REPORT OF THE
JOINT SUBCOMMITTEE
INVESTIGATING

The Extent of Unfair Competition Between Nonprofit Organizations and Small For-Profit Businesses in Virginia

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

House Document No. 35

COMMONWEALTH OF VIRGINIA
RICHMOND
1988

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REPORT OF THE JOINT SUBCOMMITTEE INVESTIGATING
THE EXTENT AND IMPACT OF UNFAIR COMPETITION BETWEEN
NONPROFIT ORGANIZATIONS AND SMALL FOR-PROFIT BUSINESSES
to
The Governor and General Assembly of Virginia
Richmond, Virginia
January, 1988

To: Honorable Gerald L. Baliles, Governor of Virginia
and
The General Assembly of Virginia

INTRODUCTION

While competition between commercial for-profit businesses and nonprofit organizations is not new, in recent years it has become much more widespread. The major reason for this is the dramatic growth in the nonprofit sector. Tax-exempt organizations are one of the fastest growing segments of the economy with annual revenues exceeding $300 billion in 1985. Their percentage of the Gross National Product has grown from 2.99 percent in 1980 and 3.29 percent in 1983 to approximately eight percent in 1985. The tax-exempt community ranges from informal social or neighborhood clubs with limited resources to complex, multi-million dollar medical complexes.

Nonprofit organizations, traditionally formed for charitable, educational, scientific or religious purposes, and thus exempt from federal income taxes and recipients of other special treatments such as postal subsidies, are increasingly engaging in commercial activities which compete with small for-profit businesses. This ever-increasing amount of nonprofit competition is not only from nonprofits per se but from for-profit subsidiaries which are spun off from the nonprofits. Small businesses which pay federal and state taxes for the privilege of doing business have begun to question and object to these activities. They do not object to the existence of most nonprofit organizations when providing genuine charitable services and if they are "playing on a level field". They do, however, find competition with nonprofit organizations unfair because of the many subsidies and special treatments received from all levels of government.

Historically, nonprofit organizations have provided services to those in need when the public and private sectors were unable or unwilling to do so. They are the "third sector" of society because they are private in organization, but public in mission. They relied on gifts, contributions, and volunteers to accomplish their missions. These traditional nonprofit charitable organizations are being replaced by "commercial" nonprofits which derive their income from the sale of goods or services produced in competition with those traditionally furnished by

for-profit businesses. Cutbacks in federal grants, heightened competition for private donations, declining demand for some services, and changes in the orientation of the economy from manufacturing to service, all have led such organizations to seek for-profit activities as sources of dependable operating revenue. Nonprofit organizations view their expansionary efforts as necessary in furthering their tax-exempt purposes and recognize that some competition with for-profit businesses has always existed, yet is now increasing.

Competition is occurring not only in traditional service industries such as health care, travel and merchandise sales, but also in newer fields such as laboratory testing, audio-visual services, data processing, and consulting. Most of the complaints regarding unfair competition concern organizations operating under § 501(c)(3) of the Internal Revenue Code which include religious, educational, charitable and scientific organizations. Public universities and hospitals are among the main targets of small business complaints. Businesses maintain that universities take business away from the private sector through on-campus stores and restaurants, computer sales, research projects, alumni group travel tours, etc. They object to hospitals using resources generally unavailable to for-profit firms to create new corporate structures in which the original nonprofit hospital become only one of many corporate entities, both nonprofit and profit-making, and which allow the hospitals to venture into nearly any area without risking the nonprofit status of the original entities.

An example of the expansionary efforts by hospitals in Virginia, as reported in the February 15, 1987 edition of The Washington Post, is that of Roanoke Hospital Association, a nonprofit group operating several hospitals in the Commonwealth, which purchased an advertising agency in January to add to its other for-profit ventures including two health clubs, an interior decorating firm, a pharmacy, and a helicopter ambulance service.

Nonprofit-owned hearing aid suppliers, laundries, prosthetic services, prescription drug centers, cooperatives that sell low-cost supplies to farmers, humane societies that neuter dogs, and nonprofit health clubs are just a few other targets of unfair competition allegations.

Concern over the commercial activities of nonprofit organizations and the effects of such on for-profit businesses has led a number of states and the federal government to investigate the issue. Action at the national level has prompted more states to look into the issue, and in August 1986, the White House Conference on Small Business ranked unfair competition between nonprofit organizations and small for-profit businesses third on its list of priorities. The House Ways and Means Subcommittee on Oversight, chaired by Rep. J. J. Pickle of Texas held hearings in the summer of 1987 on the federal treatment of commercial and other income-producing activities of organizations that have tax-exempt

status. Until then there had been no comprehensive review of the unrelated business income tax rules since 1969 and there are many unanswered questions about the scope and nature of tax-exempt organizations' income-producing activities, the administration of the unrelated business income tax by the Internal Revenue Service and the courts, and the extent of compliance with the law. One of the findings of the Subcommittee was that in 1986, of the more than 840,000 tax-exempt organizations on record, only approximately 27,000 reported unrelated income-producing activities subject to tax and about one-half of the $57 million of unrelated business income tax collected by the IRS that year was attributable to only two audits. Congress is not expected to adopt any changes in the law this year because the Subcommittee was only gathering information and will not be considering any specific legislative changes.

