Tax-Exempt Health Care Issues—2001

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This article provides a summary and update of a number of issues relative to tax-exempt health care issues that relate to the health care industry. During the 2001 tax year, the Internal Revenue Service ("IRS") and the courts have issued important guidelines with respect to a wide variety of health care-related tax-exempt issues. This article reviews many such issues related to hospital tax-exempt matters, joint venture transactions, and general operational issues with respect to both. It also discusses several other issues.

It appears that the IRS' analysis in Rev. Rul. 98-151 continues to be the seminal authority with respect to joint ventures that include a tax-exempt entity partner. The Ninth Circuit's ruling in the appeal of the Redlands case2 seems to underscore the continued relevance of Rev. Rul. 98-15. Unfortunately, neither the IRS nor the courts has discussed additional fact patterns that would be either acceptable or unacceptable in structuring joint ventures that include a tax-exempt entity partner.

In the past year, however, the IRS has taken the opportunity to stress that tax-exempt status will not be granted as a matter of right. Rather, it appears that the IRS may soon require entities to document charitable care services provided to the community in order to demonstrate their charitable purposes. Additionally, there is a greater emphasis on requiring entities to prove that they benefit the community at large and not a specific group of entities or individuals. Finally, state courts throughout the country continue to rule that, with respect to property taxes, the manner through which tax-exempt entities are operated will continue to be a determinative factor as to whether property taxes will be levied on those entities.

The IRS and federal courts, with regard to exemption issues, have also reviewed the tax-exempt status of an HMO, and whether a management company could be found to be serving charitable purposes. Additionally, the Joint Committee on Taxation has made recommendations regarding tax-exempt bond issues by health care systems.

Hospital Tax-Exempt, Joint Venture, and Operational Issues

Indigent Care Policies

In Field Service Advice 2001100303 issued on March 9, 2001, the IRS provided that, in order to maintain tax-exempt status, a hospital should

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demonstrate that it actually provides significant health care services to indigents in addition to the hospital's stated policy of providing such services.

Relying on Rev. Rul. 69-545, the Chief Counsel's Office stated that a hospital's provision of health care services to indigents is a significant indicator that the hospital promotes health for the community's benefit. As such, the Chief Counsel's Office reasoned that such policy, by itself, is not sufficient to satisfy the charity care requirement of the "community benefit" test under the "operational test" of Section 501(c)(3) of the Internal Revenue Code (the "Code"), unless the hospital also shows that the policy actually results in the delivery of significant health care services to indigents.

Field Service Advice 200110030 is consistent with case law and other pronouncements by the IRS that tax exemption must be earned and will not be given as a matter of right. However, Field Service Advice 200110030 seems to be an indication that the IRS is broadening the community benefit standard for tax-exempt hospitals that was established in Rev. Rul. 69-545.

Accordingly, hospital managers and administrators may soon be required and should be encouraged to document specifics with respect to charitable activities. Many hospitals currently track charitable services in detail, including maintaining statistics on charity care, bad debts, in-kind services, and other community benefit programs. This concept of tracking charitable services should also be employed in joint ventures that include tax-exempt partners or members.

**COMMUNITY BENEFIT TEST UNDER 2002 CPE**

On October 3, 2001, the IRS released its annual exemption organization continuing professional education text for fiscal year 2002 (the "2002 CPE"). The 2002 CPE emphasizes that a health care provider must satisfy the community benefit standard to qualify for exemption under Section 501(c)(3) of the Code. The 2002 CPE further indicates that a health care provider may meet this test by meeting some of the significant factors set forth in Rev. Rul. 69-545. These factors are intended to gauge whether an organization promotes the health of a broad class of persons sufficient to benefit the whole community.

