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Perspectives on health care legal issues

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The rise and fall of property tax exemptions

Hospitals and health care providers around the country often choose to incorporate as nonprofit entities to obtain tax benefits. One of the most sought after benefits is the ability to secure a property tax exemption on land and improvements used to provide health care services.

A little history

Offering property tax exemptions for health care facilities is based on theories and principles that date back to the 19th century. Most hospitals established in that time period cared exclusively for low-income people. And most of their services were provided by nurses, doctors and religious personnel who donated their time.

Because state and local authorities wanted to encourage this type of generosity, they devised a quid pro quo mechanism whereby a hospital could avoid paying property taxes if its property was used to provide health care to indigent persons at no cost. The underlying theory was that the facility would relieve the state and local governments from the obligation of caring for the sick. In return, the community would exempt any property owned by the hospital from the obligation of paying property taxes. The hospital could then take any money saved through the exemption process and reinvest those funds to further its charitable purpose.

Changing industry *and* rules

Since those early days, the health care industry and the rules governing property tax exemptions for charitable organizations have changed significantly. Hospitals and health care providers have gone from being purely charitable organizations to multibillion-dollar industries that resemble private corporate conglomerates. As the industry has changed, so has the way in which state and local taxing authorities analyze property tax exemptions.

During the past 20 years, local taxing authorities have chipped away at the tax exemptions of many nontraditional hospitals and health care facilities. In fact, many have declined to grant tax-exempt



status to hospitals and health care facilities in order to generate much-needed revenue and as a response to complaints brought by for-profit entities.

The result? Hospitals and health care providers are being forced to pay for unbudgeted taxes. And a property owner usually has to pay the tax before challenging the denial. With these changes, how can a hospital or health care entity predict whether its facility will be exempt?

Determining exempt status

State legislatures and courts have created a number of tests to determine whether a hospital or health care facility is being used for its charitable purpose, though the rules are sometimes difficult to apply to nontraditional uses. For example, traditional hospital facilities that provide 24-hour emergency care for paying and indigent persons usually are exempt, but medical office buildings owned by a hospital and rented to physicians who maintain a private practice often are not.

On the spectrum ranging from exempt facilities to nonexempt facilities, there are many uses that do not fall in one category or another, leaving hospital administrators and practitioners alike to draw vague conclusions as to whether their facilities will qualify for an exemption.

The tests used to obtain an exemption vary, but most states require that:

1. The entity applying for the exemption be organized as a nonprofit entity under state laws and that it qualify as a 501(c)(3) entity under federal laws, and
2. The organization meet constitutional, statutory and common law tests.

The second requirement often requires the hospital or health care provider to show that the property is owned, operated and used according to its charitable purpose.

Defining charitable purpose

Courts throughout the United States have struggled to define whether certain facilities are used pursuant to a charitable purpose. Several have used the following factors to help determine whether a facility should be granted a property tax exemption:

- > Has the facility adhered to strict construction of the appropriate constitutional or statutory provision?
- > Has the taxpayer proven it deserves an exemption?
- > Will granting the exemption give the nonprofit entity an unfair competitive advantage over for-profit entities?
- > Does the use or activity involved relieve a governmental burden?
- > Does the use or activity provide services to the public without a fee to indigent persons?

Moreover, when granting tax-exempt status, courts look at whether the facility is operating

Is it exempt or not?

Courts typically view the following types of facilities as exempt:

- > Ambulatory surgery centers providing emergency care to the indigent,
- > Hospitals that provide 24-hour emergency care,
- > Lodging facilities for patients and family members receiving care at a hospital,
- > Parking garages exclusively used by hospital employees, and
- > Sleeping facilities or apartments used by employees.

On the other hand, the following facilities typically are not exempt:

- > Ambulatory surgery centers that do not provide emergency care for the indigent,
- > Medical office buildings leased to physicians in private practice, even if affiliated with a hospital, and
- > Fitness or wellness facilities used or operated by a hospital or health care organization.

as a private enterprise purely for profit. (See “Is it exempt or not?” above.)

A noble cause

With the climate change in gaining and keeping their tax-exempt status, hospitals and health care facilities must diligently document and prove that their use is primarily for charitable purposes. Have you? <

Health care building is booming

But could it go bust?

During the past seven years, hospitals and health care real estate developers have been on a building spree. In fact, the American Hospital Association states that there hasn't been this much building since the 1950s, and some experts claim that health care real estate is the fastest growing construction sector behind federal projects.

Not only is the *quantity* of building projects growing, but the *size* of projects is on the rise. *Health Facilities Management* magazine reports that several mega hospitals currently under development are exceeding 1 million square feet each in size and costing upwards of \$300 million.

The question that many in the real estate and construction industry ask is: Why is this sector

experiencing such a boom, and what will be the end result to consumers?

Fueling the boom

One cause of the current building boom is that many hospitals are selling or leasing most of their real estate holdings to private third-party investors to gain some much-needed capital. That capital, in turn, is being used to build new inpatient facilities, add new technology or invest in other ventures that yield a greater return. This also frees up capital spending on providing exemplary health care.

