American Hospital Association

Legal Advisory

August 21, 2008

IRS Releases Final Instructions to Form 990, including Schedule H

Work Remains to Reduce Burden and Improve Accuracy

The Issue:

On August 19, the Internal Revenue Service (IRS) released final instructions for the redesigned Form 990 and 16 related schedules, including Schedule H – Hospitals, designated solely for tax-exempt hospitals. Except for the required reporting of "facility" information, Schedule H is optional for tax year 2008. However, the entire schedule is required for 2009.

Included with the final instructions are three background papers outlining notable changes to the draft instructions for each part of the core form and schedules. In addition to general and line-by-line instructions, the final instructions include a glossary of terms and various lists, tables and examples to help organizations complete the Form 990.

Our Take:

The final instructions make many improvements sought by the AHA to the core form and schedules, particularly Schedule H. Among the most important changes are: an increase in the reporting threshold for and hard cap on the number of key employees; an improved definition for "subsidized services" that does not place artificial limits on what a hospital can report as community benefit; a more streamlined definition of "facilities" for Schedule H reporting purposes; a more expansive view of what can be counted as research; and less burdensome reporting requirements for certain bond refinancing issuances.

Despite these improvements, the AHA remains concerned about some of the changes the IRS declined to make, such as adopting a more accurate methodology for reporting Medicare underpayments, as well as the amount of additional time and expense that will be required for hospitals to complete the core form and schedules. The AHA will continue to work with members to determine whether there are ways to further reduce the burden associated with the new form and schedules and improve the instructions.

At a Glance
(Continued)

What You Can Do:

Hospital leaders – particularly legal counsel, the chief financial officer and other finance staff, community outreach and public relations staff – should carefully review the final instructions to Schedule H, the core form and any other pertinent schedules. Copies of the final forms, instructions and worksheets for Schedule H can be found at http://www.irs.gov/charities/article/0,,id=185561,00.html.

The AHA reminds hospitals that, except for the section on "facilities," Schedule H is not required to be filed until a hospital makes its 2009 IRS filings sometime in 2010. *We urge members to use this extra time to review instructions and data collected for the schedule and to make any needed adjustments in programs and policies*.

In addition, because Schedule H does not adequately inform the community about the full breadth and scope of the benefits provided by a hospital through a multitude of programs and efforts tailored to community needs, it is important that you plan to effectively share your story with the community. Look for forthcoming AHA Community Connections materials with ideas and best practices for communicating this information to the communities you serve.

Further Questions:

Please contact Melinda R. Hatton, the AHA's general counsel, at mhatton@aha.org or (202) 626-2336; or Maureen Mudron, the AHA's deputy general counsel, at mmudron@aha.org.

American Hospital Association

Legal Advisory

August 21, 2008

IRS Releases Final Instructions to Form 990, including Schedule H

Work Remains to Reduce Burden and Improve Accuracy

Background

On August 19, the Internal Revenue Service (IRS) released final instructions for the redesigned Form 990 and 16 related schedules, including Schedule H – Hospitals, designated solely for tax-exempt hospitals. Except for the required reporting of "facility" information, Schedule H is optional for tax year 2008. However, the entire schedule is required for 2009.

In addition to general and line-by-line instructions, the final instructions include a glossary of terms and various lists, tables and examples to help organizations complete Form 990. The IRS also issued three background papers, which summarize the Form 990 redesign process, the parts and schedules of the new Form 990, new and significantly revised portions of the 2007 Form 990, and changes and additions to the draft instructions released in April.

The final form, instructions and background papers are available at http://www.irs.gov/charities/article/0,,id=181089,00.html.

The AHA's April 15 advisory, "IRS Releases Draft Instructions for Form 990, Related Schedules; Seeks Comments by June 1," (available at http://www.aha.org/aha_app/secureMember?page=/aha/advisory/2008/080415-legal-adv.pdf) summarized the draft instructions for Schedule H. The AHA worked with the IRS throughout the comment period, and the following discussion summarizes the changes and additions to the draft instructions that are of particular interest to hospitals.

