Health Care Provider Reference Guide

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Overview

Purpose

The purpose of this article, with the accompanying guide sheet, is to provide an introduction to and aid in the processing of IRC 501(c)(3) exemption applications submitted by health care providers, including issues to keep in mind in evaluating whether activities that "promote health" are also charitable.

Exhibit 1, *Guide Sheet for Hospitals, Clinics and Similar Health Care Providers*, is for the agent's use in identifying issues specific to health care in processing applications. A "Q" followed by a number, (Q#) in block labels (left side of page) refers to questions in the guide.

The information provided in this article is subject to change by published guidance, court decisions, or tax law changes.

In this Article

This article contains the following topics:

Qualifying as a Tax-Exempt Health Care Provider

Promotion of Health -- Charitable or Non-charitable Activity?

The promotion of health for the benefit of the community is a charitable purpose. Engaging in health care activities alone does not necessarily further charitable purposes.

For example, in Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 67 (1979), aff'd 625 F.2d 804 (8th Cir. 1980), the Tax Court held that an organization operating a pharmacy to sell drugs at cost to elderly and handicapped persons did not qualify for tax exemption under IRC 501(c)(3). The court stated:

> We do not believe that the law requires that any organization, whose purpose is to benefit health, however remotely, is automatically entitled, without more, to the desired exemption.

The proliferation of different types of health care providers and the growing complexity of health care entities require a careful review of exemption applications to ensure that health care providers primarily operate for the benefit of the community.

Qualifying as a Tax Exempt Health Care Provider

A hospital, clinic, or other similar health care provider (collectively "health care provider") may qualify for tax-exempt status under IRC 501(c)(3) provided it is organized and operated exclusively for charitable purposes. To qualify as a health care provider that promotes health as its charitable purpose, the organization must meet the community benefit standard described in Rev. Rul. 69-545, 1969-2 C.B. 117, as well as the other requirements of IRC 501(c)(3) and its regulations.

Organizational Test Q1

The organizational test is the same for health care organizations as it is for any other IRC 501(c)(3) organization.

The organizational test described in Treas. Reg. 1.501(c)(3)-1(b) requires, in part, that an organization's organizing document provide that it is organized and will be operated for exclusively charitable purposes, and that upon dissolution its assets will be distributed for exclusively charitable purposes, either by an express statement in its governing document or by operation of state law.

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Operational Test

The operational test is also the same for health care organizations as it is for any other IRC 501(c)(3) organization.

The operational test described in Treas. Reg. 1.501(c)(3)-1(c) provides, in part, that:

> . . . an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Insiders, Disqualified Persons, and Private Benefit

Inurement

IRC 501(c)(3) expressly provides that to qualify for exemption, no part of an organization's net earnings shall inure in whole or in part to the benefit of private shareholders or individuals. Private shareholders or individuals are defined as persons having a personal and private interest in the activities of the organization.

In context of Exemption Application

Inurement is statutorily prohibited for IRC 501(c)(3) organizations. In the context of an application for exemption from federal income tax, where the operations of an organization would result in inurement that cannot be resolved during the application process, exempt status would be denied.

In context of Examination

However, in the context of the examination of an existing exempt organization, the presence of inurement issues would likely be addressed through IRC 4958 sanctions (excise tax and correction) before any move to revoke exemption.

Insiders

In practice, the inurement prohibition applies to insiders, rather than members of the general public or the intended class of beneficiaries. As one court noted, "The test is functional. It looks to the reality of control rather than to the insider's place in a formal table of organization." United Cancer Council v. Commissioner, 165 F.3d 1173. However, conferring excessive private benefits on non-insiders may cause an organization to be operated for private interests rather than public purposes.

In the health care setting physicians may be insiders depending upon whether they exercise control.

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Example

An organization has applied for exemption under IRC 501(c)(3). The organization was created by a physician to operate a medical clinic. Under Rev. Proc. 90-27, 1990-1 C.B. 514, Section 5, *Standards for Issuing Rulings or Determination Letters with Respect to Exempt Status*, we would need detailed information as part of the application to provide assurances concerning the absence of private benefit and inurement. Questions to elicit this information would include:

- Is there a community board of directors? If not, how will the organization make decisions to ensure the clinic is operating for a public rather than a private purpose? For example, are patient services available to the community or only to the physician's private practice patients?

- What is the physician's compensation package? How was it determined? Were comparable data applicable to similarly situated physicians utilized?

- If the organization leases, purchases, or shares facilities, employees, equipment, or its name with the physician's own medical practice, what are the terms of any such arrangement? How does the organization ensure that theses arrangements do not result in excessive private benefit?

Nevertheless, if on examination the physician is determined to be a disqualified person receiving excess benefits, it could be handled as an excess benefit transaction and/or a revocation issue as explained below.

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Intermediate Sanctions

IRC 4958, which was added to the Code by the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, §1311, 110 Stat. 1452 (1996), popularly known as "intermediate sanctions," provides a sanction, short of revocation, for situations in which a disqualified person receives an excess benefit from an IRC 501(c)(3) or 501(c)(4) organization.

IRC 4958 imposes an initial excise tax of 25% of the value of excess benefits the organization provides to a disqualified person, and imposes a second-tier tax of 200 percent of the excess benefits if the act is not corrected within the specified time.