Hospitals and health care providers recognize that owning real estate can be costly and requires sophisticated management personnel to operate efficiently. But managing and maintaining the facility is not their only concern. Most of these holdings are leased or used by staff nurses and physicians who demand certain perks. For example, although physician lease arrangements must pass various regulatory hurdles, most rental rates offered to staff physicians are at less than fair market value. So the hospital receives a smaller return on its investment.

To maximize their return, large hospital networks are beginning to sell land and buildings that are either undeveloped or used for medical office buildings or outpatient clinics. Even though some sales may occur outright and without limitations, most do not.

Providers often convey the land and improvements to an investor under a long-term — anywhere from 50 to 99 years — ground lease. The ground-leasing strategy provides the hospital with the best of both worlds: It obtains substantial rental leases within the ground lease, and the hospital limits the use of the facility so that it will not be used to compete with profitable hospital endeavors.

Prepping for a sale

Selling or leasing land should not occur until all the facts are fully considered. Sometimes the unused land or building could be used for expansion purposes.

The building might be more valuable and worth retaining if the hospital is a major tenant in the building or if several leases are coming due and the hospital plans to increase the current rate being charged. A CPA should be retained to help analyze the options.



If selling is a viable option, the hospital should carefully evaluate potential buyers. The new landlord or owner will take over the delicate responsibility of managing the very physicians and staff who often work for or in the hospital. Hospital-staff relations are vital to the hospital's continued success. The hospital should also maintain some control over the land after it is sold or leased. This means it should retain the right to amend the rules or enforce regulations against the new owner for the use of the facility or its maintenance.

Moving forward

Although a segment of the real estate boom is new medical office buildings, a large portion is dedicated to hospital facilities. Since 2000, hospitals often have cited the following reasons for the building spree:

1. Aging facilities. The 1946 Hill-Burton Act spurred the building boom of the 1940s and 1950s. But since then, the health care industry has changed significantly. New technology can be difficult to add to old facilities. It is often cheaper to construct new facilities than to retrofit old ones.

Plus, evidence-based design studies by The Center for Health Design show that hospital design can play an important role in the healing process. The days of shared rooms are becoming a thing of the past. Patients are demanding services akin to many hotels. Newer facilities offer single-patient rooms with space for family members and the ability to control all the amenities, such as television, HVAC and lighting, from the patient's bed.

2. Specialty services. Hospitals are realizing that they must focus on expanding specialty services



that provide a greater return on investment. These services include cardiac care, neurology, orthopedics, women's and children's health, and oncology. Because insurance plans, Medicare and Medicaid pay more for these services, the health care industry wants to capitalize on the opportunities they afford.

3. Movement to underserved markets.

The phrase "following the rooftops" is often used by industry leaders when deciding where to build their newest expansion. They realize that suburban dwellers often are high-quality patients with good insurance. Add the opportunity to build with low-cost capital through traditional lending, bond financing and physician joint ventures, and the present time for building looks appealing.

4. Increased competition. Competition among hospitals is increasing as patients demand new technology, new facilities and high-quality staff. It is also no surprise that newer, high-tech facilities attract highly qualified physicians and their staff. Evidence-based design studies have shown that hospital staff members in these newer facilities are happier, healthier and more efficient.

Booming or busting

Even though the building boom continues, there are critics who question whether new facilities are needed. They claim that, even though access to health care will be more convenient, costs may increase dramatically if excess capacity exists. Others claim that new technology doesn't necessarily improve outcomes or survival rates, but that it is expensive and does drive up costs.

The bottom line? Before building a new facility, obtaining a second opinion is always important. Hospitals may find that expanding an existing building or retrofitting an older facility accomplishes the same goals at a much lower cost. <

Improve your chances of obtaining economic incentives

If you wish to develop a new facility, expand a current one or offer new services, you may be able to obtain cost-saving incentives from local and state governments. Incentives vary greatly from location to location, but commonly come in the form of grants, subsidies, bond financing and tax reductions.

Grants or subsidies often are provided for worker training, but also have been given to offset the cost of new equipment. Bond financing typically is available when a new project requires necessary infrastructure or costly new equipment is needed for development. Tax reductions usually come in the form of property tax abatements or income tax credits.

3 tips for obtaining economic incentives

Regardless of the value of incentives sought, you can improve your chances of success by adhering to these tips:

1. Seek incentives before anything else. Ideally, incentives are sought immediately after a project is internally discussed, even if only hypothetically. That means you should look for incentives before you purchase new land, facilities or equipment; begin any construction; or sign any agreements that will obligate you to go forward with the project. If the governing body believes the project will go forward as planned without any incentive, it will have little reason to negotiate an incentive for you.



2. Approach your local development office. Most state and local governments have a development department (specific names vary) that oversees incentives, processes the incentive request, and makes a recommendation to a board or other decision-making body that grants the incentive. In smaller communities that may not have development departments, the mayor or other city executive will likely be your first point of contact.

