

**REPORT OF THE
VIRGINIA HEALTH SERVICES COST
REVIEW COUNCIL**

**Health Care Institutions'
Diversification Into The
Commerical Sector and
Its Impact On Small Business
and Health Care Costs**

**TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA**



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**REPORT OF THE
VIRGINIA HEALTH SERVICES COST
REVIEW COUNCIL
ON
HEALTH CARE INSTITUTIONS' DIVERSIFICATION
INTO THE COMMERCIAL SECTOR AND
ITS IMPACT ON SMALL BUSINESS AND HEALTH CARE COSTS
HJR 237 (1992)**

**TO
THE GOVERNOR
THE GENERAL ASSEMBLY OF VIRGINIA
THE JOINT COMMISSION ON HEALTH CARE**

**Richmond, Virginia
January 1993**

I. EXECUTIVE SUMMARY

House Joint Resolution Number (HJR) 237 (Appendix 1), agreed to during the 1992 Session of the Virginia General Assembly, requested the Virginia Health Services Cost Review Council (VHSCRC) to examine health care institutions' diversification into the commercial sector and its impact on small business and health care costs. In addition, the VHSCRC was to elicit testimony and comment concerning the impact of health care institutions' commercial diversification from citizens, small business owners, hospital representatives, and agencies of the Commonwealth.

To prepare this report, the VHSCRC first undertook a literature review of current publications and positions of individuals and advocacy groups related to "unfair competition". It then undertook an analysis of the Commercial Diversification Surveys (CDS) which the VHSCRC has issued for the years 1988 through 1992. Finally, the VHSCRC solicited written comment from a wide variety of interested parties and organizations.

The literature review gave no definitive answer as to whether "unfair competition" exists. Numerous complaints of unfair competition have been brought against the nonprofit community and nonprofits have countered with their own assertions that their income-producing activities further their exempt purposes. The review revealed only anecdotal evidence to substantiate claims of unfair competition. Anecdotal evidence has numerous limitations, but no definitive empirical studies have been designed or conducted to address the issue.

The literature review also revealed activity at the federal and state levels designed to address unfair competition. The principal federal public policy response to the possibility that tax exempt status may result in unfair competition is the tax on the unrelated business income of nonprofit organizations. However, problems have been identified in the administration of this tax. Claims of lax enforcement of the unrelated business income tax have been leveled against the IRS.

In the states, the Business Coalition for Fair Competition has been addressing issues related to activities it sees as unfair competition. It has drafted and published the Model State Unfair Competition Bill which is designed to prohibit government agencies, institutions of higher education and nonprofit organizations from providing goods and services that can be provided by for-profit business. The bill is based on laws passed in Arizona, Colorado, and Iowa. The American Bar Association Committee on Exempt Organizations opposes this model bill as it relates to non-profit organizations.

Available data from the CDS proved to be most useful in describing the nature and extent of diversification and competition from nonprofit hospital affiliates. It was limited in its ability to clarify the impact of nonprofit hospital diversification on small business and health care costs.

An analysis of the CDS revealed that diversification is a popular strategy among Virginia nonprofit hospitals but tends to be more extensive in organizations having larger numbers of beds. Nonprofit hospitals engage in a number of different patient care related and unrelated activities including: home health; outpatient radiology, CT scan, and MRI; urgent care; other outpatient services; long term care; pharmacy; medical equipment; insurance; physician billing; collection; fitness and wellness; real estate; and management and consulting services. Competition may be most extensive, as judged from gross revenues earned, in the patient care related areas of: outpatient services other than radiology, CT scan and MRI; long term care services; and medical equipment and supplies. In nonpatient care related activities, competition may be strongest from holding company activities; real estate management and rental; and management and consulting services. Unfortunately, the types of business activities undertaken by holding companies can not be determined from the data.

Virginia nonprofit hospitals tend to dominate their consolidated organizations. During 1992, they earned 92 percent of the gross revenues of all consolidated organizations and over 96 percent of net profits.

The CDS indicate that assets and equity may not be employed as productively in affiliates as in hospitals. The median return on assets and return on equity tend

to be lower among affiliate organizations than among nonprofit hospitals. For-profit affiliates of nonprofit hospitals perform more poorly than their nonprofit counterparts, as judged by median profitability ratios. In fact, the median profitability ratios of for-profit affiliates of nonprofit hospitals have been zero or negative over the years, while the median profitability ratios of nonprofit affiliates have consistently been positive.

No determination can be made regarding why for-profit affiliates perform more poorly than nonprofit affiliates; however, judging from median profitability ratios, for-profit affiliates seem poorly situated to monetarily support the nonprofit activities of the larger corporation or lower the cost of health care. While, nonprofit affiliates are profitable, it is impossible to determine how their profits are used.

Although the VHSCRC actively sought their input, the feedback from interested parties and advocacy organizations from both the small business community and nonprofit hospitals was not sufficient to fully develop and respond to the issues raised in HJR 237.

Because determination of "unfairness" requires value judgements, it will always be difficult to study the extent of unfair competition between nonprofit hospitals and for-profit business. However, specific questions related to competitive advantages that nonprofit hospitals may enjoy over for-profit competitors could be investigated if additional legislation is enacted.

Some of these questions include: (1) Do nonprofit hospitals limit referrals to their own affiliates (captive referrals)? (2) Do nonprofit hospitals charge lower prices than for-profit firms providing the same services in the market area? (3) How efficiently are services provided through affiliates? (4) Do nonprofit hospitals avoid taxes on income generated in their for-profit subsidiaries? (5) Are after-tax profits channeled back to the nonprofit hospital or a foundation that raises money for the hospital?

Recently collected information on related party transactions collected by the VHSCRC pursuant to SB 518 (1992) may be useful in answering some of these questions. It is therefore suggested that a continuing resolution be adopted to have the VHSCRC further study these issues.

In addition, to more fully address the questions specified above, legislation will be required to authorize the VHSCRC to gather information on: (1) the types of services offered by each subsidiary; (2) the amount or number of each type of service provided; (3) referral information; (4) capital investments (past and new); (5) labor information; and (6) information concerning mergers or sales of subsidiaries including the proceeds of such sales and uses of these funds.

