The Hilltop Institute
analysis to advance the health of vulnerable populations

Community Benefit in Context: Origins and Evolution - ACA §9007

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Nonprofit Hospital Tax Exemption: What's at Stake?

The value of tax exemption accruing to the approximately 2,900 nonprofit hospitals in the United States[1] has been variously estimated from $8.5 billion[2] to $21 billion,[3] including the value of federal and state taxes avoided, eligibility for tax-deductible donations, and access to lower-cost capital financing from issuance of tax-free bonds. The Joint Committee on Taxation estimated aggregate financial benefits from federal, state, and local tax preferences afforded to nonprofit hospitals and their supporting organizations in 2002[4] at **$12.6 billion**, which breaks down as follows:[5]

Federal income tax	$2.5 billion
Use of federally tax-exempt debt (bond financing)	$1.8 billion
Federal deductibility of charitable contributions	$1.8 billion
Total federal benefits	**$6.1 billion**

State corporate income tax	$ .5 billion
State sales tax	$ 2.8 billion
State & local property tax	$ 3.1 billion
Total state & local benefits	**$ 6.4 billion**

[1] Includes nongovernmental short-term acute and other special nonprofit hospitals (based on American Hospital Association (AHA) 2010 hospital survey). AHA, Fast facts on U.S. hospitals. Retrieved from http://www.aha.org/research/rc/stat-studies/fast-facts.shtml.
[2] Morrisey, M., Wedig, G., & Hassan, M., *Do nonprofit hospitals pay their way?*, Health Affairs 15, no.4, 132-144 (1996), citing Copeland, J., & and Rudney, G., "*Federal tax subsidies for not-for-profit hospitals*," 46 Tax Notes (No. 13) 1559 (1990).
[3] Hearle, K., *Establishing the value of tax-exempt status* (July 2006). Retrieved from http://tinyurl.com/83hl5vp
[4] As reported by the U.S. Congressional Budget Office [hereinafter *CBO*], Nonprofit Hospitals and Tax Arbitrage (2006). Retrieved from http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/76xx/doc7696/12-06-hospitaltax.pdf
[5] Id. at 4 & n. 6. The CBO defined "supporting organizations" as "entities formed specifically to provide financial support" for 501(c)(3) hospital organizations. CBO also noted that "numbers in the text and tables may not add up to totals because of rounding." Id. at ii.

Origins of the Charitable Tax Exemption and Evolution of the Community Benefit Standard

Charitable tax exemption can be traced back as far as the 17th century and the law of charitable trusts, which developed in recognition of public policy to preserve a charitable organization's assets for charitable purposes.[6] Another important rationale for exempting charitable organizations from federal and state taxes is that the government (and ultimately the public) foregoes tax revenues in exchange for charitable activities that relieve the government of responsibilities that otherwise would have to be met at public cost.[7]

The first federal statutory reference to charitable tax exemption is found in the Wilson-Gorham Tariff Act of 1894, which specifically excluded from taxation "corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes."[8] Tax exemption for institutions dedicated to the pursuit of "charitable purposes" has been part of the United States' statutory tax structure since the enactment of the first Income Tax Code in 1913. The exemption of charitable organizations from federal corporate income tax was codified as §501(c) of the Internal Revenue Code (I.R.C) by the Revenue Act of 1954.[9]

Nonprofit hospitals have never been expressly classified as tax-exempt organizations under I.R.C. §501(c)(3), which does not by its terms recognize the promotion of health as a qualifying "charitable purpose."[10] Federal tax exemption requirements specific to nonprofit hospitals did not exist until 1956, when the Internal Revenue Service (IRS) issued Revenue Ruling 56–185, which determined that a hospital could qualify as a tax-exempt charitable organization if, among other things, it "operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay."[11]

Under the 1956 "financial ability" standard, the IRS assessed a hospital's qualification for tax exemption solely on the basis of its provision of charity care and reduced-cost medical services.