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Disqualified persons

IRC 4958 imposes intermediate sanctions on the disqualified persons in a charity (IRC 501(c)(3)) or social welfare organization (IRC 501(c)(4)) who receive excessive economic benefits from the exempt organization. Disqualified persons are persons who are in a position to exercise substantial influence over the organization, including officers, directors, and trustees. In the health care setting, physicians may be disqualified persons, depending upon their extent of influence or control due to positions such as chief of staff, department head, or other medical staff appointment.

Intermediate sanctions include both excise taxes on the excess value and correction of the excess benefit transaction by those disqualified persons who engage in an excess benefit transaction with a tax-exempt organization.

Disqualified persons are subject to intermediate sanctions on excess business transactions that are reported by the organization after it becomes operational or that may be uncovered during an examination of the organization. Still, it is important to explore the provision of services or goods between the applicant and its officers, directors, trustees, and other individuals who are in a substantial position of authority with respect to the applicant during the application process.

Intermediate sanctions may be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status. An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a disqualified person, or in an exchange of property between a disqualified person and the exempt organization. Excess benefit occurs when the value of the economic benefit provided by the organization exceeds the value of the consideration (including the performance of services) received for providing the benefit. Fair market value is the benchmark used to determine value.

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Insiders, Disqualified Persons, and Private Benefit, Continued

Private Benefit

Unlike the express prohibition of inurement of earnings to private shareholders or individuals, IRC 501(c)(3) does not specifically mention the broader concept of "private benefit." However, the statute requires that an organization be "organized and operated exclusively" for specified purposes. Treas. Reg. 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes.

Further, Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) states that an organization exempt under IRC 501(c)(3) must serve

> …a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish it is not organized or operated for the benefit of private interests such as designated individuals…

Inurement versus Private Benefit

Inurement and private benefit are often confused. Inurement is a subset of private benefit that involves unjust benefit from the income or assets of an exempt organization going to insiders. Unlike inurement, private benefit does not necessarily involve the flow of benefits to insiders. Private benefit can involve benefits to anyone.

Incidental Private Benefit

Private benefit is not fatal to an application for exempt status unless it is more than incidental. In the context of processing a Form 1023 application, the issue of whether an organization's activities will serve private interests excessively is a factual determination. GCM 37789 explains that private benefit must be both qualitatively and quantitatively incidental. *Qualitatively* incidental means the private benefit is a mere byproduct of the public benefit. *Quantitatively* incidental means the private benefit granted as a result of the specific activity must be insubstantial in amount when compared to the public benefit of the same specific activity.

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Private Benefit, (continued)

Two tax court cases that illustrate these aspects of "private benefit" are American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989) and Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202, 215-216 (1978).

The court in American Campaign Academy provided a useful definition of "private benefit" outside of the context of inurement as "non-incidental benefits conferred on disinterested persons that serve private interests." In that case, the organization's disqualifying private benefit resulted from its operating seminars that had as a significant purpose the advancement of one particular political party.

In Aid to Artisans, the exempt organization's purpose was to support struggling artists in developing countries, with any private benefit to the artists being a necessary byproduct of a greater public benefit.

In United Cancer Council, Inc. v. Commissioner, 109 T.C. 326 (1997), reversed and remanded by the U.S. Court of Appeals for the Seventh Circuit by United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173 (7th Cir. 1999), the Appeals Court stated on the private benefit issue that:

> . . . the board of a charity has a duty of care, just like the board of an ordinary business corporation . . . and a violation of that duty which involved the dissipation of the charity's assets might . . . support a finding that the charity was conferring a private benefit, even if the contracting party did not control, or exercise undue influence over, the charity. Id. at 1180.

Thus, if a charity confers a private benefit on non-insiders, the charity is not operating exclusively in the public interest and its exemption may be jeopardized if the private benefit is substantial. Whether private benefit is deemed to be substantial or insubstantial depends upon all the facts and circumstances.

Promotion of Health as a Charitable Purpose

Rev. Ruling 69-545: Community Benefit Standard

The test used for determining if a health care provider satisfies the IRC 501(c)(3) operational test is the "community benefit standard" enunciated in Revenue Ruling 69-545, 1969-2 C.B. 117, and court cases that apply Rev. Rul. 69-545.

The community benefit standard is the test used to determine whether a hospital, clinic, or other health care provider is operated to promote health in a way that accomplishes a charitable purpose.

Rev. Rul. 69-545 defined the community benefit standard in the context of a hospital. The Service and the courts have applied this standard to hospital and non-hospital health care providers. See IHC Health Plans, Inc. v. Commissioner, 325 F.3d 1188 (10th Cir. 2003); Sound Health Association v. Commissioner, 71 T.C. 158 (1978); and Geisinger Health Plan v. Commissioner, 985 F.2d 1210 (3rd Cir. 1993).

Rev. Ruling 56-185: Financial Ability Standard

Prior to Rev. Rul. 69-545, tax-exempt hospitals were required by Rev. Rul. 56-185, 1956-1 C.B. 202 to admit and treat patients who were unable to pay, either without charge or at rates below cost. This requirement was referred to as the "financial ability standard" because this uncompensated care had to be provided to the extent of the hospital's financial ability.

Rev. Rul. 69-545 modified the financial ability standard by introducing additional considerations known as the community benefit standard. Although a formal policy to provide charity care is still relevant, the new standard also takes into account a number of additional factors indicating that the operation of the hospital benefits the community as a whole.