The federal government attempted to address this same unfair competition issue in 1950 by imposing a tax on the income which resulted from unrelated activities carried on by tax-exempt organizations. It is now apparent that the UBIT is not accomplishing its original goal because no monitoring systems were established to ensure compliance with the law. The General Accounting Office recently completed a study of the competition between taxable businesses and tax-exempt organizations and found that part of the problem with the UBIT stems from the fact that the IRS has no concrete rules for defining unrelated business income. However, in recognition of the fact that they may have been lax in the enforcement of the UBIT, the IRS plans to audit 3,000 returns filed by tax-exempt organizations throughout the country to determine the accuracy of every item reported. This information will be used to develop audit selection criteria and audit procedures to assure that the income of nonprofit organizations is reported accurately.

The number of states which had some level of activity on the issue, ranging from the passage of legislation to the formation of study committees, has increased from twenty-two in 1985 to thirty-four in 1987.

Concern over the potential detrimental effects that unfair competition from nonprofit organizations could have on the small businesses of the Commonwealth prompted the 1987 General Assembly to pass House Joint Resolution No. 303, calling for a study of the issue. A copy of the resolution appears as Appendix 1 to this report.

Delegate Harvey B. Morgan of Gloucester, chief patron of the resolution, served as Chairman of the joint subcommittee. Other members of the House of Delegates appointed to serve were: Bernard S. Cohen of Alexandria, Alson H. Smith, Jr. of Frederick, and William T. Wilson of Alleghany.

Senator Richard L. Saslaw of Fairfax County served as Vice Chairman of the joint subcommittee. Other members of the Senate appointed to serve were: John H. Chichester of Stafford and Elmon T. Gray of Sussex.

Two citizen members were also appointed to serve: Mr. Thomas Inman, II of Newport News, representing small business interests, and Mr. Guy T. Tripp, III, Esquire, of Richmond City, representing nonprofit interests.

C. William Cramme', III, Senior Attorney, and Terry Mapp Barrett, Research Associate, of the Division of Legislative Services served as legal and research staff. Barbara Hanback with the House Clerk's Office provided administrative and clerical duties for the joint subcommittee.

WORK OF THE SUBCOMMITTEE

Realizing from the onset of the study that the issue of unfair competition between nonprofit organizations and small for-profit businesses would be broad, complex and difficult to come to terms with, the joint subcommittee determined that it would be best to limit the study to that of private small businesses. To facilitate the study a "small business" was defined as one having fewer than 250 employees or less than $10 million in gross revenues in each of the last three years or less than $2 million in net worth. In addition, it was determined that the study would not overlap with those of other study committees which were looking into related issues including the role of state and local government competing with private for-profit day care centers (HJR 306), the criteria for evaluating requests for exemptions from the retail sales and use tax (SJR 119), and government competition with small business (Governor's Commission on the Efficiency of State Government).

Significant concern was expressed throughout the study by parties representing both sides of the issue, nonprofit organizations and small businesses, over the alleged unfair competition and the study itself. Small businesses were primarily concerned about the unfair competition issue whereas the majority of the concerns expressed by nonprofits were related to the effects of any legislation that might result from the study. Concern was expressed that the legislation would be so broad that it would affect not only those that are engaged in commercial activities which compete with small businesses but also many "genuine" nonprofits engaged in their original charitable missions. Two public hearings were held to elicit the concerns of both groups and to determine the extent of the problem in the Commonwealth. In addition, testimony was received in the six working sessions of the subcommittee.

The joint subcommittee heard a large volume of testimony and received position papers from a number of organizations and individuals including: the Department of Taxation, the Department of Economic Development, the State Corporation Commission, the Virginia Health Services Cost Review Council, the United Way and several of its agencies, the Virginia Hospital Association, Mary Washington Hospital,

the Business Coalition for Fair Competition, the National Federation of Independent Businesses, the Virginia Society of Hearing Aid Specialists, the Virginia Chamber of Commerce, the Virginia Association of Durable Medical Equipment Companies, the Proprietary Child Care Association of Virginia, Virginia Petroleum Jobbers Association, the Virginia Gasoline and Automobile Repair Association, Inc., the YMCA, the Virginia Physical Therapy Association, the Virginia Orthopaedic Society, the Virginia Association of Rehabilitative Facilities, the Rappahanock Rehabilitative Facility, Inc., the Richmond Area Association for Retarded Citizens, the Department of Children, the Virginia Day Care Council, the Virginia Association of Textile Services, the Virginia Retail Merchants Association, the Richmond Cerebral Palsy Center, U.S. Health, Inc., the Virginia Association of Home Medical Equipment Suppliers, the American Red Cross, the Virginia Association of Public Transit Officials, the Virginia Veterinary Medical Association, Blue Cross and Blue Shield of Virginia, the Richmond Metropolitan Blood Service, as well as representatives of home health care businesses, durable medical equipment companies, child care centers, speech and hearing centers, veterinarians, transportation companies, a pharmacist, a professor of economics, and other concerned citizens.

Representatives of for-profit businesses and organizations identified several practices employed by or benefits which accrue to nonprofit organizations which they deem unfair. These included:

1- the use of surplus funds obtained through nonprofit activities as venture capital to expand into unrelated profit-making activities which compete with small for-profit businesses rather than lowering the costs of services provided to the public or putting the money back into the organization to improve current services.

2- the use of facilities, equipment, staff or supplies paid for by charitable donations or revenues from mission-related activities to pursue unrelated income-producing businesses.

3- "captive referrals" - the practice of influencing the selection by a consumer of ancillary providers or services to be provided by a subsidiary or related entity in lieu of other available providers. This could effectively eliminate client choice and ultimately drive up the cost of services through the development of monopoly market shares.

In the health care industry captive referral has become an ubiquitous practice and may be attributed in part to the reimbursement mechanism which has the government or other third party payers, and not the consumer, bearing the cost of these ancillary services.