The manual provides that treating Medicare and Medicaid patients and using surplus revenue to improve facilities, for example, could represent sufficient community benefits to justify tax exemption. With respect to hospitals, the 2002 CPE manual provides that

[a] hospital must establish the presence of significant factors demonstrating that it promotes the health of a class of persons that is broad enough so that the community as a whole benefits....[a]s long as a health care provider can establish the presence of these significant factors, it is not required that the provider establish the presence of all the factors.
As discussed in the 2002 CPE, set forth below are a series of questions to address when developing the factual record on the charitable care policies and activities of a hospital:

1. Does the hospital have a specific, written plan or policy to provide free or low-cost health care services to the poor or indigent?
2. Under what circumstances may, or has, the hospital deviated from its stated policies on providing free or low-cost health care services to the poor or indigent?
3. Does the hospital broadcast the terms and conditions of its charity care policy to the public?
4. Does the hospital maintain and operate a full-time emergency room open to all persons regardless of their ability to pay?
5. What directives or instructions does the hospital provide to ambulance services about bringing poor or indigent patients to its emergency room?
6. What inpatient, outpatient, and diagnostic services does the hospital actually provide to the poor or indigent for free or for reduced charges?
7. Under what circumstances does the hospital deny health care services to the poor or indigent?
8. Does the hospital operate with the expectation of receiving full payment from all persons to whom it renders services?
9. How and when does the hospital ascertain whether a patient will be able to pay for the hospital’s services?
10. What documents or agreements does the hospital require poor or indigent patients to sign before receiving care?
11. What is the hospital’s policy on admitting poor or indigent patients as inpatients and outpatients?
12. Under what circumstances does the hospital refer poor or indigent individuals who require services to other hospitals in the area that do admit poor or indigent patients?
13. Does the hospital maintain separate and detailed records about the number of times, and circumstances under which, it actually provided free or reduced-cost care to the poor or indigent?
14. Does the hospital maintain a separate account on its books that segregates the costs of providing free or reduced-cost care to the poor or indigent? Does this account include any other items, such as write-offs for care to patients who were not poor or indigent?

HOSPITAL JOINT VENTURES

On March 15, 2001, the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court’s ruling in Redlands Surgical Services v. C.I.R.,8 that a subsidiary of a tax-exempt health system did not qualify as a tax-exempt entity.
In Redlands, the U.S. Tax Court upheld the IRS’ denial of tax-exempt status for a health system entity’s nonprofit subsidiary that participated in an ambulatory surgery center joint venture. Specifically, the health system entity’s tax-exempt subsidiary, together with a for-profit corporation, became a co-general partner in a general partnership formed to acquire a majority interest in an existing outpatient surgical center in Redlands, California. There, the Redlands court emphasized that the denial of tax-exempt status was justified because: (i) the tax-exempt entity did not have sufficient control over the joint venture and its operations to assure that its income and assets would be used to carry out the tax-exempt entity’s charitable purposes; (ii) the tax-exempt entity failed to adequately show that the venture was operated exclusively for charitable purposes; and (iii) the tax-exempt entity was restricted in its future ability to provide outpatient services in its own facility and otherwise without the approval of its for-profit partner.9

In essence, the Redlands case affirms the IRS’ negative view of joint ventures where (i) the tax-exempt entity cedes substantially all management authority to third parties; (ii) the joint venture does not purport to serve community purposes such as by serving indigent patients and does not actually serve such community and indigent populations; (iii) the tax-exempt entity retains minimal management reserve powers; and (iv) the tax-exempt entity disproportionally accepts risk for the venture.10

On March 15, 2001, the Ninth Circuit issued its ruling in a one-paragraph opinion that stated that the arrangement in Redlands conferred impermissible private benefit, and thus did not serve the entity’s charitable purposes as required by Section 501(c)(3) of the Code. While awaiting judicial guidance with respect to Redlands, the IRS has generally not provided significant guidance with respect to joint ventures. Since the Ninth Circuit Court’s decision does not provide additional guidance with respect to joint ventures, Rev. Rul. 98-15,11 which formed the basis of the decision in Redlands, appears to be the controlling guidance on this issue.

**Property Taxes**

**Charitable Function Must Benefit Broad Population**

In *Western Massachusetts Lifecare Corporation v. Board of Assessors of Springfield*,12 the Supreme Court of Massachusetts held that Western Massachusetts Lifecare Corporation (“Western”) was not entitled to the charitable exemption under Massachusetts law for property that it leased and that Western had failed to carry its burden of establishing over-valuation.13

By way of background, Western is exempt from federal income tax as an organization classified under Section 501(c)(3) of the Code. In 1990, Western entered into a long-term ground lease for property belonging to Springfield College, which is also a non-profit corporation under Massachusetts law. Under the lease,
Western was responsible for all real estate taxes. Western constructed a continuing care retirement community on the property (the "Facility").