Detail on Final Instructions to Schedule H-Hospitals

Definition of Hospital

Pursuant to the draft instructions, Schedule H is required to be completed with aggregate data from all organizations that operate at least one facility that is required to be, or is licensed or certified as a hospital. The final instructions

revise this definition slightly by providing that an organization that operates at least one facility that is, or is required to be, licensed, registered or similarly recognized by a state as a hospital must complete Schedule H.

The draft instructions also provided that an organization is not required or permitted to include foreign hospitals on Schedule H, except that foreign joint ventures and partnerships must be included on Part IV, and information concerning foreign hospitals may be included in Part VI.

In its comments to the IRS, the AHA requested that Schedule H filers be allowed to report data throughout Schedule H from foreign hospitals that are operated as an integral part of the filing organization. The IRS did not adopt this suggestion. As was the case in the draft instructions, in the final instructions, information from foreign joint ventures and partnerships must be reported in Part IV (Management Companies & Joint Ventures), while information concerning foreign hospitals and facilities may be described in Part VI (Supplemental Information).

Part I – Charity Care and Certain Other Community Benefits at Cost (Optional for 2008; Required in 2009)

Part I requires the reporting of charity care policies, the availability of community benefit reports and the costs of certain charity care and other community benefit programs. The draft instructions provided that Schedule H should aggregate information from disregarded entities (an entity that is wholly owned by the organization that is not separate for tax purposes) and joint ventures.

The AHA commented that many corporate structures include multiple corporations, most of which provide some community benefit activities in addition to those conducted directly by the hospital, and that the draft instructions did not provide a mechanism to capture activities from related corporations that operate within such a hospital system or holding company structure. The IRS did not respond to this comment, except to indicate that this was one of four areas in the revised Form 990 requiring further study, with additions or changes to the instructions possible in the future. However, Question 7 in Part VI (Supplemental Information) permits organizations that are part of an affiliated health care system to describe the respective roles of the organization and its affiliates in promoting the health of the communities served by the system. Even though Schedule H does not provide a mechanism for quantifying activities from related organizations, hospital systems should take advantage of the opportunity to capture all such activities in their response to Question 7.

Other Equivalent Documentation

To calculate the amounts to be included in the charity care and other community benefit table, the draft instructions provided that organizations may use the worksheets provided with the instructions or other equivalent documentation that substantiates the information reported consistent with the methodology required

in the worksheets. The AHA requested that the IRS clarify that software created or purchased by health care organizations to capture information in connection with various state law community benefit reporting requirements is considered "other equivalent documentation." The IRS did not adopt this suggestion but made it clear that use of the IRS worksheets is optional.

Grants

The AHA commented that the draft instructions appeared to provide that, if an organization makes a grant to a related organization, including to a foundation or other tax-exempt organization that is not required to file Schedule H, the organization should include such grant in Line 7(i) (Cash and in-kind contributions to community groups), as long as it is restricted to community benefit use and was not funded by a restricted grant in the first place. This could include a grant that was subsequently used by the related organization to fund, in whole or in part, a grant to another organization. The AHA requested that the IRS clarify this point in the final instructions. The IRS, in response, in the final instructions, provides three examples of how to treat cash or in-kind contributions funded by restricted grants from related organizations.

Medicaid Provider Taxes

The IRS sought comments on how filing organizations should report the cost of Medicaid and provider taxes and revenue from uncompensated care pools or programs, including Medicaid Disproportionate Share Hospital (DSH) funds, as costs and revenues associated with charity care or with Medicaid and other means-tested government programs. After soliciting input from hospital members and state hospital associations, the AHA commented that the primary purpose requirement, i.e., the costs and revenues should be reported on the worksheet that best reflects the primary purpose of these payments in the organization's home state – either to offset charity care or Medicaid, was the most appropriate standard. The IRS responded by providing in the final instructions that Medicaid provider taxes paid by an organization should be allocated to charity care (Worksheet 1 and Line 7a), if such taxes are intended primarily to offset the costs of charity care, or allocated to Unreimbursed Medicaid and Other Means Tested Government Programs (Worksheet 3 and Line 7b), if such taxes are primarily intended to offset the cost of Medicaid services. The final instructions also provide that, if a state has not clarified a primary purpose, the organization may allocate portions between the two categories based on a reasonable estimate of which portions are intended for charity care and which are intended for Medicaid.

