THE
CATHOLIC HEALTH
ASSOCIATION
OF THE UNITED STATES

Start February 23, 2006

**Re: Provisions in the Tax Reconciliation Bill:
Proposed Certification of Exempt Organization Tax Returns and
Regulation of Exempt "Supporting Organizations"**

We at the Catholic Health Association of the United States (CHA) commend you and other Congressional leaders for your continued vigilance with respect to the integrity and viability of the nonprofit sector. CHA represents more than 2,000 Catholic health care sponsors, systems, facilities, and related organizations, including over 600 hospitals. Its members provide a continuum of services in hospitals, long-term care facilities, assisted living, senior housing programs, adult day care, home care, and community-based services. In light of the nonprofit, charitable nature of CHA's members, CHA enthusiastically supports the objectives of promoting public accountability and oversight of the entire charitable sector, and guarding against abusive practices that divert charitable assets and programs from the public beneficiaries intended to be served.

The Tax Relief Act of 2005 (S. 2020), as passed by the Senate in November, includes a number of proposals resulting from your recent efforts to identify and curb abuses that undermine the well-being of the charitable community. We believe many of the provisions of S. 2020 applicable to charitable organizations are well-targeted and likely will prove effective in achieving the goals of greater integrity, transparency, and accountability. However, this letter is intended to comment on two particular proposals in S. 2020 that we believe to be misdirected and, if enacted, could pose substantial additional costs for thousands of charitable health care organizations, including our members.

I. A. Proposed Certification Requirements.

Specifically, section 306(c) of S. 2020 would amend Internal Revenue Code section 6011 to impose a series of new requirements in connection with the annual tax and information returns (Forms 990 and 990-T) filed by section 501(c)(3) organizations. The new rules would apply to organizations that meet both of the following tests:

- The organization has revenues of at least $10 million for the taxable year or assets of at least $10 million as of the taxable year end; and
- The organization "is subject to the tax imposed under section 511 for the taxable year."

Organizations meeting both of these tests would be required to include with their annual returns a statement prepared by an independent auditor or independent counsel. This statement must include a certification by the auditor or counsel as to each of the following:

- That he or she reviewed the information contained in the return (including details as to trade or business activities, investment income, and program service revenues, among other matters) and, to the best of his or her knowledge, such information is accurate;
- That, to the best of his or her knowledge, the allocation of expenses between exempt purpose activities and unrelated trade or business activities complies with the regulations under section 512; and
- That he or she has (or has not) provided a tax opinion regarding the classification of any of the organization's activities as an unrelated trade or business (and provide a description of any material facts with respect to any such opinion).

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Organizations failing to comply with the foregoing certification requirement would face penalties in the amount of 0.5% of their gross revenues for the taxable year.

S. 2020 also would require exempt organizations that file Form 990-T, the return for unrelated business taxable income, to make those returns public in much the same way they are now required to make publicly available their Form 990.

B. Concerns Regarding Proposed Certification Requirement.

We have a number of concerns regarding this proposal.

1. Ambiguous Scope.

First, section 306(c) of S. 2020 is imprecise in its wording and thus creates various ambiguities. The foremost of these is the question of exactly which section 501(c)(3) organizations are intended to be subject to the certification requirement. While the revenue/asset standard is clear (albeit problematic, as discussed below), the language refers to organizations that "are subject to the tax imposed under section 511 for the taxable year." This phrase could be interpreted to mean any of the following:

(i) All organizations listed in section 511(a)(2);

(ii) Only those exempt organizations reporting revenues from unrelated trade or business activities for the taxable year; or

(iii) Only those exempt organizations reporting net income from unrelated trade or business activities for the taxable year, *i.e.*, those organizations having an actual tax liability for the unrelated business income tax.

While the interpretation set forth in (iii) above would encompass a relatively significant number of organizations, the interpretation in (ii) would include a substantially greater proportion of the nonprofit sector within its sweep. And, if (i) in fact is the intended definition, so that virtually *every* 501(c)(3) organization having $10 million or more in gross revenues or assets is covered, such a wide swath exacerbates our other concerns, discussed below. At present, we are uncertain whether hospitals and health care organizations that do not have $1,000 or more in unrelated business taxable income would be covered.

2. Substantial Cost.

Initial estimates suggest that the costs for exempt health care organizations to comply with the certification requirement will be substantial and, for some organizations, potentially ruinous.

The required certification is extremely broad, requiring an independent auditor or counsel to attest to the accuracy of a wide range of information. In an era where professional service firms are increasingly cautious in issuing opinions and creating risk exposure, it is anticipated that firms would insist that such a certification be provided only after substantial investigation and inquiry into an exempt organization’s activities and assets. In addition, because the legislation does not specify a threshold standard of confidence for the associated certification (*i.e.*, reasonable basis, more likely than not, substantial certainty, etc.), risk-averse auditors and counsel likely will infer a relatively high standard, requiring more extensive review and certainty than might otherwise be the case. These requirements are further complicated by the fact that the unrelated business income tax rules are notoriously difficult to apply in practice in that

they are intrinsically subjective and frequently require reasoned judgment calls after consideration of all facts and circumstances.

The cost of requiring an organization's outside advisors or counsel to make those judgment calls is anticipated to be substantial. The American Institute of Certified Public Accountants (AICPA) in its comments submitted to the Finance Committee on July 22, 2004, indicated that the cost for performing the independent audits for exempt organizations would run in the thousands of dollars. Our informal estimates suggest that the certification requirement could cost nonprofit hospitals as much as $30,000 per hospital or more. For most hospitals, the cost of the certification (which is purely an administrative cost) necessarily will translate to reduced funding for programs and services, price increases, or both. These costs obviously would be significant even for large charitable organizations having substantial revenues and assets such as hospitals and health systems.