4- the "halo effect" a nonprofit receives through its tax-exempt status, community support, volunteer labor, free advertising, subsidized postal rates, donations and other services which benefit its charitable image. This effect has been successfully perpetuated by nonprofits to their commercial subsidiaries through the inurement of public support for these expanding activities.

5- exemption from taxation. Exemption from taxes is one of the most visible and tangible differences between the treatment of nonprofit and for-profit entities. For example, a for-profit corporation which is a wholly-owned subsidiary of a nonprofit is allowed to donate ten percent of its taxable income to its parent under the current IRS Code. Although this is allowed to any corporation, it equates to a ten percent tax-free dividend to the nonprofit parent corporation. Additionally, any declared dividend or profits may be passed to the nonprofit parent holding company thereby escaping further taxation and negatively impacting tax revenues. Many businessmen believe that if nonprofits were deprived of the access to free venture capital and "tax-free dividends" traditional nonprofits would rapidly lose interest in taking a legitimate business risk in the marketplace.

Some indicated that having to pay taxes to subsidize the activities of nonprofits with which they are forced to compete is truly unfair.

6- the exemption of some from the regulations imposed by law to protect the public such as the exemption of certain nonprofit organizations from the day care regulations.

Small business spokesmen stressed that although they did not seek to undermine the legitimate efforts of nonprofits they felt that any nonprofit which goes beyond its original purpose should do so at the risk of its tax-exempt status.

Representative of nonprofit organizations offered the following responses to charges of "unfair competition":

1- some taxable organizations are now expanding into traditionally nonprofit areas.

2- in many cases their tax-exemption is illusionary because many barely break even.

3- without the income from profit-making activities or if they had to pay taxes, they would have to curb some of their charitable activities.

4- cutbacks in federal grants, heightened competition for private donations, changes in federal law have forced them to seek alternative methods of funding.

5- surplus income is used to provide additional services to the public.

6- many provide services to meet needs not met by for-profit entities such as employment and training for the disabled and handicapped, day care for those who cannot afford to pay for it, etc.

Testimony revealed that unfair competition from nonprofit organizations is not a problem for all businesses and appears to be limited to certain industries. The majority of complaints of unfair competition heard by the joint subcommittee was against nonprofit hospitals. Business associations, medical equipment and home health care companies contended that nonprofit hospitals have used surplus funds derived from their charitable activities to expand into unrelated profit-making activities which compete with small for-profit entities rather than to lower their costs or to improve their current services. Some of the businesses which have been entered into include home health care, durable medical equipment, health and fitness spas, hotels, interior decorating, laundries, catering, landscaping, child care, etc.

Concern was expressed over hospitals' creating new corporate structures in which a nonprofit corporation becomes the parent corporation, the original hospital becomes a subsidiary, and for-profit entities and a private foundation are created. Although corporate taxes are paid on the income of the for-profit entities, a layer of taxation is avoided when the for-profits donate their income after corporate taxes to the private foundation which filters it to the original hospital. With this kind of structure a hospital can venture into nearly any area without risking the nonprofit status of the original entity. An example of the diversification of hospitals into income-producing businesses is that of the Fairfax Hospital Association which owns a durable medical equipment company, a bill collection agency, and an equipment repair company.

One of the primary complaints lodged against hospitals was that of captive referrals. Many tesified that hospitals have opened businesses which compete with them by using surplus funds and operating out of the main facility. Existing staff is utilized until the new business is "on its feet". Some of the testimony revealed that through captive referral hospitals refer at least ninety percent of their patients to their own businesses. This not only takes most of the business away from small busineses but also deprives the state of tax revenues. Many indicated that although the area of decreased income was of great concern, they were more concerned about the captive referral problem. They stressed that the patient should have the right to choose a provider of services without the influence or interference by hospital personnel, since the services needed by the patient may be available from other suppliers in the area and may be at a lower cost.

The Virginia Hospital Association which represents both for-profit and nonprofit hospitals justified the diversification effort of nonprofit hospitals by citing a number of changes that have taken place in the health care industry in recent years which have caused hospitals to seek alternate sources of revenue to offset real or potential losses from traditional hospital and health care businesses. It was explained that changes in third party payor systems, from an actual cost to some form of prospective, fixed-fee basis has exposed them to financial risks and that concurrent with these payment system changes have been changes in the way that health care is delivered. Now health care is considered anything from wellness to hospice and much is being delivered in alternative settings, therefore hospitals are not only competing with themselves, but also with a host of other players and are being left with only the sickest who require the most care at the most expense. In addition, uncompensated care has increased at an average of twenty percent per year and the number of hospitals operating at a loss has increased from fourteen in 1985 to twenty-seven in 1986. Mary Washington Hospital testified that if it did not have the income from outside businesses, it would not be able to provide charity care.

Although the Hospital Association testified that increases in charity care was one of the reasons hospitals are seeking alternative sources of income, it was pointed out that the Health Services Cost Review Council report for 1985 indicated that the two state-supported institutions, MCV and UVA hospitals, provided almost two-thirds of the charity care in the state. The Hospital Association argued that this was not the case, because after the appropriation from the General Assembly was taken out, MCV and UVA provided only twenty percent of the charity care with the remaining being provided by the other hospitals. When asked by the subcommittee members why hospitals do not use their surplus funds to reduce rates rather than to seek income-producing activities, the Virginia Hospital Association representative testified that they use surplus funds to maintain their physical viability within their communities, to accomodate physician or patient needs (i.e. building office buildings close to the hospital), etc.

