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THE NONPROFIT HOSPITAL: A CALL FOR NEW NATIONAL GUIDANCE REQUIRING MINIMUM ANNUAL CHARITY CARE TO QUALIFY FOR FEDERAL TAX EXEMPTION

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I. INTRODUCTION

Ever since the Tariff Act of 1894 ushered in the first corporate income tax, the nonprofit hospital (“tax-exempt hospital”) has enjoyed exemption from federal income taxation.² The tax-exempt hospital’s exemption from state and local property taxes predates the federal tax

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2. See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 13 n.56 (8th ed. 2003) (“In 1894, Congress imposed a tax on corporate income The Tariff Act of 1894 provided exemption for nonprofit charitable, religious and educational organizations, fraternal beneficiary societies, certain mutual savings banks, and certain mutual insurance companies.”). See also Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *YALE L.J.* 299, 329-30 (1976).

exemption.³ These tax exemptions originated at a time when tax-exempt hospitals were operated exclusively for the poor and indigent by religious societies.⁴ These religious societies were funded primarily by charitable contributions and staffed by physicians who worked without remuneration and nurses who worked for room and board as part of their lifelong philanthropic devotion to caring for the indigent.⁵ The rationale for tax exemption was that these institutions helped to relieve the government of its burden by providing free charity care to the public.⁶ Thus, shifting the burden of providing free charity care onto these institutions would offset any loss in the government's tax revenue. This relief of government burden theory is exemplified in Senator Hollis' statement that "[f]or every dollar" of taxes forgone by exemption, "the public gets 100 per cent" return in the form of free hospital services.⁷ Since the mid-twentieth century, however, the tax-exempt hospital has changed dramatically.⁸

Owing in part to technological advancement, regulatory relaxation of the rules of exemption, and the need to sustain competition in the market place, the tax-exempt hospital has shed its almshouse/soup-kitchen image.⁹ Essentially, today's tax-exempt hospitals are huge businesses with considerable revenue bases.¹⁰ Seldom do they care for the poor or indigent as they previously did, and often times, they simply deny them treatment altogether.¹¹ Despite these changes

3. Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Towards a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 309-11 (1991).

4. *Id.*

5. *Id.* at 318-19.

6. *Id.* at 345-46. See also HOPKINS, *supra* note 2, at 136 ("The relief of poverty is the most basic and historically founded form of charitable activity.").

7. See 55 CONG. REC. S6728 (1917) (statement of Sen. Hollis).

8. Hall & Colombo, *supra* note 3, at 318-20.

9. *Id.* See also Barry R. Furrow, *Enterprise Liability and Health Care Reform: Managing Care and Risk*, 39 ST. LOUIS U. L.J. 77, 93-96 (1994) ("Health care is no longer simply delivered by the hospital, a place that doctors either own or govern, but also by other institutions that manage not only doctors but also their own nonphysician allied health professionals and expensive high technology equipment. The health care industry is in the process of reinventing itself, with state Blue Cross organizations buying HMOs, university medical centers buying physician groups, mergers proliferating, and hospitals disappearing. Industry concentration is increasing along with complex overlapping corporate structures.").

10. Furrow, *supra* note 9, at 93-96.

11. Hall & Colombo, *supra* note 3, at 318-20. See also Lucette Lagnado, *Hospital Found "Not Charitable" Loses Its Status As Tax Exempt*, WALL ST. J., Feb. 19, 2004, at B1. The decision by the Illinois Department of Revenue to revoke the tax-exempt status of Provena Covenant Medical Center ("Provena"), stemmed from a determination by the county property tax assessment review board that Provena

in the character of the tax-exempt hospitals, they continue to enjoy the same tax exemptions as when they were required by federal standards to provide meaningful charity care. In fact, the substantive federal regulatory changes over the years with respect to the standards of exemption appear to be dispensing with meaningful charity care rather than requiring it.¹² Frustrated by this trend, some states have taken legal actions to require some level of charity care from charitable hospitals as a condition for maintaining their tax-exempt status.¹³ Some states have enacted legislative initiatives requiring minimum levels of charity care to compel the tax-exempt hospitals to be more accountable.¹⁴ These state initiatives, however, are not uniform or consistent, and are often unclear.¹⁵ Accordingly, the need for new federal guidance specifying minimum annual levels of quantitative and qualitative charity care as part of the community benefits standard cannot be overemphasized.

This article begins with an examination of the origin of the federal tax exemption of the tax-exempt hospital, the current statutory frame-

“wasn’t a charitable institution, in part, because of the way it treated needy patients.” *Id.* In its investigation of Provena, the Illinois Department of Revenue found that Provena utilized extensive draconian methods of collecting bills from the poor and uninsured patients that included lawsuits and even “body attachments,” the legal term for the arrest of debtors who fail to make court appearances. *Id.* These harsh aggressive bill collection methods from the poor and the indigent, according to the Illinois authorities, are inconsistent with the hospital’s charitable tax-exempt status and thus warranted the revocation of the hospital’s tax-exempt status. *Id.* “Hospitals must be held accountable for the substantial tax benefits they enjoy as not-for-profit institutions, said E. Richard Brown, a professor at the University of California in Los Angeles, and an expert on the uninsured. ‘If they are going to receive this tax subsidy, then they have to give back to the community in the form of charity care.’” *Id.* (quotations omitted in original). Although Provena vowed to appeal the decision, the findings of the Illinois Department of Revenue epitomize the dramatic move away from meaningful charity care by tax-exempt hospitals.

12. See Rev. Rul. 69-545, 1969-2 C.B. 117 (modifying Rev. Rul. 56-185 to remove the requirement relating to caring for patients without charge or rates below costs).

13. See *Eries v. Hamot Med. Ctr.*, 602 A.2d 407 (Pa. Commw. Ct. 1992) (exemption revoked for failure to provide sufficient charitable care); *Texas v. Methodist Hosp.*, No. 494,212 (126th Dist. Ct. Travis County, Tex. Feb. 19, 1993) (Methodist Hospital sued by Texas for failure to provide meaningful level of charity care); see also Edward Jones, *IRS Auditing Methodist, Nation’s Largest Nonprofit Hospital*, 5 EXEMPT ORG. TAX REV. 932 (May 1992).

14. See TEX. HEALTH & SAFETY CODE ANN. § 311.031(2) (Vernon 2004); CAL. HEALTH & SAFETY CODE § 127355 (Deering 2003); N.Y. PUB. HEALTH § 2803-I (Consol. 2003).

