



*Tax-Exempt Hospital Industry Compliance  
With Community Benefit and Compensation  
Practices Is Being Studied, but Further  
Analyses Are Needed to Address Any  
Noncompliance*

**March 29, 2007**

**Reference Number: 2007-10-061**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 29, 2007

**MEMORANDUM FOR** COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Tax-Exempt Hospital Industry Compliance With  
Community Benefit and Compensation Practices Is Being Studied, but  
Further Analyses Are Needed to Address Any Noncompliance  
(Audit # 200610040)

This report presents the results of our review to determine the purpose and scope of the Exempt Organizations (EO) function's tax-exempt hospital compliance project and how management intends to use the results to address potential noncompliance in the industry. A Senior Staff Advisor of the Senate Finance Committee voiced concerns to the Treasury Inspector General for Tax Administration that laws governing tax-exempt hospitals have not changed since their inception in 1956 and revisions in 1969, and there seems to be little difference between tax-exempt and for-profit hospitals. The Senior Staff Advisor requested that the Treasury Inspector General for Tax Administration review the Tax Exempt and Government Entities Division's planned actions related to compliance in the tax-exempt hospital area.

*Impact on the Taxpayer*

According to the Congressional Budget Office, nonprofit hospitals received more than \$6 billion in Federal tax exemptions in 2002. EO function management is conducting the hospital compliance project to assess how tax-exempt hospitals believe they provide a community benefit in exchange for tax-favored status. Management stated that project information may assist them in differentiating tax-exempt hospitals from for-profit hospitals and could result in regulatory changes or a Revenue Ruling.



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Synopsis

As part of this compliance project, the EO function sent a 9-page questionnaire to 544 tax-exempt hospitals soliciting information on compensation practices and the community benefit standard. At the time of our fieldwork, the function was still analyzing the questionnaire responses and identifying potential examinations of organizations based on the manner in which executive compensation was determined. If information gathered in the compliance project shows hospitals are performing only minimum actions to meet the community benefit standard, the function will consider initiating examinations in this area. Management stated that project information also may assist them in differentiating tax-exempt hospitals from for-profit hospitals and in determining whether legislative action would improve the Internal Revenue Service's (IRS) ability to administer tax laws in the tax-exempt hospital industry. Additionally, the compliance project will gather information about the practices and procedures tax-exempt organizations use to assign compensation to executives and other outsiders and enhance compliance in this area, if necessary.

When the analyses are completed, EO function management will prepare two reports summarizing the results of the analyses of the questionnaires and related examinations. An interim report, due in July 2007, will present the results of the tax-exempt hospitals' responses to the community benefit questions and include any recommendations on the next steps planned by the IRS to address the community benefit standard. At the end of our fieldwork, EO function management had not yet determined whether the interim report will be made publicly available. After the examinations related to executive compensation are completed, in September 2008 management plans to publicly issue a final report summarizing the results of the tax-exempt hospital compliance project. This report will provide an update on the community benefit standard since the issuance of the interim report; will include a summary of the examination results related to excess compensation; and could include recommendations to improve future compliance by tax-exempt hospitals, recommendations related to education and outreach efforts needed in these areas, and additional training for function personnel in compensation analysis for tax-exempt hospitals.

While the EO function has specific plans for addressing potential noncompliance for the executive compensation issue, it is still in the process of evaluating the responses and has not determined what is needed for the community benefit issue. Because of the complexity that currently exists in the industry and the potential for new regulations, we believe it is premature to plan for a final project report covering both executive compensation and community benefit issues. If extensive action is needed to address noncompliance in the community benefit area, including developing new Revenue Rulings or recommending regulatory changes, management may need to develop separate plans to accomplish this.



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*Recommendation*

We recommended the Director, EO, Tax Exempt and Government Entities Division, ensure the interim report includes all planned actions related to community benefit issues and develop plans to prepare a separate final report on this issue if all necessary actions will not be completed for inclusion in the final compliance report scheduled for issuance in September 2008.