II. INTRODUCTION

HJR 237 requires the Virginia Health Services Cost Review Council to examine health care institutions' diversification into the commercial sector and its impact on small business and health care costs. The basis for this request comes primarily from the fact that a significant number of nonprofit institutions and their affiliates have expanded into many areas of the commercial sector resulting in increasing direct competition with taxable organizations, particularly small for-profit businesses. Competition between commercial for-profit businesses and non-profit organizations is not new. However, the increased expansion and resulting competition has caused these businesses to express concern over the potential detrimental effects from what they believe is unfair competition.

The issue of alleged unfair competition between nonprofit and for-profit organizations has been debated nationwide, as well as in Virginia. On a national level, this issue has been receiving attention from advocacy organizations on both sides of the issue. With the increasing concern about spiraling health care costs, the competition between for-profit businesses and tax-exempt institutions will receive continued attention. Nonprofit hospitals will face sustained pressure for cost containment in the provision of traditional inpatient services, and this will likely result in continuing revenue constraints from that source. These hospitals will therefore want to continue their diversification, believing that such activities further the overall purpose for which the institution has sought tax-exempt status. Small businesses, on the other hand, will continue to feel they are disadvantaged in the resulting competition because they do not have the comparable tax advantages that the nonprofit hospitals, or their affiliates, have.

III. BACKGROUND

The extent and impact of unfair competition between nonprofit organizations and small for-profit businesses has been before the General Assembly since 1987. In its 1987 Session, the Virginia General Assembly enacted House Joint Resolution No. 303 (1987) (Appendix 2) empowering a Joint Subcommittee to study the potential detrimental effects that unfair competition from nonprofit organizations could have on small businesses.

The Joint Subcommittee issued House Document No. 35 - "The Extent of Unfair Competition Between Nonprofit Organizations and Small For-Profit Businesses in Virginia". The Subcommittee stated that tax-exempt organizations' percentage of Gross National Product grew from 3.29 percent in 1983 to approximately 8 percent in 1985 and described in detail the expansion of nonprofit organizations into many commercial activities, including medical care, day care, and health fitness centers.

After considering the broad scope of the issues raised by the resolution, the Joint Subcommittee determined to restrict its review to the issue of whether nonprofit hospitals were competing unfairly with small businesses. It then made two recommendations to the General Assembly:

1. Enact legislation affecting hospitals affiliated with, or under the control of a holding company, which has a financial interest in a facility that engages in the provision of health-related outpatient services for which a patient is in need. The legislation would state that, prior to referring the patient to such type of facility, the hospital must provide the patient with a notice stating that the services, etc. may be available from other suppliers in the community and possibly at a lower cost; and
2. Enact legislation requiring the Virginia Health Services Cost Review Council to investigate the activities of private nonprofit health care institutions and to assemble the data to enable the General Assembly to determine whether:
 - a) 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;
 - b) They engage in activities inconsistent with their tax-exempt purposes; 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.

The 1988 Session of the Virginia General Assembly subsequently enacted legislation requiring the Virginia Health Services Cost Review Council (VHSCRC) to examine the commercial diversification of the hospital industry. Section 9-160(A)(3) of the Code of Virginia required the VHSCRC to report the results of commercial diversification of nonprofit hospitals by December 1 of each year to the General Assembly.

As outlined in the legislation, the VHSCRC has annually requested that each nonprofit hospital, the parent or controlling corporation, and each affiliate provide the following information:

- a. The name and principal activity;
- b. The date of the affiliation;
- c. The nature of the affiliation;
- d. The method by which each affiliate was acquired or created;
- e. The tax status of each affiliate and, if tax-exempt, its Internal Revenue tax exemption code number;
- f. The total assets;
- g. The total revenues;
- h. The net profit after taxes, or if not-for-profit, its excess revenues; and
- i. The net equity, or if not-for-profit, its fund balance.

Pursuant to regulations adopted by the VHSCRC, hospitals were not required to report an affiliation in which ownership interest was less than fifty percent. Hospitals were also not required to report affiliates that did not conduct business in Virginia.

The VHSCRC has published detailed information from the CDS from 1988 through 1992. A summary of the data and more detailed findings are discussed later in this report.

The 1992 Session of the Virginia General Assembly enacted Senate Bill (SB) No. 518, which, in part, contained extensive additional reporting requirements for the commercial diversification survey conducted by the VHSCRC. All hospitals, including for-profit hospitals, are now required to submit information on all the requirements referenced above. In addition, the survey was expanded to require similar information from the nursing home industry. Also, information regarding related party transactions was required to be submitted by hospitals and nursing homes so that these types of transactions could be more fully understood and used to explain the financial operations of these organizations. Finally, the VHSCRC also began collecting information concerning executive compensation from IRS Form 990s as required by SB 519.

IV. OBJECTIVES, SCOPE AND METHODOLOGY FOR THIS STUDY

The 1992 General assembly requested the VHSCRC through HJR 237 to: (1) examine health care institutions' diversification into the commercial sector and its impact on small business and health care costs, and (2) elicit testimony and comment

about the impact of health care institutions' commercial diversification from citizens, small business owners, hospital representatives, and agencies of the Commonwealth.

To accomplish the first objective, the VHSCRC undertook two activities: (1) a literature review of current publications and organizational positions related to "unfair competition" and (2) an analysis of the CDS data for the years 1988 through 1992.

To accomplish the second objective, the Council solicited written comment from a wide variety of interested parties and organizations.

The literature search included a review of materials collected for the 1988 study of "The Extent of Unfair Competition Between Nonprofit Organizations and Small For-Profit Businesses in Virginia." Materials were also solicited from the Business Coalition for Fair Competition and the Committee on Exempt Organizations, Section of Taxation, American Bar Association. In addition, three electronic literature data bases were searched for relevant articles published during the years 1985 through 1992: (1) the Wilson Business Abstracts, (2) Medline, and (3) the Index to Legal Periodicals.