Other Health Care Providers

Similarly, a rehabilitation institution, outpatient clinic, community mental health center, dental clinic, drug treatment center, or community chiropractor may qualify as an exempt health care provider if it meets the community benefit standard and otherwise qualifies under IRC 501(c)(3).

Meeting the Community Benefit Standard

Does a Hospital Meet the Community Benefit Standard?

As used with regard to a hospital, the "community benefit standard" in Rev. Rul. 69-545 includes the following factors:

- Does the hospital have a governing board, community board, board of trustees, or board of directors composed of prominent civic leaders rather than exclusively members who are hospital administrators, physicians, or others professionally connected to the hospital?

- Is admission to the hospital's medical staff open to all qualified physicians in the area, consistent with the size and nature of the facilities?

- Does the hospital operate a full-time emergency room open to everyone, regardless of his or her ability to pay? (However, Rev. Rul. 83-157, 1983-2 C.B. 94, in some situations, allows hospitals not to operate an emergency room.)

- Does the hospital provide non-emergency care to everyone in the community who is able to pay either privately or through third parties, including Medicare and Medicaid?

- Does the hospital serve a broad cross section of the community through research or charity care (as defined in Rev. Rul. 56-185)?

Each of these factors will be discussed separately in the following sections.

Community Board

Independent Persons Q2

As discussed in Article C, *Tax-Exempt Health Care Organizations Community Board and Conflicts of Interest Policy,* in the CPE volume for FY 1997 at p. 18, a "community board" is one in which independent persons representative of the community comprise a majority. Practicing physicians affiliated with the hospital, officers, department heads, and other employees of the hospital are not independent due to their close and continuing connection with the hospital. They may serve on the hospital's board of trustees, but cannot comprise a majority. Other persons who may have some business dealings with the hospital are usually included in the majority. Rev. Rul. 69-545, supra, states that control of a charitable hospital in a board of directors composed of "independent civic leaders" is a significant factor in determining community benefit.

In a multi-entity hospital system, a subsidiary tax-exempt organization (an applicant) that does not have a community board is considered to have a community board if it is controlled by an IRC 501(c)(3) organization whose board is comprised of a majority of voting members who are independent community members.

Definition of "Control"

Control means authority over structural and financial aspects. For example, structural control may include the right to appoint, elect, or remove the directors of the applicant. Financial control may include the right to approve annual operating and capital budgets, strategic planning initiatives, and significant sales, leases, mortgages or other transfers or encumbrances of real or personal property.

Conflict of Interest Policy Q3

The presence and enforcement of a conflict of interest policy applicable to a health care provider's directors, trustees, principal officers, highly compensated employees, and members of committees with board-delegated powers, can help assure fulfillment of charitable purposes.

While not mandatory, adoption of a conflict of interest policy is almost universal because it represents an important opportunity for health care providers to avoid potential private benefit, inurement, and intermediate sanction violations. A sample conflict of interest policy recommended by the Service is attached as Appendix A, which is taken from Article E, *Tax-Exempt Health Care Organizations Revised Conflicts of Interest Policy,* in the CPE volume for FY 2000.

Open Hospital Staff

Open Hospital Staff Privileges Q4

A hospital's medical staff privilege refers to permission a hospital provides to physicians, who are not employees of the hospital, to practice at the hospital. A policy of having an open medical staff demonstrates that a hospital furthers the interests of the community rather than the private interests of a select group of physicians. Contrast *Situation 2* in Revenue Ruling 69-545, 1969-2 C.B. 117, where there was not an open medical staff.

Open hospital staff privileges do not mean that any or all physicians may practice there. A hospital may place limitations on its medical staff based on physicians meeting professional standards of care, education, licensure, and accreditation, and on practice and capacity limitations of the facility. The requirement for open staff privileges is not necessarily applicable to clinics, specialty hospitals, or similar health care providers.

- Note: Where a hospital's medical staff is restricted solely to physicians from a particular medical practice, this would raise the question of possible private benefit that should be explored through further development.

Corporate Practice of Medicine

Corporate Practice of Medicine Q5

Some states prohibit non-profit corporations from employing physicians to provide outpatient medical services. These states require physicians to incorporate under the state's for-profit professional corporation laws. This is commonly known as the corporate practice of medicine doctrine.

These laws require a physician licensed in the state to hold all the stock in the corporation providing medical services and all board members are required to be physicians licensed by the state. Generally, one physician holds all the stock.

For-profit medical practices in states that adhere to the corporate practice of medicine doctrine may qualify for exemption, but only if the health care provider implements a considerable number of safeguards to ensure charitable organization and operation. Although Article F, *Corporate Practice of Medicine,* in the FY 2000 CPE Text at page 55 provides a discussion, this type of case is currently handled by EO Technical.

Emergency Room and Non-Emergency Care

Emergency Rooms Open to All
Q6

Usually, a hospital must have an emergency room open to all persons regardless of their ability to pay to meet the community benefit standard.

However, an emergency room is not required if a governmental planning agency has determined it would unnecessarily duplicate an existing service or if the health care provided by the hospital is not the type of care requiring an emergency room (e.g., specialized eye care). Therefore, an emergency room is not required for a clinic or specialty hospital. See Rev. Rul. 83-157, 1983-2 C.B. 94.

