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Provena and Health Care Reform: The "Charitable" Nature of Hospitals in the Spotlight

BY DALE C. VAN DEMARK

The federal tax-exempt status of hospitals and health systems has been in the spotlight for many years now. Public officials have questioned the basis for exemption on the ground that many tax exempt hospitals and health systems appear to provide no more charity care than for-profit systems, and yet reap the benefits of tax exemption. The result has been increased scrutiny of tax-exempt health systems, calls for changes in the rules for federal exemption, lawsuits from patients who felt ill-treated by hospital collection practices, and challenges to state and local tax exemption.

At its core, the debate surrounding the tax-exempt status of health systems has come down to perceptions of ''charity.'' The recent decision by the Supreme Court of the State of Illinois affirming the revocation of the state property tax exemption of Provena Hospitals with respect to property it owns in Urbana, Ill., (the ''Provena Decision'')[1] and the creation in the health reform legislation (the ''Reform Legislation'')[2] of a new Section 501(r) to the Internal Revenue Code adding additional requirements for federal tax exemption, are reflective of the divide in perceptions and demonstrate how differing perceptions of ''charity'' are reflected in the law. However, they also demonstrate how much overlap there can be.

[1] *Provena Covenant Medical Center et al. v. The Department of Revenue et al.* (March 18, 2010) Docket No. 107328.

[2] HR 3590 Section 9007 (this provision is not affected by the reconciliation process currently contemplated for utilization in the passing of the reform legislation).

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''Charitable'' Health Care Under Federal Law

Hospitals and health systems derive their federal tax exemption under Section 501(a) of the Internal Revenue Code (the ''Code'') as ''charitable'' organizations under Section 501(c)(3) of the Code. The ''charitable'' standard for exemption for hospitals, health systems and other health care providers is the ''community benefit'' standard which emanates from Revenue Ruling 69-545, 1969-2 C.B. 117 and Revenue Ruling 83-157, 1983-2 C.B. 94. The basic standard has remained largely intact over the years requiring:

- A governing board composed of community leaders who are not insiders of the organization.
- Medical staff privileges that are available to all qualified physicians, consistent with the size and nature of the services provided at the facility.
- The operation of a full-time emergency room open to all who require treatment, unless such would be duplicative of resources or impractical.
- The provision of non-emergency care to everyone in the community who is able to pay, privately, or through third-party payors, including Medicare and Medicaid.
- The dedication of surplus funds to improvement of patient care.

Facts and circumstances play a role in the application of the community benefit standard, and not all health care providers need satisfy all elements.[3] Indeed, the

[3] See, e.g., Rev. Rul. 70-590, 1970-2 C.B. 116 (ruling a drug clinic that did not operate an emergency room open to all or

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community benefit standard has been called vague,[4] and requires the determination that, under the totality of the circumstances, the health care provider makes its services available to the community and provides an additional public benefit that is sufficient to give rise to the strong inference that the public benefit is the primary purpose for which the organization operates.[5] That ''additional public benefit'' should either further the function of government funded institutions or provide a service that would not likely be provided without the health care provider's effort.[6]

Charity care or the provision of free care to indigents is generally cited as a way to satisfy this requirement.[7] In recent guidance to its agents, the Internal Revenue Service has identified charity care, beyond what may be provided through operation of an emergency department, as a factor to consider when applying the community benefit standard.[8] While only a single factor, charity care can be an important factor: the lack of a charity care policy has been cited as a basis for denying exemption,[9] and the existence of some form of charity program may be a negative factor if the program does not result in the provision of more than a miniscule amount of free care.[10]

This reference to charity care has more than just a visceral appeal. Prior to adoption of Rev. Rul. 69-545, the controlling standard for exemption was articulated in Rev. Rul. 56-185, 1956-1 C.B. 202, which provided that, to qualify for exemption, a hospital ''must be 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.'' At least one court has suggested that Rev. Rul. 69-545 provided only an alternative method for justifying exemption from that identified in Rev. Rul. 56-185.[11] Nonetheless, it remains axiomatic that legally, charity care, while an important factor to consider, is neither necessary in all cases nor the only factor to consider when reviewing the basis for exemption of a health care provider.

And this has been the open nerve touched by the debate around federal tax exemption of health systems, as even casual observers know.