15. Alice A. Noble, Andrew L. Hyams & Nancy M. Kane, *Charitable Hospital Accountability: A Review and Analysis of Legal and Policy Initiatives*, 26 J.L. MED. & ETHICS 116, 119-20 (1998).

work for federal tax exemption, and the community benefits standard. Next, the article discusses the rationale for the exemption and the regulatory changes in the standards of exemption that paved the way for the current movement away from charity care by the tax-exempt hospital and the need for new national guidance. Thereafter, the article discusses some state initiatives aimed at making the tax-exempt hospital more accountable. Finally, the article recommends that the Internal Revenue Service (the "Service") issue a new revenue ruling requiring the tax-exempt hospital to provide minimum annual levels of qualitative and quantitative charity care as part of the community benefit standard.

II. ORIGINS OF THE FEDERAL TAX EXEMPTION FOR NONPROFIT HOSPITALS

A. *Genesis of the Federal Tax Exemption*

The origin of federal tax exemption of today's tax-exempt hospital derives from fourteenth century England.¹⁶ The term "charitable" took its meaning from the definition of charitable purposes enumerated in the Preamble to the 1601 English Statute of Charitable Uses.¹⁷ Under the English Statute of Charitable Uses,¹⁸ expenditures typically viewed as charitable were expenditures for:

[R]elief of the aged, impotent and poor people, some for maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, some for repair of bridges, ports, havens, causeways, churches, seabanks and highways, some for education and preferment of orphans, some for marriages of the poor maids, some for supportation, aid and help of young tradesmen, handicraftsmen and persons decayed, and others for relief or redemption of prisoners or captives, and for aid or ease of any poor inhabitants concerning payments of fifteen, setting out of soldiers and other taxes.¹⁹

These English notions of what constituted charity were further entrenched in the English Common Law system following the 1891 case of *Commissioners v. Pemsel*.²⁰ In *Pemsel*, Lord McNaughten stated that the term charity, at common law, consists of "trusts for the relief

16. Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 425 (1998).

17. HOPKINS, *supra* note 2, at 86.

18. Stat. 43 Eliz. 1, c.4 (1601).

19. HOPKINS, *supra* note 2, at 104-05.

20. [1891] A.C. 531, 583 (P.C. 1891).

of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads.”²¹ Following the *Pemsel* case, its enumerated principles of charity became the basis for determining whether an organization qualified for tax exemption as a charitable organization within the English judicial system.²² These principles were inherited by American jurisprudence and served as the building blocks upon which American law on charities was established.²³

B. Early American Tax Exemption of Charitable Organizations

Early American tax exemption of the nonprofit hospital was contained in the Tariff Act of 1894.²⁴ In its exemption clause, the Act states that “nothing herein contained shall apply to . . . corporations, companies, or associates organized and conducted solely for charitable, religious, or educational purposes.”²⁵

The Tariff Act of 1909, however, limited the scope of the tax exemption by proscribing against the earnings of such tax-exempt organization inuring to the benefit of any private stockholders or individuals.²⁶ Thereafter, in 1913, Congress expanded the scope of the tax exemption to include “any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes.”²⁷ The advent of the Internal Revenue Code of 1939 amplified the range of the tax exemption to include “[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals”²⁸ Subsequent legislative initiatives continued to broaden the tax exemption to include several other organizations.²⁹

21. HOPKINS, *supra* note 2, at 104. See also Crimm, *supra* note 16, at 426.

22. *Id.*

23. Michael J. Barry, *A Sensible Alternative to Revoking the Boy Scouts' Tax Exemption*, 30 FLA. ST. U. L. REV. 137, 146 (2002).

24. HOPKINS, *supra* note 2, at 39.

25. *Id.*

26. Tariff Act of 1909, ch. 6, 38, 36 Stat. 11, 112-13 (1909).

27. Revenue Act of 1913, 63 P.L. 16, 63 Cong. Ch. 16, 33 Stat. 114, 172 (1913).

28. Internal Revenue Code § 101(6), ch. 2, 10, 53 Stat. 1, 33 (1939) (recodified as amended at I.R.C. § 501(c)(3), Pub. L. No. 591, 68A Stat. 3 (1954)).

29. E.g., Revenue Act of 1948, Pub. L. No. 80-471, 62 Stat. 110 (1948) (added organizations that provide public safety testing); Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1730 (1976) (added amateur sports organization).

C. Current Statutory and Regulatory Framework

The current statutory source of exemption of the tax-exempt hospital is governed by Internal Revenue Code (I.R.C.) § 501(a).³⁰ The provision states in relevant part that “[a]n organization described in subsection (c) . . . shall be exempt from taxation under this subtitle”³¹ In identifying the organizations referred to under I.R.C. § 501(a) as exempt from taxation, I.R.C. § 501(c)(3) includes “[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, *charitable*, scientific, testing for public safety, literary, or educational purposes . . . [provided] no part of the net earnings of which inures to the benefit of any private shareholder or individual”³²

Furthermore, the Treasury Regulations (“Regulations”) reiterate that in order to qualify for federal tax exemption, the organization must be both organized and operated exclusively for one or more of the permissible exempt purposes.³³ For example, in order to meet the organizational test, the articles of incorporation (under the state’s law) of the entity must limit its purpose to one or more permissible exempt purposes³⁴ Moreover, the articles of incorporation must not expressly empower the would-be charitable entity to engage (more than an insubstantial part of its activities) in activities which in and of themselves are not in the furtherance of one or more of the organization’s exempt purposes.³⁵

Likewise, to satisfy the operational test, the would-be charitable entity must engage primarily in activities that further its specified charitable purpose as enumerated in I.R.C. § 501(c)(3).³⁶ The Regulations caution that an organization will not meet this requirement if more than an insubstantial part of its activities is not in the furtherance of its exempt purpose or purposes.³⁷

The text of I.R.C. § 501(c)(3) does not specifically mention the tax-exempt hospital as an organization that qualifies for exemption under subsection 501(c)(3).³⁸ Nevertheless, the tax-exempt hospital

30. I.R.C. § 501(a) (2004).

31. *Id.*

32. I.R.C. § 501(c)(3) (2004) (emphasis added).

33. Treas. Reg. § 1.501(c)(3)-1(a) (2004).

34. *Id.*

35. *Id.*

36. Treas. Reg. § 1.501(c)(3)-1(c) (2004).

37. *Id.*

38. See I.R.C. § 501(c)(3) (2004); see also *Simon v. E. Ky. Welfare Rights Org.*, 426 U.S. 26, 29 (1976).

derives its tax exemption from the language of the subsection.³⁹ That language states that a corporation “organized and operated exclusively for . . . *charitable* . . . purposes” may be exempt from tax under subsection 501(c)(3), provided that the organization also complies with the proscription against its net earnings inuring to the benefit of any private shareholder or individual.⁴⁰ Thus, the specific language or words that places the tax-exempt hospital within the ambit of I.R.C. § 501(c)(3) is the phrase “organized exclusively for . . . *charitable* . . . purposes.”⁴¹ Against this background, the pertinent question is what constitutes the term “charitable”?