The Facility provided housing and services to elderly residents. Applicants who sought admission to the Facility were required to demonstrate that they have the financial ability to pay both the entrance fees and the monthly service fees. The initial entrance fees to the facility ranged from $100,200 to $230,500. Also, monthly service fees ranged from $1,032 to $2,050 a month. Western did not provide health care to residents of the Facility.

Based on these facts, the court opined that "[t]he mere fact that the organization claiming exemption has been organized as a charitable organization does not automatically mean that it is entitled to an exemption for its property." The court further stated that "[t]he organization must prove that it is in fact so conducted and that in actual operation it is a public charity."

While the court recognized the provision of housing as a charitable purpose, the court stated that

the persons who are to benefit must be "of a sufficiently large or indefinite class so that the community is benefited by its operations." An organization "operated primarily for the benefit of a limited class of persons," such that "the public at large benefits only incidentally from [its] activities," is not charitable. While there is no "precise number" of persons who must be served in order for an organization to claim charitable status, and "any given moment an organization may serve only a relatively small number of persons," membership in the class served must be "fluid" and must be "drawn from a large segment of society or all walks of life." Thus, selection requirements, financial or otherwise, that limit the potential beneficiaries of a purported charity will defeat the claim for exemption.

**DOCUMENTATION OF CHARITABLE PURPOSES**

In *ProMed Healthcare v. City of Kalamazoo*, ProMed Healthcare ("ProMed") appealed a Tax Tribunal order denying its request for tax-exempt status concerning ad valorem taxation on its personal property by the City of Kalamazoo. The Tax Tribunal ruled that ProMed failed to qualify for exemption because ProMed had failed to document the amount of charity services that it provided to members of the public.

The court agreed with the Tax Tribunal that ProMed failed to carry its burden of proving entitlement to the claimed tax exemption. The court stated that:

it appears from the record that ProMed operates a fairly typical family medical practice, where patients are expected to pay for medical care received, either through private or governmental insurance programs. Although ProMed claims that it provides some medical care to indigent patients without charge, ProMed failed to provide any documentation regarding such services. If we were to accept ProMed's argument and reverse the Tax Tribunal's ruling in the present case, we
would in effect be granting tax-exempt status to every doctor’s office in the state, as well as every organization offering health-related services, as long as those organizations are structured as non-profit corporations and maintain policies of offering some “appropriate” level of charity medical care to indigent persons.²⁸

LEASE OF HOSPITAL FACILITY

In Richmond Memorial Hospital v. City of Richmond,²¹ the court examined the issue of whether Richmond Memorial Hospital (“RMH”) was exempt from property taxes imposed by the City of Richmond. RMH is a tax-exempt entity that operates a hospital in Richmond, Virginia and owns the property at issue. In 1996, the Health Corporation of Virginia, a parent organization of RMH, entered into a joint venture with another hospital chain to operate RMH as a non-profit hospital. As part of the joint venture, RMH leased all of its assets, real and personal, tangible and intangible, to RHS Service Corporation (“RHS”).

The city maintained that by leasing its assets to the joint venture, RMH no longer used and occupied the property as a hospital because its sole position after the lease was that of lessor.²² Accordingly, the issue presented to the court was whether the property owned by one charitable corporation and leased to another charitable corporation is exempt from real estate taxes.

In determining this issue, the court stated that “[i]t is the use to which the property is put that determines whether the property shall be exempt.”²³ Here, the court determined that “it is abundantly clear and uncontraverted that the property is occupied by and used for hospital operations even though the actual use is by RHS Service Corporation, RMH’s lessee.”²⁴ However, the court further stated that, notwithstanding eligibility for exemption, “Virginia Code § 58.1-3603 serves to lift that eligibility if the property in question is a source of revenue or profit.”²⁵ However, to be taxable “the lease must generate a substantial net revenue or profit before the exemption is forfeited.”²⁶ Having found that the lease at issue did not provide substantial profit to the lessor, the court determined that RMH is entitled to tax exemption for the property.