*Response*

IRS management generally agreed with our recommendation. The interim report will reflect the progress of the community benefit component of the hospital compliance project, contain a description of the community benefit activities undertaken by hospitals that responded to the questionnaire, and outline the IRS' immediate next steps based on an assessment of the data. Management stated it was too early in the process to determine the need for a supplemental report on community benefit, or the precise next steps in the area, but agreed to issue a supplemental report if necessary. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.



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## *Abbreviations*

EO	Exempt Organizations
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service



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## *Background*

Charities, educational institutions, and religious organizations are among those entities exempt from Federal income tax under Internal Revenue Code (I.R.C.) Section (§) 501(c)(3).<sup>1</sup> Although tax-exempt hospitals are not specifically listed in this Code section, they have long been recognized as charitable activities when certain conditions are met. Specifically, a hospital must be organized and operated exclusively for charitable purposes, and it may not be operated, directly or indirectly, for the benefit of private interests. Health-related organizations make up the largest percentage of I.R.C. § 501(c)(3) nonprofit organizations and account for almost 60 percent of total revenues. Hospitals generate almost three-quarters of the total revenue of health-related organizations.

***Nonprofit hospitals received more than \$6 billion in Federal tax exemptions in 2002, according to the Congressional Budget Office.***

The Exempt Organizations (EO) function of the Tax Exempt and Government Entities Division is responsible for ensuring organizations exempt from Federal income tax comply with applicable I.R.C. sections and regulations. The more recent of the 2 most significant Revenue Rulings related to tax-exempt hospitals was issued by the Internal Revenue Service (IRS) almost 40 years ago:

- Revenue Ruling 56-185,<sup>2</sup> issued in 1956, established the “charity care standard,” which required that, in exchange for exemption from paying taxes, a hospital must admit and treat patients who are unable to pay either without charge or at rates below costs. Because uncompensated care had to be provided to the extent of the hospital’s financial ability, this became known as the “financial ability standard.”
- Revenue Ruling 69-545,<sup>3</sup> issued in 1969, established the “community benefit standard” that modified the financial ability standard. The standard required that, in exchange for exemption from paying taxes, a hospital must operate for the benefit of the community rather than serving private interests. The community benefit standard was established after passage of the Medicare/Medicaid laws in the mid-1960s that provided medical care for the elderly and poor, making the charity care standard obsolete. The community benefit standard is still applied today in the tax-exempt hospital industry.

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<sup>1</sup> I.R.C. § 501(c)(3) (2006).

<sup>2</sup> Rev. Rul. 56-185, 1956-1 C.B. 202.

<sup>3</sup> Rev. Rul. 69-545, 1969-2 C.B. 117.



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Revenue Ruling 69-545 states that a hospital otherwise qualified for tax-exempt status will meet the community benefit standard when it has a board of directors composed of prominent citizens drawn from the community; has a medical staff consistent with the size and nature of its facilities that is open to all qualified physicians in the area; operates a full-time emergency room open to all persons without regard to their ability to pay;<sup>4</sup> and provides hospital care for everyone in the community able to pay the cost either themselves, through private health insurance, or with the aid of public programs such as Medicare.

The Government Accountability Office has stated there is often little to no difference between for-profit and tax-exempt hospitals when it comes to charity care and community benefits provided. The IRS Commissioner has commented that some tax-exempt health care providers may not differ markedly from for-profit providers in their operations, their attention to the benefit of the community, or their levels of charity care. Both the Senate Finance Committee and the House Ways and Means Committee have voiced concerns related to whether taxpayers receive a public benefit in exchange for the billions of dollars of tax subsidies received by tax-exempt hospitals each year. In December 2005, a Senior Staff Adviser of the Senate Finance Committee expressed concerns to the Treasury Inspector General for Tax Administration that laws governing tax-exempt hospitals have not changed since their inception in 1956 and revisions in 1969, and there seems to be little difference between tax-exempt and for-profit hospitals. Additionally, media reports of seemingly excessive compensation and loans to executives of charitable organizations have caused concern among donors, State and Federal regulators, and the public. An exempt organization must pay no more than reasonable compensation for services performed by its officers, trustees, and employees based on I.R.C. § 501(c)(3) prohibitions against inurement and private benefit.<sup>5</sup>

