

## Memorandum

To: Honorable Judy Chu, Ph.D., Chair  
Honorable Betty T. Yee, Vice Chairwoman  
Honorable Bill Leonard  
Honorable Michelle Steel  
Honorable John Chiang

Date: February 29, 2008

From: Kristine Cazadd  
Chief Counsel 

Subject: **Petition for Adoption of Proposed Rule 145 – *Hospitals -Qualifying Organizations for the Welfare Exemption***  
**March 19, 2008, Board Meeting – Chief Counsel Matters – Item J Rulemaking**

Honorable Vice Chairwoman Betty Yee, as an individual, has filed a petition pursuant to Government Code section 11340.6 to request that the Board adopt proposed Property Tax Rule<sup>1</sup> 145 – *Hospitals- Qualifying Organizations for the Welfare Exemption*. The proposed rule is scheduled on the Chief Counsel Matters Agenda for the Board’s consideration at the March 19, 2008 meeting. Proposed Rule 145 interprets section 214 of the Revenue and Taxation Code to require a nonprofit tax-exempt hospital and/or multispecialty clinic to provide full charity care and/or partial charity care in the amount of five percent of the medical facility’s total annual operating expenses to qualify as an organization eligible for the welfare exemption. The proposed rule requires that 50 percent of the charity care be provided at no cost to patients who satisfy the income criteria set forth in the proposed rule. On March 19, 2008, the Board may: (1) grant the petition in whole or in part and commence the official rulemaking process by ordering the publication of the notice pursuant to Government Code section 11346.5; (2) direct staff to commence an interested parties process to consider the proposed rule in part or in whole; or (3) deny the petition. If the Board is interested in pursuing this matter, staff recommends that the interested parties process be initiated.

This memorandum will set forth: (1) a general background of welfare exemption law governing nonprofit tax exempt hospitals and multispecialty clinics; and (2) a discussion of the proposed rule.

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<sup>1</sup> All “Property Tax Rule” or “rule” references are to Title 18 of the California Code of Regulations.

## **I. General Background of the Welfare Exemption Law Governing Nonprofit Tax-Exempt Hospitals and Multispecialty Clinics**

The California Constitution<sup>2</sup> and section 214 of the Revenue and Taxation Code<sup>3</sup> provide the welfare exemption for the property of nonprofit organizations. In order to qualify for the welfare exemption, section 214 et seq. sets forth the statutory requirements that all nonprofit entities must:

- Be organized and operated for one or more exempt purposes (religious, hospital, scientific, charitable), as specified in section 214, subdivision (a).
- Have tax-exempt status, and are required to provide a letter to the Board issued by the Internal Revenue Service (section 501(c)(3) of the Internal Revenue Code) or Franchise Tax Board (23701d of the Revenue and Taxation Code) confirming status as an organization exempt from federal income tax and/or state franchise and income taxes. (section 214.8.)
- Not be organized or operated for profit. A corporation incorporated under the Nonprofit Corporation Law of this state (Title 1, Division II, Parts 2 and 4 of the Corporations Code or corresponding laws of another state) will usually qualify as not organized for profit. Specific provisions relating to hospital profit are discussed below.
- Have earnings that do not benefit any private shareholder or individual (section 214(a)(2)).
- Have formative documents (i.e., Articles of Incorporation) that contain acceptable irrevocable dedication and dissolution clauses (sections 214, subd. (a)(6), 214.01).

### Hospital Purpose Aspect of the Welfare Exemption

Section 214 does not define the term, “hospital,” nor does it specify separate requirements that must be met by a nonprofit hospital to qualify for exemption. But the California Supreme Court has interpreted the term, “hospital,” for purposes of the welfare exemption in the landmark California Supreme Court case, *Cedars of Lebanon v. County of Los Angeles* (1950) 35 Cal.2d 735-736.

A hospital is primarily a service organization. It serves three groups: the patients, its doctors, and the public. It furnishes a place where the patient, whether poor or rich, can be treated under ideal conditions. It makes available room, special diet, X-ray, laboratory, surgery, and a multitude of other services and equipment now available through the advances of medical science. Essential to the administration of these techniques is the corps of highly trained nurses and student nurses who are on duty twenty-four hours per day. In the large hospitals there are the interns and residents whose presence makes it possible for the hospital to do a better job. In addition, the hospital . . . must have administration to see that its services function properly and are coordinated, and that patients are received and cared for

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<sup>2</sup> Article XIII, section 4(b).