D. Definition of “Charitable”

The Internal Revenue Code does not define the term “charitable.”⁴² The Regulations, however, clarify that the term is used “in its generally accepted legal sense.”⁴³ Furthermore, the Regulations state that the term should not be construed as limited by the separate enumeration in subsection 501(c)(3) of other tax exempt purposes which may fall within the broad outlines of charity as developed by judicial decision.⁴⁴ As used under the Regulations, the term is construed to encompass, among others, “relief of the poor and distressed or of the underprivileged.”⁴⁵ Thus, a nonprofit hospital seeking tax exemption within I.R.C. § 501(c)(3) must: (a) be organized as a nonprofit corporation under state law and comply with that state’s requirements;⁴⁶ (b) comply with the proscription against private inurement;⁴⁷ (c) comply with the nontax federal health regulatory statutes, including the Medicare fraud abuse laws prohibiting patient dumping;⁴⁸ and (d) meet the “community benefit” standard discussed below.⁴⁹

39. *Id.*

40. *Id.* (emphasis added).

41. *Id.* (emphasis added).

42. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 330 (1976).

43. Treas. Reg. § 1.501(c)(3)-1(d)(2) (2004).

44. *Id.*

45. *Id.*

46. I.R.C. § 501(c)(3) (2004); *see also* Treas. Reg. § 1.501(c)(3)-1(b)(1) (2004).

47. I.R.C. § 501(c)(3); *see also* Treas. Reg. § 1.501(c)(3)-1(c)(2) (2004).

48. Hospital Audit Guidelines, §§ 333.1(2)-(3). *See also* HOPKINS, *supra* note 2, at 720 (“Examining agents are admonished to determine whether a hospital engages in the practice known as patient dumping.”).

49. I.R.C. § 501(c)(3); Rev. Rul. 56-185, 1956-1 C.B. 202; Rev. Rul. 69-545, 1969 C.B. 117.

E. The Community Benefit Standard

The community benefit standard is the test utilized by the IRS in determining whether a nonprofit hospital qualifies for tax exemption under I.R.C. § 501(c)(3).⁵⁰ Under Revenue Ruling 69-545,⁵¹ the rationale for federal tax exemption of the nonprofit hospital is predicated on the premise that the hospital promotes the health of a broad cross section of the community, thereby operating for community benefit and serving a charitable purpose.⁵² This is the “community benefit standard” for federal income tax exemption.⁵³ The Regulations state that an organization is not organized or operated exclusively for charitable purposes unless it serves a public rather than a private interest.⁵⁴ Thus, an organization that promotes the health of a limited class of beneficiaries serves the private interests of those individuals rather than a public interest, and therefore is not organized and operated exclusively for a charitable purpose.⁵⁵

The Regulations indicate that the promotion of health, like the relief of poverty and the advancement of education and religion, is 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 from its activities does not include all members of the community.⁵⁶ Although dependent upon facts and

50. HOPKINS, *supra* note 2, at 719-20. Quoting from the IRS Audit Guidelines for Hospitals, Manual Transmittal 7(10)69-38 for Exempt Organization Guidelines Handbook (Mar. 27, 1992), Mr. Hopkins writes, “[t]he tax exemption of nonprofit hospitals today rests on the community benefit standard. In determining whether a hospital meets this standard, IRS agents are expected to consider the following factors: (1) whether the hospital has a governing board composed of “prominent civic leaders” rather than hospital administrators, physicians, and the like (the agents are requested to review the minutes of the board meetings to determine how active the members are), (2) if the organization is part of a multi-entity hospital system, whether the minutes reflect “corporate separateness” (and whether the minutes show that the board members understand the purpose and activities of the various entities), (3) whether admission to the medical staff is open to all qualified physicians in the area, consistent with the size and nature of the facilities, (4) whether the hospital operates a full-time emergency room to everyone, regardless of ability to pay, and (5) whether the hospital provides nonemergency care to everyone in the community who is able to pay either privately or through third parties (such as Medicare and Medicaid).” *Id.* See also Rev. Rul. 69-545, 1969-2 C.B. 117.

51. Rev. Rul. 69-545, 1969-2 C.B. 117.

52. See HOPKINS, *supra* note 2, at 146-47.

53. *Id.*

54. Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) (2004).

55. Rev. Rul. 69-545, 1969 C.B. 117.

56. *Id.*

circumstances, the community benefit standard requires, in general, that a tax-exempt hospital: (i) be governed by a board of trustees or directors composed of individuals drawn from the community at large (as opposed to interested private individuals),⁵⁷ (ii) have an open medical staff policy,⁵⁸ (iii) operate a full time emergency room open to all regardless of ability to pay,⁵⁹ and (iv) admit as patients those able to pay for their care either by themselves or through third party payers like private health insurance or government sponsored programs such as Medicare and Medicaid.⁶⁰

Even though the community benefit standard does not expressly require a tax-exempt hospital to provide any minimum quantitative level of charity care, other than the operation of an emergency room open to all without regard to ability to pay,⁶¹ the IRS, in an Internal Field Service Advice (“FSA”) memorandum issued in 2001, advised its agents to look not only at a provider’s stated policy regarding charity care, but also at what the provider actually does and how it documents its charity care.⁶² Although some critics have charged that the FSA was erroneous and inconsistent in suggesting that there is a charity care component to the community benefit standard,⁶³ the FSA could be viewed as endorsing the need for the issuance of new national guidance requiring demonstrable levels of annual charity care to qualify for federal tax exemption as exemplified in the original rationale for the tax exemption.

III. RATIONALE FOR BESTOWING THE FEDERAL TAX EXEMPTION

A. *In General*

A number of scholars have advanced different theories to explain the rationale for conferring federal tax exemption on charitable organizations. These theories include the income measurement theory,⁶⁴ the

57. *Id.* See also HOPKINS, *supra* note 2, at 719-20.

58. *Id.*

59. *Id.* Rev. Rul. 83-157, 1983-2 C.B. 94 (Rev. Rul. 83-157 modified the open emergency room requirement under Rev. Rul. 69-545 to now allow a hospital without an emergency room to still qualify under the community benefit standard if it can show that the need for such service was adequately met in the community).