Nonprofit child care centers were also a major target of complaints heard by the subcommittee. Although the subcommittee initially decided that they would not address this issue, they afforded those child care representatives who wished to testify the opportunity to do so. Private, for-profit child care centers testified that they experience competition from YMCAs, churches, United Way agencies, privately-owned nonprofits, colleges and universities, and the government, most of which are exempt from the licensure requirements of the law and from taxation. It was stressed that since children are involved, all centers should be licensed and pointed out that nonprofit centers may be certified to qualify them for federal aid. Many testified that the exemptions give nonprofits an unfair advantage over the private, for-profit centers because they can afford to charge less. In addition, the state loses valuable income,

business, personal and real property tax revenues because of the tax exemptions. It was estimated that the state lost $94,000 in tax revenues because of child care operations by the YMCAs and the Department of Parks and Recreation. One complaint specifically against the YMCAs was that they are benefiting from information referrals because they are allowed to distribute literature in the public schools, yet private centers are not.

Nonprofit child care center representatives testified that the issue is not whether a center is for-profit or nonprofit but the availability of quality care for children and that they are concerned about the working poor's access to care comparable to that available to those with higher income. They pointed out that nonprofits play a significant role in child care as they meet the needs not met by government or for-profit sectors. Most are devoted to serving the working poor - they make contributions to the at-risk population by directing energies at breaking the cycle of poverty by providing counseling, health services, clothing, etc., and act as advocates for the interests of the working poor. They also pointed out that those centers which tend to serve a largely indigent population almost exclusively are undercapitalized and unable to borrow money as they have no collateral. Interest is a nonallowable expense if they are doing any type of business with the federal government and they can provide no bonus incentives and only low salaries for their staffs. They indicated that their tax-exempt status is illusionary since most nonprofits barely breakeven and that all day care centers can apply for federal money for food and services for children of low and moderate income families. It was noted that most nonprofits have boards to which they must answer yet most for-profits do not.

Other groups voicing concerns about unfair competition included:

1 - veterinarians about competition from humane societies which provide many of the same services but are able to charge lower fees because of donations they receive and which benefit from the "halo effect".

2 - textile services about competition from nonprofit laundries which, in bidding situations, are able to submit the lowest bid because they do not have to pay taxes. They indicated that prices would be lower for all if the nonprofits were added to the tax base.

3 - a health fitness center about competition with YMCAs. They argued that the Ys should be taxed and pointed out that a $12 million YMCA is being built in Washington, DC and will cater to legislators.

4 - hearing aid specialists about unfair competition from nonprofit centers many of which operate out of hospitals and thus do not have to pay rent and for their equipment. They objected to the tax-exemptions and pointed out that business licenses are not required and such entities benefit from captive referrals.

5 - a taxicab company about competition from a transportation company receiving federal grants.

6 - several business associations in regard to unfair competition in general.

Others testifying before or presenting position papers to the joint subcommittee were later referred to Delegate Axselle's subcommittee on government competition with small business. The Virginia Petroleum Jobbers Association and the Virginia Gasoline and Automobile Repair Association, Inc. indicated concern about the state competing with private enterprise by installing vending machines at its rest areas. They objected to this as it meant that fewer motorists would be stopping at the service stations, convenience stores, restaurants along the interstates. A representative of charter party carriers and common carrier brokers also presented his clients' problems to the subcommittee and requested that specific legislation be recommended to level the playing field in these areas. The joint subcommittee considered the legislation requested but determined that it was more closely related to the issue of government competition with private business and thus could be more appropriately addressed by Delegate Axselle's subcommittee.

As mentioned earlier, a number of nonprofit organizations were concerned that any legislation to come out of this study could be so broad as to affect not only those nonprofits engaging in commercial activities which compete with small businesses, but also genuine nonprofits which are concerned only with pursuing their original missions. Representatives of several of these "genuine" nonprofits followed the study closely and testified before the subcommittee. They were concerned that if their tax-exempt status were taken away from them, they would have to curb some of their charitable activities and did not know who would fill the void.

The YMCA, responding to charges of unfair competition from day care centers and fitness clubs, informed the subcommittee that their mission is broad and flexible so that each can offer the programs and services that are in the best interest of their community. They pointed out that they use surplus income to provide additional services to the communities and to help those who cannot afford to pay. They also pointed out that for-profits have entered into traditional YMCA fields yet they do not object to this as each is fulfilling its respective and different mission - the YMCAs reach all income levels whereas for-profit businesses reach only those who can afford to pay. They testified that they have provided personal fitness programs since the mid-1800s and have served school-aged children in child-care type activities since the early 1900s.

Throughout the course of the study, the members were disturbed by the lack of information on nonprofit organizations currently available from the Department of Taxation and the lack of enforcement of the unrelated business income tax provisions by the Internal Revenue Service.

Although the subcommittee requested information on the amount of state and local taxes not collected because of various exemptions in the federal and state income tax laws and on the number of nonprofit organizations operating in the state, such information was not available.

At the subcommittee's request, information was provided to it at its first meeting by the Department of Taxation on the tax treatment of nonprofits. It was revealed that if an exempt organization has income from a commercial enterprise, or any other income which is unrelated to its exempt function, the organization is subject to federal income tax on its unrelated business taxable income. Since Virginia conforms to federal tax law, any organization that is exempt from federal taxation is also exempt from state taxation and that if it is subject to federal taxation of its unrelated business income, it would also be subject to state taxation of such. If an organization is exempt from federal taxation, it merely files a copy of its exemption with the Department of Taxation.