The CDS for the years 1988 through 1992 contain information which was used to examine the impact of competition from nonprofit hospitals on small business. However, at this writing, the Council's capacity to assess the impact of diversification on health care costs is limited. This is partially because the information resulting from the 1992 legislative changes has only recently been received and has not been arranged in a data base for analysis. Even so, the data analysis included here examines available CDS data from prior years to assess the nature and extent of competition to for-profit business from nonprofit hospital affiliates organized both for-profit and nonprofit.

Finally, efforts were made to contact organizations and individuals on both sides of the issue in Virginia. An example of correspondence sent to members of the National Federation of Independent Business is found at Appendix 3. Membership of the Virginia Retail Merchants Association was also contacted. In addition, other organizations, including the Virginia Hospital Association, the Virginia Health Care Association, the Virginia Chamber of Commerce, the Medical Society of Virginia, and the Proprietary Child Care Association, as well as other advocacy groups, were contacted for their input.

In carrying out its study activities, the VHSCRC confined its examination to issues directly related to unfair competition which may result from the favored tax status of nonprofit hospitals. Related issues, not considered here, include whether

the community service provided by nonprofit hospitals justifies continued tax-exempt status and the alleged practice by hospitals and physicians of referring patients to related health care facilities in which the hospital or physician has a financial interest (i.e., "captive referrals"). The first issue is the topic of SJR 142 (1992). SJR 141 (1992) mandates the study of physician ownership and financial interest as these relate to patient referral patterns to facilities.

V. LITERATURE REVIEW OF CURRENT PUBLICATIONS AND ORGANIZATIONAL POSITIONS

A. The Definition of Unfair Competition

It is important to distinguish the claims of unfair competition currently being brought against nonprofit hospitals from other areas of unfair competition that are covered through existing laws. Statutes such as the Sherman Antitrust Act, the Clayton Act, the Federal Trade Commission Act and the Wheeler-Lea Act exist to address monopoly power, restraint of trade or deceptive business practices. These are not the topic of this study.

This study is concerned solely with the claim that unfair competition results when tax-favored diversified hospitals compete with for-profit firms in patient-care-related and unrelated activities. The unfairness is said to result from several competitive advantages that may accrue to the nonprofit hospital and/or its affiliates. Charges of unfair competition brought by the business community against nonprofit hospitals will be specified and discussed below.

B. The Relationship of Hospital Diversification to Unfair Competition

1. Hospital Diversification

Hospital diversification refers to the formation of conglomerate enterprises, often organized under a parent holding company, and sometimes having both nonprofit and for-profit subsidiaries. There is no one way for hospitals to diversify. A number of corporate designs have been identified including the controlled foundation, independent foundation, parent holding company and parent company models (Cleverley, 1984).

Two of the more common corporate designs are the parent holding company model and the parent company model (Ernst and Whinney, 1982; Virginia Health Services Cost Review Council, 1991). In the first, a holding company is placed at the top of the corporate structure and for-profit and nonprofit entities are organized as

sister corporations to the hospital. Each entity conducts separate business activities as defined by the corporate mission. In the parent company model, the hospital holds controlling interest in one or more subsidiaries and also conducts its own operations. Since nonprofit hospital corporate design varies, throughout this report the general term 'affiliates' refers to both sister organizations and subsidiaries.

2. Why Hospitals Have Diversified

According to Paul Starr (1984), the corporate transformation of American medicine had its beginnings in the passage of Medicare and Medicaid. Public financing made health care lucrative for providers and attractive to investors. Large corporate enterprises began to form. Regulation and other efforts to control the resulting health care expenditures led to a reduced ability to shift costs, lower occupancy rates, increased competition, shrinking capital markets, a decline in philanthropic giving, and adoption of a more business-like character by hospitals (Ernst and Whinney, 1982; Gerber, 1983; Alexander, Morlock, and Gifford, 1988; Horwitz, 1988). As a result, acquisitions, mergers, and diversification became widespread during the 1980s in both the nonprofit and for-profit sectors of the hospital industry.

According to an early Ernst and Whinney (1982) report, tax planning was not a primary motivating force in nonprofit hospital diversifications with which they were involved. However, they noted that of all the tax issues that face a diversifying nonprofit hospital, the primary concern is generally the removal of unrelated business activities from the hospital entity.

3. How Nonprofit Hospitals Compete with For-Profit Firms

Nonprofit hospitals compete directly with for-profit firms by providing some services that are also available from the for-profit sector. This occurs, for example, when a nonprofit hospital competes with for-profit hospitals in the provision of patient care. However, business activities may be segregated into for-profit and nonprofit affiliates of a nonprofit hospital. The impact of business activity conducted through affiliates of a nonprofit hospital on its for-profit competitors is a primary concern of this study.

C. The Controversy Over Unfair Competition

The general debate over unfair competition involves the small business community and its lobbyists (for example, the Office of Advocacy, Small Business Administration and the Business Coalition for Fair Competition) on one side and the nonprofit sector and its lobbyists on the other. Both have publicly expressed their opinions and solicited support for their positions.

According to Gomes and Owens (1988), the general controversy "stems from the alleged inherent unfairness of business competition when one group of competitors enjoys a government-subsidized competitive advantage." The competitive advantage, in this case, relates to the tax-exempt status of nonprofit hospitals.

1. Position: Nonprofit Competition Is Unfair

The Business Coalition for Fair Competition identifies tax treatment as well as other advantages enjoyed by nonprofit organizations as unfair. The Coalition points out that nonprofit organizations receive exemptions from federal corporate income tax as well as state and local taxes. Most notable among the latter are sales, income, business, occupation and property taxes. In Virginia, state nonprofit status results in exemption from state corporate income tax as well as other state corporate taxes. Local taxes, including property taxes, may follow the state exemption standard or be determined in each jurisdiction (Cushman, 1992).

In addition to tax advantages, the Coalition points out that nonprofit organizations receive federally subsidized postal rates. Further, the Coalition asserts that these organizations accrue a marketing advantage from their tax status. They believe that the public generally confers a higher value or status to a product associated with an exempt organization, even though an identical or similar product may be available from the for-profit sector at a similar price. They call this a "halo effect" which allows nonprofit organizations to market goods and services more effectively.