<sup>3</sup> All section references are to the Revenue and Taxation Code unless otherwise specified.

regardless of the hour or the patient's condition. Nothing can be left to chance because a slip may mean a life or many lives. These facilities also stand ready to serve the community in times of epidemic or disaster.<sup>4</sup>

A hospital as defined above is an organization eligible for exemption under the hospital purposes aspect of section 214. Certain outpatient clinics also are exempt as hospitals. In that regard, section 214.9 provides that for purposes of section 214, a "hospital" includes a nonprofit multispecialty clinic, as described in section 1206, subdivision (l) of the Health and Safety Code, "so long as the multispecialty clinic does not reduce the level of charitable or subsidized activities it provides as a proportion of its total activities."

While a nonprofit hospital must not be organized and operated for profit, this does not preclude the hospital from earning a profit. Section 214, subdivision (a)(1) provides in that regard that a hospital is not deemed to be organized or operated for profit if, during the preceding fiscal year, operating revenues exclusive of gifts, endowments and grants-in-aid, did not exceed 10 percent of its operating expenses. The statute defines operating expenses to include depreciation based on the cost of replacement and amortization of, and interest on, indebtedness. A court of appeal decision has construed this provision as allowing hospitals to earn more than a ten percent profit, provided that it is used for debt retirement, expansion of plant or facility, or placed in a reserve for operating contingencies. (*Rideout Hospital Foundation, Inc. v County of Yuba* (1992) 8 Cal.App.4<sup>th</sup> 214.)

As noted above, all nonprofit organizations, including hospitals and multispecialty clinics, must be tax exempt under section 23701d of the Revenue and Taxation Code or under section 501(c)(3) of the Internal Revenue Code (IRC) to be eligible for the welfare exemption in section 214. (Section 214.8, subd. (a).) Therefore, to qualify for exemption from federal income tax under IRC section 501(c)(3), a nonprofit hospital and/or multispecialty clinic must be organized and operated exclusively in furtherance of a purpose considered "charitable" in the generally accepted legal sense of that term, and the hospital may not be operated, directly or indirectly for the benefit of private interests.

## II. Discussion of Proposed Rule

The proposed rule would interpret the term, "hospital" in section 214 of the Revenue and Taxation Code to require that a nonprofit hospital and/or multispecialty clinic provide full or partial charity care in the amount of five percent of its total annual operating expenses to qualify for exemption under section 214.<sup>5</sup> (See Proposed Rule 145, subd. (c).) Furthermore, at least half the charity care requirement must be met by the provision of "full charity care," which is medical care at no cost to patients who satisfy the income criteria set forth in subdivision (h) of the proposed rule.

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<sup>4</sup> *Cedars of Lebanon v. County of Los Angeles* (1950) 35 Cal.2d 735-736.

<sup>5</sup> A recent State Auditor's report indicated that there is little difference in the amount of charity care provided by nonprofit and for-profit hospitals. (California State Auditor Report 2007-107, December 2007.) The report noted that nonprofit hospitals differ from for-profit hospitals in that they engage in activities considered to be charitable such as health education, medical research and support of public health programs.

The regulatory proposal defines charity care as inpatient, outpatient, or emergency medical care, including ancillary services provided to those who cannot afford to pay, (performed without expectation of payment or reimbursement.) But instances in which the patient paying a discounted fee for medical care and the hospital or multispecialty clinic provides partial charity care would also satisfy half of the charity care requirement. Charity care does not include a bad debt the hospital has been unable to collect, where the person has the ability to pay but is unwilling to pay. Nor does it include unreimbursed amounts for medical care to lower-income persons enrolled in Medi-Cal, Medicare or other public or private health insurance programs.