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[6] Gustafsson, L., The definition of "charitable" for federal income tax purposes: Defrocking the old and suggesting some new fundamental assumptions, 33 Hous. L. Rev. 587 (1996) (citing the Statute of Charitable Uses of 1601).
[7] See Bob Jones Univ. v. United States, 461 U.S. 574, 588 n. 12 (1983); Gustafsson, supra.
[8] The Supreme Court held the Wilson-Gorham Tariff Act, 28 Stat. 570 (1894), unconstitutional in Pollock v. Farmers' Loan & Trust Company, 157 U.S. 429 (1895). Adoption of the 16th Amendment removed the constitutional impediment to the Act that was the basis for the Pollock decision, thereby permitting Congress to enact the federal Income Tax Code, 38 Stat. 172 (1913). The current version of the federal tax exemption for charitable organizations is codified as 26 U.S.C. § 501(c) (3). See generally Arnsberger, P., Ludlum, M., Riley, M., & Stanton, M., A history of the tax-exempt sector: An SOI perspective. Statistics of Income Bulletin (providing, in Appendix B, synopses of federal legislation relevant to charitable tax exemption from 1894-2007) (Winter 2008). Retrieved from http://www.irs.gov/pub/irs-soi/tehistory.pdf
[9] Id. For the text of current I.R.C. § 501(c) (3), see n. 17, infra.
[10] Id.; The Tax-Exempt Hospital Sector: Hearing before the House Committee on Ways and Means, 109th Cong. (2005) [hereinafter Tax-Exempt Hospital Sector Hearing]. Retrieved from http://www.gpo.gov/fdsys/pkg/CHRG-109hhrg26414/pdf/CHRG-109hhrg26414.pdf
[11] Rev. Rul. 56–185, 1956–1 C.B. 202, 203.

This standard remained in place until 1969, when the IRS established a broader standard for nonprofit hospital tax exemption based on the extent to which these hospitals provide **"community benefits"** to the communities they serve. When the Medicare and Medicaid programs were established in 1965, this raised concern that decreased demand for charity care would make it difficult for hospitals to satisfy the financial ability standard of Revenue Ruling 56-185.[12] In 1969, the IRS issued Revenue Ruling 69-545, which recognized the promotion of health as "one of the purposes in the general law of charity that is deemed *beneficial to the community as a whole* even though the class of beneficiaries eligible to receive a direct benefit… does not include all members of the community … provided that the class is not so small that its relief is not of benefit to the community (emphasis added)."[13] Although providing free and discounted care would continue to count toward justifying tax exemption, other hospital investments and activities promoting community health would also qualify toward meeting nonprofit hospitals' obligations in exchange for federal tax exemption. The 1969 Revenue Ruling expressly modified Revenue Ruling 56-185 "to remove … the requirements relating to caring for patients without charge or at rates below cost."[14]

Public controversy over whether nonprofit hospitals provided adequate community benefits to justify their tax exemption gave rise to Congressional consideration of the issue between 2005 and 2009. Under the leadership of Senators Grassley and Baucus, key committees gathered extensive testimony that ultimately informed Congressional development of the community benefit standards enacted as §9007 of the Affordable Care Act (ACA) in 2010. [15] Until then, the IRS's 1969 Revenue Ruling continued to stand alone as the operative federal community benefit standard, and it remains in effect today alongside the ACA requirements. The IRS continues to assess the "facts and circumstances" of hospital community benefit practices to determine whether they provide sufficient health benefits to their communities to justify their qualification for tax exemption.[16]

General Requirements for Federal Tax Exemption of Nonprofit Organizations

After the ACA, general requirements for federal tax-exempt status under I.R.C. §501(c)(3) still include the imperative that a tax-exempt entity be organized and operated "exclusively" for

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[12] *Tax-Exempt Hospital Sector Hearing*, *supra* note 10.
[13] Rev. Rul. 69-545, 1969-2 C.B. 117, 119
[14] Id. at 117, 120.
[15] Section 9007 of the Patient Protection and Affordable Care Act, P.L. 111-148 (2010), as amended by the Health Care and Education Reconciliation Act of 2010, P.L. 111-152 [hereinafter the consolidated Acts are referred to as the *ACA*]. For a comprehensive review and analysis of Congressional activity exploring nonprofit hospital tax exemption, see Davis, C., National Health Law Program, *Nonprofit hospitals and community benefit* (July 2011). Retrieved from http://healthjusticenetwork.files.wordpress.com/2011/07/nhelp_community_benefit.pdf
[16]Statement by Lois Lerner, Director of the IRS Exempt Organizations Division, on the IRS Report on Nonprofit Hospitals, at a Press Briefing, Feb. 12, 2009. Retrieved from http://www.irs.gov/pub/irs-tege/lernerstatement_hospitalproject_021209.pdf; U.S. Congressional Research Service, Tax-Exempt Section 501(c)(3) Hospitals: Community Benefit Standard and Schedule H (2008). Retrieved from http://assets.opencrs.com/rpts/RL34605_20080731.pdf

religious, **charitable**, scientific, educational, or certain other specified purposes, and bar the private inurement of benefits to any individual with significant influence over the organization, as well as of more than incidental private benefit to individuals without significant influence over the organization. A tax-exempt charitable organization may not engage in substantial lobbying activity or participate or intervene in any political campaign for or against a candidate for public office."[17]