Other examples of areas in which nonprofit organizations have been accused of enjoying an unfair advantage include captive referrals, borrowing, cost allocation, pricing, purchasing, and attracting labor (Motley III, 1989). For example, complaints have been raised about nonprofit hospitals referring patients to their for-profit subsidiaries for related services or equipment (i.e., captive referrals). Complaints have also been voiced that affiliates can use the nonprofit parent's name and equity to borrow funds from outside sources or simply borrow from the parent at preferred rates. Another concern is that cost allocation procedures may allow expenses, of a nonprofit parent to be allocated to a for-profit subsidiary. In the latter case, the for-profit subsidiary reduces its corporate income taxes by reporting higher expenses. A further concern is that tax exemption allows added profits (i.e. profits are not reduced by tax payments), giving the nonprofit organization a bidding advantage over for-profit firms in purchasing. Some fear that tax exemption may allow nonprofit organizations to cut prices in order to enter a market. The result may be lower returns to for-profit competitors. Finally, workers may be willing to donate their time or work for low wages in the nonprofit sector, lowering the labor costs of the nonprofit organization and giving it a substantial advantage over for-profit competitors.

2. Position: Nonprofit Competition Is Not Unfair

On the other side of the issue, the nonprofit sector and its lobbyists believe that their income-producing activities further their exempt purposes and generate needed revenue to fund their nonprofit activities (GAO, 1987; Gomes and Owens, 1988). In addition, they see competition, in many cases, as the result of for-profit businesses entering traditional nonprofit activities such as health care (GAO, 1987).

Others have suggested that for-profit affiliate activities benefit the nonprofit hospital, and by extension, perhaps, the community. In a 1987 article in *Virginia Business* (Rhodes), Laurens Sartoris, President of the Virginia Hospital Association, was referenced as saying that typically an affiliate's after-tax profit flows through an intermediate holding company to the primary holding company and back down to either the hospital or a foundation that raises money for the hospital. He indicated that it is virtually impossible for funds to flow out of the hospital and into the for-profit operations. The first scenario suggests that for-profit affiliate activity may have the potential to lower health care costs.

3. Scholarly Literature On Unfair Competition

Economists and legal scholars have addressed the issue of unfair competition as well. On a theoretical level, Rose-Ackerman (1982) has questioned the existence of unfair competition in cases where for-profit and nonprofit firms compete with one another within the same industry. She uses the pasta business as an illustration; however, health care could just as easily be used. Following her example, we can ask whether the fairness of tax policy should be measured by comparing the income statements of organizations competing in the home health business. Her analysis suggests that the ultimate impact of a nonprofit organization's activities is not felt by the for-profit firm but by the people associated with it as investors, workers and consumers. Rather than speak of fairness to corporate entities, she suggests that we "pierce the organizational veil" to consider the interests of people. In such a situation, a nonprofit organization would keep a larger share of profits than the for-profit firm. She asks us to consider why a fair tax code must treat beneficiaries of the nonprofit organization (presumably, patients and the community) as if they were equal to for-profit investors. Here, the more important question would seem to be whether the nonprofit organization indeed benefits the community and, hence, deserves nonprofit status.

Rose-Ackerman does not discount the possible existence of unfair competition, however. Using a sophisticated economic analysis, she suggests that a case for unfairness could be made if competition from nonprofit organizations could not be anticipated by for-profit firms operating in an industry but nonprofit organizations

later enter that industry. In such a case, she says, some for-profit firms may earn subcompetitive returns because of "excessive entry." In economic terms, the supply curve will shift, lowering the equilibrium prices and gross returns.

Many scholars have questioned whether nonprofit organizations could be motivated by their tax-exempt status to engage in predatory pricing which would tend to drive for-profit firms from the industry (Gomes and Owens, 1988). Some argue that predatory pricing would violate rational decision-making models and entail economic and legal risks. They see nonprofit organizations as no more likely than for-profit firms to engage in predatory pricing. Also, there are several theories (Lee, 1971; Newhouse, 1970; Pauly and Redish, 1973) and some evidence (Herzlinger and Krasker, 1987) to suggest that nonprofit organizations are less efficient than their for-profit counterparts. This would suggest that nonprofit organizations may not be able to exploit any cost advantages that favored tax status conveys. In addition, since individuals in nonprofit organizations cannot receive distributions of earning surpluses, many believe that there is little motivation for nonprofit organizations to replace for-profit firms.

Most of the evidence regarding any unfair competitive advantage enjoyed by nonprofit organizations has come from anecdotal accounts of poor performance by competing for-profit firms. Much of the testimony given in the earlier study of "The Extent of Unfair Competition Between Nonprofit Organizations and Small For-Profit Businesses in Virginia" (1988) was of this nature. Steinberg (1991) warns us that these anecdotes provide insufficient information on which to base public policy. Because his comments are instructive, they are repeated below. He notes, for example, that

"If a FP firm complains that its business is suffering due to unfair competition by NPs, we would like to know:

- 1) Is the FP producing in an efficient manner. If not, NP success could be due to FP failures rather than differential tax treatment.
- 2) Does the NP have an inherent cost advantage (perhaps due to economies of scope), so that FPs would suffer even if tax differentials were eliminated?
- 3) Do NP successes and corresponding FP failures represent systematic responses to differential tax treatment, or is there an important random component? To the extent that success and failure occur for random reasons, FPs are just as likely to succeed and NPs to fail as vice versa. However, only the former would be

reported anecdotally, leaving a biased picture.

- 4) Do FPs suffer from competition at all times, or only under certain market circumstances? For example, if FPs suffered from competition only in circumstances where their profits would otherwise be exorbitant, public relief should probably not be granted.
- 5) If NPs enjoy greater success at the expense of FPs, which of the many tax and regulatory differences in treatment of the two sectors are responsible? Elimination of some differences might not help FPs very much, and the different taxes have varying impacts on the broader economy."

Despite the limitations of anecdotal evidence, definitive empirical studies have not yet been designed or conducted.