The IRS faces numerous challenges in administering oversight of the tax-exempt hospital industry. From Fiscal Year 1995 through the first half of Fiscal Year 2005, the IRS examined more than 375 health care organizations (out of a population of approximately 7,000), including both hospitals and related organizations or parts of hospital systems. However, EO function management stated that historical information related to closed examinations of tax-exempt hospitals did not contain details sufficient to assess whether specific compliance issues related to community benefit existed in the industry. In addition, the EO function's inventory system contains one specific code that includes medical care, educational, and research organizations. This prohibits management from performing automated analysis of past compliance work specific to tax-exempt hospitals.

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<sup>4</sup> Rev. Rul. 83-157, 1983-2 C.B. 94 ruled that hospitals could qualify for exemption under the community benefit approach even if they did not operate emergency facilities, as long as there were other indications of community benefit.

<sup>5</sup> Inurement involves an insider (whether an individual or an entity) who takes the exempt organization's profits in some manner that benefits himself or herself. Private benefit encompasses those who are not only inside but also "outside" the organization. All inurement is private benefit, but not all private benefit is inurement.





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Also, there have been a number of changes in the health care industry affecting the application of the community benefit standard since the issuance of Revenue Ruling 69-545. Testifying before Congress in May 2005, the IRS Commissioner stated the IRS' ability to regulate the compliance of tax-exempt hospitals is difficult when industry practice, or the industry itself, has changed but the rules have generally remained constant since 1969. The increased merger activity in the health care sector in the 1980s and 1990s resulted in more complex business structures, evolving this industry into something substantially different from what it was when guidance was last issued. As a result of these challenges, outside stakeholders have raised the issue that it may be the time for a more thorough review of the tax-exempt hospital area to determine whether (1) the community benefit standard is still applicable and (2) there are bright-line tests<sup>6</sup> that might be available to aid tax-exempt hospitals in complying with the law and the IRS in administering it.

This review was performed at the EO function Examinations Great Lakes Area Office<sup>7</sup> in Chicago, Illinois. We also contacted Tax Exempt and Government Entities Division personnel in Houston, Texas; Washington, D.C.; and Louisville, Kentucky, during the period July through November 2006. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>6</sup> A bright-line test is a clear division between what is acceptable and what is not from a legal, accounting, or regulatory perspective.

<sup>7</sup> A geographic organizational level used by the IRS business units and offices to help their specific types of taxpayers understand and comply with tax laws and issues.



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*Results of Review*

**Exempt Organizations Function Management Has Initiated Actions to Begin Assessing the Community Benefit and Compensation Practices of Tax-Exempt Hospitals**

Changes to the health care industry have resulted in the appearance that there are very few differences in the manner in which nonprofit and for-profit hospitals operate. This is compounded by the fact that nonprofit hospitals annually receive billions of dollars in tax exemptions from Federal and State sources. Figure 1 outlines the estimated value of tax exemptions provided to nonprofit<sup>8</sup> hospitals in Calendar Year 2002.

<b>Figure 1: Estimated Value of Tax Exemptions Provided to Nonprofit Hospitals, Calendar Year 2002</b>	
	<b>Value (billions of dollars)</b>
Corporate Income Tax (Federal)	\$ 2.5
Tax-Exempt Bond Financing (Federal)	1.8
Charitable Contributions (Federal)	1.8
Corporate Income Tax (State)	0.5
Sales Tax (State and Local)	2.8
Property Tax (Local)	3.1
<b>TOTAL</b>	<b>\$ 12.6<sup>9</sup></b>

Source: Congressional Budget Office *Nonprofit Hospitals and the Provision of Community Benefits* paper dated December 2006.

<sup>8</sup> The terms “nonprofit” and “tax-exempt” are sometimes used interchangeably, but they are technically distinct. For the purpose of Federal taxation, an organization may be deemed tax-exempt by meeting the requirements of I.R.C. § 501. Nonprofit status, on the other hand, is granted by State Governments on the basis of criteria that vary from State to State. However, in the Congressional Budget Office’s analysis, hospitals that identified themselves as nonprofit in Medicare Hospital Cost Reports are assumed to be exempt from Federal, State, and local taxes.