Key factors in determining if the emergency room is open to all regardless of ability to pay are:

- No one is denied treatment in the emergency room based on ability to pay. (Note: Admission to the hospital may be based on ability to pay directly or through third party providers.)

- The hospital's emergency room generally has patient transportation arrangements with police, fire, and ambulance services.

Medicare or Medicaid
Q7

Participation in Medicare (government program that pays health care for the elderly or disabled) or Medicaid (government program that pays health care for the poor) is a factor that helps establish that a health care provider meets the community benefit standard.

Charity Care and Research

Charity Care Q8

The provision of charity care is relevant in determining whether a hospital meets the community benefit standard of Rev. Rul. 69-545. Many hospitals adopt a charity care policy to help them meet the health care needs of low income and uninsured members of their communities. A charity care policy is reflected by the formal adoption of a written policy providing objective standards that are used in determining who qualifies for such care. Hospital bad debt is not considered to be charity care.

Further, because clinics and other health care providers are not required to have an emergency room, many demonstrate community benefit by implementing a charity care policy and by providing a significant amount of charity care. Treating patients covered through Medicare and Medicaid may also demonstrate community benefit. Charity care policies must be available to the public.

A charity care policy provides that certain patients will be offered free or reduced-cost care, often using a sliding scale, based on the patient's ability to pay. Health care providers should be in a position to describe the amounts expended or anticipated to be expended on charity care.

Medical Training, Research and Other Health Related Activities Q9

Other activities that serve the community, when combined with factors enumerated in Rev. Rul. 69-545, help to demonstrate the required benefit to the community.

Medical training or research are ways that a health care provider can serve the health needs of the community. Additional activities demonstrating community benefit include free health education programs (e.g., cardiac information, pregnancy counseling), seminars (e.g., stop smoking seminars), or community health fairs (e.g., blood pressure or cholesterol testing).

Private Benefit Issues: Fair Market Value

Private Benefit and Valuation Issues

Whenever a transaction takes place between an exempt organization and other individuals or groups, care must be taken to ensure there is not excessive private benefit conferred on members or officers. Values related to transactions must be documented in order to establish any private benefit is merely incidental.

Physician Office Space Q10

The terms of any lease must be at fair market value to prevent excessive private benefit. Rev. Ruls. 69-463, 1969-2 C.B. 131 and 69-464, 1969-2 C.B. 132, state a hospital may lease space to physicians and to medical groups at locations adjacent to the hospital campus. This is considered to further the hospital's exempt purposes by facilitating patient access to the hospital.

The lease must be at fair market value and the hospital should explain how it arrived at a commercially reasonable lease.

Lease of Assets Q11

When an exempt health care provider leases equipment, office space or other assets from individuals and entities with whom it has an ongoing financial relationship, such as a member of its board of directors, an employee, officer, or a physician with staff privileges, the possibility that the lease is not at fair market value is greater than if the lease is at arm's-length. In these situations, it is important to review the lease and any documentation about how the lease was negotiated to ensure that it is commercially reasonable and represents fair market value.

If the dollar amounts are significant, the health care provider should obtain independent verification that the transaction is commercially reasonable and is at fair market value.

Hospital Purchase of Physician Practices Q12

Hospitals may purchase medical practices, ambulatory surgery centers, magnetic imaging centers, and other for-profit health care operations and often employ or contract back with the selling physicians to operate these entities as wholly owned, IRC 501(c)(3) health care providers.

When the purchase involves significant amounts of money, the organization should be in a position to justify the terms of the purchase through, for example, timely valuation of the assets purchased. Such valuations help ensure the hospital has not overpaid. See Article Q, *Valuation of Medical Practices*, in the FY 1996 CPE text for a discussion of acceptable valuation methods.

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Private Benefit Issues: Fair Market Value, Continued

Retained Rights

A review of the underlying documents is necessary to determine if there is retained authority over the use of the assets by the seller. For example, the right to direct future affiliations with other medical practices, the right to hire additional physicians, or the right to repurchase a medical practice (other than a right of first refusal) may effectively limit the ability of a hospital to utilize its assets to further exclusively charitable purposes and also reduces the value of the assets.

Retained rights can usually be found in the asset purchase agreement, but they can also be in a professional service agreement or employment contract.

Private Benefit Issues: Compensation

Recruitment Incentives Q13

Recruitment incentives are used by a hospital to recruit physicians to its staff or its community. Where the hospital or community is experiencing a shortage of physicians, incentives such as bonuses, housing or moving allowances, guaranteed income allowances, or below market rental of office space can be used to further the hospital's exempt purposes. See Rev. Rul. 97-21, 1997-1 C.B. 121.

Incentives should be provided at arm's-length, be consistent with written policies, should not result in excessive compensation paid to employees or unreasonable payments (including unreasonable income guarantees) paid to non-employees, and should be legal.

Reasonable Compensation Q14

In determining whether compensation is excessive, total compensation must be determined first. Compensation includes not only salary, but also any fringe benefits and pension plans or other deferred compensation provided. The exempt organization should provide assurance that the total compensation package provided to a physician (base salary, bonuses, and benefits) is reasonable for the physician's specialty and area.

Generally, compensation is more likely to be reasonable if it is established at arm's-length by an independent board of directors or committee subject to a conflict of interest policy and is based on current compensation studies of similarly situated employees in similar geographic locales.

Revenue-Based Compensation

If compensation is based on revenues**,** the potential for unreasonable compensation warrants a close review of the compensation arrangement.

