THE HOSPITAL & HEALTHSYSTEM
ASSOCIATION OF PENNSYLVANIA

September 7, 2007

The Honorable Charles Grassley
United States Senate
135 Hart Senate Office Building
Washington, DC 20510-1501

RE: Comments on *Tax-Exempt Hospitals: Discussion Draft*

Dear Senator:

On behalf of our nearly 250 member hospitals and health systems in Pennsylvania, The Hospital & Healthsystem Association of Pennsylvania appreciates the opportunity to submit comments on the paper, *Tax-Exempt Hospitals: Discussion Draft*, released by the minority staff of the Senate Committee on Finance. The proposed changes in this paper would have a significant impact on Pennsylvania hospitals and the capability of meeting the health care needs of the Commonwealth of Pennsylvania.

As mentioned in the paper, Pennsylvania is one of a few states with specific requirements for qualification as a tax-exempt entity. On November 26, 1997, House Bill 55, the Institutions of Purely Public Charity Act, was signed by Governor Tom Ridge and became Act 55 of 1997. The bill received unanimous support from the General Assembly. The Act was intended to bring clarity to the criteria to determine an institution's real property and sales tax exemption status. Proponents of the Act hoped that it would deliver educational, health care and other charitable institutions from further unwarranted legal attacks by local governments and school districts. At a recent hearing of the Pennsylvania Senate Finance Committee the general consensus among local governments, school boards, and nonprofit organizations was that Act 55 of 1997 continues to provide clarity to the tax exemption requirements of nonprofit organizations. We believe Pennsylvania is unique among the states in this matter. No other state has developed such comprehensive requirements for state tax exemption.

Until Act 55 of 1997, Pennsylvania lacked a clear definition of "institutions of purely public charity," the term used in the Pennsylvania Constitution to describe entities eligible for exemption from state sales tax and real property taxes. In 1985, five criteria were adopted by the Pennsylvania Supreme Court (*Hospital Utilization Project v. Commonwealth*, 507 Pa.1, 487 A.2d. 1306 (1985)) to determine whether an institution is an "institution of purely public charity." Under this new test, an institution qualifies as an "institution of purely public charity" if it:

- Advances a charitable purpose.
- Operates entirely free from private profit motive.
- Donates or renders gratuitously a substantial portion of its services.
- Benefits a substantial and indefinite class of people who are legitimate objects of charity.
- Relieves the government of some of its burden.

During the decade following the 1985 Pennsylvania Supreme Court decision, there was a surge of litigation by local governments and school districts that believed the court had created new and quite narrow standards that would eliminate the exemption for certain previously exempt institutions. Instead of clarifying the situation, the litigation following the Supreme Court decision created confusion and costly confrontations between traditionally tax-exempt institutions and political subdivisions.

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Attached is a summary of the key provisions in Act 55 of 1997.

Based on our review of the recommendations in the paper, we have three primary concerns:

A. THE FULL VALUE OF THE BENEFITS HOSPITALS PROVIDE SHOULD BE INCLUDED.

Government Underpayments—The full value of the community benefit that hospitals should include any underpayments by government payors. These underpayments should be treated as a quantifiable community benefit. Hospitals do not set payment rates for Medicare and Medicaid services, and Medicare and Medicaid do not pay the full cost of care. For the 176 acute nonprofit hospitals in Pennsylvania, the estimated annual shortfall from government payors is $1.2 billion. Medicare is about $500 million, Medicaid about $697 million, and other government programs $27 million. Nonprofit hospitals are fulfilling government's obligations despite inadequate payments. These underpayments represent a real cost of serving the community and should count as a quantifiable community benefit.

Bad Debt—Patient bad debt is a community benefit. Like Medicare and Medicaid underpayments, there are compelling reasons that patient bad debt should be counted as quantifiable benefit. A significant majority of bad debt is attributable to low-income patients, who, for many reasons, decline to complete the forms required to establish eligibility for hospitals' charity care or financial assistance programs. For the 176 acute nonprofit hospitals in Pennsylvania, the estimated annual cost of bad debt is almost $1.1 billion.

B. A QUANTITATIVE STANDARD WOULD ADVERSELY IMPACT ACCESS TO HEALTH CARE.

The paper recommends that nonprofit hospitals must provide a minimum of 5 percent of its annual patient operating expenses or revenues to charity care, whichever is greater, in accordance with its charity care policy. Under Pennsylvania law, the standard that is used by most hospitals is the requirement that it must maintain an open admissions policy and provide uncompensated goods or services at least equal to 75 percent of net operating income, but not less than 3 percent of total operating expenses. Pennsylvania law defines uncompensated care to include charity care, bad debt, and underfunding by government payers (including Medicare and Medicaid).