<sup>9</sup> The numbers in Figure 1 do not add up to the total presented due to rounding.



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EO function management stated its historical information related to tax-exempt hospitals did not contain details sufficient to assess whether specific compliance issues existed in the industry. As a result, they began a compliance project<sup>10</sup> in Fiscal Year 2006 to learn more about current practices of these hospitals. Management indicated the compliance project will identify the following information:

- How tax-exempt hospitals believe they provide a community benefit in exchange for tax-favored status.
- Whether the community benefit standard is still applicable in today's industry environment if these organizations operate in the same manner as for-profit hospitals.
- Whether a legislative action would improve the IRS' ability to administer tax laws in the tax-exempt hospital industry.

EO function management believes information gathered during this project may assist the IRS in restoring public trust in tax-exempt hospitals by identifying areas in which the function can provide more education to its customers about complying with the regulations and in helping tax-exempt hospitals establish strong internal governance structures so they can comply with the I.R.C. If information gathered in the compliance project shows hospitals are performing only minimum actions to meet the community benefit standard, the function will consider initiating examinations in this area. Management stated that project information also may assist them in differentiating tax-exempt hospitals from for-profit hospitals and could result in regulatory changes or a Revenue Ruling, if necessary, related to a revised standard for tax-exempt status. Additionally, the compliance project will gather information about the practices and procedures tax-exempt organizations use to assign compensation to executives and other outsiders and enhance compliance in this area, if necessary.

### **Methodology of the project**

The EO function assembled a multifunctional team to plan and implement the compliance project. The team prepared a detailed Action Plan and Project Proposal that outlined the objectives of the project, required action items, dates, resources necessary, and potential actions that may be taken to address issues identified.

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<sup>10</sup> A compliance project is designed to address an identified issue, which may or may not be associated with a particular market segment. In the past, the EO function has conducted compliance projects to assess and address known areas of noncompliance through examinations, compliance checks, and educational programs. These projects are managed by a project team, which is responsible for developing a strategy to address the issue if a method to address the issue is not readily apparent.



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In May 2006, the project team sent a compliance check<sup>11</sup> letter and 9-page questionnaire to 544 tax-exempt hospitals soliciting information on compensation practices and how tax-exempt hospitals meet the community benefit standard. The questionnaire contained the following three parts:

- The first part requested entity information, such as the organization's name, employer identification number, and date of the most recently filed tax return.
- The second part requested information to determine whether and how the tax-exempt hospital demonstrates its qualification for exemption as an organization described in I.R.C. § 501(c)(3) under the community benefit standard as discussed in Revenue Ruling 69-545. Information gathered in this portion of the project will allow the EO function to determine:
  - Whether nonemergency services are available to everyone with ability to pay.
  - Whether the hospital treats Medicare and Medicaid patients in a nondiscriminatory manner.
  - How the hospital deals with the uninsured.
  - Whether and how determinations of financial responsibility are made.
  - The nature and extent of the hospital's charity care policies and, if such a policy exists, how the hospital distinguishes charity care from bad debt.
  - The nature and extent of medical research programs.
  - The hospital's participation in partnerships, limited liability companies, joint ventures, and Subchapter S corporations.<sup>12</sup>
  - The hospital's financial relationship with staff members and other closely connected individuals and entities.
  - What additional guidance, education, and/or compliance actions are appropriate.

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<sup>11</sup> A compliance check is a review conducted by the IRS to determine whether an organization is adhering to recordkeeping and information reporting requirements and whether an organization's activities are consistent with their stated tax-exempt purpose.

<sup>12</sup> A Subchapter S corporation has a limited number of shareholders and is a small business corporation that elects to be a flowthrough entity for income tax purposes. Flowthrough entities describe certain entities, such as partnerships and S corporations, because their income, losses, credits, and other tax items are generally distributed untaxed to their owners.