The subcommittee learned that the IRS has not been diligent in enforcing compliance with the UBIT and that at the federal level a subcommittee of the House Ways and Means Committee was holding hearings on the unrelated business income tax and would focus on the federal tax treatment of commercial and other income-producing activities of organization which have tax-exempt status under § 501 of the Internal Revenue Code. It also learned that the IRS plans to audit 3,000 returns filed by tax-exempt organizations throughout the nation to determine the accuracy of every item reported. This information will be used by it to develop audit selection criteria and audit procedures to assure that the income of nonprofit organizations is reported accurately. Because of the state's comformance with federal law, the subcommittee felt that its hands were somewhat tied when it came to the unrelated business issue.

In an attempt to determine the impact on tax revenues of the growth of nonprofit organizations in Virginia, the subcommittee surveyed the Commissioners of Revenue in the state to determine if they had experienced any erosion in their tax bases because of an increase in the number of nonprofit in their localities. Although almost ninety percent of those responding indicated that they had not, the majority of their comments indicated that they had noticed a slight increase and that although it was not a problem now, it could be. The subcommittee was concerned about the lack of definite figures provided by the Commissioners in light of the requirement of § 58.1-3604 of the Code that assessing officers of localities make and maintain an inventory and assessment of all tax-exempt real property within their areas. The Department of Taxation indicated that because the assessing officers did not completely understand what was requested of them, only within the last year or so have all localities complied with this section even though it has been in the Code since 1975. The subcommittee was concerned about this lack of compliance with the law and felt that the

assessing officers should be strongly urged to keep and submit to the Department of Taxation accurate records on tax-exempt property.

During its working sessions, the joint subcommittee discussed at length the issue, reviewed the recommendations and position papers presented by various groups, considered various approaches to the problems, and finally was able to reach some agreement as to the most appropriate action to recommend. The subcommittee recognized that there are two valid sides to the competition issue which made the problem even more difficult to deal with: (1) the need for nonprofit organizations to maintain financial stability which will enable them to continue to fulfill their charitable mission and (2) the intervention of nonprofits in the private market through unfair competition.

Realizing that broad, general statutes would be too far-reaching and possibly affect "genuine" nonprofits, the subcommittee attempted to direct its attention to specific issues and industries where the most unfair competition was reported. Several meetings were devoted to discussing and making changes to various drafts which had been requested.

CONSIDERATIONS

The following are some of the issues the subcommittee considered addressing but ultimately rejected:

1- Recommending legislation eliminating all exemptions from licensure requirements of the Code for child care centers.

A number of child care representatives testified that the state laws permitting exemptions from licensure child care centers run by churches, colleges and universities, and other nonprofit groups are unfair. After much discussion the subcommittee decided that since a case involving the church exemption was still in litigation, it should not take a position on this. In addition, this issue could be more appropriately addressed by the various study committees specifically looking into the child care issue.

2- Creating a separate division within the Department of Taxation to which all nonprofits would report and which would be responsible for determining if nonprofit corporations are engaging in activities beyond the realm of the purposes for their incorporation.

or

3- Recommending legislation giving the Department of Taxation authority to investigate specific complaints of unfair competition.

The Department of Taxation indicated these approaches would be costly to implement as additional staff would be needed. It was pointed out that Virginia decided in 1971 and then again in 1987 to conform with federal law because it is less costly. It was explained that the Department does not look at or adjust items above the adjusted federal taxable income line which would include unrelated business taxable income, yet if the IRS makes any adjustments then it does too. The subcommittee felt that the first approach would create too much bureaucracy and that both would cost too much money.

4 - Recommending legislation which would require the Tax Commissioner to report any finding of a corporation's failure to report any unrelated business taxable income to the IRS.

As explained earlier, the subcommittee felt that its hands were somewhat tied with respect to any action regarding the unrelated business taxable income issue since Virginia has elected to conform with the federal tax laws with regard to income taxes. It was very much concerned over the lack of enforcement by the IRS of the unrelated business income tax as, in 1986, out of the more than 840,000 tax-exempt organizations on record with the Internal Revenue Service, only 27,000 reported income-producing activites subject to tax and about one-half of the $57 million of unrelated business income tax collected by the IRS was attributable to only two audits. The subcommittee considered recommending legislation requiring the Tax Commissioner to report any findings of a corporation's failure to report any unrelated business income to the IRS, however, the Department of Taxation informed the subcommittee that this is already done as part of an exchange of information agreement with the IRS.

5 - Recommending legislation that would require certain tax-exempt organizations to report certain information regarding their affiliations with, interest in and income derived from other nonprofit entities and for-profit entities to the Department of Taxation.

As mentioned earlier, throughout the course of the study, the members were disturbed by the lack of information on nonprofit organizations from the Department of Taxation. Although they requested information on the amount of state and local taxes foregone because of various exemptions in the federal and state income tax laws and on the number of nonprofit organizations operating in the state, such information was not available. The subcommittee considered recommending legislation requiring certain tax-exempt organizations to report certain information on their affiliations with, interest in and income derived from other nonprofit entities and for-profit entities to the Department of Taxation and making

such information available for public inspection. It decided against this because of the difficulty in determining the exact information that one would need to examine the activities of nonprofit organizations to see if they were unrelated to the missions of the organizations. The subcommittee determined that it would wait a year to see what type of information is used in the investigation of hospitals' activities and provided to the General Assembly pursuant to one piece of legislation they were recommending and then talk with the Tax Commissioner about the some type of reporting requirements for other nonprofit organizations.

6 - Recommending legislation requested by an attorney representing charter party carriers and common carrier brokers designed to streamline the certification process for charter party carriers and to require all common carrier brokers to be licensed.

