

**Testimony
of the
American Hospital Association
before the
U.S. Senate
Committee on Finance
Roundtable on Tax Exemption**

July 22, 2004

Good afternoon, Mr. Chairman. I'm Dan Coleman, president and chief executive officer of John C. Lincoln Health Network in Phoenix. On behalf of the American Hospital Association's (AHA) 4,700 hospital, health care system, and other health care provider members, and our 31,000 individual members, we appreciate this opportunity to participate in the Senate Finance Committee's roundtable meeting and to offer comments on certain staff draft proposals to reform and encourage best practices for tax-exempt organizations.

The not-for-profit John C. Lincoln Health Network includes acute and extended care medical facilities, primary care centers, a family practice residency program, the Desert Mission Food Bank, a children's dental clinic, housing facilities for low-income seniors, an accredited childcare center, and Marley House – a family resource center that helps protect children at risk for abuse and neglect.

John C. Lincoln provides high-quality medical services that our patients need, deserve and expect. Our long tradition of caring for people stems from our roots as a tuberculosis health camp in the hills of Sunnyslope, Arizona. More recently, we were very proud to receive the 2002 Foster G. McGaw Prize for excellence in community service ... one of the health care field's most prestigious honors.

Staff Discussion Draft on Reforms and Best Practices

Like John C. Lincoln Health Network, more than 60 percent of the nation's hospitals are exempt from federal income tax under Section 501 (c)(3). Consequently, many of our nation's hospitals would be affected by the tax-exempt proposals outlined in the staff discussion draft document. This afternoon, I will comment on a few specific proposals in the draft and how they might affect our members' mission of caring for people. Again, we appreciate the opportunity to provide these constructive comments, and we hope to continue this dialogue as the Finance Committee contemplates further action in the area of charitable giving reform in the not-



We commend Senator Grassley for his willingness to address serious concerns regarding charitable organizations, while preserving the continued contributions of not-for-profit hospitals in their communities.

Disclosure and Reporting

Mr. Chairman, hospitals are committed to increasing the transparency of hospital operations and practices to serve our patients in the best way possible. We agree that the current health care “system” does not serve Americans well in many ways. One way to address the problem would be to make more information available to the public. We’re committed to working with the committee and others to develop these methods.

Five-Year Review of Tax-Exempt Status By The IRS

As organizations that file Form 990, hospitals essentially already provide information to the IRS annually that allows a review of exempt status. The staff draft proposes a five-year review and a penalty of loss of exempt status for failing the review. Eliminating the certainty that comes from the IRS determination of exemption letter will have consequences for hospitals’ ability to raise capital through tax exempt financing, particularly as most bonds are issued for a period of greater than five years. Bond counsel will be hesitant to issue a “clean” opinion on a bond issuance under the specter of scheduled reviews and potential loss of exemption.

Revision of IRS Form 990

The staff discussion proposals to expand reporting on the IRS Form 990 could provide oversight agencies and the public with useful additional information about the operations of not-for-profit hospitals. We believe refining and improving Form 990 is the best method to achieve this Committee’s objectives in the area of charitable organizations. We agree with the staff proposal that the annual information reporting to the IRS could be improved, and that filing could be expedited by requiring electronic filing. Greater consistency in filing standards for IRS Form 990 would provide federal and state authorities with better means of identifying concerns by allowing easier comparison of similarly situated tax-exempt organizations. Electronic filing would reduce the administrative burden on the IRS as well as allow the public to access information more quickly.

Amending Form 990 to require evidence of appropriate governance practices, such as conflict of interest policies and governance best practices, could be sufficient to negate the need for periodic exemption reviews. It also would help the IRS detect problems earlier. While requiring an independent financial audit of large tax-exempt organizations’ financial statements, with a certification to that effect attached to Form 990, may be helpful to the IRS’s enforcement activities, for most non-profit hospitals certified public accountants prepare the annual returns. An additional review by an independent auditor would therefore be unnecessary and add to hospitals’ already formidable regulatory burden.