60. Rev. Rul. 69-545, 1969-2 C.B. 117.

61. See *id.*

62. IRS FSA 200110030 (Mar. 9, 2001).

63. *Id.*

64. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 330-33 (1976). Essentially, Professors Bittker & Rahdert argue that the subsidy theory does not provide a full explanation of the rationale for federal tax exemption. *Id.* The professors contend that the reason for

capital formation theory,⁶⁵ the altruism theory,⁶⁶ the donative theory,⁶⁷ and the risk compensation theory.⁶⁸ The original basis for the federal tax exemption, however, is embodied in the subsidy theory discussed below.⁶⁹

B. *The Subsidy Rationale*

The subsidy rationale is predicated on the theory that tax-exempt hospitals help relieve the government of its burdens by providing essential goods and services that the government would otherwise have been responsible for delivering to the public.⁷⁰ Accordingly, rather than assess taxes on these organizations providing such public

bestowing federal tax exemption was due to the impracticality of accounting for the net earnings of the charitable organizations because these organizations, according to the professors, do not earn "income" within the meaning of the term under the Internal Revenue Code. *Id.*

65. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980). Under the Capital Formation Theory, Professor Hansmann essentially proposes that the income tax exemption of the charitable organizations is a means of compensating these organizations for their inability to obtain access to traditional sources of debt financing as well as other forms of raising capital needed to grow and expand the organization like other corporate entities. *Id.*

66. Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 610-16 (1990). Under the Altruism Theory, Professor Atkinson contends that the tax exemption of the nonprofit organization is a reflection of the collective good that these organizations provide to the public at large due to their altruistic nature. *Id.*

67. Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1383-84 (1991). Under the Donative Theory, Professors Hall and Colombo argue that the primary rationale for charitable exemption is to subsidize organizations that are capable of attracting a substantial level of donative support from the public. *Id.*

68. Crimm, *supra* note 16, at 439. Under the Risk Compensation Theory, Professor Crimm suggests that nonprofit organizations arise where the government and the private sectors fail to adequately provide the desired goods and services to the public. *Id.* Therefore, Professor Crimm contends the exemption of these charitable organizations from taxation is a return on their investment of providing free public goods and services. *Id.*

69. See Michael J. Barry, *A Sensible Alternative to Revoking The Boy Scouts' Tax Exemption*, 30 FLA. ST. U. L. REV. 137 (citing *Bob Jones Univ. v. United States*, 461 U.S. 574, 590 (1983)).

70. See HOPKINS, *supra* note 2, at 16 (quoting House Ways & Means Committee Report, H. Rep. No. 1860, 75th Cong. Sess. 19 (1939) as follows: "The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare."). See also Crimm, *supra* note 16, at 430.

goods and services that the government would have otherwise provided, the government should instead compensate these organizations in the form of an indirect tax subsidy – that is, by a tax exemption.⁷¹ Some have criticized this theory because of its premise on government subsidy as the rationale for the exemption and have instead suggested that the government is merely abstaining from requiring that the exempt organizations support the state by paying tax rather than subsidizing them.⁷²

Notwithstanding the various rationales put forth by scholars to explain the basis of the tax exemption of charitable organizations, congressional records make clear that:

[t]he exemption from taxation of property devoted to charity and other purposes is based upon the theory that the government is compensated for loss of revenue by its relief from financial burden which would otherwise have been met by appropriations from public funds, and by the benefits resulting from promotion of the general welfare.⁷³

As noted by the Eighth Circuit, “[o]ne stated reason for . . . [an] exemption of this kind is that the favored entity performs a public service and benefits the public or relieves it of a burden which otherwise belongs to it.”⁷⁴ Therefore, if the government would have otherwise provided the service, it is more prudent and less expensive to forgo the tax rather than incur the entire cost of rendering the charitable services to the community.⁷⁵

IV. REGULATORY EVOLUTION OF THE STANDARD OF TAX EXEMPTION

A. *In General*

Having briefly examined the rationale for conferring federal tax exemption on the charitable hospital, the foregoing turns to the regulatory changes that have relaxed the tax exemption standards over the years and have paved the way for the tax-exempt hospitals’ departure from traditional standards of demonstrable charity care. As the foregoing discussion revealed, the traditional standards for conferring tax exemption were initially strict and required meaningful charitable care. At the time the tax exemption for nonprofit hospitals originated, nonprofit hospitals were funded by donations, and staffed by doctors

71. Crimm, *supra* note 16, at 431. See also Barry, *supra* note 69.

72. *Id.* See also Walz v. Comm’r, 397 U.S. 664 (1970).

73. H.R. 1860, 75th Cong. (3d Sess. 1938).

74. St. Louis Union Trust Co. v. United States, 374 F.2d 427, 432 (8th Cir. 1967) (quoting Duffy v. Birmingham, 190 F.2d 738, 740 (8th Cir. 1951)).

75. See Harding Hosp., Inc. v. United States, 505 F.2d 1068, 1071 (6th Cir. 1974).

who worked without remunerations and nurses who worked for room and board as part of their philanthropic devotion to caring for the poor and indigent.⁷⁶

B. *The Changing Character of the Tax-Exempt Hospital*

The tax-exempt hospital has long ago discarded its traditional charity care image.⁷⁷ As the practice of medicine evolved over the years and became more sophisticated, the role of the nonprofit hospitals as almshouses of the poor changed dramatically from being the dumping ground for the poor to being huge corporate health care delivery businesses.⁷⁸ The prevalence of abundant employer-provided health insurance and the availability of government sponsored programs such as Medicare and Medicaid was met with steady erosion of meaningful charity care by the nonprofit hospital.⁷⁹

In order to deal with the pressures and competition from their for-profit counterparts, the tax-exempt hospitals increasingly catered to mostly fee-paying patients.⁸⁰ In so doing, nonprofit hospitals decreased their reliance on donations and volunteer labor by striving to generate as much revenue as possible through commercial activities.⁸¹ As these changes in the character of the nonprofit hospital became more and more widespread, the Service issued Revenue Ruling 56-185⁸² to provide guidance on requirements for tax exemption.⁸³

C. *Revenue Ruling 56-185*

In Revenue Ruling 56-185,⁸⁴ the Service stated that in order for a nonprofit hospital to establish that it is exempt as a public charitable organization as contemplated in I.R.C. § 501(c)(3), it must, among others, meet the following general requirements:

1. [The tax-exempt hospital] must be organized as a nonprofit charitable organization for the purpose of operating a hospital for the care of the sick. A nonprofit hospital chartered only in general terms as a charitable corporation is considered to meet the test as being organized exclusively for charitable purposes

76. Hall & Colombo, *supra* note 3, at 318.

77. See Noble et al., *supra* note 15, at 116.

78. Hall & Colombo, *supra* note 3, at 318-20.

79. *Id.*

80. *Id.*

81. *Id.*

82. Rev. Rul. 56-185, 1956-1 C.B. 202.

83. J. ROGERS HOLLINGSWORTH & ELLEN J. HOLLINGSWORTH, *CONTROVERSY ABOUT AMERICAN HOSPITALS: FUNDING, OWNERSHIP AND PERFORMANCE* 66-67 (1987).

