PUBLICATION

IRS Releases Study Of More Than 500 Nonprofit Hospitals

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On February 12, 2009, the Internal Revenue Service (IRS) released a 191-page study of more than 500 nonprofit hospitals which focused on the community benefit and executive compensation practices of these hospitals. Under current laws, nonprofit hospitals have to show that they meet a facts and circumstances "community benefit" standard in order to maintain their tax exemption under section 501(c)(3) of the Internal Revenue Code. Under Rev. Rul. 69-545 and progeny, the IRS has looked to factors such as the presence of a full-time emergency room open to all regardless of ability to pay; the provision of hospital care for all who can afford to pay, including Medicare and Medicaid beneficiaries; the use of surplus funds to further exempt purposes; an open medical staff; and a community board. The findings in the IRS study reflect responses by these hospitals to an IRS questionnaire requesting information on patient mix, emergency room statistics, board governance practices, medical staff privileges, uncompensated care and community programs, among others.

<u>Community Benefit Findings.</u> The IRS study reflects that some hospitals provide a large amount of charity care and other uncompensated care, but some hospitals provide little or no charity care. Community-benefit expenditures as a percentage of revenues were lowest for rural hospitals and highest for large urban hospitals. The hospitals surveyed by the IRS reported average combined community benefit expenditures of 9% of total hospital revenues (with a median of 6% of revenues). Uncompensated care represented the largest of the expense categories totaling 7% of total hospital revenues on average (with a median of 4%) and 56% of total community benefit expenditures of the surveyed hospitals. After uncompensated care, the next largest community benefit expenditures were medical education and training (23%), research (15%) and community programs (6%). Excluding research expenses attributable to the 15 leading research hospitals in the study, uncompensated care constituted 71% of all expenditures, and medical research expenditures dropped to 1%. Community benefit expenditures increased as the uninsured demographics of the surrounding area increased. The overall group of nonprofit hospitals reported excess revenues (total revenues less total expenses) of 5% of total revenues, with large revenue size hospitals generally the most profitable and critical access hospitals the least profitable; however, 21% of respondents reported total expenses greater than total revenues.

The IRS stated that the new Schedule H for redesigned Form 990 will allow them to analyze quantitative and qualitative community benefit information in a more accurate manner. After Schedule H data is available, the IRS intends to assess whether it has identified the proper set of expenditures for hospitals to report and examine whether any part of bad debt, Medicare shortfalls, or community building should be considered in the calculation of community benefit.

<u>Executive Compensation Findings.</u> The IRS also examined the executive compensation practices of the responding nonprofit hospitals. Under the Internal Revenue Code, exempt organizations can pay no more than reasonable compensation to their officers, directors, trustees and other disqualified persons (persons in a position of substantial influence). The IRS can impose penalty excise taxes upon a finding of unreasonable compensation, but the Treasury Regulations also provide a process to establish a rebuttable presumption of reasonable compensation. *See* Treas. Reg. 53.4958-6 et seq. The study indicates that nearly all the hospitals reported complying with important elements of the rebuttable presumption procedure available to establish the reasonableness of compensation for top management. The IRS confirmed widespread use of comparability data and independent personnel to review and establish executive compensation amounts. The average and

median total compensation for the top management official at the surveyed hospitals were $490,000 and $377,000, respectively, with the higher compensation reported in hospitals with higher revenues and hospitals in high population areas. Some hospitals were selected for examination, but the IRS stated that nearly all of the examined compensation arrangements were upheld as reasonable under the current standard.

Observations. The IRS noted that the community benefit standard and the requirement for reasonable compensation have proven difficult to administer. The IRS commented, however, that any attempt to refine the community benefit standard will seriously impact the existing tax exempt hospital sector because of each hospital's varying practices and financial capabilities. Similarly, the IRS stated that while some compensation amounts appear high, they also appear supportable under current law. The IRS indicated it will continue its enforcement work in this area, and will seek a better understanding of certain aspects of current law, including the permitted use of for profit comparables.

The IRS Nonprofit Hospital Study - Final Report is available here.