SALES TAX

In Wilson’s Total Fitness Center, Inc. v. Director of Revenue,²⁷ a health club argued that the “primarily purpose of its facility was the improvement of health and fitness through exercise.”²⁸ As such, the health club claimed its membership fees were exempt from sales tax under Mo. Rev. Stat. §144.020.1(2) (1994), which imposes such taxes on fees paid to any place of amusement, entertainment or recreation. The Administrative Hearing Commission of the Missouri Director of Revenue disagreed with the health club and found that the “primary purpose of the health club’s facility was recreation.”²⁹
In reaching its decision in the Wilson case, the Missouri Supreme Court overruled its prior decision in Columbia Athletic Club v. Director of Revenue, whereby the primary purpose of a health facility was based on a facts and circumstances test to determine whether the purpose of the health facility was the improvement of health or recreation. In overruling Columbia Athletic, the Missouri Supreme Court stated that "the fine line between exercise that is primarily focused on health benefits and exercise that is primarily focused on recreation simply cannot be distinguished in a meaningful and consistent manner." Accordingly, the court held that the de minimus test previously set out in Spudich v. Director of Revenue is reinstated. Under the de minimus test, athletic and exercise or fitness clubs are places of recreation for purposes of §144.020.1(2), and the fees paid to them are subject to sales tax.

**TAX EXEMPTION FOR CLINIC—MINNESOTA**

In Cook Area Health Services, Inc. v. County of St. Louis, the Minnesota Tax Court was asked to determine whether a clinic was entitled to tax exemption under Minn. Stat. §272.02. The court determined that the clinic satisfied a six factor test established by the Minnesota Supreme Court to determine whether an organization is operated as a public charity.

The test is as follows: (i) whether the stated purpose of the undertaking is to be helpful to others without immediate expectation of material reward; (ii) whether the entity involved is supported by donations and gifts in whole or in part; (iii) whether the recipients of the "charity" are required to pay for the assistance received in whole or in part; (iv) whether the income received from gifts and donations and charges to users produces a profit to the charitable institution; (v) whether the beneficiaries of the "charity" are restricted or unrestricted and, if restricted, whether the class of persons to whom the "charity" is made available is one having a reasonable relationship to the charitable objectives; and (vi) whether dividends, in form or substance, or assets upon dissolution are available to private interests. Based on the above analysis, the court determined that the clinic was a public charity entitled to tax exemption.

**REVOCATION OF TAX-EXEMPT STATUS FOR HMO**

In IHC Health Plans, Inc. v. United States Tax Court, the U.S. Tax Court in Washington affirmed a previous decision by the IRS revoking the tax-exemption of IHC Health Plans ("IHC"), a not-for-profit subsidiary of Salt Lake City-based Intermountain Health Care, Inc. ("Intermountain"), which owns twenty-two hospitals in Utah and Idaho.

In 1999, the IRS revoked IHC’s health tax-exemption after finding that IHC operated like a for-profit business. The IRS argued that IHC failed to meet the "community benefit" test the IRS applies to hospitals under Rev. Rul. 69-545 (e.g.,
failure to provide medical services by employed physicians at its own facilities; failure to operate an emergency room open to the public; and failure to offer health care services to any portion of the Medicare eligible population in the community. The HMO did not provide medical services by employed physicians at its own facilities; did not operate an emergency room open to the public; and did not offer health care services to any portion of the Medicare eligible population in the community. Rather, the IRS argued that IHC provided services almost exclusively to its own enrollees who are generally individuals who could afford to pay IHC's premiums.

In October 1999, Intermountain appealed the IRS decision to the Tax Court. The Tax Court affirmed the IRS' decision regarding IHC and further held that IHC's failure to have any program to reduce premiums for low-income members or to provide any free or low-cost health care services beyond a few free health screenings further indicated that IHC was operated like a for-profit entity and that it primarily benefited its own subscribers rather than the community at large.41

MANAGEMENT OF TAX-EXEMPT HOSPITALS NOT A CHARITABLE FUNCTION

On April 26, 2001, the IRS approved the reorganization plan submitted by Phillipsburg, Kansas based Great Plains Health Alliance, which leases and manages twenty-five rural hospitals in Kansas and Nebraska. The administrative settlement between the IRS and Great Plains ended Great Plains’ appeal of an IRS action that revoked the company’s tax-exempt status as of March 2, 1998.