The proposed rule provides that a hospital or multispecialty clinic that does not meet the charity care requirement may deposit the difference between the cost of total charity care required and the cost of total charity care provided into health care funding programs, as specified. The rule also provides that the hospital or multispecialty clinic may elect to satisfy the charity care requirement by depositing the total cost of charity care amount the hospital or clinic is required to provide under subdivision (c) into the designated health care funding programs. Under this provision, families whose annual income is equal to or less than 250 percent of the Federal Poverty Guidelines (FPG) would be eligible for full charity care, families whose annual income is from 251 percent to 350 percent of FPG would be eligible for partial charity care. Subdivision (k) of the proposed rule provides definitions of certain terms for clarification purposes. The proposed rule would require hospitals and multispecialty clinics to file a report along with a copy of IRS Form 990, including Schedule H, "Hospitals," with the Board verifying compliance with the charity care requirement.<sup>6</sup> Failure to comply with the proposed rule would result in disqualification of the hospital or multispecialty clinic organization under section 214.

### **III. Current Board Administration of the Welfare Exemption.**

Currently, 158 hospital entities hold organizational clearance certificates issued by the Board to verify their status as an organization eligible for the exemption. The filing for the organizational clearance certificate (OCC) is a one-time filing. The OCC claim form BOE 277 must be filed along with formative documents, a federal or state tax letter verifying the organization's tax exempt status, financial statements, and documentation of the organization's exempt purpose. To ensure that organizations holding such certificates continue to meet the requirements of section 214, organizations are required to file periodic claim forms, which request information concerning any amendments to the organization's articles of incorporation, change in tax exempt status, activities conducted and financial statements. With respect to hospitals, the Board staff reviews the periodic claim to verify that a hospital's operating revenues in excess of ten percent of its operating expenses are used for the prescribed purposes of debt retirement, plant expansion or placed in a reserve for operating contingencies. Beginning in 2009, hospitals will be required to file a periodic claim form every four years. If the proposed rule were adopted, there possibly may be additional administrative costs

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<sup>6</sup> It should be noted that the Internal Revenue Service recently added Schedule H to Form 990 to require hospitals to report their charity care and community benefit activities and costs. The entire Schedule H must be completed for tax years beginning in 2009.

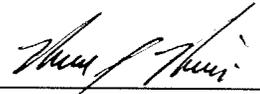
incurred by the Board with regard to the welfare exemption for hospitals and multispecialty clinics. The adoption of a charity care standard for hospitals and multispecialty clinics would require the development of a charity care reporting form, staff research to review more than 9,000 OCC holders to determine which ones are multispecialty clinics not operated as part of a hospital, and staff review of the new form and documentation filed by hospitals and multispecialty clinics to determine compliance with the charity care standard.

#### IV. Conclusion

In summary, hospitals and multispecialty clinics are required to be organized and operated exclusively for charitable purposes since their formation as tax exempt nonprofit entities to qualify for and maintain their tax exempt status and their eligibility for the welfare exemption provided in section 214. While hospitals are not required by federal or state law to provide charity care, they will be required to report their charity care and other community benefits beginning in 2009 to the Internal Revenue Service. The proposed rule, therefore, would not add the requirement that a hospital or multispecialty clinic be organized and operated for charitable purposes as that has always been a requirement. But the proposed rule would interpret and make specific sections 214 and 214.9 to require that a hospital or multispecialty clinic provide a specified amount of charity care. If the Board is interested in going forward with this matter, staff recommends that the interested parties process be initiated to consider the proposed rule.

If you need more information or have any questions regarding this matter, please contact Tax Counsel IV Mary Ann Alonzo at (916) 324-1392.

Approved: \_\_\_\_\_

  
Ramon J. Hirsig  
Executive Director

KC/MA/ef  
Attachment

ChiefCounsel/Final/ACCMemoProposedRule145  
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	Mr. Todd Gilman	MIC: 70
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## DRAFT CHARITY CARE REGULATION FOR NONPROFIT HOSPITALS