As mentioned earlier, a representative of charter party carriers and travel brokers informed the subcommittee that although the ICC has deregulated charter party carrier services so that they no longer have to go through extensive and expensive processes to be licensed to operate interstate, the standards they must meet to operate in Virginia are very stringent. It was suggested that the licensing requirements be streamlined. It also pointed out that nonprofit and state-supported groups have been getting around the licensing requirements for common carrier brokers by saying that they are not making a profit and thus are not subject to the law and that this was unfair as all should be treated alike. The joint subcommittee considered the legislation recommended but determined that it was more related to the issue of government competition and thus could be more appropriately addressed by Delegate Axselle's subcommittee on government competition.

RECOMMENDATIONS

After careful consideration, the joint subcommittee decided to offer the following recommendations to the General Assembly:

I. THAT THE GENERAL ASSEMBLY SHOULD PASS THE BILL OFFERED BY THE SUBCOMMITTEE WHICH REQUIRES A HOSPITAL AFFILIATED WITH, OR UNDER THE COMMON CONTROL OF A HOLDING COMPANY, WHICH HAS A FINANCIAL INTEREST IN A FACILITY THAT ENGAGES IN THE PROVISION OF HEALTH-RELATED OUTPATIENT SERVICES OF WHICH A PATIENT IS IN NEED TO, PRIOR TO REFERRING THE PATIENT TO SUCH TYPE OF FACILITY, PROVIDE HIM WITH A NOTICE STATING THAT THE SERVICES, ETC. MAY BE AVAILABLE FROM OTHER SUPPLIERS IN THE COMMUNITY AND POSSIBLY AT A LOWER COST.

II. THAT THE GENERAL ASSEMBLY SHOULD PASS THE BILL OFFERED BY THE SUBCOMMITTEE WHICH REQUIRES THE VIRGINIA HEALTH SERVICES COST REVIEW COUNCIL TO INVESTIGATE THE ACTIVITIES OF PRIVATE NONPROFIT HEALTH CARE INSITUTIONS AND TO ASSEMBLE THE DATA TO ENABLE THE GENERAL ASSEMBLY TO DETERMINE WHETHER:

1 - SURPLUS FUNDS OR PROFITS OF THE INSTITUTIONS OR THEIR AFFILIATES THAT COULD BE USED TO LOWER COSTS, IMPROVE EFFICIENCY, OR SUPPORT CHARITY CARE OR COMMUNITY NEEDS ARE BEING USED TO ENGAGE IN OTHER INCOME-PRODUCING ACTIVITIES;

2 - THEY ENGAGE IN ACTIVITIES INCONSISTENT WITH THEIR TAX-EXEMPT PURPOSES; AND

3 - THE BENEFITS TO WHICH THEY ARE ENTITLED BECAUSE OF THEIR TAX-EXEMPT STATUS ENABLE THEM TO HAVE A COMPETITIVE ADVANTAGE OVER TAXABLE BUSINESSES.

REASONS FOR RECOMMENDATIONS

I. THAT THE GENERAL ASSEMBLY SHOULD PASS THE BILL OFFERED BY THE SUBCOMMITTEE WHICH REQUIRES A HOSPITAL AFFILIATED WITH, OR UNDER THE COMMON CONTROL OF A HOLDING COMPANY, WHICH HAS A FINANCIAL INTEREST IN A FACILITY THAT ENGAGES IN THE PROVISION OF HEALTH-RELATED OUTPATIENT SERVICES OF WHICH A PATIENT IS IN NEED TO, PRIOR TO REFERRING THE PATIENT TO SUCH TYPE OF FACILITY, PROVIDE HIM WITH A NOTICE STATING THAT THE SERVICES, ETC. MAY BE AVAILABLE FROM OTHER SUPPLIERS IN THE COMMUNITY AND POSSIBLY AT LOWER COSTS.

One of the examples of unfair competition cited most frequently during the study was that of captive referrals, and primarily those by nonprofit hospitals. Representatives of durable medical equipment companies, home health care companies, etc. complained that patients are being deprived by hospitals of their right to choose who delivers the care and services needed. It was explained that when a patient who will need medical supplies, equipment, home health care, etc. is about to be discharged from a hospital he is informed by a hospital representative that such supplies, etc. are available through the hospital or its agency. The patient may not be aware of other suppliers in the area and thus agrees to obtain the items through the hospital. Although this may be convenient for the patient, he may wind up paying more for the item than he would have paid had he obtained it from an outside provider.

A concerned citizen informed the subcommittee that when her husband who was in the hospital needed a particular supply, the hospital said that they could get it for him at a cost of $52. She said that she later found out that she could have obtained a superior product from outside providers for $17.00 or $32.69. This indicated that captive referrals not only detrimentally affect the revenues of those small businesses which compete with the hospital but also may be more costly to consumers.

Small businesses indicated that if hospitals were allowed to continue with this practice, they would be forced out of business and both consumers and the Commonwealth would suffer. They explained that consumers would have to pay higher costs because of the lack of competition and the Commonwealth would lose considerable tax revenues, thus resulting in additional tax burdens for its citizens and businesses.

The subcommittee recognized the importance of addressing this issue and discussed various approaches to it. The legislation passed in 1986 requiring physicians to disclose financial interests in physical therapy clinics prior to referring a patient to one, § 54-278.3, was discussed as one approach. Opinions were sought from the Physical Therapy Association and the Orthopaedic Society as to how the law was working. Although the

Physical Therapy Association indicated that they were aware of incidences in which law was not being followed, therapists were not reporting abuses because they did not wish to "cut off the hand that feeds them." In Virginia physical therapists can operate only on a referral basis, the subcommittee realized that it was too early to predict how a law enacted in July 1986 was working. The Orthopaedic Society indicated that it was willing to work with the physical therapists on any problems they were experiencing.