Reform Legislation Changes to the Exemption Standard

The Reform Legislation provides the first significant amendment to the standard for hospital tax exemption since the adoption of Rev. Rul. 69-545.[12] The Reform Legislation creates a new section 501(r) of the Internal Revenue Code which would require hospitals[13] to satisfy four additional requirements for exemption:

- The hospital must conduct a community health needs assessment at least once every three years.
- The hospital must maintain an appropriate financial assistance policy.
- The hospital must limit charges for emergency or other medically necessary care to those who qualify for financial assistance to not more than the amounts generally billed to individuals who have insurance covering such care.
- The hospital cannot engage in extraordinary collection actions before the organization has made reasonable efforts to determine whether the patient is eligible for financial assistance.

The Reform Legislation does not elaborate on the second two requirements but does describe in more detail the requirements for a community health needs assessment and an appropriate financial assistance policy.

A community health needs assessment must take into account input from individuals representing ''the broad interest of the community served by the hospital facility, including those with special knowledge of or expertise in public health.''[14] The assessment must be made widely available to the public, and the hospital must adopt an implementation strategy to meet the community needs identified.[15] A community health needs assessment must be conducted at least once every three years.[16]

An appropriate financial assistance policy is a written policy that includes the following components:

- Eligibility criteria and identification of whether the policy includes free or discounted care.
- Basis for calculating charges.
- Method for applying for financial assistance.
- Actions the hospital may take in the event of nonpayment (if the hospital does not have a separate billing and collections policy).
- Measures to widely publicize the policy to the community served.[17]

In addition, hospitals must have a written policy requiring the organization to provide free emergency care.[18]

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exhibit other attributes of the community benefit standard was exempt).

[4] See, e.g., *Geisinger Health Plan v. Comm'r*, 985 F.2d 1210, 1217 (3rd Cir. 1993) (''In sum, no clear test has emerged to apply to nonprofit hospitals seeking tax exemption.'') and *IHC Health Plans v. Comm'r*, 325 F.3d 1188, 1197 (10th Cir. 2003) (noting the community benefit standard is ''somewhat amorphous'').

[5] *IHC Health Plans*, 325 F.3d at 1198.

[6] Id. at 1197.

[7] Id.; see also, *Geisinger*, 985 F.2d at 1217.

[8] IRS 2004 Exempt Organization CPE Text ''Health Care Provider Reference Guide.''

[9] See, e.g., *Harding Hospital, Inc., v. United States*, 505 F.2d 1068, 1077 (6th Cir. 1974).

[10] *Geisinger*, 985 F.2d at 1219-1220.

[11] See, *Eastern Kentucky Welfare Rights Organization v. Simon*, 506 F.2d 1278, 1289 (D.C. Cir. 1974), vacated on other grounds, 426 U.S. 26 (1976).

[12] In addition to creating new requirements for exemption, Section 9007 of the Reform Legislation creates a new excise tax, a mandatory review of exempt status on a periodic basis and additional reporting requirements. Even a cursory review of the other provisions of Section 9007 of the Reform Legislation is beyond the scope of this article.

[13] The new requirements will apply to all organizations that operate hospitals that are required to be licensed or otherwise registered under state law and apply with respect to each facility operated by an organization. In addition, the requirements apply to other organizations that the Secretary of the Treasury determines has the provision of ''hospital care'' as its principal function. Reform Legislation Section 9007 (501(r)(2)).

[14] Reform Legislation Section 9007 (501(r)(3)(B)(i)).

[15] Reform Legislation Section 9007 (501(r)(3)(B)(ii) and (A)(ii)).

[16] Reform Legislation Section 9007 (501(r)(3)(A)(i)).

[17] Reform Legislation Section 9007 (501(r)(4)(A)).

[18] Reform Legislation Section 9007 (501(r)(4)(B)). While not a simple reiteration of one of the existing community benefit requirements, this requirement is strikingly close, and raises the question as to why some of the other existing community benefit requirements are not, likewise, important enough to be required to be put in writing.

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New Section 501(r) raises a number of significant compliance questions, such as: what sort of broad input is sufficient for the health needs assessment? Is a hospital required to try to achieve every health care need identified? Will all hospitals now be required to operate an emergency department? What constitutes ''extraordinary collection actions''? These, and other questions, will be engaging hospitals and their advisors as they move toward ensuring compliance.