Nonprofit Hospital-Specific Community Benefit Requirements under I.R.C. §501(r)

Section 9007 of the ACA[18] established "additional requirements for charitable hospitals" in the new I.R.C. §501(r). Nonprofit hospitals must meet these requirements in order to qualify as federally tax-exempt corporations under I.R.C. §501(c)(3). Section §501(r) standardizes community benefit reporting for 501(c)(3) tax-exempt hospitals and establishes specific requirements that these hospitals must meet as a condition of preserving their federal tax exemption, as well as to avoid costly intermediate sanctions under I.R.C. §4959.[19] I.R.C. §501(r) requirements, include:

- Conducting a community health needs assessment and developing a corresponding "implementation strategy" (i.e., a community benefit plan) at least every three years;
- Establishing a written financial assistance policy that includes measures to "widely publicize" the policy in the community the hospital serves;
- Establishing an emergency medical care policy that requires nondiscriminatory treatment of emergency medical conditions,[20] regardless of the patient's eligibility for financial assistance;
- Compliance with specified limitations on hospital charges; and

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[17] U.S. Congress, Joint Committee on Taxation, "Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations," JCX-29-05 (Comm.Print 2005). I.R.C. §501(c) (3) provides for income tax exemption to "corporations … organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition … or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation …, and which does not participate in, or intervene in … any political campaign on behalf of (or in opposition to) any candidate for public office."

[18] Section 9007 of the ACA added a new subsection (r) to§ 501 of the Internal Revenue Code.

[19] ACA §9007(b), "Excise Tax for Failures to Meet Hospital Exemption Requirements," established I.R.C. §4959, which imposes a $50,000 excise tax for each year a tax-exempt hospital organization fails to meet the community health needs assessment requirement of I.R.C. §501(r) (3). A hospital organization that operates multiple hospital facilities is subject to the $50,000 tax with respect to each noncompliant hospital facility it operates. IRS, Notice 2011-52 at ¶ .10, Notice and Request for Comments Regarding the Community Health Needs Assessment Requirements for Tax-Exempt Hospitals. Retrieved from http://www.irs.gov/pub/irs-drop/n-11-52.pdf

[20] For the meaning of "emergency medical condition," ACA §9007 references the Emergency Treatment and Active Labor Act (EMTALA), 42 U.S.C. §1395dd.

- Compliance with specified billing and collections requirements, including a prohibition of initiating "extraordinary collection actions" before making "reasonable efforts" to determine whether the individual is eligible for financial assistance

I.R.C. §501(r) does **not** establish any specific minimum value of community benefits that a hospital must provide to qualify for the exemption. Rather, the IRS employs a "facts and circumstances" test to assess whether a hospital's community benefit expenditures are sufficient to support its 501(c)(3) charitable status.[21]

Treasury and the IRS have issued two requests for comments to inform their promulgation of interpretive regulations for I.R.C. §501(r). The first, IRS Notice 2010-39, requested comments regarding the new requirements generally and also included specific requests for comments on community health needs assessment, "reasonable efforts" to determine eligibility for financial assistance, and the requirement that hospital systems report separately by facility. The second, IRS Notice 2011-52, focuses on community health needs assessment and indicates what the IRS "intends to provide" in future regulations interpreting I.R.C. §501(r). With the exception of these indications of future regulatory action in Notice 2011-52, the IRS has limited its interpretation of I.R.C. §501(r) to updates of Schedule H (Form 990) and accompanying Instructions.