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- The third part requested information to identify abuses by hospitals that pay excessive compensation and benefits to their officers and other insiders. Information gathered in this portion of the project will allow the EO function to:
  - Address the compensation of specific individuals and instances of questionable compensation practices and procedures.
  - Increase awareness of tax issues as hospitals set compensation in the future.
  - Learn more about the practices and procedures that hospitals are following as they set compensation.
  - Gauge the existence and effectiveness of the controls employed by hospitals over compensation issues.
  - Learn more about how hospitals report compensation to the IRS and the public on their annual Returns of Organization Exempt From Income Tax (Form 990).

The EO function originally requested a response from the 544 hospitals within 30 days, but a 30-day extension was granted.

### **Project status**

The project team had received responses for 533 (98 percent) of the 544 questionnaires by the end of our fieldwork; 41 (8 percent) of the 533 organizations indicated they were not tax exempt or had been dissolved. The EO function initiated follow-up calls and letters to the 11 organizations that had not responded.

At the time of our fieldwork, EO function management was analyzing the responses to the community benefit questions. They stated that, when completed, this analysis may result in recommendations to improve compliance for tax-exempt hospitals and differentiate their operations from those of for-profit hospitals. Recommendations could include regulatory changes or additional Revenue Rulings.

In addition, the function is beginning an analysis of the tax-exempt hospitals' responses to the executive compensation questions. As part of this analysis, personnel are performing three separate steps to identify potential examinations of organizations based on the manner in which executive compensation was determined. At the end of our fieldwork, management was analyzing these responses to identify those tax-exempt hospitals that will be selected for examination. Management stated the examinations related to executive compensation were scheduled to begin in January 2007 and be completed by January 2008.



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### **Third-party input**

Given the depth and complexity of the EO function's tax-exempt hospital questionnaire, the American Hospital Association<sup>13</sup> requested that Ernst & Young, LLP perform an independent analysis of the questionnaire's community benefit answers submitted by their members. On June 19, 2006, the American Hospital Association initiated a conference call that was open to any hospital that had received the IRS questionnaire and included both Ernst & Young, LLP and IRS personnel. The purpose of the call was to help clarify issues from the questionnaires by providing the tax-exempt hospitals the opportunity to speak with IRS personnel. As a result of the conference call, 132 of the 533 tax-exempt hospitals that had responded to the EO function questionnaire also submitted copies of their questionnaires to Ernst & Young, LLP personnel. Based on their analysis, Ernst & Young, LLP personnel prepared a report and documented a number of "lessons learned" for the IRS, including:

- Allow tax-exempt hospitals to tell their community benefit story, in more than just yes/no or simple number responses. Community benefit may be difficult to measure, and relying on only yes/no or quantitative responses may be misleading.
- Request tax-exempt hospitals to provide copies of their community benefit reports with their Forms 990.
- Provide for clarity of definitions to ensure uniformity of answers. For example, one question asked if a tax-exempt hospital denied services to *any* individuals. A tax-exempt hospital that is "at capacity" would indicate to ambulances that it is unable to take new cases. Based on this, some hospitals may indicate they have denied services to individuals, while other hospitals may consider this normal hospital operation and answer no because they would not consider this denial of services.

In May 2006, the Catholic Health Association<sup>14</sup> developed a supplemental report that can be attached to Form 990. It believes attaching the supplemental report will promote consistency in the reporting of community benefit information and share the community benefit contributions of tax-exempt hospitals with the IRS and the public in a more organized, comprehensive, and consistent manner. The Catholic Health Association believes that, through enhanced reporting of community benefit practices, a tax-exempt hospital will be better equipped to demonstrate to Government agencies and its community that its tax-exempt status is warranted. The Chairman of the Senate Finance Committee issued a statement praising this report and encouraged tax-exempt hospitals to use the report when they file Forms 990.

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<sup>13</sup> The American Hospital Association is the national organization that represents and serves all types of hospitals, health care networks, their patients, and communities.

<sup>14</sup> The Catholic Health Association represents the nation's largest group of tax-exempt health care sponsors, systems, and facilities. Its membership is comprised of almost all of the Catholic health care providers in the United States.





