

A Compliance-Oriented Refresher on Nonprofit, Tax-Exempt Health Care Organization Tax and Accounting Developments

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On June 6, 2009, in a radio speech during his visit to Europe, President Obama fast-tracked his commitment to comprehensive health care reform – a precursor to the major health care legislation being debated this summer. "We must attack the root causes of skyrocketing health care costs. Some of these costs are the result of unwarranted profiteering that has no place in our health care system, and in too many communities, folks are paying higher costs without receiving better care in return . . . [we] should learn from their successes and promote the best practices, not the most expensive ones."

As focus upon, and change within, the existing United States health care system remains in the forefront of regulatory and media scrutiny, the nonprofit, tax-exempt hospital organization would benefit from a summary of current tax compliance areas of concern in the past year. These areas include: (1) recent voluntary - but for practical intents and purposes, mandatory - compliance surveys sent to nonprofit hospitals from the Internal Revenue Service ("IRS"); (2) final revised Form 990 and Instructions; and (3) Financial Accounting Standards Board Interpretation No. 48 ("FIN 48") audit compliance reminders. This article intends to serve as a "bird's eye" summary of these developments, providing recommendations for preventive maintenance and ultimately preparing the tax-exempt, nonprofit hospital for broader reforms.

Lessons from IRS Compliance Checks: Review Governance Documents, Assess Policies and Procedures, Evaluate Board Effectiveness

IRS compliance checks are neither formal audits nor examinations; rather, they are informal surveys by the IRS to determine if an entity is adhering to standard IRS record-keeping and reporting requirements.¹ While participation is voluntary, the IRS notes that failure to respond may trigger a formal audit or investigation. As such, responses to a compliance check request should never be ignored, and careful attention should be paid to all responses.

Currently, three key compliance check projects are of particular interest to the tax-exempt health care compliance officer. First, a Final Report was issued in February 2009 on

a compliance check questionnaire sent to over 500 nonprofit hospitals in 2006 ("Hospital Compliance Check").² Second, in September 2008, the IRS issued an interim report on the results of another compliance check questionnaire sent in 2007 to charitable organizations receiving tax-exempt bond proceeds ("Tax-Exempt Bond Compliance Check").³ Finally, a third initiative is underway through compliance checks sent in January 2009 to governmental issuers of tax-exempt bonds ("Governmental Issuer Compliance Check").⁴ These compliance checks were keyed towards specific areas of concern. These areas and recommendations to address them are discussed below.

Key Areas of Concern Drawn from the Hospital Compliance Check

The original Hospital Compliance Check focused on community benefit and executive compensation in nonprofit, tax-exempt hospitals. The Final Report was meant simply to provide data to the public as opposed to drawing hard conclusions. The general consensus with respect to community benefit was that the overall average of total revenues spent on aggregate community benefit was 9 percent, with a median at 6 percent. But such percentages were based on varying methods of calculating community benefit. The Report noted that the new Schedule H to Form 990⁵ would assist in remedying these variations so future data would be more informative. With respect to executive compensation, a small subset of twenty large hospital systems were reviewed for excess compensation. Of these hospitals, the average total compensation (base salary, bonus, benefits) was \$801,720, and the average Chief Executive Officer compensation was \$1.4 million. Eighty-five percent of these hospitals properly used

comparability data and independent personnel to review and establish the compensation amounts.

While that compliance check is closed, the nonprofit, tax-exempt health care compliance officer should ask if his or her system's organizational structure, controls, policies and procedures are sufficient to respond to inquiries based on the areas below. These questions eventually were reflected in the new Schedule H and will be required to be disclosed in future years (most reporting is optional currently).

Information on charity care. Can internal accounting measure, in terms of costs and number of patients, the provision of medical services to patients with private/public/no insurance, Medicaid, and Medicare? Can data be provided with respect to inpatient and outpatient treatment? Can denial of treatment to patients on the basis of private/public insurance, Medicaid, and Medicare be substantiated? Have the emergency room admission policies been reviewed in recent years?

Information on board of directors. How many directors serve on the Board? Is the number sufficient or excessive? Does the composition of the Board reflect a sufficiently diverse cross-section of community representation, expertise, and other characteristics reflecting diversity and capacity? Are the number of meetings adequate? Is the Board accountable for its actions, reflected by written ethics and conflicts of interest policies?

Medical staff privileges. Are all qualified physicians in the community eligible for medical staff privileges at the hospital? If not, what are the parameters?