84. Rev. Rul. 56-185, 1956-1 C. B. 202.

2. [The 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. [Thus, it is permissible under this requirement] for hospitals to charge those able to pay for services rendered in order to meet the operating expenses of the institution, without denying medical care or treatment to others unable to pay. The fact that [a tax-exempt hospital's] charity record is relatively low is not conclusive that a hospital is not operated for charitable purposes to the full extent of its financial ability. [The tax-exempt hospital] may furnish services at reduced rates which are below cost, and thereby render charity in that manner. [The tax-exempt hospital] may also set aside earnings, which it uses for improvements and additions to hospital facilities. [The hospital] must not, however, refuse to accept patients in need of hospital care who cannot pay for such services. Furthermore, if [the hospital] operates with the expectation of full payment from all those to whom it renders services, it does not dispense charity merely because some of its patients fail to pay for the services rendered.
3. [The tax-exempt hospital] must not restrict the use of its facilities to a particular group of physicians and surgeons, such as a medical partnership or association, to the exclusion of all other qualified doctors. Such limitation on the use of hospital facilities is inconsistent with the public service concept inherent in section 501(c)(3) and the prohibition against the inurement of benefits to private shareholders or individuals
4. [The tax-exempt hospital's] net earnings must not inure directly or indirectly to the benefit of any private shareholder or individual.⁸⁵

This ruling by the IRS reflects the charity care standard of exemption, a standard that is consistent with the traditional view of the tax-exempt hospital as the health care provider for the poor and indigent.⁸⁶ The ruling, however, came under attack for its lack of clarity and specificity.⁸⁷ For example, the language of the ruling infers that the IRS contemplated that exempt status could be achieved by a hospital whose primary function was the delivery of health care services to persons able and expected to pay, so long as the hospital also provided free or reduced care to those not able to pay.⁸⁸ The ruling also drew

85. *Id.* See also *Comm'r v. Battle Creek, Inc.*, 126 F.2d 405 (5th Cir. 1942).

86. See HOPKINS, *supra* note 2, at 146.

87. Robert A. Boisture, *Assessing the Impact of Health Care Reform on the Formation of Tax-Exempt Health Care Providers and HMOs*, 94 TAX NOTES TODAY 41-30, 6 (1994) (quoting NATIONAL CENTER FOR HEALTH STATISTICS, HEALTH CARE IN THE UNITED STATES 153 (1992)).

88. *Id.*

criticism because it was seen as allowing hospitals an exemption on the basis of charitable activities which otherwise might not constitute sufficient tax-exempt activity to satisfy the “operated exclusively” language of I.R.C. § 501(c)(3).⁸⁹ Finally, under the ruling, it appears that the nonprofit hospital need not be very concerned about providing free medical care since most indigent people now carry some form of insurance coverage or prepayment plan under Medicare and Medicaid.⁹⁰ Thus, the number of patients who lack an ability to pay for health care is significantly reduced. Consequently, the Service, in 1969, modified its 1956 ruling with the issuance of Revenue Ruling 69-545.⁹¹

D. Revenue Ruling 69-545

Under this ruling, the Service moved away from its former relief of poverty standard of 1956 to a community benefit standard. The ruling expressly modified Revenue Ruling 56-185 to eliminate the ‘financial ability’ requirement (i.e., the charity care standard).⁹² The Service also appears to recognize that the promotion of health is inherently a charitable purpose, and is not obviated by the fact that the cost is borne by patients or third party payors.⁹³ Thus, under this ruling, a nonprofit hospital must promote the health of a class of persons broad enough to benefit the community and must be operated to serve a public rather than a private interest.⁹⁴

In determining whether a hospital meets the community benefit standard, the Service pointed out that a nonprofit hospital that provided no free or reduced rate of service to indigent persons, except for emergency room care, could still qualify for tax exemption.⁹⁵ The Ser-

89. *Id.*

90. *Id.*

91. Rev. Rul. 69-545, 1969-2 C.B. 117.

92. Hall & Colombo, *supra* note 3, at 397 (“[I]n a 1956 ruling, the Service stated that in order to be exempt, a hospital must ‘be operated to the extent of its financial ability for those not able to pay for services rendered . . .’ In 1969, however, the IRS altered its ‘charity care’ standard for hospital exemption . . .”). See also HOPKINS, *supra* note 2, at 146 (“[In 1956] the IRS stated that a hospital, to be charitable, ‘must be operated to the extent of its financial ability for those not able to pay for services rendered and not exclusively for those who are able and expected to pay.’ This approach (the *charity care* standard) was a reflection of the charitable hospital as it once was - a health care provider emphasizing care more for the poor than for the sick . . . [I]n 1969 the IRS modified its 1956 position . . .”).

93. HOPKINS, *supra* note 2, at 146. See also Rev. 69-545, 1969-2 C.B. 117.

94. *Id.*

95. Rev. Rul. 69-545, 1969-2 C.B. 117.

vice reasoned that a hospital's maintenance of an emergency room open to all persons, regardless of their ability to pay, constituted an important benefit to the community which, according to the Service, satisfied the required standard.⁹⁶ Thus, the key here is the existence of an emergency room open to all.⁹⁷ Unlike the 1956 ruling, Revenue Ruling 69-545 only required that the nonprofit hospital promote health care for the general benefit of the community, regardless of the whether certain indigent persons may be excluded from participation.⁹⁸

Essentially, the community benefit standard requires a nonprofit hospital seeking tax-exempt status to operate an open emergency room, treat Medicare and Medicaid patients, and provide for an independent governing body comprising of community leaders.⁹⁹ Revenue Ruling 69-545 is indicative of the Service's relaxation of the requirements for tax exemption, which in turn blurs the difference between the tax-exempt hospitals and their for-profit counterparts.¹⁰⁰ The Service further modified the community benefit standard due to the increasing availability of insurance benefits and government sponsored programs such as Medicare and Medicaid.¹⁰¹ This modification was incorporated in Revenue Ruling 83-157, which further eroded the requirement of meaningful charity care from the community benefit standard.