Draft legislation modeled after § 54-278.3 was discussed and amended several times. The legislation provides that any hospital affiliated with or under the common control of a holding company, or any employee or volunteer associated with such hospital, having a financial interest in a facility which engages in the provision of health-related out-patient services, etc., shall, prior to referring a patient to such type of a facility, provide him or his personal representative with a notice which states in bold print that the services, etc. may be available from other suppliers in the community and may be at a lower cost. It also provides that the patient shall sign the notice and the health care provider shall retain a copy of the notice for two years and that in cases in which the patient or his personal representative refuses to sign the notice, the person providing the notice shall sign it to indicate that the patient or his representative has been shown the notice but refused to sign it. The legislation provides for injunctive remedies and gives the court the authority to impose a civil fine not to exceed $1,000 to be paid to the Literary Fund for violations of the section.

Although § 54-278.3 applies only to the patient, the subcommittee determined that in a hospital setting, the patient may not be able to sign a notice therefore his personal representative would be permitted to sign for him. Also considered was language which would require that a list of other suppliers be attached to the notice. Without such a list, some of the members indicated that the legislation would be useless because the patient would not even know the names of other suppliers. The subcommittee also considered making the notices open to public inspection yet there were some concerns that this would infringe on the privacy of the patients and instead decided to require the referring health care provider to retain a copy of the notice which would be subject to the usual legal search requirements for two years. The original draft was applicable to all health care providers yet the subcommittee felt that the provisions of § 54-278.3 would take care of any problems with referrals of physicians. It also contained a criminal penalty for violations of the section but the subcommittee felt that a

civil penalty would be more appropriate.

A copy of this draft legislation appears as Appendix 2 to this report.

II. THAT THE GENERAL ASSEMBLY SHOULD PASS THE BILL OFFERED BY THE SUBCOMMITTEE WHICH REQUIRES THE VIRGINIA HEALTH SERVICES COST REVIEW COUNCIL TO INVESTIGATE THE ACTIVITIES OF PRIVATE NONPROFIT HEALTH CARE INSITUTIONS AND TO ASSEMBLE THE DATA TO ENABLE THE GENERAL ASSEMBLY TO DETERMINE WHETHER:

1 - SURPLUS FUNDS OR PROFITS OF THE INSTITUTIONS OR THEIR AFFILIATES THAT COULD BE USED TO LOWER COSTS, IMPROVE EFFICIENCY, OR SUPPORT CHARITY CARE OR COMMUNITY NEEDS ARE BEING USED TO ENGAGE IN OTHER INCOME-PRODUCING ACTIVITIES;

2 - THEY ENGAGE IN ACTIVITIES INCONSISTENT WITH THEIR TAX-EXEMPT PURPOSES; AND

3 - THE BENEFITS TO WHICH THEY ARE ENTITLED BECAUSE OF THEIR TAX-EXEMPT STATUS ENABLE THEM TO HAVE A COMPETITIVE ADVANTAGE OVER TAXABLE BUSINESSES.

Since the majority of the testimony received by the subcommittee related to the commercial activities of nonprofit hospitals, the subcommittee determined that such activities should be investigated to determine whether hospitals are competing unfairly with small business. As explained earlier, several groups and individuals complained about hospitals using surplus funds derived from charitable sources to expand into businesses which compete with for-profit businesses such as home health care, durable medical equipment, catering, laundries; and having some of these businesses operate out of the main facility using existing staff and equipment until they were on their feet. The other major complaint was about hospitals' use of captive referrals.

It was decided that the Health Services Cost Review Council which reviews the budgets and financial statements of hospitals would be the most appropriate agency to do this. The Director of the Council informed the subcommittee that in 1985 Virginia consumers were saved approximately $35 million in health care costs by the Council's requiring hospitals to cut their expenses; and that since 1978 when it was created the Council has saved consumers $129 million. She indicated that the Council did not have the authority under existing law to obtain the information the subcommittee was seeking on the commercial activities of nonprofit hospitals, yet if its authority was broadened it could do so but would need additional staff and funding.

Legislation was discussed and recommended which would require the Cost Review Council to investigate the activities of private nonprofit hospitals which currently report to it and to assemble the data to enable

the General Assembly to determine whether:

1 - surplus funds or profits of the institutions or their affiliates that could be used to lower costs, improve efficiency, or support charity care or community needs are being used to engage in other income-producing activities;

2 - they engage in activities inconsistent with their tax-exempt purposes; and

3 - the benefits to which they are entitled because of their tax-exempt status enable them to have a competitive advantage over taxable businesses.

The subcommittee considered requiring the Council to make the determinations regarding unfair competition by hospitals yet decided that it would be more appropriate for the General Assembly to make such determinations.

The legislation provides that the Council may obtain information for carrying out its investigation from the Department of Taxation notwithstanding the provisions of the confidentiality section of the tax code. It also provides that the Council shall forward copies of its summaries and reports to the General Assembly.

A copy of this draft legislation appears as Appendix 3 to this report.

CONCLUSION

The subcommittee expresses its appreciation to all parties who participated in its study. The study group's recommendations have been offered only after careful and thorough study of the information it received. The subcommittee believes that its recommendations are in the best interest of the Commonwealth and it encourages the General Assembly to adopt its recommendations.

Respectfully submitted,

Harvey B. Morgan, Chairman
Richard L. Saslaw, Vice-Chairman
John H. Chichester
Bernard S. Cohen
Elmon T. Gray
Alson H. Smith, Jr.
William T. Wilson
Thomas Inman, II
Guy T. Tripp, III

APPENDIX 1

GENERAL ASSEMBLY OF VIRGINIA -- 1987 SESSION

HOUSE JOINT RESOLUTION NO. 303

Requesting a joint subcommittee to investigate the extent of unfair competition between nonprofit organizations and small for-profit businesses in Virginia.