### Property Tax Rule 145 – Hospitals - Qualifying Organizations for the Welfare Exemption

- a. Qualifying Hospital – A nonprofit hospital shall provide charity care to be eligible for the welfare exemption from property taxation on its property provided by Revenue and Taxation Code section 214.
- b. Qualifying Multispecialty Clinic – A multispecialty clinic that is not part of a nonprofit hospital shall provide charity care to be eligible for the welfare exemption from property taxation on its property provided by Revenue and Taxation Code section 214.
- c. The cost of providing charity care shall be equal to at least five (5%) percent of the hospital's or multispecialty clinic's total annual operating expenses for the prior fiscal year, with at least fifty percent (50%) of the cost provided as free charity care to patients.
- d. A hospital or multispecialty clinic that provides less charity care than required subdivision (c), may comply with the charity care requirement by depositing the difference between the cost of the total charity care the hospital or clinic is required to provide under subdivision (c) and the total cost of charity care provided by the hospital or clinic into the California Healthcare for Indigents Program (CHIP) Fund or Rural Health Services Program.
- e. Notwithstanding subdivisions (a), (b), (c) and (d), a hospital or multispecialty clinic may comply with the charity care requirement by depositing the total cost of charity care the hospital or clinic is required to provide under subdivision (c) into the California Healthcare for Indigents Program (CHIP) Fund or Rural Health Services Program.
- f. Charity care, for purposes of Revenue and Taxation Code section 214, means inpatient, outpatient, or emergency medical care, including ancillary services provided to those who cannot afford to pay and without expectation of payment or reimbursement.
  1. Notwithstanding subdivision (f), the unpaid costs for services provided to a patient whom a hospital or multispecialty clinic has determined cannot pay in part or in full are also within the meaning of charity care for purposes of Revenue and Taxation Code section 214.
  2. Charity care does not include a bad debt, meaning the hospital's unpaid account of any person who has received medical care or is financially

responsible for the cost of care provided to another, where such person has the ability to pay but is unwilling to pay.

3. Charity care does not include the difference between the hospital or multispecialty clinic's costs and reimbursements for services provided to low-income and disabled persons enrolled in Medi-Cal, Medicare or other public or private health insurance programs.
- g. Implementation - Hospitals and Multispecialty Clinics may provide full or partial charity care to comply with the charity care standard set forth in subdivisions (a) and (b).
1. Full Charity Care - Medical care provided to inpatients or outpatients without receiving any payment for providing those services from any source, including the patient or person legally obligated to support the patients, third party payors, Medicare, Medi-Cal, the Healthy Families Program or other government-sponsored health care benefit programs.
  2. Partial Charity Care - Medical care provided to inpatients or outpatients at discounted prices.
- h. Charity Care Patient Eligibility Criteria - A hospital or multispecialty clinic shall apply the following criteria to determine patient eligibility:
1. Eligibility for Full Charity Care - Patients whose annual family income is at or below 250 percent of the federal poverty income level shall be eligible to apply for and receive full charity care.
  2. Eligibility for Partial Charity Care – Patients whose annual family income is from 251 percent to 350 percent of the federal poverty income level shall be eligible to apply for and receive partial charity care.
- i. The hospital and multispecialty clinic shall file a copy of each of the following documents verifying its implementation of a charity care and reduced payment policy with the State Board of Equalization by February 15, 20\_\_:
1. BOE Form No. \_\_\_\_\_ (*for reporting hospital charity care compliance*).
  2. IRS Form 990, including Schedule H, with any supplemental information and any attachments or any other schedules applicable to multispecialty clinics.

j. Failure to meet the requirements of this regulation will result in disqualification from the property tax welfare exemption provided by Revenue and Taxation Code section 214.

k. Definitions

1. Qualifying hospital – the legal entity exempt from state and federal income taxes that is the owner of record and/or the operator of the hospital property and a claimant for the organizational clearance certificate from the Board of Equalization.
2. Qualifying multispecialty clinic – the legal entity exempt from state and federal income taxes that is the owner of record and/or the operator of multispecialty clinic property and a claimant for the organizational clearance certificate from the Board of Equalization.
3. Total annual operating expenses – the aggregate operating expenses of the hospital or multispecialty clinic for the accounting period in question, determined in accordance with generally accepted accounting principles.
4. Cost of providing charity care – the actual amount of money a hospital spends to provide each service, not the price the hospital charges for that service.
5. Patient’s family - For persons 18 years of age and older, the patient’s family includes the spouse or domestic partner as defined in Family Code section 297, and dependent children under 21 years of age regardless of child’s residence. For persons under 18 years of age, the family includes parents, caretaker relative(s), and dependent children under 21 years of age of the patient, parent(s) or caretaker relative(s).
6. Patient’s family income – for purposes of determining eligibility, the patient’s family income includes the income of mother, father and dependent children, but excludes the income of any other adults in the household.
7. Federal poverty level – the poverty guidelines based on annual family income and family size issued annually in the Federal Register by the United States Department of Health and Human Services under authority of subsection (2) of Section 9902 of Title 42 of the United States Code.