For purposes of this article, however, what is of particular interest is the emphasis on charity care and the efforts hospitals must take to publicize their policies and ensure that patients take advantage of those policies. The new statutory requirements for exemption echo the old standard of Rev. Rul. 56-185 and take a step toward conforming the standard for exemption to some of the public statements regarding what hospitals ''should'' be doing to benefit from exemption.

Significantly, as well, these new requirements are statutory, and not the product of administrative analysis, as are revenue rulings; and they are *additional* requirements to the community benefit standard. It is likely that the significance of the statutory nature of these new requirements will not be lost on the Treasury Department and Internal Revenue Service as they determine how to apply the new law. Accordingly, we should expect significant emphasis on these additional elements from the regulatory agencies.

Provena and Standards for Exemption

The applicability of state and local tax exemption for hospitals is an issue that generally simmers beneath the surface, rising occasionally and drawing national attention. The determination by the Illinois Department of Revenue that Provena Hospitals was not entitled to a property tax exemption with respect to property it owns in Urbana, Ill., and the subsequent affirmation by the Illinois Supreme Court is no exception.[19] This article will not review the Provena Decision in detail or discuss most of the many interesting aspects of the decision as it relates to hospitals in Illinois. Rather, this article will highlight a few key aspects of the decision related to the applicable standard.

Central to the Provena Decision was the analysis of what ''charitable'' means under Illinois law.[20] In Illinois, property tax exemption is a matter of both constitutional and legislative concern. The constitution provides that the Illinois General Assembly can exempt from tax property used for a charitable purpose. The General Assembly did so, but included a further restriction on the application of the exemption, namely, that the property be owned by a charitable institution.[21] Accordingly, there are two separate tests that need to be met: first, the property owner must be a charitable institution and second, the property must be put to a charitable use.

The Court identified the five characteristics of a charitable institution under Illinois law:

1. It has no capital, capital stock or shareholders.
2. It earns no profits or dividends and derives its funds mainly from private and public charity and holds them in trust for the purposes expressed in the charter.
3. It dispenses charity to all who need it and apply for it.
4. It does not provide gain or profit in a private sense to any person connected with it.
5. It does not appear to place any obstacles in the way of those who need and would avail themselves of the charitable benefit it dispenses.[22]

Of these factors, the first and fourth are of little interest, as they reflect the basic structural requirements of any organization under Section 501(c)(3) of the Internal Revenue Code that does not violate the private inurement prohibition.

The second factor is quite interesting, and represents a stark difference from the federal standard for what constitutes ''charitable.'' Unlike the federal exemption standard, this requirement includes the notion that to be charitable, an organization must be, overwhelmingly, the *recipient* of charity. Of course, Provena failed to satisfy the second factor,[23] as nearly every federally exempt hospital would, because it derives its funds mainly from fees for services it provides.

Unfortunately, because of some confusion early in the process of adjudication, the Court had incomplete evidence to review with respect to the third and fifth factors. However, those requirements are of interest in how they relate both to the community benefit standard and the Reform Legislation provisions. As noted above, the community benefit standard requires charity care in the context of emergency room services and strongly favors the existence of additional charity care in determining whether there is public benefit being provided by the hospital. The Reform Legislation builds on that, requiring that hospitals have and publicize a charity care/financial assistance policy, and prohibiting hospitals from aggressively seeking payment before making a determination of eligibility for financial assistance.

While it is impossible to say that an Illinois hospital that satisfies the community benefit standard and the additional requirements under new Section 501(r) of the Internal Revenue Code would constitute a charitable institution under Illinois law, it is clear that compliance with the new requirements could help.

The additional requirements under new Section 501(r) of the Internal Revenue Code would not help, however, with respect to the second part of the Illinois standard that looks to the property's use. Charitable use requires the utilization of the property exclusivity for charitable purposes. According to the Court, ''it is the *sine qua non* of charitable status that those seeking a charitable exemption be able to demonstrate that their activities will help alleviate some financial burden incurred by the affected taxing bodies in performing their governmental functions.''[24] A lack of evidence harmed Provena Hospitals on this point, but the Court also noted that because the charity care provided by Provena Hospitals was *de minimus* when compared to its

[19] See, e.g., *Illinois High Court: Nonprofit Hospital Can Be Taxed*, Suzanne Sataline, Wall Street Journal (March 19, 2010); *Ill. High Court: Hospital Shouldn't be Tax Exempt*, Mike Robinson and David Mercer, Associated Press (March 18, 2010); and *Illinois High Court Rejects Exemption for Provena Covenant Medical Center*, Peyton M. Sturges, BNA's Health Care Daily Report (March 19, 2010).