In sum, the literature gives us no definitive answers as to whether "unfair" competition, as previously defined, exists. It does, however, suggest questions which, if answered, may shed light on competitive advantages nonprofit hospitals may enjoy over their for-profit competitors: (1) Do affiliates of nonprofit hospitals charge lower prices for goods and services? (2) Are labor costs lower among nonprofit affiliates than among for-profit competitors? (3) Do nonprofit hospitals and their affiliates engage in practices that lower their overall corporate tax exposure? Alternately, does affiliate activity benefit the community by providing funds which are used for charitable purposes? These are only a few of the questions suggested by the literature review.

D. Legislative Efforts to Address Competition Between Nonprofit and For-Profit Organizations

1. The Federal Unrelated Business Income Tax (UBIT)

The principal public policy response to the possibility that tax exempt status may result in unfair competition came when Congress enacted the Revenue Act of 1950. Prior to 1950, all income was exempt from taxation as long as it was used exclusively for exempt purposes. This was true even if the activity generating the income was unrelated to the exempt purpose of the organization. Essentially, taxability was determined by the incomes's destination rather than its source (GAO, 1987; Gomes and Owens, 1988; Niccolls, Nave, and Olswang, 1989).

The Revenue Act of 1950, which contained the UBIT, changed this. Under sections 511 through 513 of the Internal Revenue Code, attention was focused on the source of income rather than the eventual destination, and the regular corporate income tax was imposed on the unrelated income of nonprofit organizations. Unrelated income was defined as income earned from a trade or business regularly carried on by the organization, which is not substantially related to the charitable or educational purpose, or other purpose constituting the basis for tax-exempt status under section 501.

The congressional intent was twofold: (1) to prevent unfair competition between taxable businesses and tax-exempt organizations with respect to business activities unrelated to an exempt purpose and (2) to increase federal revenues by closing tax loopholes wherein a tax-exempt organization could purchase a taxable business and operate the business on a tax-free basis. The UBIT was not intended to discourage tax-exempt organizations from engaging in a business activity regardless of its competitive nature. While the statute has undergone minor amendments over the years (GAO, 1987; Gomes and Owens, 1988), it remains the primary statutory deterrent to unfair competition as defined here.

Unfortunately, problems have been identified in the administration of the UBIT. The business community has complained that the tax is too narrowly and loosely defined (Hansmann, 1989; Motley III, 1989; Davis, 1986). Further, once an activity has been determined to be unrelated to the organization's exempt purpose, it is sometimes difficult to account for the revenue and expenses associated with the unrelated activity (GAO, 1987). Claims of lax enforcement of the UBIT have been leveled against the IRS, as well, and nonprofit compliance with the UBIT is believed to be poor (Steinberg, 1991). Although it is difficult to measure UBIT avoidance, the tax journals offer advice to organizations on how to avoid taxes on unrelated business income (Schnee and Brock, 1992).

2. Initiatives at the State Level

The Business Coalition for Fair Competition (BCFC) is active in addressing issues related to unfair competition. According to its literature, BCFC was formed in 1983 "to resolve the inequitable situation caused when nonprofit or tax-exempt organizations engage in commercial activities in direct competition with existing tax-paying businesses." Similar coalitions have been organized on the local level.

BCFC has drafted and published The Model State Unfair Competition Bill. This bill prohibits government agencies, institutions of higher education and nonprofit organizations from providing goods and services that can be provided by for-profit business. The bill is based on laws passed in Arizona, Colorado, Iowa and on

proposed legislation in Georgia. A copy of the bill, as revised in April of 1992, is included in Appendix 4.

Opposed to the Model Bill as it relates to nonprofit organizations is the American Bar Association (ABA) Committee on Exempt Organizations. A copy of the proposed comments of the ABA Committee on Exempt Organizations, which is currently under review by the ABA, is included in Appendix 5.

Members of the ABA Committee on Exempt Organizations represent nonprofit organizations as well as businesses. In their proposed comments, the committee identifies several policy issues and recommends that The Model State Unfair Competition Bill not be enacted by state legislatures as long as it contains provisions regulating nonprofit organizations. No position is taken on the proposed law to the extent it applies only to competition by government.

Specifically, the ABA Committee questions whether a significant problem exists with unfair competition. The committee calls for the BCFC to study the incidence and dollar significance of unfair competition and to further demonstrate that a sector-wide rather than a precisely-regulable problem exists.

The ABA committee also points out what it believes to be inconsistencies that would result between state and federal law if the model bill was enacted. For example, the committee notes that federal law permits nonprofit organizations to engage in unrelated business activities either directly, if UBIT is paid, or through a taxable subsidiary, if corporate tax is paid. The model bill would not allow unrelated business activities unless they fell within a specific exception and were commercially priced. The committee points out that inconsistency between federal and state tax laws tend to increase an organization's administrative and accounting costs. This may detract from alternate uses for the money such as charitable activities.

VI. COMMERCIAL DIVERSIFICATION SURVEY ANALYSIS

Summary data from the VHSCRC's Commercial Diversification Survey of Virginia Hospitals is included in tables and figures which are presented below.

The CDS data base, as it presently exists, is primarily useful in describing the nature and extent of diversification and competition from nonprofit hospital affiliates. We can also look at the financial performance of affiliates to gain insight into their ability to contribute profits to hospital operations.

Unfortunately, the CDS data does not allow us to answer the questions which were posed through the literature review. That is, we cannot tell if affiliates of

nonprofit hospitals charge lower prices for goods and services than their for-profit competitors. We are also unable to tell if labor costs are lower among affiliates of nonprofit hospitals. Further, we are unable to say if nonprofit hospitals and their affiliates engage in practices that lower their overall corporate tax exposure. We do not know if nonprofit hospital affiliate profits are used to lower health care costs or benefit the community in other ways.

The addition of further information to the survey and the use of related party transaction information in later years may be beneficial in answering some of the questions posed earlier. However, to make comparisons, information about for-profit competitors will be needed, as well.

1. Hospital Diversification

Commercial diversification is a popular strategy among Virginia hospitals. Table 1 shows that more hospitals are diversified than nondiversified. During 1992, there were a total of 82 diversified hospitals compared to 45 nondiversified hospitals. Because nonprofit hospitals dominate the industry in Virginia, there are more nonprofit diversified hospitals than for-profit diversified hospitals, 68 compared to 14. Furthermore, the number of nonprofit diversified hospitals increased from 60 to 68 between 1988 and 1992. During this same period, for-profit diversified hospitals increased from 12 to 14. On the other hand, the number of nondiversified hospitals, both for-profit and nonprofit, declined from 53 to 45.