Be sure you frame your dialogue with these offices in a hypothetical manner, indicating that you are considering a project but that you're not yet committed to it. A pre-existing positive relationship with the appropriate body can help as well.

3. Negotiate. Every incentive campaign involves negotiation. State and local governments offer incentives in exchange for new or retained jobs, an increased tax base, and innovative services. While constrained by state statute, incentive-granting bodies generally have discretion to base their decisions on both the value of the project and the likelihood that the project will not occur unless incentives are given.

To be successful, make sure you position your group to negotiate. In the case of new development, this means approaching multiple municipalities or, if possible, multiple states.

If you're a larger provider, you may even consider putting two different properties under conditional sales contracts in an effort to cause governments to compete for your project. In the case of an expansion of an existing facility or providing new services, the size of the expansion or the scope of services should, at least during the negotiation phase, vary based on the amount of incentive offered.

Don't promise what you can't deliver

Of course, you should never promise a level of development or expansion that you cannot reasonably achieve simply to obtain an incentive. Incentives usually are conditioned on job creation and retention and other performance quotas. Work with your attorney to research and negotiate available incentives in your area. <

Medical waste disposal: What you need to know

How medical waste is disposed of has been a hot issue for the Environmental Protection Agency (EPA) during the last five years. In 2002, the EPA introduced a health care compliance initiative in response to the growing number of environmental violations within the health care sector.

The goal of the initiative is to ensure that health care facilities comply with all federal environmental laws and regulations, though the EPA is focusing most of its efforts on facilities that deal with hazardous wastes, wastewater discharges, air emissions and storage tanks.

How bad is it?

According to the EPA, most hospitals and health care providers are not aware of their responsibility

under federal environmental guidelines and have failed to implement effective compliance strategies. Through its initiative, the EPA is taking a closer look at affected facilities, and stepping up its inspection and enforcement activities.

Since the initiative began, the EPA has inspected 44 facilities, resulting in 22 enforcement actions and \$911,018 in penalties. In 2003, the EPA aggressively sought fines against Nassau University Medical Center in East Meadow, N.Y., for \$279,900 and Mountainside Hospital in Montclair, N.J., for \$64,349 for violations of the Resource Conservation and Recovery Act relating to the improper designation, storage and labeling of hazardous wastes. The EPA also noted that neither hospital had a permit to store hazardous wastes.

Since then, the EPA has continued to focus its enforcement efforts toward hospitals and health care facilities by issuing more fines for noncompliance.



What should you do?

In light of the EPA's initiative, hospitals and health care providers should review their policies and procedures now to be prepared for an unannounced inspection by the EPA or state regulators. For example, within each category emphasized by the EPA, review the appropriate criteria.

For clean air compliance, make sure that:

- > Incinerators have all permits,
- > Labs have any necessary permits,
- > Asbestos is properly removed, and
- > Paint booths have all permits.

For hazardous waste (HW) compliance, check that:

- > HW is properly labeled,
- > HW storage sites are inspected to ensure they don't exceed storage requirements,

- > Employees are trained on and follow HW segregation and disposal policies, and
- > Underground storage tanks are in compliance and properly maintained.

For clean water compliance, see that:

- > Permits have been obtained for wastewater discharges, and
- > HW is not disposed of through floor drains.

Moreover, spill prevention control measures should be in place.

What does the future hold?

It's likely that the EPA will continue to monitor the health care industry's handling of medical waste. Hospitals and health care providers should review their applicable state and federal laws and regulations to make sure they are in compliance. <

A message to our clients and friends:

Hall Render is pleased to provide you with this issue of *Practical Health Law*. This newsletter will be sent to you bi-monthly compliments of our health law attorneys; each issue will also be housed in the **Articles and Newsletters** section of www.HallRender.com.

We understand the value of good information when making sound business decisions. *Practical Health Law* is written by Hall Render's health law attorneys, each with extensive experience handling the legal issues of health care providers. We trust the information in each issue will be a valuable resource. Our attorneys stand ready to respond promptly to your questions and needs; please contact us if there are specific topics you'd like to see addressed.

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For a complete listing of the firm's services, attorneys and e-mail addresses, please visit our website at www.HallRender.com.

IN Downtown Office: Suite 2000, Box 82064, One American Square, Indianapolis, IN 46282, Ph: 317-633-4884 Fax: 317-633-4878
IN North Office: Suite 820, 8402 Harcourt Road, Indianapolis, IN 46260 Ph: 317-871-6222 Fax: 317-338-3946
KY Office: 614 West Main Street, Suite 4000, Louisville, KY 40202 Ph: 502-568-1890 Fax: 502-568-4878
MI Lansing Office: 110 West Michigan Avenue, 12th Floor, Lansing, MI 48933
MI Troy Office: Columbia Center, Suite 315, 201 W. Big Beaver Road, Troy, MI 48084 Ph: 248-740-7505 Fax: 248-740-7501
WI Office: 111 East Kilbourn Avenue, Suite 1300, Milwaukee, WI 53202 Ph: 414-721-0442 Fax: 414-721-0491