Agreed to by the House of Delegates, February 8, 1987
Agreed to by the Senate, February 24, 1987

WHEREAS, although there are many fine charitable organizations in this Commonwealth, there are some that may be generating revenues to perform purposes other than those for which they were created; and

WHEREAS, some commercial nonprofit organizations derive a substantial part of their revenue from the sale of products or services which duplicate and compete with those in the private sector; and

WHEREAS, because of their tax-exempt status and other preferred treatment, nonprofit organizations incur significantly lower costs in marketing their products and services and distort the fair marketplace; and

WHEREAS, our economy thrives on competition, yet such competition works only if all of the competitors operate under the same set of rules, which is not the case with nonprofits; and

WHEREAS, nonprofits may enter into commercial business ventures to fund their nonprofit status, transfer unrestricted or surplus funds to be used as venture capital between family organizational entities, and contract for services with for-profit businesses without adequate accountability; and

WHEREAS, in some competitive bidding situations, a nonprofit entity which owns a for-profit entity will have that entity bid against other for-profit businesses, which results in the services being performed in a nonprofit environment; and

WHEREAS, small businesses may have been hurt by this unfair competition with nonprofit organizations; and

WHEREAS, it is important to protect and provide a good business climate for small businesses, which themselves are a valuable source of funding for legitimate nonprofit entities in Virginia; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That a joint subcommittee be established to investigate the extent and impact of unfair competition between nonprofit organizations and small for-profit businesses in Virginia.

The joint subcommittee shall be appointed as follows: four members of the House Committee on Corporations, Insurance and Banking, to be appointed by the Speaker of the House; three members of the Senate Committee on Commerce and Labor to be appointed by the Senate Committee on Privileges and Elections; and two citizen members, one of whom shall be appointed by the Speaker of the House and the other of whom shall be appointed by the Senate Committee on Privileges and Elections.

The joint subcommittee shall complete its work prior to November 15, 1987.

The indirect costs of this study are estimated to be $10,650; the direct costs of this study shall not exceed $6,480.

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APPENDIX 2

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SENATE BILL NO. ..... HOUSE BILL NO. .....

BILL to amend the Code of Virginia by adding a section numbered 54-278.5, relating to disclosure of other providers of services; penalty.

Be it enacted by the General Assembly of Virginia:

. That the Code of Virginia is amended by adding a section numbered 4-278.5 as follows:

§ 54-278.5. Disclosure of other providers of services.--A.1. Any ɔspital affiliated with or under the common control of a holding ɔmpany that has a financial interest in a facility or entity that ıgages in the provision of health-related outpatient services, ɔpliances or devices of which a patient is in need, or any employee : volunteer associated with such hospital, shall, prior to referring ıe patient to such type of a facility or entity, provide the patient : his representative with a notice stating in bold print that the ɜrvices, appliances or devices may be available from other suppliers ı the community and may be at a lower cost.

2. The person providing such notice to the patient shall have him · his representative sign it to indicate that he has read, ıderstands and has received a copy of the notice. If the patient or s representative refuses to sign the notice, the person providing .e notice may sign it to indicate that the patient or his presentative has been shown a copy of the notice but refused to sign . In addition, the person providing the notice shall retain the

original signed notice for two years.

3. As used in this section, "representative" means any member of the immediate family of the patient or any other person acting on his behalf and who is not a health care provider or other person who may profit from such referral.

B. The Attorney General, a Commonwealth's attorney, or the attorney for a city, county or town may cause an action to be brought in the appropriate circuit court in the name of the Commonwealth, or of the county, city or town, to enjoin any violation of this section. The circuit court having jurisdiction may enjoin such violations, notwithstanding the existence of an adequate remedy at law. When an injunction is issued, the circuit court shall impose a civil fine to be paid to the Literary Fund not to exceed $1,000. In any action under this section, it shall not be necessary that damages be proved.

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APPENDIX 3

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TMB

SENATE BILL NO. ..... HOUSE BILL NO. .....

BILL to amend and reenact § 9-160 of the Code of Virginia, relating to analysis of activities of private nonprofit hospitals.

Be it enacted by the General Assembly of Virginia:

That § 9-160 of the Code of Virginia is amended and reenacted as llows:

§ 9-160. Continuing analysis, publication, etc.--A. The Council all:

1. Undertake financial analysis and studies relating to health re institutions ~~,~~ ;

2. Publish and disseminate information relating to health care stitutions' costs and charges including the publication of changes charges other than those having a minimal impact prior to any anges taking effect ~~.~~ ;

3. Investigate the activities of the private nonprofit health re institutions that report to it and assemble the data to enable e General Assembly to determine whether:

a. Surplus funds or profits of the institutions or their filiates that could be used to lower costs, improve efficiency, or pport charity care or community needs are being used to engage in ner income-producing activities;

b. They engage in activities inconsistent with their tax-exempt rposes; and

c. The benefits to which they are entitled because of their tax-exempt status enable them to have a competitive advantage over taxable businesses.

In carrying out this investigation, the Council may obtain information from the Department of Taxation, notwithstanding the provisions of § 58.1-3.

B. The Council shall prepare and may make public summaries and compilations or other supplementary reports based on the information filed with or made available to the Council. The Council shall forward copies of such summaries and reports to the General Assembly.

C. The Council, in carrying out its responsibilities under this section and § 9-161, shall be cognizant of other programs which bear upon the operation of health care institutions including programs relating to health planning, licensing and utilization review.

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