A fixed salary with a bonus based on a percentage of a physician's gross or net collections or billings is revenue-based. Employment contracts should be examined to determine if the amounts paid are excessive, and to ensure that the exempt organization is not using the revenue-based compensation as a vehicle for distributing the organization's profits. It may be appropriate to accept employment contracts with names and other identifying information redacted when the health care provider is concerned with confidentiality.

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Private Benefit Issues: Compensation, Continued

Compensation Plan	The compensation plan, first and foremost, must be a legitimate vehicle to compensate physicians fairly. If the health care provider cannot explain how it determines compensation is reasonable, then it needs to develop a process to ensure that its significant employment contracts will result in the payment of reasonable compensation. A process that undertakes to review compensations studies of similarly situated employees would provide an appropriate process.
Compensation for a For-Profit Medical Group Q15	A health care provider may contract with a for-profit medical group to provide professional health care services. This is not an exempt organization issue as long as the total payment by the exempt organization is reasonable in relation to the total services it receives.

Joint Ventures or Partnerships with For-Profit Entities

Exemption Issues Q16

A joint venture between an exempt organization and a for-profit entity can take the form of a partnership or a limited liability company (LLC).

EO Technical will handle all applications for exemption submitted by health care providers that will engage in whole hospital joint ventures with for-profit entities or in joint ventures with for-profit entities when the joint venture is the applicant organization's primary activity.

Rev. Rul. 98-15, 1998-1 C.B. 718, provides two examples demonstrating when a whole hospital joint venture with a for-profit entity will or will not adversely affect exemption. In Situation 1, which does not jeopardize exemption, the organization and operation of the joint venture allows the exempt health care provider to continue to further a charitable purpose and to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners. This is the case because, among other requirements, the governing documents of the joint venture provide for the exempt organization to appoint 3 of the 5 directors and require that the joint venture operate any hospital it owns in a manner that furthers charitable purposes by promoting health for a broad cross section of the community.

In contrast, Situation 2 involves a joint venture in which the partners each name 3 members to the six-member board. A majority of the board members must approve certain major decisions regarding operation of the joint venture. The governing documents provide that the joint venture operate the health care facilities it owns and engage in other health care-related activities. However, there is no binding obligation for the joint venture to serve charitable purposes or otherwise provide its services to the community as a whole. For this and other reasons the tax-exempt partner can no longer establish that it is neither organized nor operated for the benefit of private interests nor is the benefit to the for-profit partner incidental to the furtherance of an exempt purpose. Thus, the tax-exempt partner will fail the operational test when it enters into the joint venture, adversely affecting exemption.

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Q16 (continued) Other joint ventures where the hospital is the controlling partner and has an operational role generally do not raise exemption issues if participation in the partnership is necessary for the hospital's exempt purpose and the benefit to the for-profit partners is not excessive. However, the details of the partnership arrangement need to be carefully developed to ensure the joint venture falls within the confines of Situation 1 of Rev. Rul. 98-15.

A certificate of need may help to establish that an activity is necessary to accomplish exempt purposes. Return of capital (initial investment) is generally beyond the scope of an exempt partner's obligation to the for-profit partners and indicates the for-profit partners' investment is not at risk.

Factors to Consider

Some factors to consider in developing a joint venture case are whether:

- The exempt organization has an operational role
- The investment is limited to the specific amount invested
- The partners receive distributions consistent with their economic interests
- Ownership interests are proportionate to the partners' investment
- The exempt organization obtains access to capital or expertise that is not otherwise available

When a healthcare provider that engages in other charitable activities also participates in a joint venture with for-profit entities where this activity does not further its charitable purposes, the tax-exempt entity may be subject to unrelated business income taxation under IRC 512(c).

Other Health Care Providers

HMOs
Q17

Where the health care provider is a health maintenance organization (HMO), the case is currently handled by EO Technical. An HMO is generally an organization that arranges for its members or subscribers to obtain medical care by contracting with health care providers.

Faculty Group Practices
Q18

A faculty group practice is a health care provider established to employ physicians who are faculty members of a medical school. The group practice offers faculty physicians an opportunity to sharpen their skill by providing medical treatment of patients. It may be organized under corporate practice of medicine state laws. Generally, the courts have determined that faculty group practices qualify under IRC 501(c)(3). See University of Maryland Physicians, P.A. v. Commissioner, 41 T.C.M. 732 (1981); University of Massachusetts Medical School Group Practice v. Commissioner, 74 T.C. 1299 (1980); and B. H. W. Anesthesia Foundation v. Commissioner, 72 T.C. 681 (1979).

Currently, these types of cases are handled by EO Technical.

Fire, Rescue, and Emergency Services
Q19

Providing fire, rescue, or emergency services for the general community may accomplish charitable purposes under IRC 501(c)(3) because such services provide relief to the poor and distressed, or lessen the burdens of government.

- Rescue service --- A nonprofit organization that conducts emergency rescue services for stranded, injured or lost persons provides relief of distressed persons and is exempt as an organization described in IRC 501(c)(3). See Rev. Rul. 69-174, 1969-1 C.B. 149.

- Volunteer fire company --- A nonprofit organization that provides fire protection and ambulance and rescue services to a community qualifies for exemption as a charitable organization under IRC 501(c)(3). See Rev. Rul. 74-361, 1974-2 C.B. 159.