Notwithstanding the substantial costs involved with compliance, the costs of potential *non-compliance* are even more daunting. Section 306(c) of S. 2020 imposes a penalty of 0.5% of the organization's gross revenues. As a result, health care organizations having little or no unrelated trade or business activities could incur sizeable penalties for inadvertent violations. For example, an organization meeting the $10 million revenue threshold but having de minimis unrelated trade or business activities would face a penalty of $50,000 or more, even if the organization suffered a net loss for the taxable year.

3. **Fundamental Unfairness**.

The above-cited provisions of S. 2020 would create unwarranted disparities in the application of federal income tax laws between nonprofit and for profit entities. For example, S. 2020 would require exempt organizations to have their Forms 990 and Forms 990-T certified by independent auditors or counsel. For profit taxpayers are not required to have the content of their tax returns certified by independent auditors or counsel. Also, S. 2020 would require exempt organizations to disclose whether they have sought tax opinions regarding their activities and provide a description of the material facts with respect to such an opinion. For profit taxpayers are not required to disclose whether they have sought tax opinions on any aspects of their activities.

The foregoing discrepancies are fundamentally unfair and run counter to the tax policy underlying the unrelated business income tax. The unrelated business income tax was established to eliminate unfair competition by exempt organizations against taxpaying entities, but not to punish or put exempt entities at a competitive *disadvantage*. S. 2020 would lead to exactly such a result.

4. **Compliance Concerns**.

CHA shares your goal of improving compliance through measures intended to provide greater transparency as to the activities of charitable organizations. We are concerned, however, that there is not enough contemporary guidance from the Internal Revenue Service ("IRS") in the unrelated business income tax area to reliably make the determinations required by S. 2020. As mentioned above, the unrelated business income tax rules are notoriously difficult to apply in that they are intrinsically subjective and frequently require reasoned judgment calls after careful consideration of all facts and circumstances. The IRS needs to provide more up-to-date and more detailed guidance with respect to how these facts and circumstances are evaluated in the context of activities conducted by

charitable organizations. The majority of the available guidance is inherently fact-specific and cannot be relied upon by charitable organizations as precedent.

Compliance with the certification requirement is further complicated by the tax opinion disclosure requirement of S. 2020. Exempt organization leaders may determine *not* to seek tax opinions on matters that ordinarily would warrant additional review, based on the fact that such opinions will need to be publicly disclosed in connection with the annual certification. Organization leaders likely will assume (whether correctly or not) that, by reporting the existence of tax opinions, they may incur greater risk of audit and/or more clearly point IRS auditors to areas of exposure or appear to donors and the community as though they are engaging in questionable activities.

C. Conclusion.

For the reasons set forth above, we respectfully request that the Congressional conferees examining S. 2020 carefully reconsider section 306(c) and its disproportionately harmful effect on the charitable sector. We recommend and support the elimination of the certification requirements from the bill and retention of the requirement for exempt organizations that file Form 990-T to make those returns public in the same way that exempt organizations are now required to make publicly available their Form 990.

II. A. Proposed Improved Accountability of Exempt "Supporting Organizations."

S. 2020 would impose several new requirements or limitations on supporting organizations that qualify for federal tax exemption under section 509(a)(3) of the Internal Revenue Code. These include requiring all Type III supporting organizations to annually distribute "the sum of (1) the greater of (i) 85 percent of its income or (ii) five percent of the aggregate fair market value of all of the assets of the organization…" (or pay a substantial tax penalty) and prohibit all Type III organizations from supporting more than five supported organizations. For the reasons set forth below, these provisions should not be made applicable to health system parent organizations.

B. Concerns Regarding Improved Accountability of Exempt Supporting Organizations.

Most health systems are structured using the "parent holding company" model. Under this model, the hospitals and other health care operating corporations in the system are "subsidiaries" of the parent. Generally, this parent/subsidiary relationship is created by the parent serving as the sole corporate member of each of the subsidiaries with "reserved powers," such as the power to appoint or elect the subsidiary boards, and to approve many other fundamental corporate actions of the subsidiaries. Most of these parent organizations are recognized as public charities by the IRS as Section 509(a)(3), Type III organizations.

Parent organizations generally provide management and strategic services to the subsidiaries in the health system. The parent primarily receives its funding from the supported organizations as payments of management fees, assessments, etc., not from donors.

As we understand from the Independent Sector Report, the proposed legislation seeks to address abuses by donors who are using the flexibility of Type III organizations to inappropriately maintain de facto control over the organization and then causing it to improperly provide private benefits. This scenario is not in any way applicable to health system parent organizations which do not derive funds

from donors.

As long recognized by the IRS, health system parent organizations are a legitimate use of the Type III structure. It appears that these parent organizations have been inadvertently swept up in the proposal to curb perceived abuses which are not applicable to them.

C. Conclusion

Applying the proposed provisions to Type III health system parent organizations makes no sense and would create significant problems where none currently exist. For example, requiring the annual distribution of certain amounts to the supported organizations would mean that a parent organization would have to make annual distributions to the same subsidiaries from which the parent generally derives its funding.

Most importantly, prohibiting a Type III organization from supporting more than five organizations in the health system context would completely undermine parent organizations, as most health systems are comprised of numerous tax-exempt hospitals, home health agencies, nursing homes, clinics, etc.

For these reasons, Type III organizations serving as parent organizations of tax-exempt health systems should be exempted from the proposed provisions of S 2020 aimed at curbing abuses in donor-funded Type III organizations.

Thank you for your consideration of these comments. CHA shares your view that, in promoting the integrity and viability of charitable organizations, the public as a whole derives the ultimate benefit.

Sincerely,

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