[20] The Provena Decision is a nuanced and interesting opinion, but a full review of it is beyond the scope of this article.

[21] Provena Decision p. 15.

[22] Provena Decision p. 16.

[23] Provena Decision p. 17.

[24] Provena Decision p. 20.

overall operations, there was sufficient evidence to support the Department of Revenue's conclusion.[25] Of course, on this basis, nearly every federally exempt hospital would fail to satisfy the standard.

Conclusion

While these two pieces of law are reflective of the great complexity of the issues around the different meanings of ''charity,'' they also reflect a broad step toward greater emphasis on the provision of care for free or at reduced rates for purposes of justifying exemption. But this lesson should not be overstated. It is important to keep in mind that there are a great variety of taxes, filing requirements and other legal requirements associated with exemption. In the Provena Decision, for example, the Court noted that Provena Hospitals was exempt from state retailer's occupation tax, service tax, use tax and service use tax and exempt from filing requirements under certain state laws.[26] And as the Court correctly noted throughout the decision, exemption under federal law and other state laws, and satisfaction of those requirements, is not dispositive of the question with respect to state property law. Indeed, it is critical to understand that standards of exemption emanate from a variety of laws, each which may treat the matter of ''charity'' and exemption differently.

For Illinois hospitals, the Provena Decision may represent a significant burden. While it is clear that a tax-exempt hospital could be construed as a charitable institution (and that compliance with the Reform Legislation could help satisfy this requirement), the Court provided a rather strict reading of the charitable use requirement. Nonetheless, the factual record was not complete in the Provena Decision, and each Illinois hospital will have to make a decision as to whether it will challenge an adverse determination of its exempt status for property tax purposes on the basis of its own operations. Any such challenge would have to be undertaken with the clear understanding of the significant obstacles to success that exist.[27]

For hospitals outside of Illinois, the importance of the Provena Decision should not be overstated: it is an Illinois Supreme Court decision applying Illinois property tax law to an Illinois institution with respect to Illinois property. This is not to say that it could not be read as persuasive authority on certain points, but it has no direct application outside of Illinois. Rather, the importance of the Provena Decision beyond the borders of Illinois may be its potential to embolden state and local taxing authorities to examine exemption for hospitals for a variety of tax purposes and assert stricter interpretations of ''charity'' than may have been posited in the past.

New Section 501(r) will require hospitals to take specific actions to maintain exemption and avoid excise taxes. There is no doubt that these new requirements will increase costs and decrease revenue, and that some organizations are more prepared to comply than others. Importantly, the requirements focus on the need to strengthen policies around the provision of free or discounted rate services. But, the requirements reflect, in some instances, existing best practices and standards of operation. Indeed, the public clamor, private lawsuits, and increased scrutiny of hospitals and health systems generally over the years have resulted in best practices guidelines that have strengthened charity care policies generally. Further, the greater emphasis on charity care under new Section 501(r) will better align federal standards for exemption with the amorphous public perception of what ''charity'' means.

But the federal legislation also leaves open many questions. Each hospital will need to review these requirements in light of their own circumstances to determine how best to respond prior to the creation of further guidance.

Accordingly, the two key points we can take from the Provena Decision and the Reform Legislation for tax-exempt hospitals are:

1. Don't overreact, assess.
2. It is more important than ever to focus and understand what a hospital does with respect to charity care and how its financial assistance policies are implemented and publicized.

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[25] Provena Decision p. 21–22.

[26] Provena Decision p. 3.

[27] The Provena Decision makes clear that under Illinois law there is a presumption against exemption (''The party claiming an exemption must prove by clear and convincing evidence that the property in question falls within both the constitutional authorization and the terms of the statute under which the exemption is claimed.''). Provena Decision p. 14.

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