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Membership Organization

However, when a nonprofit organization operating fire, rescue, or emergency services is a membership organization, it must clearly demonstrate that it benefits the community as a whole in addition to its members.

Where an organization, otherwise qualified for exemption under IRC 501(c)(3), provides emergency, fire, rescue, and ambulance services for its members on a fee basis, the following types of factors should be considered to ensure that it does not operate for the private benefit of its members:

- Does the organization operate on a policy of furnishing services to all individuals in need regardless of membership or the ability to pay?
- Is membership available to everyone in the community at nominal cost so that nearly all segments of the interested public could obtain services at the preferential member rate?
- Are charges to non-members reasonably related to the cost of services rendered and not of a punitive nature?

By meeting the above factors, the organization can demonstrate that it is not impermissibly serving its members' private interests.

Volunteer Firefighters' Relief Organizations

Typical volunteer firefighters' relief organizations are created to provide ancillary benefits such as disability and accident insurance, life insurance, and pensions to unpaid, volunteer firefighters. Using a "lessening the burdens of government" rationale, some of these organizations may qualify for exemption under IRC 501(c)(3). Other volunteer firefighters' relief organizations may qualify under IRC 501(c)(4) using a "community benefit" rationale. For more information relating to the treatment of this type of organization, see Article N, *Volunteer Firefighters' Relief Organizations,* in the FY 1996 CPE Text at page 349 and Article G, *Volunteer Firefighters' Relief Organizations,* in the FY 2000 CPE Text at page 105.

Foundation Status: Hospital

General Discussion

Applications may be submitted by organizations where it is difficult to determine if they are a hospital under IRC 509(a)(1) and 170(b)(1)(A)(iii), or a publicly supported organization under IRC 509(a)(1) and 170(b)(1)(A)(vi) or IRC 509(a)(2). They may ask for one particular foundation classification, when they may be better described under another foundation status.

This commonly occurs with small clinics, generally in rural or inner city settings. They are organized to treat patients suffering from a wide range of maladies, or suffering from a particular condition. Such an organization may not have the need for operating an emergency room, or for a wide variety of staff practicing different specialties. Examples could include, but are not limited to, a rural medical clinic serving the poor, or a women's health clinic serving those in need of maternity care.

On occasion an applicant receiving exemption under one foundation classification, but not the requested classification, has challenged the Service's determination despite being found not to be a private foundation. In Friends of the Society of Servants of God v. Commissioner, 75 T.C. 209 (1980), petitioner had requested a definitive ruling that it was not a private foundation under IRC 509(a)(1) on the basis that it was a church described in IRC 170(b)(1)(A)(i). The Service granted an advance ruling as a public charity under IRC 509(a)(1) and 170(b)(1)(A)(vi). Under the advance ruling, the applicant would need to meet the public support requirements during the advance period or be reclassified as a private foundation. The tax court agreed that the advance ruling on petitioner's status as a private foundation under IRC 509(a) was adverse in many important respects and that the court had jurisdiction under IRC 7428(a) to review the advance ruling.

Note also that classification of foundation status under IRC 509(a)(1) and 170(b)(1)(A)(vi) or IRC 509(a)(2) does **not** allow the applicant to avoid the community benefit test or allow insiders, rather than a community board, to control the organization. The community benefit standard arises out of the IRC 501(c)(3) requirements, not out of IRC 509(a).

Continued on next page

Foundation Status: Hospital, Continued

Eligible for Hospital Exclusion IRC 170(b)(1)(A)(iii) Q20, Q21

An organization whose principal purpose is the provision of medical or hospital care will qualify as a hospital under IRC 509(a)(1) and 170(b)(1)(A)(iii). The term hospital includes a federal, state, county or municipal hospital; a rehabilitation institution; an outpatient clinic; a community mental health center; or a drug treatment center. A health care provider whose accommodations qualify as being part of a skilled nursing facility within the meaning of 42 U.S.C. 1395x(j) may qualify as a hospital.

Medical care means the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, provided the cost of such treatment is deductible under IRC 213 by the person being treated. See Treas. Reg. 1.170A-9(c)(1).

An outpatient clinic includes a medical center equipped to provide health care services to persons in the community through a staff of health specialists who provide medical care to persons in the community even though it does not have facilities to maintain patients overnight or provide any non-ambulatory care. See Rev. Rul. 73-313, 1973-2 C.B. 174.

Not Eligible for IRC 170(b)(1)(A)(iii) Exclusion

However, an organization that primarily provides health care services to patients in their own homes under the direction of their private physicians and only incidentally provides patient treatment at the organization's offices is not described in IRC 170(b)(1)(A)(iii). See Rev. Rul. 76-452, 1976-2 C.B. 60.

Hospitals do not include convalescent homes or homes for children or the aged, nor do they include institutions whose principal purpose is to train handicapped individuals to pursue a vocation

Exhibit 1

Guide Sheet for Hospitals, Clinics and Similar Health Care Providers

INSTRUCTIONS – This guide sheet is designed to assist in the processing of certain health care provider IRC 501(c)(3) exemption applications. Generally, a "Yes" response indicates a favorable factor, whereas, a "No" response indicates a potential concern. See the accompanying health care provider reference guide for assistance in completing this guide sheet. Contact EO Technical for additional help.

