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Mock IRS exams can help reduce tax risks for tax-exempt hospitals

By Michael J. Engle, BKD, LLP

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The Internal Revenue Service (IRS) has increased its focus on tax-exempt organizations and continues to investigate, monitor, and evaluate their activities. It is imperative that tax-exempt organizations have policies and procedures in place which address organization-wide compliance with IRS rules and regulations. Members of Congress have spurred the IRS to increase scrutiny and have held hearings and passed legislation to curb perceived abuses. The IRS has shifted its focus predominantly to enforcement, including penalty assessments. The risks of not complying with the IRS rules and regulations are potentially devastating and could result in:

- Loss of exemption
- Loss of exemption for tax-exempt bonds
- Major payroll tax assessments
- Large payments for defects in 403(b) annuity plans
- Excise taxes against insiders (board, management, and others)
- Criminal actions

Tax-exempt status and risk management

Tax-exempt organizations have as much or more at risk than their taxable counter-

parts when it comes to tax issues. Failing to adhere to the rules could potentially jeopardize a not-for-profit organization's tax-exempt status. Because the tax returns of tax-exempt organizations are public documents, an organization's board of directors and executives could be publicly criticized for not following proper policies and procedures, and management could be subject to excise tax and penalties. Risk management is a means for a tax-exempt organization's management to take a proactive stance and to better prepare. Many organizations use a simulated IRS exam as a self-assessment tool.

A risk management strategy can help reduce the likelihood that a tax-exempt organization will be judged noncompliant and help avoid potentially devastating consequences. To help manage risks, tax-exempt organizations must establish and comply with specific policies, procedures, and internal controls. Proactive management techniques help identify tax risks, so appropriate steps are taken to address and correct issues before being subjected to an IRS audit examination. One way management can identify tax risks and determine if it is in compliance with the rules and regulations is to perform a mock IRS exam.

Simulated IRS exams

A mock IRS exam is a self-assessment review typically performed by an outside independent person with the same



techniques used by the IRS. The mock IRS exam focuses on such areas as:

- Executive compensation
- Joint ventures
- Worker classifications
- Fringe-benefit reporting
- Unrelated business income
- 403(b) plans
- Deferred compensation
- Tax-exempt bonds
- Accountable plans and expense reimbursements
- Community benefit and charity-care policies

As part of the procedures, the reviewer studies organization documents, minutes, contracts, and current tax compliance filings including Form 990; conducts on-site interviews with key personnel with a working knowledge of operational and financial activities for targeted risk areas; researches and analyzes applicable tax law of the specific fact patterns; and prepares a written report.

Mock IRS exams can be customized to focus on a specific area of concern, such as executive compensation, or it can be very broad with emphasis on many different areas. The benefits of a conducting a mock IRS exam include:

- Ensuring policies and activities are in fundamental accordance with tax-exempt status
- Reducing the risk of adverse publicity from an IRS settlement or “closing agreement,” a state attorney general’s action, the media, or others who monitor tax-exempt hospitals
- Reducing financial risk and internal cost that might arise from a prolonged IRS exam
- Establishing a proactive approach to controlling tax exposure
- Enabling implementation of policies, procedures, and internal controls to further the organization’s tax-exempt reputation
- Providing board and management with confidence that the organization maintains the appropriate level of compliance with tax laws and regulations

Focus on charity care and compensation

As the abundance of rules and regulations are continually changing and growing in number, the enforcement activities of the IRS, state, and local taxing authorities have achieved record levels. U.S. Senator Chuck Grassley (R-IA), chair of the Senate Finance Committee, sent letters to high-ranking IRS officials urging their increased scrutiny of the tax-exempt health care community. His primary concerns pertained to tax-exempt hospitals, including hospital compensation practices, levels of charity care and community involvement.

In response to Sen. Grassley and others, the IRS recently established a compensation examination pilot program to review executive compensation offered by tax-exempt organizations, including deferred compen-

sation and fringe benefits. The pilot program examines compensation of individuals or instances of questionable compensation practices, increases awareness of tax issues as organizations set future compensation, and surveys the practices organizations follow in setting compensation and reporting on annual Form 990 returns.

A risk management strategy can help reduce the likelihood that a tax-exempt organization will be judged noncompliant and help avoid potentially devastating consequences

“Particular organizations that we contact may or may not have problems in the compensation area, but specific aspects of their operations have raised questions that must be answered,” said IRS Commissioner Mark W. Everson. “The IRS has an obligation to investigate questionable compensation practices and put a stop to abuses.”

The IRS also established a compliance check program to evaluate how tax-exempt hospitals provide charity care and community benefit to the communities they serve. A 72-question survey covers: provision of charity care, emergency room operations, patient demographics, the hospital’s governing board, medical staff privileges, medical research activities, professional education, billing and collection practices, and community outreach. The questionnaire also includes nine questions on compensation practices.

In a recent interim report, the IRS summarized responses to the compliance check

program. Citing a lack of uniformity in definitions and reporting, the report calls for development of a separate schedule for tax-exempt hospitals to complete as part of the Form 990. The IRS released a discussion draft of the new form, Schedule H, for hospitals to report how they provide community benefit.

Summary

Compliance with tax-exempt rules, regulations, and laws is becoming more and more important due to increased scrutiny. Effectively managing risks will help ascertain whether a tax-exempt organization might be subject to fines, penalties, sanctions, and possible loss of its exempt status. An effective way to help manage a tax-exempt organi-

zation’s risk for tax issues is to conduct a mock IRS exam to determine compliance with rules, regulations, and tax laws. It is best to proactively self-identify and address risk and compliance issues internally before an external investigative body comes calling to investigate. ■

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