E. Revenue Ruling 83-157

In Revenue Ruling 83-157,¹⁰² the Service stated that a nonprofit hospital similarly situated to the one described in Revenue Ruling 69-545 can still qualify for a tax exemption even if it does *not* operate an emergency room by demonstrating other ways it provides community benefits.¹⁰³ The Service confirmed that the operation of an emergency room was not absolutely required if a hospital was in an area that had

96. Harry G. Gourevitch, *Tax Aspects of Health Care Reform: The Tax Treatment of Health Care Providers*, 9 EXEMPT ORG. TAX REV. 1317, 1319-23 (1994).

97. *Id.*

98. *See* Rev. Rul. 69-545, 1969-2 C.B. 117.

99. *Id.*

100. Robert A. Boisture, *Assessing the Impact of Health Care Reform on the Formation of Tax-Exempt Health Care Providers and HMOs*, 94 TAX NOTES TODAY 41-30 (1994).

101. James B. Simpson & Sarah D. Strum, *How Good a Samaritan? Federal Income Tax Exemption for Charitable Hospitals Reconsidered*, 4 U. PUGET SOUND L. REV. 633, 637-44 (1991).

102. Rev. Rul. 83-157, 1983-2 C.B. 94.

103. *Id.*

sufficient emergency care available to all persons.¹⁰⁴ For instance, the Service stated that a hospital may be a specialized institution (e.g., an eye hospital or a cancer center) that offers medical care under conditions unlikely to necessitate the operation of an emergency room.¹⁰⁵ Thus, forcing it to operate an emergency room under those circumstances would amount to a wasteful duplication of services.¹⁰⁶ Essentially, the ruling indicates that a nonprofit hospital in a similar situation would be deemed to have satisfied the community benefit standard if other facts and circumstances are met.¹⁰⁷

These facts and circumstances include the following issues: whether control of the hospital is governed by a board of trustees composed of individuals who do not have any direct economic interest in the hospital; whether the hospital maintains an open medical staff, with privileges available to all qualified physicians, consistent with the size and nature of the facilities; whether the hospital's policy enables any member of the medical staff to rent available office space; whether the hospital offers programs of medical training, research, and education; and whether the hospital is involved in various projects and programs to improve the health of the community.¹⁰⁸

Currently, the law is not entirely clear as to what exactly is required under the community benefit standard. What is clear, however, is that the tax-exempt hospital has dramatically moved away from its traditional almshouse image to become wealthy institutions of care as a result of the relaxation of the rules governing tax exemption and the concurrent lack of clarity on the community benefit standard. The distinction between the tax-exempt hospital and its for-profit counterpart is becoming increasingly blurred. Accordingly, a number of states and local governments have challenged their continued exemption and some have even had their tax-exempt status revoked.¹⁰⁹

104. *See id.* *See also* HOPKINS, *supra* note 2, at 620; IRS Audit Guidelines, Manual Transmittal 7(10) 69-38 for Exempt Organizations Examination Guidelines Handbook (March 27, 1992).

105. Rev. Rul. 83-157, 1983-2 C.B. 94.

106. *Id.*

107. *Id.*

108. *See id.* *See also* HOPKINS, *supra* note 2, at 719-20.

109. *See* Lucette Lagnado, *Hospital Found "Not Charitable" Loses Its Status As Tax Exempt*, WALL ST. J., Feb. 19, 2004, at B1.

V. CHALLENGES FACED BY TAX-EXEMPT HOSPITALS

A. Overview

The economic pressures faced by the tax-exempt hospital in today's world of Medicare and Medicaid reimbursement declines and cutthroat competition cannot be overemphasized.¹¹⁰ During the mid-twentieth century, tax-exempt hospitals had to engage in fierce competition for market share with their for-profit counterparts, who for the most part, were better equipped with modern technology to dispense health care treatment.¹¹¹ To meet with these new challenges, the tax-exempt hospital began charging more patients for care and limiting its care to more acute illnesses.¹¹² Over the years, the tax-exempt hospitals were able to dramatically transform themselves from their almshouse roots to sophisticated viable competitors in the seemingly cutthroat health care market.¹¹³ During the transformation, the tax-exempt hospitals rarely catered to the indigent and often turned away patients who lacked ability to pay.¹¹⁴ As noted by the United States Court of Appeals for the District of Columbia Circuit, the "rationale upon which the limited definition of 'charitable' was predicated has largely disappeared."¹¹⁵ Today, tax-exempt hospitals have all but dispensed with meaningful charity care—the fundamental basis for their exemption. In light of these changes and the lack of regulatory clarity,¹¹⁶ many have even questioned the continued justification of the exemptions.¹¹⁷

B. Attacks on Continued Exemption

Due to the redefinition of the community benefit standard by the Service to dispense with meaningful charity care customarily associ-

110. Lawrence E. Singer, *The Conversion Conundrum: The State and Federal Response to Hospitals' Changes in Charitable Status*, 221 AM. J.L. & MED. 221, 221-23 (1997).

111. G.J. Simon, Jr., *Non Profit Hospital Tax Exemptions: Where Did They Come From and Where Are They Going?*, 31 DUQ. L. REV. 343 (1993).

112. *Id.*

113. *Id.*

114. Barry R. Furrow, *Enterprise Liability and Health Care Reform: Managing Care and Risk*, 39 ST. LOUIS U. L.J. 77, 93-95 (1994). See also Lucette Lagnado, *Hospital Found "Not Charitable" Loses Its Status As Tax Exempt*, WALL ST. J., Feb. 19, 2004, at B1.

115. *E. Ky. Welfare Rights Org. v. Simon*, 506 F.2d 1278, 1288-90 (D.C. Cir. 1974), vacated on other grounds, 426 U.S. 26 (1976).

116. John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 497-98 (2002).

117. See Charles B. Gilbert, *Health-Care Reform and the Nonprofit Hospital: Is Tax-Exempt Status Still Warranted?*, 26 URB. LAW. 143, 143 (1994).

ated with nonprofit hospitals, a number of individuals, states, and local governments have questioned the continued justification of tax exemption for the nonprofit hospital and in response have taken initiatives to require more accountability from tax-exempt hospitals.¹¹⁸ Although states and local governments are not legally bound by federal tax exemption in determining tax-exempt status for nonfederal tax purposes, they generally follow the federal guidelines.¹¹⁹

In Utah, for example, the state supreme court in *Utah County v. Intermountain Health Care*¹²⁰ utilized a six-prong charity care test to deny tax exempt status to two nonprofit hospitals under the state's constitution. Under the test, the court inquired:

- (1) whether the stated purpose of the entity is to provide a significant service to others without immediate expectation of material reward;
- (2) whether the entity is supported, and to what extent, by donations and gifts;
- (3) whether the recipients of the "charity" are required to pay for the assistance received, in whole or in part;
- (4) whether the income received from all sources (gifts, donations, and payment from recipients) produces a "profit" to the entity in the sense that the income exceeds operating and long-term maintenance expenses;
- (5) whether the beneficiaries of the "charity" are restricted or unrestricted and, if restricted, whether the restriction bears a reasonable relationship to the entity's charitable objectives; and
- (6) whether dividends or some other form of financial benefit, or assets on dissolution, are available to private interests, and whether the entity is organized and operated so that any commercial activities are subordinate or incidental to charitable ones.¹²¹

According to the Utah Supreme Court, these factors are merely guidelines and no particular factor is solely determinative.¹²² Thus, the failure to comply with one or a number of them without more should not automatically result in revocation of exempt status.¹²³

In Vermont, on the other hand, the state supreme court¹²⁴ relied on the traditional notions of tax exemption to sustain the tax-exempt status of hospital. In *Medical Center Hospital v. City of Burlington*, the

118. See Hall & Colombo, *supra* note 3, at 374-76; see also Charles B. Gilbert, *Health-Care Reform and the Nonprofit Hospital: Is Tax-Exempt Status Still Warranted?*, 26 URB. LAW. 143, 143 (1994).

119. Noble et al., *supra* note 15, at 120.

120. *Utah County v. Intermountain Health Care*, 709 P.2d 265, 272 (Utah 1985).

121. *Id.* at 269-70.

122. *Id.* at 270.

123. *Id.*

124. *Med. Ctr. Hosp. v. City of Burlington*, 566 A.2d 1352 (Vt. 1989).

court held that an “open door policy” was sufficient for Medical Center Hospital to qualify as a charitable organization.¹²⁵

Nonetheless, attorney generals of a number of states have challenged the tax-exempt status of nonprofit hospitals in their states. The first in the line of attacks was the office of the Attorney General of Texas.¹²⁶ Although the case was dismissed on jurisdictional grounds, Texas brought the suit against Methodist Hospital¹²⁷ in 1990 complaining that the hospital was not providing sufficient charity care to warrant continued tax exemption. As previously stated, the suit was dismissed on grounds that the state’s attorney general lacked the power to enforce the tax code.¹²⁸ Following the dismissal, however, the Texas legislature enacted legislation aimed at greater accountability from tax-exempt hospitals, and requiring them to dedicate portions of their revenues to charity care and community benefits as discussed below.¹²⁹

C. *The Texas Statute*

The Texas statute provides in relevant part that: “a nonprofit hospital shall provide health care services to the community and shall comply with all federal, state, and local government requirements for tax exemption in order to maintain such exemption.”¹³⁰ Under the statute, the required health care services to the community encompasses “charity care” and “government-sponsored indigent health care” and may include other components of community benefits.¹³¹

(i) *Charity Care Defined*

Under the Texas statute, the term “charity care” is defined as the unreimbursed cost to a hospital of:

- (A) providing, funding, or otherwise financially supporting health care services on an inpatient or outpatient basis to a person classified by the hospital as “financially indigent” or “medically indigent”; and/or
- (B) providing, funding, or otherwise financially supporting health care services provided to financially indigent persons through

125. See Noble et al., *supra* note 15, at 120.

126. Texas v. Methodist Hosp., No. 494,212 (126th Dist. Ct., Travis County, Tex. Feb. 19, 1993).

127. *Id.*

128. *Id.*

129. TEX. HEALTH & SAFETY CODE ANN. § 311.043 (Vernon 2004).

130. § 311.043(a).

131. *Id.*

other nonprofit or public outpatient clinics, hospitals, or health care organizations.¹³²

(ii) *Government Sponsored Indigent Care Defined*

“Government-sponsored indigent health care” on the other hand, is defined under the statute as the “unreimbursed cost to a hospital of providing health care services to recipients of Medicaid and other federal, state, or local indigent health care programs, eligibility for which is based on financial need.”¹³³

(iii) *Level of Charity Care and Community Benefits Required Under the Texas Statute*

To qualify as a charitable organization, Texas requires that a nonprofit hospital or hospital system provide charity care and “community benefits” as follows:

- (1) charity care and government-sponsored indigent health care must be provided at a level that is reasonable in relation to the community needs, as determined through the community needs assessment, the available resources of the hospital or hospital system, and the tax-exempt benefits received by the hospital or hospital system;¹³⁴
- (2) charity care and government-sponsored indigent health care must be provided in an amount equal to at least four percent of the hospital’s or hospital system’s net patient revenue;¹³⁵
- (3) charity care and government-sponsored indigent health care must be provided in an amount equal to at least 100 percent of the hospital’s or hospital system’s tax-exempt benefits, excluding federal income tax;¹³⁶ or
- (4) charity care and community benefits must be provided in a combined amount equal to at least five percent of the hospital’s or hospital system’s net patient revenue, provided that charity care and government-sponsored indigent health care are provided in an amount equal to at least four percent of net patient revenue.¹³⁷

(iv) *Community Benefits Defined*

“Community benefits” under the Texas statute is defined as the “unreimbursed cost to a hospital of providing charity care, govern-

132. § 311.031(2).

133. § 311.031(8).

134. TEX. TAX CODE ANN. § 11.1801(a)(1) (Vernon 2004).

135. § 11.1801(a)(2).

136. § 11.1801(a)(3).

137. § 11.1801(a)(4).

ment-sponsored indigent health care, donations, education, government-sponsored program services, research, and subsidized health services.”¹³⁸ However, community benefits do not “include the cost to the hospital of paying any taxes or other governmental assessments.”¹³⁹

(v) *Community Benefits Planning*

In order to provide community benefits, the statute provides that the nonprofit hospital must develop a community benefit plan as follows:

- (a) A nonprofit hospital shall develop:
- (1) an organizational mission statement that identifies the hospital’s commitment to serving the health care needs of the community;¹⁴⁰ and
 - (2) a community benefits plan defined as an operational plan for serving the community’s health care needs that sets out goals and objectives for providing community benefits that include charity care and government-sponsored indigent health care, as the terms community benefits, charity care, and government-sponsored indigent health care are defined . . . and that identifies the populations and communities served by the hospital.¹⁴¹
- (b) When developing the community benefits plan, the hospital shall consider the health care needs of the community as determined by community-wide needs assessments. For purposes of this subsection, “community” means the primary geographic area and patient categories for which the hospital provides health care services; provided, however, that the primary geographic area shall at least encompass the entire county in which the hospital is located.¹⁴²
- (c) The hospital shall include at least the following elements in the community benefits plan:
- (1) mechanisms to evaluate the plan’s effectiveness, including but not limited to a method for soliciting the views of the communities served by the hospital;
 - (2) measurable objectives to be achieved within a specified time frame; and
 - (3) a budget for the plan.¹⁴³

138. TEX. HEALTH & SAFETY CODE ANN. § 311.042(2) (Vernon 2004).

139. *Id.*

140. §311.044(a)(1).