If the 5 percent test and the restricted definition of charity care were applied in Pennsylvania, the proposed excise tax on Pennsylvania hospitals is estimated to be $2.1 billion annually. This would have a devastating impact on health care delivery in Pennsylvania where nearly one-third of Pennsylvania hospitals had a negative operating margin in fiscal year 2006, and the statewide operating margin for general acute care hospitals was slightly above 4 percent for the same period.

C. HOSPITALS IN STATES WITH DEMONSTRATED REVIEW POLICIES FOR CONVERSIONS SHOULD BE EXEMPT FROM THE "TERMINATION TAX."

While we agree with the rationale for this tax when states do not provide oversight of nonprofit conversions, we disagree that it should apply in states that have appropriate oversight. Hospitals in states with demonstrated oversight of nonprofit hospital conversions should be exempt from the termination tax.

For almost a decade, Pennsylvanian's Office of Attorney General (OAG) has used a review protocol for fundamental change transactions affecting health care nonprofit hospitals. Whenever a nonprofit, charitable health care entity enters into a transaction effecting a fundamental corporate change which involves a transfer of ownership or control of charitable assets, the

Office of Attorney General must review each transaction to ensure that the public interest in the charitable assets of the nonprofit organization is fully protected. A copy of the review protocol is attached.

We appreciate the opportunity to submit our comments, and we especially appreciate the committee staff efforts to reach out to the hospital community and to better understand its concerns. If you have any further questions, please contact me at (717) 561-5314 or cscanlan@haponline.org; or Michael Strazzella at (202) 863-9287 or mstrazzella@haponline.org.

Sincerely,

Carolyn F. Scanlan

CAROLYN F. SCANLAN
President and Chief Executive Officer

Attachments: Summary of Act 55 of 1997
Office of Attorney General Review Protocol

c: Honorable Arlen Specter
Honorable Robert Casey, Jr.

Key Provisions of Act 55 of 1997

Act 55 of 1997 uses the same five criteria established by the Pennsylvania Supreme Court in 1985 as the framework for defining an "institution of purely public charity," but elaborates how an entity must demonstrate satisfaction of each criterion.

Charitable Purpose—There are six ways to meet this criterion:

- Relief of poverty.
- Advancement and provision of education.
- Advancement of religion.
- Prevention and treatment of disease or injury.
- Government or municipal purposes.
- A purpose, which is recognized as important and beneficial to the public and advances social, moral, or physical objectives.

No Private Profit Motive—The Act puts to rest any suggestion that an institution with revenue exceeding necessary expenses operates with a private profit motive. Rather, to demonstrate the lack of profit motive, an institution must ensure the following:

- Neither its net earnings, nor donations it receives, inure to the benefit of private shareholders or other individuals.
- Any revenue in excess of expenses is used for the furtherance of its charitable purpose or to fund other charitable organizations.
- Compensation and benefits of any director, officer, or employee shall not be based primarily on financial performance of the organization.
- No surplus funds may be used for the private inurement to any person in the event of a sale or dissolution of an institution of purely public charity.

Community Service—The requirement that an institution donate a substantial portion of its services may be met under one of six alternative percentage tests. These quantifiable tests were designed to ensure that an institution provides some portion of its goods and services at no fee or reduced fees. The test that is used by most hospitals is the requirement that it must maintain an open admissions policy and provide uncompensated goods or services at least equal to 75 percent of net operating income, but not less than 3 percent of total operating expenses.

Objects of Charity—The Act clarifies the criterion, "legitimate object of charity," as individuals who cannot provide for themselves what the institution provides for them. The Act specifically declares that federally exempt labor organizations, agricultural organizations, business leagues, social clubs, and fraternal benefit societies qualify under this test.

Relief of Government Burden—The Act clarifies the range of activities that can be deemed to relieve governmental burden. Thus, the Act considers any of the following to be relief of a government burden:

- Providing a service that government would otherwise be obligated to provide.
- Providing services that are a government responsibility or have historically been performed by government.
- Receiving on a regular basis payment for services rendered under a governmental program that are less than the full costs incurred by the institution.

- Providing a service which reduces dependence on governmental programs.
- Advancing or promoting religion by a religious ministry.
- Voluntary agreement which local governments.

There are two unique and creative provisions in Act 55 of 1997—promotion of voluntary agreements with local governments, and prohibition of competition with small businesses.