Health Professions Education

In the draft instructions, "health professions education" for purposes of reporting charity care and certain other community benefits in the table, was defined to *exclude* education or training programs available only to the hospital's employees and medical staff, or scholarships provided to those individuals. The draft instructions further provided that, if such programs are not restricted to an

organization's employees and medical staff, an organization must use a reasonable allocation to report only the expenses related to providing such programs to persons who are not employees or medical staff. In the final instructions, the definition of "health professions education" still excludes programs available only to hospital employees and medical staff. However, the requirement to allocate expenses between those related to employees and medical staff (which were not permitted to be reported) and those related to the general public (which were permitted to be reported) has been eliminated. Therefore, an organization may report all such expenses, so long as the primary purpose of the education or training programs is to educate health professionals in the broader community.

Subsidized Health Services

In the draft instructions, "subsidized health services" for purposes of reporting charity care and certain other community benefits in the table were defined as clinical services provided despite a financial loss to the organization, but not including financial loss associated with bad debt, charity care, Medicaid and other means-tested government programs. Ancillary services, physician clinic and skilled nursing facility (SNF) services were generally excluded from this definition. The AHA commented that hospitals subsidize a range of services to meet the specific needs of their communities and, therefore, it is inappropriate to exclude these specific types of services provided that they meet the criteria outlined in the definition. The IRS responded by clarifying in the final instructions that services or care provided by physician clinics and SNFs will be considered subsidized health services if such clinics and facilities satisfy the general criteria set forth in the definition of subsidized health services, i.e., provided despite a financial loss and because it meets an identified community need. The final instructions provide, however, that if physician clinics are included, hospitals must provide an explanation, including the amount of such costs, in Part VI (Supplemental Information).

Research

In the draft instructions, "research" for purposes of reporting charity care and certain other community benefits in the table was defined, in part, as any study or investigation that receives funding from a tax-exempt or governmental entity of which the goal is to generate generalizable knowledge that is then made available to the public. The final instructions provide that, in addition to research funded by a tax-exempt or governmental entity, an organization may include the costs of any internally funded research that it conducts. The final instructions also provide that research sponsored by an individual or for-profit organization may be described in Part VI (Supplemental Information).

Part II – Community Building Activities (Optional)

The final instructions provide that, if an organization makes a grant to another organization to be used to accomplish one of the community building activities

listed in Part II, the organization should include the amount of the grant on the appropriate line of the table.

The draft instructions provided a number of examples for each of the categories of community building activities listed in this part. The AHA commented that the IRS should broaden the "workforce development" category to include other circumstances under which physician recruitment could be reported, such as the absence or shortage of a particular physician specialty. The IRS did not respond to this comment.

In the draft instructions, "environmental improvements" were defined to include activities to address environmental hazards that affect community health, such as the alleviation of water or air pollution, safe removal or treatment of garbage or other waste products, and other activities to protect the community from environmental hazards. In the final instructions, the IRS added that an organization may not include on this Line or in this Part of Schedule H expenditures that it made to comply with environmental laws and regulations that apply to activities of: (1) itself; (2) its disregarded entities; (3) a joint venture in which it has an ownership interest; or (4) a member of a group exemption included in a group return of which the organization is also a member. In addition, an organization may not include expenditures that it made to reduce the environmental hazards caused by, or the environmental impact of, its own activities or those entities described above.

Part III – Bad Debt, Medicare & Collection Practices (Optional for 2008; Required for 2009)

Statement No. 15

Section A – Bad Debt Expense of Part III asks whether hospitals report bad debt expense in accordance with Healthcare Financial Management Association Statement No. 15. The draft instructions clarified that Statement 15 has not been adopted by the American Institute of Certified Public Accountants and that the IRS does not require hospitals to adopt or rely on it. In meetings with the AHA, the IRS assured hospitals that a "no" response to this question will not reflect poorly on an organization or otherwise be used to target an organization for an audit. The final instructions provide that the IRS does not require organizations to adopt Statement 15 or use it to determine bad debt expense or charity care costs.

Bad Debt Expense

Section A requires hospitals to report the amount of bad debt expense (at cost), as well as provide an estimate of the amount of this cost that reasonably could be attributable to patients who likely would qualify for financial assistance.