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In Fiscal Year 2003, the EO function Examination office began a comprehensive project to redesign the Form 990 to provide better compliance information to the IRS, the States, and the public. This project will continue in Fiscal Year 2007, with a draft revision of the Form 990 expected by summer 2007. EO function management indicated that additional revisions to the Form 990 could be made to better identify community benefit actions of tax-exempt hospitals and may assist in future compliance efforts, if warranted, based on their analysis of the questionnaire responses.

**Project work remaining**

Through review of compliance project documentation and interviews with EO function management, we determined two reports will be prepared summarizing the results of the function's analyses of the questionnaires and related examinations. First, an interim report will present the results of the tax-exempt hospitals' responses to the community benefit questions. According to management, the interim report will summarize the information obtained from the questionnaires and discuss how tax-exempt hospitals demonstrate their qualifications for exemption as organizations described in I.R.C. § 501(c)(3) under the community benefit standard articulated in Revenue Ruling 69-545. The interim report will also include any recommendations on the next steps planned by the EO function to address the community benefit standard. A draft of this report was tentatively scheduled to be provided on January 31, 2007, to the Tax Exempt and Government Entities Division Executive Steering Committee for review. The interim report is scheduled for issuance by July 31, 2007. At the end of our fieldwork, management had not yet determined whether the interim report will be made publicly available.

After the examinations related to executive compensation are completed, in September 2008 EO function management plans to issue a final report summarizing the results of the tax-exempt hospital compliance project. This report will provide an update on the community benefit standard since the issuance of the interim report; will include a summary of the examination results related to excess compensation; and could include recommendations to improve future compliance by tax-exempt hospitals, recommendations related to education and outreach efforts needed in these areas, and additional training for function personnel in compensation analysis for tax-exempt hospitals. Management also may determine that more follow-up actions, such as additional compliance initiatives/projects, are necessary for the tax-exempt hospitals industry.

Management tentatively plans to issue this report publicly, as has been done for past reports summarizing the results of compliance projects such as the Credit Counseling Compliance Project and the Political Activities Compliance Initiative. In both of those projects, the prepared reports summarized the projects' results and contained recommendations and enhancements for future actions to address compliance issues. Those reports were issued publicly on the IRS Internet site.

According to the EO function Hospital Project Proposal, the final report for the Hospital Project will include summarization of results, recommendations to improve future compliance, educational efforts, training needs, and follow-up actions. While the EO function has specific



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plans for addressing potential noncompliance for the executive compensation issue, it is still in the process of evaluating the responses and has not determined what is needed for the community benefit issue. Because of the complexity that currently exists in the industry and the potential for new regulations, we believe it is premature to plan for a final project report covering both executive compensation and community benefit issues. If extensive action is needed to address noncompliance in the community benefit area, including developing new Revenue Rulings or recommending regulatory changes, management may need to develop separate plans to accomplish this.

### ***Recommendation***

**Recommendation 1:** The Director, EO, Tax Exempt and Government Entities Division, should ensure the interim report includes an assessment of how tax-exempt hospitals are providing a community benefit, as well as any planned actions management determines are necessary to address the community benefit standard (e.g., revised Revenue Rulings, discussions with Department of the Treasury officials on potential regulatory changes, necessary education and outreach efforts, potential examinations) based on their evaluation of this issue. In addition, management should develop plans to prepare a separate final report on community benefit if all necessary actions will not be completed for inclusion in the final compliance report scheduled for issuance in September 2008.

**Management's Response:** IRS management generally agreed with this recommendation. The interim report will reflect the progress of the community benefit component of the hospital compliance project, contain a description of the community benefit activities undertaken by hospitals that responded to the questionnaire, and outline the IRS' immediate next steps based on an assessment of the data. Management stated it was too early in the process to determine the need for a supplemental report on community benefit, or the precise next steps in the area, but agreed to issue a supplemental report if necessary.