Medical research. What amounts of public and private funding go to the hospital's medical research programs and medical trial programs? Does the hospital provide funding to outside individuals or organizations? Are the research findings publicly disseminated, or is access limited?

Continuing medical education. Does the hospital provide continuing medical education programs? Does the hospital track whether funding for the programs comes from public or private sources?

Uncompensated care. Is there a written policy for the provision of medical care to those who cannot pay? Does the hospital maintain records on how many patients received such uncompensated care, and can it calculate how much was spent with respect to uncompensated care? Is uncompensated care determined by taking the excess of the amount charged for the service less private/public insurance, Medicaid, Medicare, and patient payments? Are bad debts treated as uncompensated care? What other items, other than the excess described here, are treated as uncompensated care? Is uncompensated care provided for inpatient, outpatient, or emergency room care?

Billing practices. What are the written billing policies for inpatient, outpatient, and emergency room patients? What are the time periods relating to invoicing and due dates? Does

the hospital use collections agencies? Does the hospital offer installment or other extended pay arrangements? Do hospital charges vary depending upon whether the patient has private/public insurance or level of income?

Community programs. Are community health programs offered to the public (i.e., medical screening programs, immunization programs, lectures, seminars, healthcare needs assessments, newsletters)? Are fees charged for these programs? How much is spent annually on these programs?

Compensation practices. Does the organization's accounting department accurately compile salary/compensation, deferred compensation, and benefit breakdowns for officers, directors, trustees, key employees, and independent contractors? Is there a written compensation policy and a conflicts of interest policy? How is compensation determined? Are outside consultants utilized? What comparability factors are used? Is there a mechanism in place to identify instances in which there are business relationships between the organization and its officers, directors, trustees, or key employees?

Key Areas of Concern Drawn from the Tax-Exempt Bond and Governmental Issuer Compliance Checks

With many nonprofit, tax-exempt organizations obtaining financing through tax-exempt bonds, it becomes especially important for the compliance officer to ensure the organization has sufficient mechanisms in place to satisfy the post-issuance requirements that must be met for tax-exempt bonds to remain tax-exempt as "qualified 501(c)(3) bonds." In brief, to maintain status as a "qualified 501(c)(3) bond," the tax-exempt organization must satisfy: (a) requirements related to the use of the proceeds and the financed property (i.e. the bond-financed property generally cannot be used for private business use); and (b) limits on the yield on the investments acquired with the proceeds (the bonds cannot be "arbitrage" bonds whereas the yield on investments acquired with the bonds exceed the yield on the bond issue itself). The second requirement is a bit difficult to understand, but in brief, proceeds from tax-exempt bonds are not supposed to be invested in property that generates a yield that exceeds the interest rate charged to the borrower of the bond proceeds.

In 2007, the IRS sent the "Tax-Exempt Bond Financing Compliance Check Questionnaire" to over 200 organizations that reported a tax-exempt bond obligation on their 2005 Form 990. The purpose was to determine how many of these organizations: (a) had post-issuance compliance procedures in place (95 percent reported they had, but only 16 percent of those responding had written procedures); (b) assigned a management official the primary responsibility for monitoring bond issuance requirements (89 percent did); and (c) whether the books and records were sufficient to substantiate require-

ments (97 percent stated yes). In January 2009, the IRS sent a similar questionnaire to the governmental entities issuing the bonds. In light of these compliance checks, the compliance officer (particularly those unfamiliar with the technicalities of the tax-exempt bond process) should assess whether internal controls exist to handle the following areas of IRS concern.

Post-issuance compliance. Does the organization have a written procedure or guideline to ensure the qualified 501(c)(3) bond financing proceeds, after the issuance closes, remain in compliance with requirements relating to the: (1) proper and timely use of proceeds and bond-financed property; (2) arbitrage yield restrictions; and (3) timely filing of any applicable tax returns?⁶ Is there a primary person responsible for monitoring these requirements? Are there training or educational resources available for such persons?

General recordkeeping. Are records maintained with respect to the tax-exempt bonds? How long and in what medium are they maintained?

Investments and arbitrage compliance. Is there documentation of allocation of the investment earnings between general investments and bond financing investments? Is there documentation relating to investment contracts, credit enhancement transactions, and financial derivatives? Are copies maintained of arbitrage-related documents such as computations of bond yield, rebate, and yield reduction payments? Are there written procedures or policies for monitoring these requirements?