TABLE 1: NUMBER OF VIRGINIA HOSPITALS BY DIVERSIFICATION AND CONTROL, 1988 TO 1992

	1988	1989	1990	1991	1992
FP Nondiv	25	24	27	27	23
NP Nondiv	28	25	23	22	22
Total Nondiv	53	49	50	49	45
FP Div	12	13	15	13	14
NP Div	60	62	64	64	68
Total Div	72	75	79	77	82
Total All Hospitals	125	124	129	126	127

Table 2 shows the extent of diversification by organization bed size. Bed size is the total number of hospital beds within a corporate organization. Only organizations with hospital beds are included. The table does not include information pertaining to one diversified outpatient surgical hospital (Lewis-Gale Clinic) because this facility has no inpatient beds. An organization is considered to be nonprofit if its parent is a nonprofit organization. In all cases except one, hospitals affiliated with a nonprofit parent are also nonprofit in form. One exception is the Carilion Health System which includes Gill Memorial EENT, Inc., a for-profit specialty hospital and home for adults. All of the remaining six hospitals in the Carilion system are nonprofit and the organization is classified as nonprofit.

**TABLE 2: NUMBER OF NONPROFIT HOSPITAL AFFILIATES
IN 1992 BY ORGANIZATION BED SIZE***

Organization Bed Size	Number of Organization with Affiliates				Total
	less than 5	5 to 10	10 to 15	greater than 10	
less than 50 beds	2				2
50 to 99 beds	7				7
100 to 199 beds	16	4			20
200 to 299 beds	3		1		4
300 to 399 beds	6	3	2		11
more than 400 beds	1	2	1	2	6
Totals	35	9	4	2	50

*This table includes only diversified organizations with beds. Only affiliates which are not hospitals are counted.

Diversification tends to be more extensive in organizations with greater numbers of beds. Only nonprofit hospital organizations with 200 or more beds have 10 or more affiliates. The largest number of reported affiliates is 28 and occurs in the organization category of 'more than 400 beds.' This is the Inova Health Systems. The next largest number of reported affiliates is 23 from the Carilion Health Systems.

2. Nature and Extent of Competition From Diversified Nonprofit Hospitals

Table 3 shows the number of nonprofit hospital and for-profit hospital affiliates by relationship to patient care and affiliate control (i.e., ownership status of the individual affiliate). When interpreting information from this table, it is important to note that VHSCRC reporting requirements changed in 1992. Beginning in 1992, hospitals were required to report affiliates in which they have a 25 percent or greater ownership interest. In previous years, the reporting requirement was a 50 percent ownership interest. The result was to substantially increase the number of affiliates included in the 1992 report.

Looking at Table 3, it is also apparent that the number of reported affiliates decreased between 1988 and 1991. This may mean that some affiliates have been collapsed into other affiliates. If this is so, some affiliates may be engaging in more than the primary reported activity. Since hospitals do not report secondary activities of affiliates, there is likely to be an under reporting of affiliate business enterprises. Consequently, the comments offered in this section are tentative observations about the nature and extent of nonprofit hospital competition.

**TABLE 3: NUMBER OF VIRGINIA NONPROFIT HOSPITAL AFFILIATES
BY RELATIONSHIP TO PATIENT CARE & CONTROL, 1988 TO 1992***

	1988 Survey		1989 Survey		1990 Survey		1991 Survey		1992 Survey	
	for-profit	nonprofit	for-profit	nonprofit	for-profit	nonprofit	for-profit	nonprofit	for-profit	nonprofit
Related to Patient Care										
Home Health	2	8	1	11	2	8	1	8	2	10
Outpatient Radiology, CT Scan, MRI	5	4	4	4	3	5	3	3	12	1
Urgent Care Centers	10	2	8	1	8	1	7	1	6	4
Other Outpatient Services	21	14	20	16	20	18	16	19	20	17
Long Term Care	2	9	2	10	2	13	2	14	2	17
Pharmacy	3	0	6	1	4	0	3	0	2	0
Medical Equipment & Supplies	3	1	4	1	4	1	5	1	11	0
PPO's, HMO's & Insurance	4	1	5	1	5	1	5	1	4	1
Total Related to Patient Care	50	39	50	45	48	47	42	47	59	50
Not Related to Patient Care										
Holding Company	13	11	13	13	14	12	15	12	14	19
Fund Raising	0	12	0	11	0	11	0	14	0	17
Physician Billing	3	1	1	2	1	2	1	2	1	1
Collection Agency	5	2	5	2	5	2	5	2	4	2
Fitness & Wellness Centers	4	1	4	1	3	1	3	1	3	1
Real Estate Management & Rental	5	2	5	2	7	2	6	2	20	11
Corporate Support Services	3	3	2	4	2	4	2	4	3	3
Management & Consulting Services	3	3	4	3	5	2	5	2	8	2
Other Unrelated to Health Care	14	11	17	10	17	10	14	11	7	5
Inactive	12	15	6	6	5	6	6	5	6	1
Total Not Related to Patient Care	62	61	57	54	59	52	57	55	66	62
Total All Affiliates	112	100	107	99	107	99	99	102	125	112

*Reporting requirements were changed in 1992 from 50% to 25% ownership interest.

3. The Nature of Competition

As shown in Table 3, diversified hospitals engage in a number of different business activities through their affiliates. During 1992, slightly fewer affiliates of nonprofit hospitals were engaged in patient care related than unrelated activities. Specifically, there were 59 for-profit and 50 nonprofit affiliates engaged in patient care related business activities. This compares to 66 for-profit and 62 nonprofit affiliates engaged in unrelated activities.