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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to determine the purpose and scope of the EO function's tax-exempt hospital compliance project and how management intends to use the results to address potential noncompliance in the industry. Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives; include the processes and procedures for planning, organizing, directing, and controlling program operations; and include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the EO function's policies, procedures, and practices for planning and implementing its tax-exempt hospital compliance project. We reviewed these controls by interviewing function management and analyzing applicable project documentation. We did not identify any significant material weaknesses. To accomplish our objective, we:

- I. Determined whether the EO function provided adequate oversight in planning and implementing its tax-exempt hospital compliance project.
  - A. Obtained and analyzed background documentation on the planning process of the project.
  - B. Interviewed applicable project team members and determined their roles and responsibilities in the project.
  - C. Determined how the function ensured the sampled organizations responded to the questionnaire and whether the responses were completely and accurately recorded.
- II. Evaluated how the EO function intends to use the results of the hospital questionnaires to identify and address noncompliance and to determine whether any changes to the community benefit standard are needed.
  - A. Assessed the process to analyze project results and identify issues for further actions.
  - B. Determined whether function management had identified any potential noncompliance issues from the responses received to date.
  - C. Determined what steps, if any, the function will take to address the issues raised by the responses to the hospital questionnaire.
  - D. Determined whether management had developed or plans to develop any guidance related to tax-exempt hospitals based on results to date.



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- E. Determined how management plans to report the results of the project to stakeholders and customers.



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## **Appendix II**

### *Major Contributors to This Report*

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## **Appendix III**

### *Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T  
Director, Exempt Organizations, Tax Exempt and Government Entities Division SE:T:EO  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaison: Director, Communications and Liaison, Tax Exempt and Government Entities Division SE:T:CL



*Tax-Exempt Hospital Industry Compliance With Community Benefit and Compensation Practices Is Being Studied, but Further Analyses Are Needed to Address Any Noncompliance*

**Appendix IV**

*Management's Response to the Draft Report*




DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

**RECEIVED**  
MAR 27 2007

MAR 26 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:  Steven T. Miller  
Commissioner, Tax-Exempt and Government Entities

SUBJECT: Tax-Exempt Hospital Industry Compliance with Community Benefit and Compensation Practices is Being Studied, but Further Analyses are Needed to Address Any Noncompliance (Audit #200610040)

We have reviewed your draft report on the tax-exempt hospital industry's compliance with the community benefit requirements of tax law and on our compliance project to learn more about how and whether exempt hospitals are meeting these requirements. We generally agree with your audit recommendation.

The question of whether tax-exempt hospitals are sufficiently distinguishable from taxable hospitals to justify their tax advantages has received much attention. For example, the House Ways and Means Committee held a hearing on the subject in May 2005. We initiated our compliance project to develop baseline information not only on how hospitals satisfy their community benefit responsibilities, but also on how they compensate their executives. As you noted in the draft report, our compliance project is ongoing, and we expect to issue an interim report this summer and a final report in September 2008.

Our comments on your recommendation are attached. If you have any questions or concerns, please contact me or Marsha Ramirez at (214) 413-5425.

Attachment



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*Tax-Exempt Hospital Industry Compliance With Community Benefit and Compensation Practices Is Being Studied, but Further Analyses Are Needed to Address Any Noncompliance*

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Attachment

Recommendation 1:

The Director, Exempt Organizations, should ensure the interim report includes an assessment of how tax-exempt hospitals are providing a community benefit, as well as any planned actions that EO function management determines are necessary to address the community benefit standard (e.g., revised Revenue Rulings, discussions with Treasury officials on potential regulatory changes, necessary education and outreach efforts, potential examinations, etc.) based on their evaluation of the issue. In addition, EO function management should develop plans to prepare a separate final report on community benefit if all necessary actions will not be completed for inclusion in the final compliance report scheduled for September 2008.

Corrective Action:

We generally agree with this recommendation. The interim report will reflect the progress of the community benefit component of our hospital compliance project, will contain a description of the community benefit activities undertaken by hospitals that responded to the questionnaire, and will outline our immediate next steps based on our assessment of the data. It is too early in the process to determine the need for a supplemental report on community benefit, or the precise next steps in the area. Such a decision can only be made after work on the reports is closer to completion. We will issue a supplemental report if at that time we determine that such a report is necessary.

Implementation Date:

August 31, 2008

Responsible Official:

Director, EO Examinations, Tax-Exempt and Government Entities Division