Governance

Hospital governing boards, drawn most often from the communities they serve, are traditionally highly responsive to their communities. The AHA fully supports strong, accountable, and independent board governance, and notes that the staff discussion draft proposal is intended to encourage governing best practices. Most hospitals already engage in the practices recommended in the staff discussion draft. However, some of the recommendations would erect barriers to recruiting trustees and directors, such as the imposition of federal liability where state non-profit law already protects the public. Additionally, the recommendation to limit board composition to no fewer than three members and no more than 15 seems arbitrary, and doesn't recognize the necessity that hospitals' boards reflect the diverse needs of the communities they serve.

Supporting Organizations

Many hospital parent corporations are structured to be legitimate supporting organizations, and have related foundations that are also critical partners in the fundraising efforts that support the hospitals' charitable mission. The supporting organization classification described in I.R.C. §509 (a)(3) is often used in the hospital environment to secure non-private foundation status for the parent corporation and related organizations. In the hospital context, the supporting organization charter typically names the hospital to be benefited and, as required by IRS regulations, provides for an interlocking board of directors or management (or both) with the hospital. Supporting organizations allow hospitals to create fundraising entities with separate boards that can focus exclusively on the foundation's support mission. Such closely affiliated entities allow hospitals that are public charities to avoid private foundation status, and is in keeping with the original intent of 509(a)(3). The "public charity" status of the supporting organization mirrors the hospital's own public charity status, through which the supporting organization receives the oversight necessary to ensure responsiveness to the public. To impose private foundation rules on such closely connected supporting organizations, or to eliminate the supporting organization classification, would hamper hospital management and operations without any corresponding public benefit.

The misuse of the supporting organization classification that has caused the Committee staff's concern certainly should be addressed. Private individuals who are establishing and securing tax-exemptions for organizations that are not organized or being properly operated as supporting organizations should be subject to the full enforcement power of the IRS to revoke exempt status and/or impose intermediate sanctions. If the misuse focuses specifically on situations in which individuals organize, donate to, and then withdraw the assets of the organization in the form of loans, the appropriate remedies already available to the service should be utilized, and new remedies adopted if necessary. However, any proposed elimination of these supporting organizations would greatly harm hospitals.

Conversion to For-Profit

We understand that the Committee staff is concerned that conversions of tax-exempt organizations to for-profit companies have not adequately protected charitable interests and assets. The typical transaction in the hospital arena by which “conversion” occurs is through the sale of all, or substantially all, of the assets of a hospital to a for-profit entity. Typically, such transactions raise two significant issues: 1) Have the assets that have been transferred, and the consideration received therefore, been valued adequately? and 2) Do the terms cause private benefit, or private inurement? Valuation in these transactions can be especially difficult where insider employment arrangements are made by the surviving entity.

In most states, attorneys general have specific authority to review and approve all aspects of such conversions. In fact, there is good evidence of how some attorneys general have participated effectively. Determination of how to serve the public’s health care needs in a conversion is best left at the state and local level. The IRS is ill-equipped to make such a determination, but is well-equipped under existing law to step in if an abuse has occurred in valuation or excessive compensation. If assets are valued too low, the IRS can revoke exemption retroactively and impose taxes. Similarly, if there is insider benefit, the IRS can revoke exemption or impose intermediate sanctions. No additional enforcement authority is needed to pursue these remedies.

Conclusion

Mr. Chairman, the people of America’s hospitals work very hard, every day, to get high-quality care to all who come through their doors. They do it with caring and compassion. And they do it in the face of mounting challenges. They are a key reason why our nation has the best health care in the world.

We appreciate the Committee’s interest and vigilance in ensuring the integrity of the tax-exempt sector and understand the need for a credible IRS enforcement process in the not-for-profit community. These comments represent our first thoughts on proposals for reforms and best practices in the area of tax-exempt organizations. We look forward to working with the Committee as its proposals are refined.