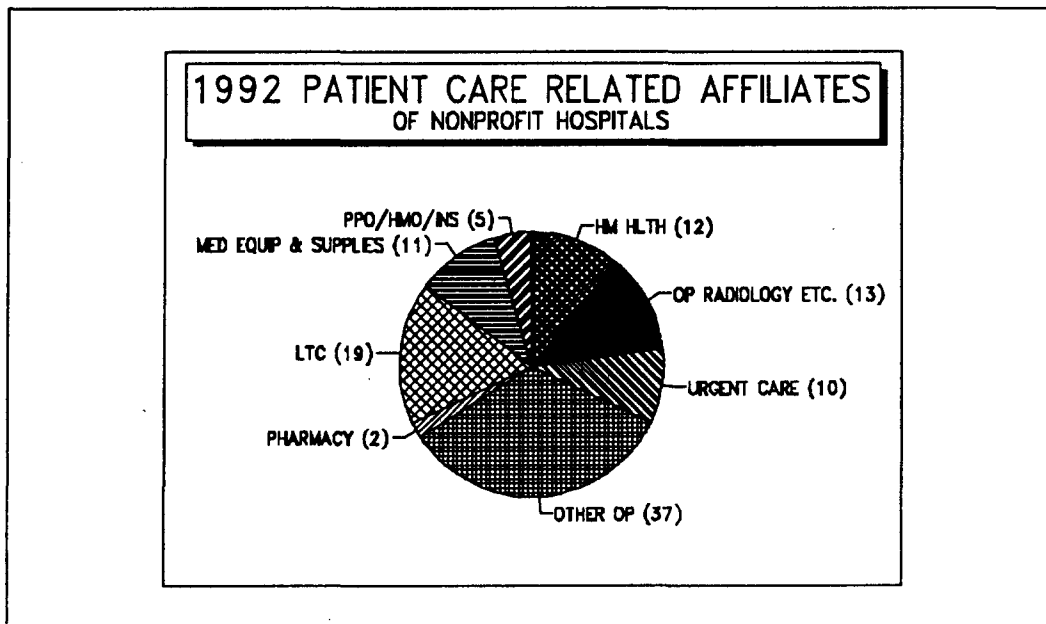
Some of the areas in which nonprofit hospital affiliates compete with for-profit business include: home health; outpatient radiology, CT scan, MRI; other outpatient services; urgent care; long term care; pharmacy; medical equipment; insurance; physician billing; collection; fitness and wellness; real estate; and management and consulting services.

4. The Extent of Competition

The CDS data provides two ways of measuring the extent of competition from diversified nonprofit hospitals: (a) the number of affiliates competing in various business areas and (b) the volume of business as shown through gross revenues.

As shown in Figure 1, the largest number of patient care related affiliates of nonprofit hospitals were reported to be primarily involved in the provision of outpatient services other than radiology, CT scan and MRI. Slightly more of these affiliates were organized as for-profit firms (20) than nonprofit organizations (17). (See Table 3.)

FIGURE 1:

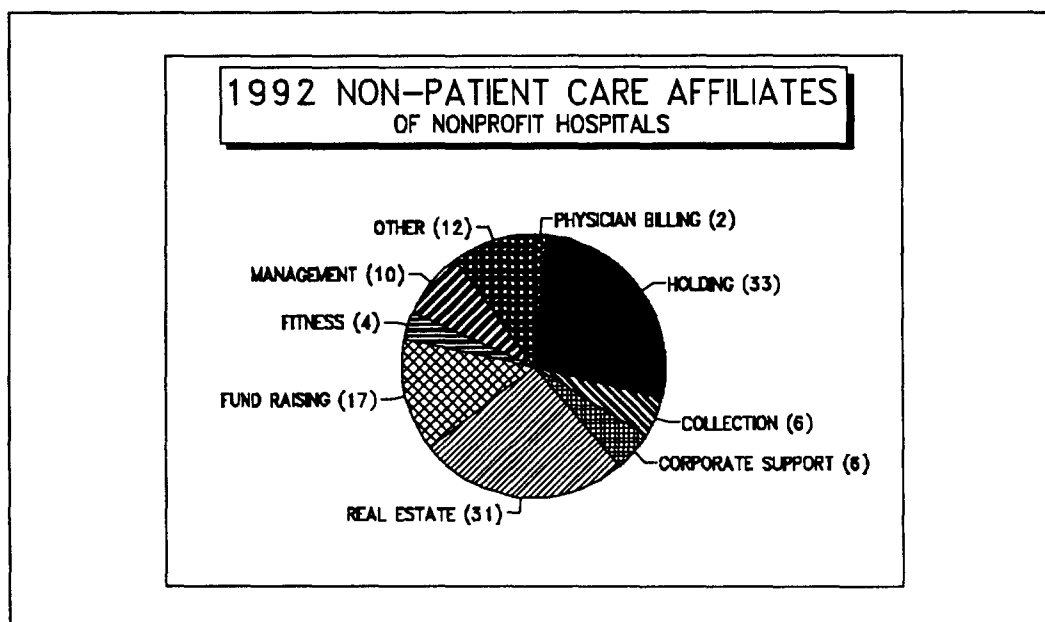


The second largest group was identified as providing long term care services. Most of these were organized as nonprofit organizations (17 compared to 2).

Using gross revenues as a measure of competition reveals other outpatient services (\$131,450,488), medical equipment and supplies (\$126,624,978), and long term care (\$106,150,000) to be areas in which competition is strongest. Other important areas of competition are insurance (\$67,086,606) and home health (\$41,470,171). (See Table 4.)

Figure 2 shows that the largest number of non-patient care affiliates of nonprofit hospitals were reported to be conducting business as holding companies. More of these affiliates were organized as nonprofit organizations (19) than for-profit firms (14). (See Table 3.)

FIGURE 2:



The next largest group was identified as real estate management and rental companies. Most of these were organized as for-profit firms (20 compared to 11).

The group of holding companies earned the highest gross revenues among non-patient care affiliates of nonprofit hospitals (\$63,167,086). Also among the top three groups in gross revenues were corporate support services(\$25,114,966) and management consulting services (\$26,682,860). (See Table 4.)

Unfortunately, the CDS gives no insight into the particular business activities subsumed under the title of holding company. This is a particular problem in measuring the nature of competition since it is impossible to identify the type of competition engendered by the over \$63 million dollars in 1992 gross revenues from these organizations.