Schedule H Reporting

Part I of Schedule H lists IRS-approved community benefit categories in which nonprofit hospitals are required to report costs associated with their provision of community benefits. Community benefit categories recognized in Schedule H include:[22]

- Costs of providing financial assistance;
- Costs exceeding Medicaid reimbursement for hospital services provided (Medicaid shortfall);
- Costs of other means-tested government programs; e.g., State Children's Health Insurance Program (SCHIP) reimbursement shortfall;[23]
- Other benefits, including hospital costs of providing:
    - Community health improvement services (which may include community building activities that promote community health)[24] and community benefit operations,

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[21] Rev. Rul. 69-545, *supra* note 13; Statement by Lois Lerner, Director of the IRS Exempt Organizations Division, *supra* note 16.
[22] IRS 2011 Form 990, Schedule H. Retrieved from http://www.irs.gov/pub/irs-pdf/f990sh.pdf. Hospitals' annual Schedule H submissions must be accompanied by audited financial statements. ACA § 9007 (d), I.R.C. §6033 (b) (15) (B).
[23] *See* IRS Instructions for Form 990, Schedule H, p. 12. Retrieved from http://www.irs.gov/pub/irs-pdf/i990sh.pdf

- Health professions education,
- Research,
- Subsidized health services, and
- Cash and in-kind contributions for community benefit

How Much is Enough?

The IRS has provided little guidance as to the level community benefit nonprofit hospitals are expected to provide in order to satisfy the "facts and circumstances" test the agency employs to determine whether a nonprofit hospital's community benefit expenditures adequately justify its qualification for charitable tax-exempt status. Some tax advisors recommend that nonprofit hospitals make community benefit expenditures equivalent to their estimated tax liability if they were for-profit hospitals.[25] Although federal law has not adopted this approach, several states have established mandatory minimum community benefit expenditure requirements as a condition of state tax exemption.[26]

State Community Benefit Requirements

In addition to complying with federal community benefit requirements, nonprofit hospitals must also take appropriate steps to protect their state income, property, and sales tax exemptions. State community benefit standards may or may not align with their federal community benefit requirements. The state requirements may, in fact, be more stringent. If that is the case, a nonprofit hospital's compliance with the ACA's community benefit requirements alone will not ensure tax exemption at the state level. As discussed above, the financial benefits nonprofit

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[24] "Some community building activities may also meet the definition of community benefit." IRS 2011 Instructions for Schedule H (Form 990). Since its redesign in 2008, Schedule H has included a separate Part II for listing costs associated with community building activities. IRS's indication that community building activities may be reportable as community benefit (presumably in the Schedule H "community health improvement services" category) appears for the first time in the 2011 Instructions. Community health improvement services are defined elsewhere in the Instructions as "activities or programs… carried out or supported for the express purpose of improving community health" (p. 14). The Catholic Health Association has developed recommendations for hospital reporting of community building activities as community benefit, titled *Guidance for Determining Whether to Report a Program or Activity as Community Health Improvement or Community Building*. Retrieved from http://www.chausa.org/communitybenefit/. *See also Guidelines for Reporting Environmental Improvement As Community Benefit and Community Building on IRS Form 990, Schedule H*. Retrieved from http://www.chausa.org/communitybenefit/.

[25] See, e.g., Dixon Hughes, PLLC. Tax - *Exempt Checkup*. Retrieved from http://www.dhgllp.com/res_pubs/indhc_Tax_Exempt_Checkup_Sheet.pdf

[26] The Hilltop Institute, *Community benefit briefing* (June 2011). Retrieved from http://www.hilltopinstitute.org/publications/HCBP%20Newsletters/HCBPNewsletter-June2011.pdf ; U.S. Government Accountability Office, Nonprofit hospitals variation in standards and guidance limits comparison of how hospitals meet community benefit requirements (2008).

hospitals derive from state tax exemption are substantial, potentially exceeding the benefits a nonprofit hospital can derive from its federal tax exempt status.

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About The Hilltop Institute and Hilltop's Hospital Community Benefit Program

The Hilltop Institute at UMBC is a non-partisan health research organization dedicated to improving the health and wellbeing of vulnerable populations. Hilltop conducts research, analysis, and evaluations on behalf of government agencies, foundations, and nonprofit organizations at the national, state, and local levels. Hilltop is committed to addressing complex issues through informed, objective, and innovative research and analysis.

Hilltop's Hospital Community Benefit Program, funded by the Kresge Foundation and the Robert Wood Johnson Foundation, is the central resource created specifically for state and local policymakers who seek to ensure that tax-exempt hospital community benefit activities are responsive to pressing community health needs. The program provides tools to state and local health departments, hospital regulators, legislators, revenue collection and budgeting agencies, and hospitals, as these stakeholders develop approaches that will best suit their communities and work toward a more accessible, coordinated, and effective community health system. For more information, contact Martha H. Somerville, JD, MPH, Director, at msomerville@hilltop.umbc.edu.

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