

## **C. TAX-EXEMPT HEALTH CARE ORGANIZATIONS COMMUNITY BOARD AND CONFLICTS OF INTEREST POLICY**

by  
Lawrence M. Brauer and Charles F. Kaiser

### 1. Overview

#### A. Introduction

Tax-exempt health care organizations that engage in business dealings with members of their boards run a serious risk of violating the inurement prohibition and private benefit restriction of IRC 501(c)(3). Service experience has shown the potential for abuse to be especially acute when affiliated physicians comprise a substantial part of the board of a health care organization when that health care organization is part of an integrated delivery system (IDS) that purchased for-profit entities controlled by those physicians. To ensure that those organizations would operate for public, rather than private interests, the Service developed the "20 percent safe harbor" guideline. This guideline allowed the Service to recognize health care organizations that were part of an integrated delivery system (IDS) as exempt under IRC 501(c)(3) if physicians affiliated with the organization comprised no more than 20 percent of its board of trustees. (Throughout this article the term "trustee" includes members of a board of directors.)

Failure to meet the 20 percent safe harbor does not preclude exemption. In lieu of the safe harbor, an organization may show other facts and circumstances that balance the roles of physicians or other interested parties to insure the organization operates for exclusively public purposes. In general, a health care organization should show that its board broadly represents the community and that the majority of its members are independent of the organization; that the board has adopted and operates under a conflicts of interest policy; and that all components of the organization conduct periodic activity reviews to ensure the organization operates in a charitable manner.

Collectively, the facts and circumstances are referred to as the "Community Board and Conflicts of Interest Policy." This article describes the particular elements needed to make a successful showing that a health care organization operates according to the policy. It supplements articles on IDS's and health care in the 1994, 1995, and 1996 CPE texts.

## B. Background

IRC 501(c)(3) provides exemption for organizations organized and operated exclusively for charitable purposes, where no part of the net earnings inures to the benefit of any private shareholder or individual. An organization cannot be organized or operated exclusively for charitable purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of IRC 501(c)(3), an organization must establish that it is not organized or operated for the benefit of private interests. Reg. 1.501(c)(3)-1(d)(1)(ii).

Promotion of health is considered a charitable purpose in the general law of charity. Thus, a health care organization may qualify as organized and operated in furtherance of charitable purposes if it is operated to benefit the community as a whole rather than private individuals or interests. Rev. Rul. 69-545, 1969-2 C.B. 117, establishes a community benefit standard that focuses on a number of factors to determine whether a hospital operates to benefit the community as a whole rather than private interests. In this revenue ruling, control of a tax-exempt hospital by a board of trustees composed of "independent civic leaders" was a significant fact.

The application of the community benefit standard of Rev. Rul. 69-545, supra, to exempt hospitals and other exempt health care organizations was sustained in Eastern Kentucky Welfare Rights Org. v. Simon, 506 F.2d 1278 (D.C. Cir. 1974), vacated on other grounds, 426 U.S. 26 (1975), and in Sound Health Association, 71 T.C. 158 (1978), acq., 1981-2 C.B. 2.

## 2. Community Board

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. Nevertheless, the entire board of trustees is subject to the conflicts of interest policy.

## 3. Conflicts of Interest

The purpose of a conflicts of interest policy is to protect the exempt organization's interest in transactions or arrangements that may also benefit an officer's or director's private interest. The primary benefit of a conflicts of

interest policy is that the board can make decisions in an objective manner without undue influence by persons with a private interest. The presence and enforcement of a conflicts of interest policy can also help assure that an exempt health care organization fulfills its charitable purposes, properly oversees the activities of its directors and principal officers, and pays no more than reasonable compensation to physicians and other highly compensated employees. In this latter regard, see Rev. Rul. 69-383, 1969-2 C.B. 113. Maintaining adequate books and records, as generally required by IRC 6001 and Reg. 1.6100-1(c), helps to ensure that the exempt health care organization operates in accordance with its commitment to the conflicts of interest policy.

#### 4. Application

The Service will generally apply the Community Board and Conflicts of Interest Policy when considering applications for recognition of exemption from hospitals and other health care organizations that are part of a multi-entity hospital system. The Service will also generally apply this Community Board and Conflicts of Interests Policy to requests for private letter rulings from exempt health care organizations that have the 20 percent safe harbor expressly stated in their determination or ruling letters. For an existing exempt health care organization, the Service will consider its historic development and record of significant charitable operations to determine if it requires an independent community board. Where facts and circumstances, such as a long history of substantial community service and the absence of inurement or private benefit, provide assurance that the community benefit standard is satisfied, the community board standard may not be required. On the other hand, the Service will consider whether the 20 percent safe harbor guideline should be applied in situations where an existing exempt health care organization has a record of problems with its charitable operations or a history of inurement or private benefit. In any event, the organization should adopt a substantial conflicts of interest policy.

The Community Board and Conflicts of Interest Policy may provide guidance to examining agents in evaluating the facts of a particular case. For example, if an examining agent is concerned about the existence of excessive private benefit, the required records and periodic reviews may provide a valuable source of information. Agents may also find the Community Board and Conflicts of Interest Policy useful as a guide for considering how an exempt health care organization, in danger of having its exemption revoked, may be rehabilitated. For example, an agent may consider recommending that the organization adopt a more stringent conflicts of interest policy that incorporates a community board standard with a strict quorum requirement.