	Yes	No
1. Does the health care provider's organizing document meet the "organizational test?"		
2. Does the health care provider have a community board of directors?		
a. If the health care provider does not have a community board and is part of a multi-entity health care system, are there any other IRC 501 (c)(3) entities in the system with a community board that has structural control over the health care provider?		
3. Does the health care provider have a conflict of interest policy covering its directors, principal officers, highly paid employees, and members of committees with board delegated authority that is similar to the policy recommended by the Service?		
4. If the organization is a hospital, does it maintain an open medical staff whereby medical staff privileges are available to all qualified physicians in the area consistent with the size and nature of its facilities?		
5. Is the health care provider a professional corporation organized under a corporate practice of medicine state law? If Yes, send the application to EO Technical.		
6. If the organization is a hospital, does it maintain a full-time emergency room?		
a. Is the emergency room open to all persons regardless of their ability to pay?		
b. Does the hospital have arrangements with police, fire and ambulance services to deliver patients to its emergency room?		
7. Does the health care provider accept persons covered under Medicare or Medicaid?		
a. If the health care provider has not obtained a Medicaid contract, has it pursued good faith negotiations to obtain a Medicaid contract?		
b. If the health care provider doesn't accept Medicare, contact EO Technical.		
8. Does the health care provider have a charity care policy and is it communicated to the public?		
a. Was a copy of the charity care policy submitted with the application?		
b. Does the charity care policy provide for free or reduced rate medical care consistent with the patient's financial resources?		
9. Does the health care provider conduct a formal program of medical training, medical research, or community educational programs?		

	Yes	No
10. Does the health care provider lease office space to physicians with whom it has a financial relationship?		
a. Was a copy of the lease submitted?		
b. Has the health care provider explained how it established a lease at fair market value?		
11. Does the health care provider lease any equipment, assets, or office space from physicians or other individuals, corporations or partnerships (aside from structurally controlled organizations) with an on-going financial relationship with the provider?		
a. Was a copy of the lease submitted?		
b. Has the health care provider explained how it established a lease at fair market value?		
12. Has the health care provider purchased medical practices, ambulatory surgery centers, or other business assets from physicians or other persons (1) who have substantial influence over the health care provider; (2) who are employed by the health care provider; or (3) who contract back with the health care provider to operate the business?		
a. Was a copy of the asset purchase agreement (purchase and sale contract) submitted?		
b. Is there an appraisal supporting the purchase price?		
c. Does the appraisal utilize the cost, market and/or income methods or some combination thereof to arrive at fair market value?		
d. Does the asset purchase agreement include any retained rights by the seller to (1) affect future affiliations with others; (2) to determine if additional physicians can be hired; or (3) to repurchase the assets within a certain time period (other than a right of first refusal)?		
13. Does the hospital offer recruitment incentives to physicians?		
a. Are recruitment incentives consistent with Rev. Rul. 97-21, 1997-1 C.B. 121?		
14. Has the health care provider explained the amounts and bases by which it compensates its officers, highly compensated employees, and physicians?		
a. Were representative employment contracts submitted?		
b. Are compensation arrangements approved by an independent board of directors or compensation committee subject to a conflict of interest policy?		
c. If a physician's compensation is based on revenues, is there an incentive for providing charity care and/or meeting quality of care or patient satisfaction benchmarks?		
d. If a physician's compensation is based on revenues, is there a cap on total compensation based on reasonable compensation for physicians in similar specialties in similar geographic locales?		
e. If a physician's compensation is based on revenues, are the revenues limited to the work product of the physician and/or nurse practitioner(s) under the direct supervision of the physician?		

	Yes	No
15. Does the medical provider employ a for-profit medical group to serve its patients?		
a. Was the professional services agreement or employment contract submitted with the application?		
b. Is total compensation reasonable based on the factors in Q14?		
16. Does the health care provider participate in a joint venture, partnership or limited liability company (LLC) arrangement with a for-profit entity?		
a. Were copies of all such agreement(s) provided?		
b. Did the health care provider receive ownership interest in the joint venture, partnership or LLC proportionate to its contribution?		
c. Are all returns of capital and distributions of earnings made to the members proportional to their ownership interests?		
d. Is a majority of the governing board chosen by the tax-exempt health care provider?		
e. Does a majority of the governing body approve major decisions that include: the annual capital and operating budgets; distribution of earnings; selection of key executives; acquisition or disposition of health care facilities; contracts in excess of a specific dollar amount threshold; changes to the types of services offered by the hospital; and renewal or termination of any management agreements?		
f. Do the governing documents require it to operate all of its health care entities (including any health care entities contributed by the for-profit) in a manner furthering charitable purposes?		
g. Do the governing documents explicitly provide directors have a duty to operate in a manner furthering charitable purposes and this may override their duty to operate for the financial benefit of the for-profit members?		
h. Are the governing documents legal, binding and enforceable under applicable state law?		
i. Are any management contracts for a definite term of years and terminable for cause? Were copies of management contracts provided?		
j. Has the Applicant provided information to establish that the terms, fees and conditions of any management agreements are reasonable and comparable to management contracts of other organizations providing similar services at similarly situated health care entities?		
k. Have you determined that no officers, directors, or other employees of the health care provider who were involved in the decision-making or the negotiations involving the formation of the joint venture, partnership, or LLC, were promised employment or any other inducements by the for-profit and any of its related entities, or the joint venture, partnership or the LLC itself?		
l. Have you determined that none of these individuals has any interest, directly or indirectly, in the for-profit or any of its related entities?		
17. Is the health care provider an HMO? If Yes, send application to EO Technical.		
18. Is the health care provider a faculty group practice? If Yes, send application to EO Technical.		