The IRS revoked Great Plains’ status based on the IRS’ reasoning that Great Plains was only a management services company that did not provide charitable care as provided by the Code. Specifically, the IRS reasoned that Great Plains’ operation as a manager of hospitals was not an inherently charitable act, even though the hospitals that it manages are tax-exempt entities. In reaching its decision, the IRS did not accept Great Plains’ argument that managing hospitals furthered the charitable missions of those hospitals.

Pursuant to the reorganization plan, Great Plains was required to reorganize itself to meet the IRS demands for greater accountability over the hospitals that it leases.

ELIMINATION OF $150,000,000 LIMIT FOR QUALIFIED 501(c)(3) BONDS

The Joint Committee on Taxation recommended that the $150,000,000 limit for tax-exempt bond financing should be eliminated as it relates to capital expenditures incurred before the date of enactment of the Taxpayer Relief Act of 1997 ("1997 Act"). Specifically, the 1997 Act repealed the $150,000,000 limit for bonds, issued after the date of its enactment, to finance capital expenditures
incurred by tax-exempt entities after the date of enactment. Because this provision of the 1997 Act applied only to bonds issued with respect to capital expenditures incurred after the date of enactment, the $150,000,000 limit continues to govern the issuance of other non-hospital qualified 501(c)(3) bonds issued prior to that date. The proposed repeal of this law would simplify hospital mergers and consolidations.

NOTES


3. Field Service Advice reflects internal advice from the IRS Assistant Chief Counsel to IRS field attorneys.

4. Rev. Rul. 69-545, 1969-2 C.B. 177. Rev. Rul. 69-545 notes that in considering whether a nonprofit hospital is operated to serve a private benefit, the IRS will weigh all the relevant facts and circumstances in each case, including the use and control of the hospital. The revenue ruling compares the facts surrounding two hypothetical hospitals and concludes that the first hospital qualifies as an organization described in 501(c)(3) and the second hospital does not because it is operated for the private benefit of the physicians who control the hospital.

5. Field Service Advice 200110030.

6. To qualify and maintain a qualification for exemption under Section 501(c)(3), an organization must be both (1) organized and (2) operated exclusively for one or more exempt purposes. The theory of exemption under Section 501(c)(3) is that the tax-exempt organization furnishes a benefit to the public from its activities and if it provides a benefit to private individuals more than incidentally, it is not entitled to exemption from taxation.

7. Field Service Advice 200110030.


10. Id.

11. In Rev. Rul. 98-15, the IRS released guidance relating to participation in joint ventures by tax-exempt entities and their affiliates. There, the IRS indicated that joint venture participation can endanger an entity's tax-exempt status where: (i) the tax-exempt entity does not retain sufficient control over the venture; and (ii) the venture is not organized and does not operate to further community benefits. In contrast, the IRS has indicated favor with joint ventures where the tax-exempt entity controlled the board of the entity, the entity retained sufficient control over numerous decisions relative to the venture, and the venture documents required (and provided sufficient authority to the tax-exempt entity to assure) the venture to serve community health needs.


13. Id. at 103.

14. Id. at 100.

15. Id.


17. Id.; see also Jacob's Pillow Dance Festival, Inc. v. Assessors of Becket, 320 Mass. 311, 69 N.E.2d 463 (1946).

18. Id. at 103–104 (citations omitted).


20. Id. at *15.


24. Id. at 312.

25. Id. at 313.
26. Id.; see also Mariners Museum, 255 Va. at 45.
27. 38 S.W.3d 424 (Mo. 2001).
28. Id. at 425.
29. Id.
30. 961 S.W.2d 806 (Mo. 1998).
31. Id. at 426.
32. 745 S.W.2d 677 (Mo. 1988).
33. Id.
34. 2001 Minn. Tax LEXIS 16 (Apr. 27, 2001).
35. Id. at 5; see also North Star Res. Inst. v. County of Hennepin, 306 Minn. 1, 6, 236 N.W.2d 754, 757 (Minn. 1975).
36. Id.
37. Id. at 22.
39. IHC has approximately 440,000 members in its HMO, PPO, plan of service and traditional health insurance plans Intermountain, the State’s largest health system, earned $141,000,000 in 2000, on net revenue of 1.93 billion dollars. IHC earned $13.5 million on 2000 revenue of $587 million.
42. Volume II—Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System.