Voluntary Agreements—Many charitable institutions, threatened by costly local government legal challenges to their tax exemption, opted to make payment, or provide services to local governments in-lieu-of taxes ("PILOTS" and "SILOTS"). The Act supports these payments and offers incentives for continuing to make them.

Unfair Competition with Small Businesses—The Act also prevents charities from using their tax-exempt status to compete unfairly with small businesses. Charities are not permitted to "fund, capitalize, guarantee the indebtedness of, lease obligations of, or subsidize a commercial business that is unrelated to the institution's charitable purpose."

OFFICE OF ATTORNEY GENERAL REVIEW OF PROTOCOL FOR FUNDAMENTAL CHANGE TRANSACTIONS AFFECTING HEALTH CARE NONPROFITS

Underlying Principle

Whenever a nonprofit, charitable health care entity enters into a transaction effecting a fundamental corporate change which involves a transfer of ownership or control of charitable assets, regardless of the form of the transaction contemplated (i.e., sale, merger, consolidation, lease, option, conveyance, exchange, transfer, joint venture, affiliation, management agreement or collaboration arrangement, or other method of disposition); unless the transaction is in the usual and regular course of the nonprofit's activities; and regardless of whether the other party or parties to the transaction are a nonprofit, mutual benefit or for-profit organization; the Office of Attorney General, as parenspatriae, must review each transaction to ensure that the public interest in the charitable assets of the nonprofit organization is fully protected. Consequently, to review each transaction, the OAG must be provided relevant financial, corporate, and transactional information in order to reach a decision on whether or not to object to or withhold objection to the proposed transaction. This decision will determine the Attorney General's position relative to Orphans' Court proceedings required in fundamental change transactions under the Nonprofit Corporations Law.

Review Protocol

This protocol was developed to be used as a guide by attorneys and reviewers in the Charitable Trusts & Organizations Section, and its outside experts, in reviewing fundamental transactions affecting nonprofit, charitable health care entities. It provides broad, general guidelines with respect to issues that routinely appear in such transactions and is not intended to be an exhaustive or exclusive list of items to be reviewed and investigated, as these will vary on a case-to-case basis.

1. Notice to the Attorney General

The parties to the transaction shall provide written notice of same to the Attorney General at least 90 days prior to the contemplated date of its consummation. The Attorney General shall be given sufficient time from the receipt of the written notice within which to review and evaluate adequately and fully the proposed transaction. This notice shall include any and/or all of the following documents as the Attorney General may determine to be necessary:

a) All information, including organic documents such as Articles of Incorporation, bylaws, endowment fund documentation, trust restrictions, expenditure history, and other information necessary to define the trust upon which the charitable assets are held.

b) All complete transaction documents with attachments, including collateral or ancillary agreements involving officers, directors, or employees (i.e., employment contracts, stock option agreements in the acquiring entity, etc.).

c) All documents signed by the principals or their agents which are necessary to determine the proposed transaction's effect, if

any, on related or subsidiary business entities, whether nonprofit or for-profit.

d) All asset contribution agreements, operating agreements, and management contracts, if any, which comprise part or all of the transaction.

e) All financial information and organic documents regarding the post-transaction successor or resulting charitable entity (foundation), including the information detailed in Item (a), supra; and including relevant information with respect to officers, directors, and employees (current and post-transaction), in order to determine independence, board composition, charitable purpose, and to review any financial arrangements with officers, directors, or employees which may be affected by the transaction, particularly those which have the potential of affecting an individual's objectivity in supporting or approving the transaction.

f) All information necessary to evaluate the effects of the transaction on each component of an integrated delivery system, where transactions involve hospitals, including any changes in contracts between the integrated delivery system entities and related physician groups.

g) All financial documents of the transaction parties and related entities, where applicable, including audited financial statements, any fiduciary accounts whether or not filed with the various Orphans' Courts of the Commonwealth, ownership records, business projection data, current capital asset valuation data (assessed at market value), and any records upon which future earnings, existing asset values, and fair market value analysis can be based.

h) All fairness opinions and independent valuation reports of the assets and liabilities of the parties, prepared on their behalf.

i) All relevant contracts (assets and liabilities) which may affect value, including, but not limited to, business contracts, employee contracts such as buy-out provisions, profit-sharing agreements, severance packages, etc.

j) All information and/or representations disclosing related party transactions, which are necessary to assess whether or not the transaction is at arms-length or involves self-dealing.

k) All documents relating to non-cash elements of the transaction, including pertinent valuations of security for loans, stock restrictions, etc.