Bad Debt Expense Footnote

Section A also requires an organization to provide the text of any footnote to the hospital's financial statements that describes bad debt expense. The draft instructions provided that such a footnote may relate to "accounts receivable," "allowance for doubtful accounts" or similar designations. The AHA commented that many health care organizations' financial statements do not contain footnotes related to bad debt expense, or any noted or similar designation, and that the IRS should clarify that organizations are not required to create footnotes in financial statements to satisfy this question. The IRS responded by providing in the final instructions that, if an organization's financial statements do not include any such footnote, the organization should so state in Part VI (Supplemental Information) and explain how the organization's financial statements account for bad debt, if at all.

Medicare Allowable Costs of Care and Revenue

Section B – Medicare requires reporting of Medicare revenue and costs, and hospitals may use an optional worksheet to help report such information. The draft instructions provided that "total revenue received from Medicare" includes payments for Indirect Medical Education, DSH, outliers, capital, bad debt and any other amounts paid to the hospital on the basis of the Medicare cost report. The draft instructions also provided that revenues billed and retained by the hospital for employed or contracted physicians (Part B physician services) also may be included; however, no provision was made for including the cost of such services. The draft instructions failed to provide a definition or examples of "Medicare allowable costs of care," but the instructions appeared to imply that Medicare cost reporting rules and accounting standards should be used. Additionally, the draft instructions failed to provide for the treatment of revenues and costs associated with Medicare Advantage patients, which do not appear in the Medicare Cost Report. The AHA commented that, to be consistent with the calculations on other parts of Schedule H and provide a full accounting with respect to Medicare, Section B should capture the costs and revenues associated with *all* Medicare services, e.g., Part B physician services, and patients, e.g., Medicare Advantage patients, using the most accurate approach available.

The final instructions, however, provide that an organization is to include only those allowable costs and Medicare reimbursements that are reported in its Medicare Cost Report(s) for the year, including the organization's share of any such allowable costs and reimbursements from disregarded entities and joint ventures in which it has an ownership interest. The final instructions also provide that certain Medicare program revenues and costs are not included in the reporting on Lines 5, 6 and 7 of this section, e.g., Medicare Part C and Part D programs, but that organizations may report in Part VI (Supplemental Information) any such amounts, as well as provide a reconciliation of amounts reportable in Section B and all of the organization's total revenues and total expenses attributable to Medicare programs. In addition to Medicare Part C and

Part D, the final instructions provide the following examples of revenues and costs that may not be included in an organization's Medicare Cost Report: revenues and costs for freestanding ambulatory surgery centers, physician services billed by the organization and clinical laboratory services.

Medicare Shortfall as Community Benefit

Section B, Line 8 requires hospitals to describe the extent to which Medicare underpayments should be treated as community benefit. The draft instructions provided that such rationale must have a reasonable basis. The AHA commented that the IRS should provide guidance to hospitals about the type of explanation it would find useful. The IRS did not respond to this comment. However, it did clarify in the final instructions that an organization must check the box that best describes the costing methodology used to determine Medicare allowable costs reported in the organization's Medicare Cost Report and describe this methodology in Part VI (Supplemental Information). The AHA will continue to work with the IRS through FAQs or other means to provide hospitals with additional guidance on examples of "reasonable basis" that would be most useful in this section of the schedule.

Part IV – Management Companies and Joint Ventures (Optional for 2008; Required in 2009)

For the purposes of this part, the draft instructions provided that the percentage share of profits or stock ownership percentage of officers, directors, trustees, key employees and physicians who are employees practicing as physicians, or who have staff privileges with one or more of the organization's hospitals, are measured as of the close of the organization's taxable year. In the final instructions, the IRS clarifies that aggregate percentages are to be measured as of the close of the organization's tax year or the last day the organization was a member of the joint venture, whichever is earlier.