Documentation of expenditures and assets relating to financings. Does the organization maintain documentation of allocation of the use of bond financing proceeds? Are there copies of requisitions, draw schedules, draw requests, invoices, and checks relating to bond proceeds spent during the construction period? Are there copies of construction, renovation, and/or purchase of the bond-financed facilities? Is there a list or schedule of all bond-financed facilities or equipment?

Private business use. Are records maintained of all unrelated trade or business activities allocated to bond-financed facilities, as well as activities by third parties allocated to bond-financed facilities? Are there joint venture agreements, management agreements, naming rights, subleases, or other arrangements with respect to the facilities? Generally, what is the process by which the organization ensures the qualified 501(c)(3) bonds remain tax-exempt?

Preparation for the Revised Form 990 and Schedule H: Assess Governance and Internal Accounting Systems

Plenty of articles and commentary cover the extensive revisions to IRS Form 990 (Return for Organization Exempt from Income Tax); this brief article does not purport to cover the revisions in detail as by now the nonprofit, tax-exempt compliance officer knows of the revisions. Instead, it is a reminder as to what constitutes "best practices." Rather than dwell on the details of completing the new Form 990 and related Schedules, the compliance officer might directly ask the following questions.

- (1) Has the structure, organization, and effectiveness of the governing body (Board of Directors or Board of Trustees and officers) been assessed?** Section VI of the new Form 990 contains more detailed questions relating to the organization of the governing body and management of the exempt organization. If the organization has not reviewed or otherwise evaluated the Board's structure and effectiveness, the compliance officer may suggest such a review and refer to new Form 990, Section VI (Governance, Management, and Disclosure) questions as a guideline.⁷ Key written documents that may be added include conflicts of interest policies (and especially the ability to monitor and enforce the policy), whistleblower policies, and document retention and destruction policies. In addition, written compensation policies and documented efforts at establishing comparability data for executive compensation are recommended.
- (2) Is the Board and other leadership actively involved in assessing needs, setting community benefit standards, approving policies, and representing interests? Are internal controls and recordkeeping sufficient to track such activities?** New Schedule H (Hospitals) will require much more detailed community benefit data than previously requested by the IRS. While some information may be tracked for state requirements, the new IRS requirements may not necessarily be identical. The compliance officer should develop a good understanding of the data required for new Schedule H and be prepared to enlist active Board involvement in determining if the data and activities are sufficient (not simply for the IRS, which does not have minimum standards, but for the public and regulatory agencies).
- (3) Has there been a recent review or evaluation of all related entities or ventures within the organization?** Frankly, effective internal governance requires knowledge of all entities existing within a health care system. New Schedule R (Related Organizations and Unrelated Partnerships) solicits information relating to limited liability companies, partnerships, corporations, "disregarded" entities, and joint ventures with which the tax-exempt organization is involved. The compliance officer should have a clear understanding of all entities under the primary organization's umbrella (and not simply rely on outside counsel or accountants who may not always have adequate information). In larger organizations, it is surprising how many entities slip through the cracks.

Accounting for FIN 48: Work with Independent Auditor to Determine Compliance with FIN 48

The nonprofit, tax-exempt organization subject to audited financial statements will need to comply with Financial Accounting Standards Board ("FASB") Interpretation No. 48, entitled "Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109." This accounting standard (referred to as "FIN 48") is a 58-page document⁸ that provides accountants a detailed process to measure and quantify "uncertain income tax positions." The standard may

be applicable to tax-exempt organizations that have issued tax-exempt bonds. Simply being tax-exempt is a "tax position" for the tax-exempt health care organization, so auditors will need to evaluate and disclose potential tax problem areas that come to light during their investigation. The compliance officer should be aware of the following key problem areas that can jeopardize tax-exempt status, and thereby give rise to FIN 48 disclosures.