l) All tax-related information, including the existence of tax-free debt subject to redemption, disqualified person transactions yielding tax liability, etc.

m) A listing of ongoing litigation, including full court captions, involving the transaction parties or their related entities, which may affect the interests of the parties and the valuation of charitable assets.

n) All information in the possession of the transaction parties relative to the perspective of the nonprofit's beneficiary class or representatives thereof (e.g., the community).

o) All information, including internal and external reports and studies, bearing on the effect of the proposed transaction on the availability or accessibility of health care in the affected community.

p) Organizational charts of the parties to the transaction, as they exist both pre- and post- consummation of the transaction involved, detailing the relationship between the principal parties and any and all subsidiaries thereof.

q) Any and all additional documents that the Office of Attorney General deems necessary for its review purposes.

Any and all information provided in the course of the review will be held in confidence by the Office of Attorney General as a part of its investigative files and, as such, will not be returned to the transaction parties. No information will be privately or publicly disseminated concerning any transaction that is not objected to by the Attorney General, unless such a dissemination is ordered by a court of competent jurisdiction. The Attorney General will notify all transaction parties of any formal or informal request seeking access to the information provided.

2. The Review Process

The Attorney General is entitled to retain outside experts and consultants for the purpose of evaluating information detailed in Item 1, supra. This is more likely to occur in a nonprofit to for-profit transaction. These consultants may be either from state agencies, the private sector, or both. They shall be retained pursuant to written contracts, and the costs for retaining such consultants shall be paid by the parties requesting transaction approval.

The review of the transaction shall include, among other components:

a) Information gathering.

b) Review of fiduciary responsibilities of directors, particularly relative to the exercise of due diligence, the assessment of self-dealing and whether or not the transaction is at arms-length.

c) Fair market valuation analysis.

d) Inurement inquiry, including stock options, pension plans and perquisites, performance bonuses, consulting contracts or other post-transaction employment agreements, corporate loans, golden parachute provisions and severance packages, salaries, and related party transactions.

e) Public interest review to evaluate the transaction's effect upon the availability and accessibility of health care in the affected community, to include community involvement and antitrust review.

f) Appropriate cypres determination, to ensure that all restricted funds remain segregated and used for their restricted purposes; and that the remaining or successor charitable organization competently and efficiently utilizes the assets for a like charitable purpose benefitting the same class of beneficiaries. The analysis is particularly important when the transaction results in the reallocation of charitable funds from operational use to grant-making use, to ensure that a constancy of charitable purpose is maintained. It is critical to evaluate whether the acquiring entity will maintain control of the charitable assets, post-transaction, through the creation of a newly controlled foundation or through appointments to the existing charity's board.

3. Notice to the Public

The role of the Office of Attorney General in its review of the proposed transaction, is to ensure that the actions of nonprofit directors satisfied their fiduciary duties to the public beneficiaries of the health care entity, and to ensure that the charitable assets thereof are preserved and used for their proper charitable purpose. Further, the Attorney General will consider the broad public policy issue of whether the transaction is in the public interest, specifically whether the proposed transaction will adversely affect the availability or accessibility of health care in the affected community or region.

Implicit in this review is that reasonable public notice of a proposed transaction shall be provided by the parties to the affected community or region, along with reasonable and timely opportunity for such community to contribute to the deliberations of the parties and the Attorney General relative to the health care and charitable trust issues.
In this way, a thorough and complete review of the transaction can be accomplished in a manner that is open to public scrutiny, and the interest of public beneficiaries of nonprofit health care entities may best be protected.

4. Response of Attorney General

Upon completion of its review of the transaction, the Office of Attorney General may: issue a letter indicating that it has no objection to the transaction; bring judicial proceedings to enjoin consummation of any disputed transaction; seek to void any transaction consummated as being in derogation of the law or contrary to public policy; or take any other action it deems appropriate. If, in the opinion of the Office of Attorney General the public interest will be best served thereby,

the Office of Attorney General may request that the parties to the transaction seek approval of the Orphans' Court in the county of the nonprofit charitable corporation's registered office. This is more likely to occur in a nonprofit to for-profit transaction. The procedures set forth in this protocol are in addition to all other powers conferred on the Office of Attorney General by statute or common law.

5. Post-transaction Oversight

The Office of Attorney General will maintain oversight of the transaction after its consummation to ensure that no subsequently executed contracts or arrangements between the parties or their agents effect a denigration of its terms. This oversight may mandate that the resulting entity or surviving charity report on some basis to the OAG to ensure that the terms of the transaction are fulfilled.

Effective December 23, 1997