141. §311.044(a)(2).

142. §311.044(b).

143. §311.044(c).

- (d) In determining the community-wide needs assessment required by Subsection (b), a nonprofit hospital shall consider consulting with and seeking input from representatives of the following entities or organizations located in the community . . .
- (1) the local health department;
 - (2) the public health region . . .;
 - (3) the public health district;
 - (4) health-related organizations, including a health professional association or hospital association;
 - (5) health science centers;
 - (6) private business;
 - (7) consumers;
 - (8) local governments; and
 - (9) insurance companies and managed care organizations with an active market presence in the community.¹⁴⁴

(vi) *Enforcement Mechanisms of the Texas Statute*

To enforce community benefit rules, the Texas statute requires:

- (a) The [Texas] department [of Health] shall submit to the attorney general and comptroller not later than July 1 of each year a report listing each nonprofit hospital or hospital system that did not meet the [community benefit] requirements . . . during the preceding fiscal year.¹⁴⁵
- (b) The department shall submit to the attorney general and the comptroller not later than November 1 of each year a report containing the following information for each nonprofit hospital or hospital system during the preceding fiscal year:
 - (1) the amount of charity care . . . provided;
 - (2) the amount of government-sponsored indigent health care . . . provided;
 - (3) the amount of community benefits . . . provided;
 - (4) the amount of net patient revenue . . . and the amount constituting four percent of net patient revenue;
 - (5) the dollar amount of the hospital's or hospital system's charity care and community benefits requirements met;
 - (6) a computation of the percentage by which the amount described by Subdivision (5) is above or below the dollar amount of the hospital's or hospital system's charity care and community benefits requirements;
 - (7) the amount of tax-exempt benefits, . . . provided, if the hospital is required to report tax-exempt benefits . . .; and

144. TEX. HEALTH & SAFETY CODE ANN. §311.044(d) (Vernon 2004).

145. §311.0455(a).

- (8) the amount of charity care expenses reported in the hospital's or hospital system's audited financial statement.¹⁴⁶

D. *The California Legislation*

(i) *Overview*

Unlike Texas, the California statute does not contain rigid quantitative community benefits as a predicate for eligibility for tax exemption. Rather, the statute requires all private and nonprofit hospitals conduct community benefit needs assessments and develop community benefit plans that are to be reported annually to the state.¹⁴⁷ In developing the community benefit plan, the California Code requires the hospital to include the following elements:

- (a) Mechanisms to evaluate the plan's effectiveness
- (b) Measurable objectives to be achieved within specified timeframes.
- (c) Community benefits categorized into the following framework: (1) Medical care services; (2) Other benefits for vulnerable populations; (3) Other benefits for the broader community; (4) Health research, education, and training programs; (5) Nonquantifiable benefits.¹⁴⁸

(ii) *Definition of Community Benefits under the California Statute*

The California statute defines "community benefits" as a "hospital's activities that are intended to address community needs and priorities primarily through disease prevention and improvement of health status."¹⁴⁹ Activities that qualify for community benefits include, but not limited to, health care services to vulnerable populations, such as the elderly; public health programs; services offered without regard to financial return because they meet a community need, such as social services or health promotion, and the "donation of funds, property, or other resources that contribute to a community priority."¹⁵⁰

146. §311.0455(b).

147. CAL. HEALTH & SAFETY CODE § 127340 (Deering 2003).

148. § 127355.

149. § 127345(c).

150. § 127345.

E. *The New York Statute*

Like Texas, the New York statute is detailed and strict in enumerating its community benefit service plan requirements.¹⁵¹ Under its community benefit service plans the following is required:

1. The governing body of a voluntary non-profit general hospital must issue an organizational mission statement identifying at a minimum the populations and communities served by the hospital and the hospital's commitment to meeting the health care needs of the community.¹⁵²
2. The governing body must at least every three years:
 - (i) review and amend as necessary the hospital mission statement;
 - (ii) solicit the views of the communities served by the hospital on such issues as the hospital's performance and service priorities;
 - (iii) demonstrate the hospital's operational and financial commitment to meeting community health care needs, to provide charity care services and to improve access to health care services by the underserved; and
 - (iv) prepare and make available to the public a statement showing on a combined basis a summary of the financial resources of the hospital and related corporations and the allocation of available resources to hospital purposes including the provision of free or reduced charge services.¹⁵³
3. The governing body must at least annually prepare and make available to the public an implementation report regarding the hospital's performance in meeting the health care needs of the community, providing charity care services, and improving access to health care services by the underserved.¹⁵⁴
4. The governing body shall file with the commissioner its mission statement, its annual implementation report, and at least every three years a report detailing amendments to the statement and reflecting changes in the hospital's operational and financial commitment to meeting the health care needs of the community, providing charity care services, and improving access to health care services by the underserved.¹⁵⁵

151. N.Y. PUB. HEALTH § 2803-I (Consol. 2003).

152. § 2803-I(1).

153. § 2803-I(2).

154. § 2803-I(3).

155. § 2803-I(4).

VI. RECOMMENDATIONS

Clearly, the existing rules for determining community benefits for federal tax exemption of the nonprofit hospital are at best inconsistent and need clarity. Although the original rationale for exempting the nonprofit hospital from federal income taxation was that it was organized and operated exclusively for charitable purposes, the requirement of meaningful charity care has all but disappeared from the Service's community benefit standard. The Service further fanned the embers of uncertainty as to the required degree of charity care in its 2001 Field Service Advise memorandum¹⁵⁶ by instructing its agents in their audit examinations to look not only at a tax-exempt hospital's stated policy regarding charity, but also to look at what the hospital actually does with respect to charity care and how it is documented.

To bring clarity and national consistency to the rules and standards for federal tax exemption with respect to charity care, the Service needs to issue a new revenue ruling specifying both qualitative and quantitative levels of annual charity care (beyond an emergency room open to all without regard to ability to pay) required from nonprofit hospitals as part of the community benefit standard.

In this regard, each tax-exempt hospital should be required to conduct an annual community-wide needs assessment of its geographic area to determine the health care needs of the community. Based on the results of the needs assessment, the tax-exempt hospital should be required to provide, at a minimum, community benefits and charity care (exclusive of bad debts) that exceed the community needs and that is at least equal to the value of the tax-exempt benefits received by the hospital. To enforce these requirements, the Service should assess an excise tax against any tax-exempt hospital that fails to provide charity care and community benefits at the levels specified.

156. IRS FSA 200110030 (Mar. 9, 2001).