Part V – Facility Information (Required in 2008)

In the draft instructions, a "facility" was defined to include a campus (or component), building, structure or other physical location or address at which the organization provides medical or hospital care, including a hospital, outpatient facility, surgery center, urgent care clinic or rehabilitation facility, whether operated directly by the filing organization or indirectly through a disregarded entity or joint venture taxed as a partnership. The AHA commented that the definition was too broad and that large health care systems that operate numerous hospitals would be required to report every building, structure, clinic, etc., resulting in dozens of pages of information that would not help the reader better understand the hospital. The IRS responded by changing the definition to those facilities that, at any time during the tax year, were required to be licensed, registered or similarly recognized as a health care facility under state law. In the final instructions, the IRS added a new instruction that an organization must list in

Part VI (Supplemental Information) the number of each type of facility, other than those that are required to be licensed, registered or similarly recognized as a health care provider under state law and reported in Part V (Facility Information), for which the organization reports information on Schedule H, e.g., rehabilitation clinics, diagnostic centers and skilled nursing facilities.

Part VI – Supplemental Information (Optional for 2008; Required in 2009)

The final instructions to this part specifically list the line numbers of questions from other parts of Schedule H and describe the supplemental information (descriptions, explanations, etc.) an organization is either required to provide or permitted to provide in response to those questions.

FINAL INSTRUCTIONS TO CORE FORM AND SCHEDULES OF INTEREST TO HOSPITALS

Form 990

Independent Voting Member

Part VI (Governance, Management, and Disclosure) requires reporting of the organization's board composition and independence, its governance and management structure and policies, and whether the organization promotes transparency and accountability to its constituents or beneficiaries. The draft instructions provided that a member of a governing body is considered "independent" only if all four of the following circumstances applied at all times during the organization's tax year:

1. The member was not compensated as an officer or other employee of the organization or related organization.

2. The member did not receive total compensation or other payments exceeding $10,000 for the year from the organization, or from related organizations as an independent contractor, other than reimbursement of expenses or reasonable compensation for services provided in the capacity as a member of the governing body.

3. The member did not otherwise receive, directly or indirectly, material financial benefits from the organization or from a related organization – a transaction greater than $50,000 is a material financial benefit for this purpose.

4. The member did not have a family member who received compensation or other material financial benefits from the organization or from a related organization.

In meetings with the IRS, the AHA urged the agency to clarify that prong three (material financial benefit) of this definition does not reach physicians with staff privileges. In the final instructions, the IRS revised the definition by replacing prongs three and four with a single test. The new definition of independent member of a governing body is as follows:

1. The member was not compensated as an officer or other employee of the organization or related organization.

2. The member did not receive total compensation or other payments exceeding $10,000 for the year from the organization, or from related organizations as an independent contractor, other than reimbursement of expenses or reasonable compensation for services provided in the capacity as a member of the governing body.

3. Neither the member, nor any family member of the member, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) that is required to be reported in Schedule L (Transactions with Interest Persons) for the organization's tax year, or in a transaction with a related organization of a type and amount that would be reportable on Schedule L if required to be filed by the related organization.

Additionally, the final instructions provide that an organization need not engage in more than a reasonable effort to obtain the necessary information to determine the independence of members of the governing body and may rely on information provided by members. For example, the final instructions provide that an organization may rely on information in a questionnaire it annually sends to members that includes the name, title, date and signature of each person reporting information and contains instructions and definitions for determining whether the member is or is not independent.

Reporting of Family or Business Relationships between Listed Persons

Part VI (Governance, Management, and Disclosure) also requires an organization to report if any officer, director, trustee or key employee has a family or business relationship with any other officer, director, trustee or key employee. The final instructions provide that an organization is not required to provide information about a family or business relationship between two officers, directors, trustees or key employees if it is unable to secure the information after making a reasonable effort to obtain it. An example of a reasonable effort provided in the final instructions is for the organization to distribute an annual questionnaire to each person that includes the name, title, date and signature of

each person, reporting information and the instructions and definitions for business and family relationships. In addition, the threshold for reporting business transactions has been increased from $5,000 to $10,000, and a new "privileged relationship exception" including relationships between attorney and client, medical professional and patient, and priest/clergy and penitent/communicant has been added in the final instructions.