- (1) **Failure to be organized and operated exclusively for charitable purposes.** Ensuring the organization's articles of incorporation/certificate of formation are updated and properly reflect IRS requirements helps satisfy the "organization" requirement of being tax-exempt. The "operated exclusively" requirement is far broader, but may be satisfied by paying attention to community benefit/care requirements, monitoring related party transactions, proper filing of tax returns, and other common sense due diligence matters. Failures to pay attention to these details can jeopardize tax-exempt status and give rise to FIN 48 disclosure issues.
- (2) **Participate in private inurement or material private benefit transactions.** The compliance officer can minimize problems by ensuring compensation and conflict of interest policies exist and are actively followed and enforced. Following comparability data and use of disinterested compensation consultants is practically mandatory for large, tax-exempt health care organizations. Careful attention should be paid not only to what meets legal requirements, but what may be perceived as improper by the public.
- (3) **Participate in prohibited political campaign activities or lobbying.** The compliance officer should be aware of political activity restrictions applicable to tax-exempt organizations. Not only are political campaign contributions prohibited under IRS rules, seemingly innocuous activities, such as an invitation to speak at the organization's facilities, can potentially violate these rules. The IRS published Revenue Ruling 2007-41,⁹ which outlines ways in which tax-exempt organizations can and cannot participate in voter education, voter drives, candidate appearances, and issue advocacy. The Revenue Ruling also discusses how individual officers and directors of an exempt organization may structure participation in campaigns in their individual capacity, as well as guidance on how web sites may or may not be linked to campaigns.
- (4) **Participate in excessive Unrelated Business Taxable Income ("UBTI") transactions.** UBTI is generated when an exempt organization participates in a business activity that does not further the organization's charitable purpose. For example, rental of an exempt organization's commercial property to a third party typically triggers UBTI - the exempt organization is taxed at regular corporate rates on net income generated from the activity. If the level of UBTI is substantial with respect to the overall net income of the exempt organization, the tax-exempt status of the organization becomes an issue. The compliance officer should review all of these issues with the organization's internal and external accounting staff, as well as legal counsel, to highlight any activities that might generate UBTI.

Conclusion

There has been a wealth of educational material summarizing recent tax and accounting developments in the nonprofit, tax-exempt organization area, and the detail can be a bit overwhelming. This article very briefly summarized the IRS compliance surveys, the final revised Form 990 and Instructions, and FIN 48 audit standard applicability. The article explained the general steps the nonprofit, tax-exempt compliance officer should take as a result of those developments. By having the proper "birds-eye" perspective, a better plan to handle the details can be implemented, making compliance with Form 990 and FIN 48 more manageable. ■

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¹ See IRS Publication 3114, *Compliance Check, Audit, Examination, or Review* (Rev. 1-2005), available at <http://www.irs.gov/pub/irs-pdf/p3114.pdf>. The compliance check is authorized pursuant to §60501 of the Internal Revenue Code of 1986, as amended ("Code").

² See IRS Form 13790, *Compliance Check Questionnaire, Tax Exempt Hospitals* (Rev. 5-2006), available at http://www.irs.gov/pub/irs-tege/exhibit_1_form13790.pdf. A copy of the final report, along with an executive summary, is available at <http://www.irs.gov/charities/charitable/article/0,,id=203109,00.html>.

³ See IRS Form 13907, *Tax Exempt Bond Financings Compliance Check Questionnaire* (Rev. 8-2007), available at http://ftp.irs.gov/pub/irs-tege/form_13907_teb_financing_questionnaire.pdf. A copy of the interim report following these compliance checks is available at http://www.irs.gov/pub/irs-tege/interim_report_-_draft_09-11-08_v1.pdf.

⁴ See IRS Form 14002, *Governmental Bond Financings Compliance Check Questionnaire* (Rev. 9-2008), available at <http://www.irs.gov/pub/irs-tege/fl14002.pdf>. See also <http://www.irs.gov/taxexemptbond/article/0,,id=202946,00.html> for a detailed summary of the purposes.

⁵ See *On the Front Lines, An Analysis of the New Schedule H (IRS Form 990) and Proposed Instructions: Are Hospitals Ready for Increased Disclosures?*, CCH Health Care Compliance Letter, Part I, Vol. 11-15, July 22, 2008, and Part II, Vol. 11-16, Aug. 5, 2008.

⁶ With respect to tax returns, adequate books and records need to be maintained to support tax exemption of the interest as reported to the beneficial holders of the bonds. The issuer and conduit borrowers may need to file IRS Form 8038, 8038-G, 8038-GC, and other specialized forms. New Form 990's Schedule K also will solicit information from the tax-exempt organization that reports an outstanding tax-exempt bond issue that had an outstanding principal amount in excess of \$100,000 as of the last day of the tax year.

⁷ All final Form 990s and related Schedules are available at <http://www.irs.gov/charities/article/0,,id=176637,00.html>.

⁸ FIN 48 is available at <http://www.fasb.org/pdf/fin%2048.pdf>.

⁹ Rev. Rul. 2007-41, 2007-25 I.R.B., June 25, 2007, available at http://www.irs.gov/irb/2007-25_IRB/ar09.html.