	Yes	No
19. If the organization is a fire, rescue, or emergency service provider, does it offer comparable services to the entire community?		
20. Does the hospital or clinic qualify as a hospital described in IRC 509(a)(1) and 170(b)(1)(A)(iii)?		
21. Is the health care provider a drug treatment center, a community mental health center or skilled nursing facility?		

SAMPLE CONFLICT OF INTEREST POLICY
(Revised 1999)

Article I

Purpose

The purpose of the conflict of interest policy is to protect the Corporation's interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Corporation. This policy is intended to supplement but not replace any applicable state laws governing conflicts of interest applicable to nonprofit and charitable corporations.

Article II

Definitions

1. Interested Person

Any director, principal officer, or member of a committee with board delegated powers who has a direct or indirect financial interest, as defined below, is an interested person. If a person is an interested person with respect to any entity in the health care system of which the Corporation is a part, he or she is an interested person with respect to all entities in the health care system.

2. Financial Interest

A person has a financial interest if the person has, directly or indirectly, through business, investment or family--

a. an ownership or investment interest in any entity with which the Corporation has a transaction or arrangement, or

b. a compensation arrangement with the Corporation or with any entity or individual with which the Corporation has a transaction or arrangement, or

c. a potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Corporation is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are substantial in nature.

A financial interest is not necessarily a conflict of interest. Under Article III, Section 2, a person who has a financial interest may have a conflict of interest only if the appropriate board or committee decides that a conflict of interest exists.

Article III

Procedures

1. Duty to Disclose

In connection with any actual or possible conflict of interest, an interested person must disclose the existence of his or her financial interest and must be given the opportunity to disclose all material facts to the directors and members of committees with board delegated powers considering the proposed transaction or arrangement.

2. Determining Whether a Conflict of Interest Exists

After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he/she shall leave the board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

3. Procedures for Addressing the Conflict of Interest

a. An interested person may make a presentation at the board or committee meeting, but after such presentation, he/she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement that results in the conflict of interest.

b. The chairperson of the board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.

c. After exercising due diligence, the board or committee shall determine whether the Corporation can obtain a more advantageous transaction or arrangement with reasonable efforts from a person or entity that would not give rise to a conflict of interest.

d. If a more advantageous transaction or arrangement is not reasonably attainable under circumstances that would not give rise to a conflict of interest, the board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Corporation's best interest and for its own benefit and whether the transaction is fair and reasonable to the Corporation and shall make its decision as

to whether to enter into the transaction or arrangement in conformity with such determination.

4. Violations of the Conflict of Interest Policy

a. If the board or committee has reasonable cause to believe that a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.

b. If, after hearing the response of the member and making such further investigation as may be warranted in the circumstances, the board or committee determines that the member has in fact failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

Article IV

Records of Proceedings

The minutes of the board and all committee with board-delegated powers shall contain--

1. The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the board's or committee's decision as to whether a conflict of interest in fact existed.

2. The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection therewith.

Article V

Compensation

1. A voting member of the board of directors who receives compensation, directly or indirectly, from the Corporation for services is precluded from voting on matters pertaining to that member's compensation.

2. A physician who is a voting member of the board of directors and receives compensation, directly or indirectly, from the Corporation for services is precluded from discussing and voting on matters pertaining to that member's and other physicians' compensation. No physician or physician director, either individually or collectively, is prohibited from providing information to the board of directors regarding physician compensation.

3. A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Corporation for services is precluded from voting on matters pertaining to that member's compensation.

4. Physicians who receive compensation, directly or indirectly, from the Corporation, whether as employees or independent contractors, are precluded from membership on any committee whose jurisdiction includes compensation matters. No physician, either individually or collectively, is prohibited from providing information to any committee regarding physician compensation.

Article VI

Annual Statements

Each director, principal officer and member of a committee with board delegated powers shall annually sign a statement which affirms that such person—

a. Has received a copy of the conflict of interest policy,

b. Has read and understands the policy,

c. Has agreed to comply with the policy, and

d. Understands that the Corporation is a charitable organization and that in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

Article VII

Periodic Reviews

To ensure that the Corporation operates in a manner consistent with its charitable purposes and that it does not engage in activities that could jeopardize its status as an organization exempt from federal income tax, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

a. Whether compensation arrangements and benefits are reasonable and are the result of arm's-length bargaining.

b. Whether acquisitions of physician practices and other provider services result in inurement or impermissible private benefit.

c. Whether partnership and joint venture arrangements and arrangements with management service organizations and physician hospital organizations conform to written policies, are properly recorded, reflect reasonable payments for goods and

services, further the Corporation's charitable purposes and do not result in inurement or impermissible private benefit.

d. Whether agreements to provide health care and agreements with other health care providers, employees, and third party payors further the Corporation's charitable purposes and do not result in inurement or impermissible private benefit.

Article VIII

Use of Outside Experts

In conducting the periodic reviews provided for in Article VII, the Corporation may, but need not, use outside advisors. If outside experts are used their use shall not relieve the board of its responsibility for ensuring that periodic reviews are conducted.