Key Employee

Part VII (Compensation of Officers, Directors, Trustees, Key Employees, and Five Highest Compensated Employees) requires compensation reporting regarding officers, directors, trustees, key employees and the five highest-compensated employees. The draft instructions provided that a key employee is an employee of the organization (other than an officer, director, or trustee) who: (1) has the responsibilities, power, or influence over the organization as a whole that is similar to those of officers, directors or trustees; (2) manages a discrete segment or activity of the organization that represents 5 percent or more of the activities, assets, income or expenses of the organization, as compared to the organization as a whole; or (3) has or shares authority to control or determine 5 percent of more of the organization's capital expenditures, operating budget or compensation for employees. Significantly, employees whose compensation does not exceed $150,000 are excluded from this definition.

The AHA commented that this definition was still too broad. We further commented that hospitals and hospital systems can be large and complex, and that this definition does too little to mitigate the burden associated with reporting compensation information for all of the employees that would be included under this definition. The AHA specifically requested, among other things, that the percentage threshold (5 percent) be increased, and that an upper limit on the number of employees to be reported be included in the definition. The IRS responded by increasing the percentage threshold to 10 percent and providing that no more than 20 key employees are to be reported. Thus, the new definition of key employees is an employee of the organization other than an officer, director or trustee who:

1. Receives reportable compensation from the organization and all related organizations exceeding $150,000 for the year (the "$150,000 Test");

2. (a) Has responsibilities, powers or influence over the organization as a whole that is similar to those of officers, directors or trustees;

   (b) Manages a discrete segment or activity of the organization that represents 10 percent or more of the activities, assets, income or expenses of the organization, as compared to the organization as whole;

   or

(c) Has or shares authority to control or determine 10 percent of more of the organization's capital expenditures, operating budget, or compensation for employees (Collectively, the "Responsibility Test"); and

3. Is one of the 20 employees (that satisfies the $150,000 Test and the Responsibility Test) with the highest reportable compensation from the organization and related organizations for the calendar year ending with or within the organization's tax year.

Reporting of Other Compensation from the Organization and Related Organizations and Compensation from Unrelated Organizations

Part VII (Compensation of Officers, Directors, Trustees, Key Employees, and Five Highest Compensated Employees), Section A, Column (F) requires the reporting of an estimated amount of other compensation from the organization and related organizations. The final instructions provide that *other compensation* paid by a filing organization or a related organization is not required to be reported unless it is $10,000 or more for the calendar year, or if it is one of the five types of compensation (generally deferred compensation and health benefits) that must be reported regardless of amount. Additionally, *reportable compensation* paid by a related organization is not required to be reported unless it is $10,000 or more for the calendar year or is paid for past services to the filing organization in the person's capacity as a former director or trustee. The $10,000 exceptions do not apply to reporting compensation in Schedule J, Part II.

The final instructions provide that an organization is not required to report compensation from a related organization if the organization is unable to secure the information on compensation paid by the related organization after making a reasonable effort to obtain it. Organizations are required to report the efforts undertaken in Schedule O. An example of a reasonable effort provided in the final instructions is an annual questionnaire similar to those discussed above.

Schedule J – Deferred Compensation

The draft instructions to Schedule J required deferred compensation to be reported in the year earned, whether or not funded, vested or subject to substantial forfeiture, *and* in the year paid. Schedule J includes a Column (F) for the reporting of amounts that also were reported in another year. The AHA commented that Column (F) does not address the unfairness and misperception associated with reporting compensation that is not yet considered to be income to the recipient and urged the IRS to require that amounts of unpaid, unvested, deferred compensation be reported only in the year the compensation is paid to the recipient. The IRS did not adopt the AHA's suggestion, and the final instructions do not make any changes to the draft instructions related to this issue.

Schedule K – Supplemental Information on Tax-exempt Bonds (Only Part I Required for 2008)

The draft instructions to Schedule K required organizations to complete the Schedule for each outstanding tax-exempt bond that had both an outstanding principal amount in excess of $100,000 as of the last day of the tax year, and was issued after December 31, 2002. The draft instructions also provided that refundings after December 31, 2002 of pre-2003 issues must be treated as post-2002 issues and reported on Schedule K. The AHA commented that the IRS should clarify in the final instructions that such reporting does not include information on expenditure and investment of proceeds or uses of bond-financed facilities occurring prior to 2003. The IRS responded by providing in the final instructions that organizations are not required to complete Part III (Private Business Use) of the Schedule for refunding bonds issued after December 31, 2002 to refund pre-2003 bonds.