The Community Board and Conflicts of Interest Policy that follows incorporates facts and circumstances that the Service considers significant for exemption. We are also providing a sample conflicts of interest policy that may be adopted in an organization's bylaws or as a resolution of an organization's board of trustees.

## **COMMUNITY BOARD AND CONFLICTS OF INTEREST POLICY**

### **I. Community Board**

A majority of the voting members of the board of trustees of a hospital should be comprised of independent community members. This means that practicing physicians affiliated with a hospital, as well as officers, department heads and other employees of the hospital, cannot constitute a majority of the board. In a multi-entity hospital system, the board of a subsidiary non-profit health care organization is considered to be comprised of independent community members if it is controlled by an exempt organization whose board is comprised of a majority of voting members who are independent community members.

### **II. Conflicts of Interest Policy**

One significant fact that will help demonstrate that a tax-exempt health care organization promotes the health of the community as a whole, rather than to benefit private interests, is the organization's adoption of a substantial conflicts of interest policy. All exempt organizations in a hospital system should adopt the conflicts of interest policy. The policy should apply to any transaction or arrangement with an "interested person." An "interested person" is a trustee or director, a principal officer, or a member of a committee with board-delegated powers who has a direct or indirect "financial interest," as defined in Section IV.

An interested person who has a financial interest in one or more organizations within the hospital system will be considered to have a financial interest in all related organizations within the system.

A substantial conflicts of interest policy should include the following provisions:

- A. Disclosure by interested persons of financial interests and all material facts relating thereto.
- B. Procedures for determining whether the financial interest of the interested person may result in a conflict of interest.
- C. Procedures for addressing the conflict of interest after determining that there is a conflict:

1. Requiring that the interested person leave the meeting during the discussion of, and the vote on, the transaction or arrangement that results in the conflict of interest;
  2. Appointing, if appropriate, a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement;
  3. Determining, by a majority vote of the disinterested trustees present, that the transaction or arrangement is in the organization's best interests and for its own benefit; is fair and reasonable to the organization; and, after exercising due diligence, determining that the organization cannot obtain a more advantageous transaction or arrangement with reasonable efforts under the circumstances; and
  4. Taking appropriate disciplinary and corrective action with respect to an interested person who violates the conflicts of interest policy.
- D. Procedures for adequate record keeping. The minutes of the board meetings and all committees with board-delegated powers should include:
1. The names of the persons who disclosed financial interests, the nature of the financial interests, and whether the board determined there was a conflict of interest; and
  2. The names of all persons present for discussions or votes relating to the transaction or arrangement; the content of these discussions, including any alternatives to the proposed transaction or arrangement; and a record of the vote.
- E. Procedures ensuring that the policy is distributed to all trustees, principal officers and members of committees with board-delegated powers. Each such person should sign an annual statement that he or she:
1. Received a copy of the conflicts of interest policy;
  2. Has read and understands the policy;
  3. Agrees to comply with the policy;

4. Understands that the policy applies to all committees and subcommittees having board-delegated powers; and
  5. Understands that the organization is a charitable organization that must engage primarily in activities that accomplish one or more of its tax-exempt purposes to maintain its tax-exempt status.
- F. Procedures for applying the policy to a compensation committee should include:
1. Restrictions barring practicing physicians who receive, directly or indirectly, compensation from the organization, for services as employees or as independent contractors, from membership on its compensation committee; and
  2. Restrictions precluding a voting member of a compensation committee who has a conflict of interest in the organization from which the member receives compensation, directly or indirectly, from voting on matters pertaining to that member's compensation.

### III. System of Periodic Reviews

Another significant fact that will help demonstrate that a tax-exempt health care organization promotes the health of the community as a whole, rather than private interests, is that the board of trustees and all committees with board-delegated powers require that, as part of their systems of controls, all tax-exempt organizations within the hospital system conduct periodic reviews of their activities to ensure that the organizations are operating in a manner consistent with accomplishing their charitable purposes and that their operations do not result in private inurement or impermissible benefit to private interests. Issues of special concern are:

- A. Whether compensation arrangements and benefits are reasonable and are the result of arm's-length negotiations;
- B. Whether acquisitions of physician practices and other provider services result in private 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 or services, further charitable purposes, and do not result in private inurement or impermissible private benefit; and
- D. Whether agreements to provide health care and agreements with other health care providers, employees, and third-party payors serve charitable purposes.

#### IV. Financial Interest Defined

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 tax-exempt health care organization has a transaction or arrangement, or
- B. A compensation arrangement with the tax-exempt health care organization or with any entity or individual with which the organization 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 tax-exempt health care organization is negotiating a transaction or arrangement.

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

## **SAMPLE CONFLICTS OF INTEREST POLICY**

### Article I

#### Purpose

The purpose of the conflicts 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.

### Article III

#### Procedures

##### 1. Duty to Disclose

In connection with any actual or possible conflicts of interest, an interested person must disclose the existence and nature of his or her financial interest 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, the interested person shall leave the board or committee meeting while the financial 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. 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.
- b. 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.
- c. 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 Conflicts 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--

- a. 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.
- b. 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 Committees

- a. 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.

- b. 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.

## 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 conflicts 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.