena has made significant changes.

“We’ve tightened up our billing and collection policies and practices,” adds Meghan Kieffer, system vice president and general counsel. “We have a specific policy on collection guidelines. The local hospital CFO has to be consulted and sign off before a case goes to litigation.”

Just as important, Provena has gone back to school on communicating with the public. “Hospitals generally don’t do a good job telling our story,” says Foley. “We are always reacting. Now, we’re doing a better job defining and documenting our community benefit.”

Today, Provena’s financial assistance policy and instructions on how to apply for aid are readily found on its Web site. Provena runs newspaper ads stressing its commitment to the poor and the underserved. Posters and brochures

appear all over the hospital trumpeting the charity care policy.

“We thought we were doing a good job before at communicating the availability of financial assistance—but now the public is more aware of what we do,” says Foley. Provena reports it’s documenting more charity

“Hospitals generally don’t do a good job telling our story.”

*William Foley, CEO,
Provena Health*

care in its hospitals now, “probably as a result of heightening public awareness.”

At both board and management levels, Provena is “tracking community benefit more than before,” says Kieffer. “The board is very aware of the financial assistance policy. They’ve

had education on community benefit, and the manager of community benefit, a new position, has made a formal presentation to the board. The board’s Stewardship Committee, which oversees finances and human resources, and, in turn, the full board review a detailed report of community benefit across the system, and they compare those expenditures with the value of Provena’s tax exemption.

“We do more than we get back as a tax benefit,” Foley says, and now the numbers demonstrate that more clearly. Provena uses the Catholic Health Association’s social accountability budget as a measurement.

“If hospitals would work with their communities the way Provena is working with us, hospitals would not have to fear challenges to their tax-exempt status or class-action lawsuits,” Claudia Lennhoff of the Campaign

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County Health Care Consumers group told USA Today. Provena is now a model for the industry, she says.

Blip or Major Force?

Are the challenges to tax exemption—from local authorities, attorneys general, IRS and Congress—a short-term spike in regulatory oversight, or are they part of a larger trend toward greater accountability?

“This is part of a larger trend,” says Foley. “Look at the intensity and frequency of what’s going on. It’s coming from all sides.”

Kieffer adds: “Tax exemption is what keeps me up at night. It won’t go away quietly. Just as happened with Columbia/HCA and corporate compliance, some not-for-profits have abused their tax exemption, and it’s costing the rest of us. It’s become a huge issue. It’s taking staff resources and money for legal fees away from patient care.” She counsels other not-for-profits: “You need to really pay attention to this. Don’t take

tax exemption for granted. Provena didn’t do anything wrong, but you have to change your documentation style and how you do business. Healthcare is a big business from the average citizen’s viewpoint. To the public, healthcare looks like a commercial enterprise.”

Rick Wade, senior vice president for strategic communications at the American Hospital Association, agrees.

“Tax exemption will be an area of continued attention for the foreseeable future,” he says. “Even if it dies down at the federal level, we will see pockets of activity around the country, especially driven by the financial needs of local governments.”

Wade contends hospitals should be judged not on whether they’re big or advertise or compete, but on whether their behavior benefits the community. “What is the organization’s performance in terms of its charity care and other forms of

community benefit that no one else would do because they’re not profitable? That is what makes a case for special treatment.

“There’s a whole movement toward greater accountability, with Sarbanes Oxley on the corporate side, and it’s appropriate that hospitals are part of that,” concludes Wade. “Boards are going to be compelled to compare community benefit against the value of their tax exemption because people in the community are going to do that.”GB

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