**TABLE 4: GROSS REVENUES OF AFFILIATES OF NONPROFIT HOSPITALS
BY RELATIONSHIP TO PATIENT CARE, 1988 TO 1992**

	1988 Survey	1989 Survey	1990 Survey	1991 Survey	1992 Survey
Related to Patient Care					
Home Health	9,537,637	11,970,693	11,556,023	15,010,131	41,470,171
Outpatient Radiology, CT Scan, MRI	7,070,119	9,548,415	14,117,414	12,022,676	10,719,658
Urgent Care Centers	9,368,500	7,268,103	8,739,540	9,784,394	15,307,828
Other Outpatient Services	62,130,526	76,698,162	97,247,640	106,958,234	131,450,488
Long Term Care	27,171,225	41,031,892	66,740,648	99,370,895	106,150,000
Pharmacy	2,070,524	3,596,972	1,852,975	1,027,730	763,727
Medical Equipment & Supplies	26,633,026	43,981,789	59,411,369	79,452,895	126,624,978
PPO's, HMO's & Insurance	24,552,279	64,615,342	59,114,206	65,562,786	67,086,606
Total Related to Patient Care	168,533,836	258,711,368	318,779,815	389,189,741	499,573,456
Not Related to Patient Care					
Holding Company	11,792,164	14,769,176	27,508,667	45,489,572	63,167,086
Fund Raising	4,831,459	3,196,742	7,208,966	11,584,214	9,157,574
Physician Billing	13,160,535	4,461,018	4,692,995	10,049,499	9,200,565
Collection Agency	4,352,687	5,100,378	5,847,237	6,557,101	7,538,427
Fitness & Wellness Centers	5,896,434	7,234,985	6,426,455	7,014,378	8,092,204
Real Estate Management & Rental	2,694,184	4,544,208	1,569,698	1,638,018	11,158,442
Corporate Support Services	8,305,771	14,532,189	33,157,200	25,415,727	25,114,966
Management & Consulting Services	8,920,932	9,884,372	8,804,743	17,628,601	26,682,860
Other Unrelated to Health Care	25,016,533	26,491,567	31,773,071	27,865,581	13,263,002
Inactive	0	42,673	0	0	41,508
Total Not Related to Patient Care	84,970,699	90,257,308	126,989,032	153,242,691	173,416,634
Total All Affiliates	253,504,535	348,968,676	445,768,847	542,432,432	672,990,090

5. Financial Performance of Hospital Organizations

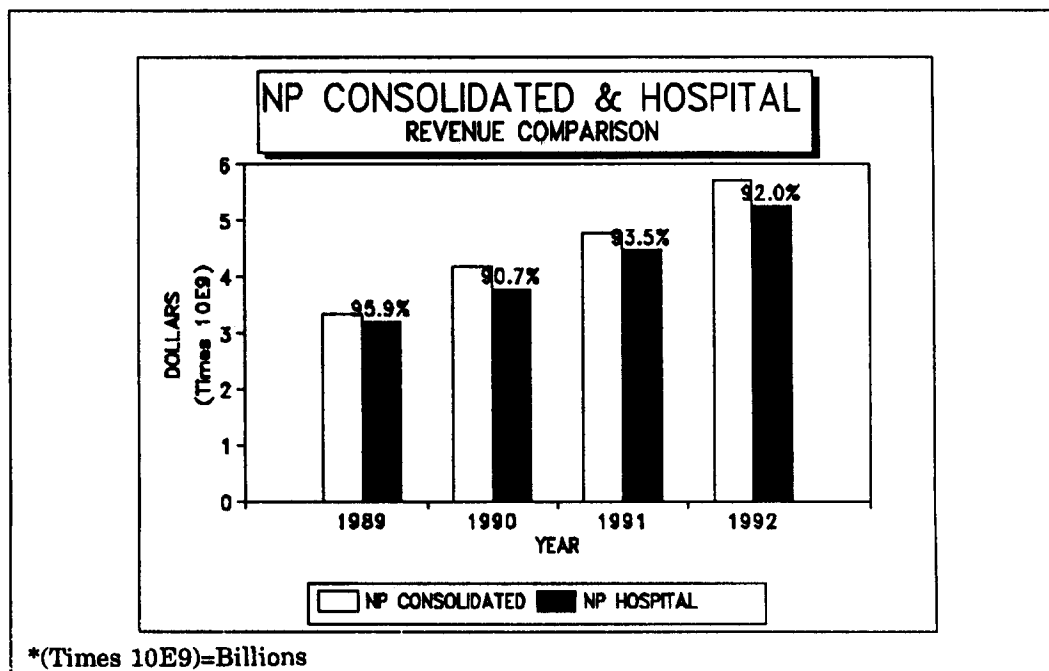
In 1992, there were 68 nonprofit hospitals organized into about 50 diversified organizations. Aggregate gross revenues, net profit, assets and net equity are shown in Table 5 for these organizations from 1989 to 1992. Data elements pertaining to nonprofit organizations and hospitals were abstracted from this table to construct Figures 3, 4, 5 and 6 below.

TABLE 5: COMPARISON OF CONSOLIDATED AND HOSPITAL FINANCIAL DATA FOR DIVERSIFIED NONPROFIT ORGANIZATIONS AND HOSPITALS BY YEAR

	Revenues	Net Profit/Loss	Assets	Net Equity
1989 Organizations	3,342,457,617	144,333,058	3,292,825,969	1,868,460,318
Hospitals	3,206,901,297	147,777,882	2,609,199,282	1,556,604,702
1990 Organizations	4,168,714,350	184,423,994	3,636,474,229	2,106,605,780
Hospitals	3,781,303,644	163,157,674	2,939,566,313	1,729,701,411
1991 Organizations	4,768,252,980	236,287,001	4,261,793,875	2,386,355,500
Hospitals	4,459,567,654	206,492,806	3,316,284,550	1,879,602,087
1992 Organizations	5,711,478,785	250,300,489	4,974,392,134	2,745,830,615
Hospitals	5,252,196,587	241,326,596	3,929,476,829	2,141,306,127

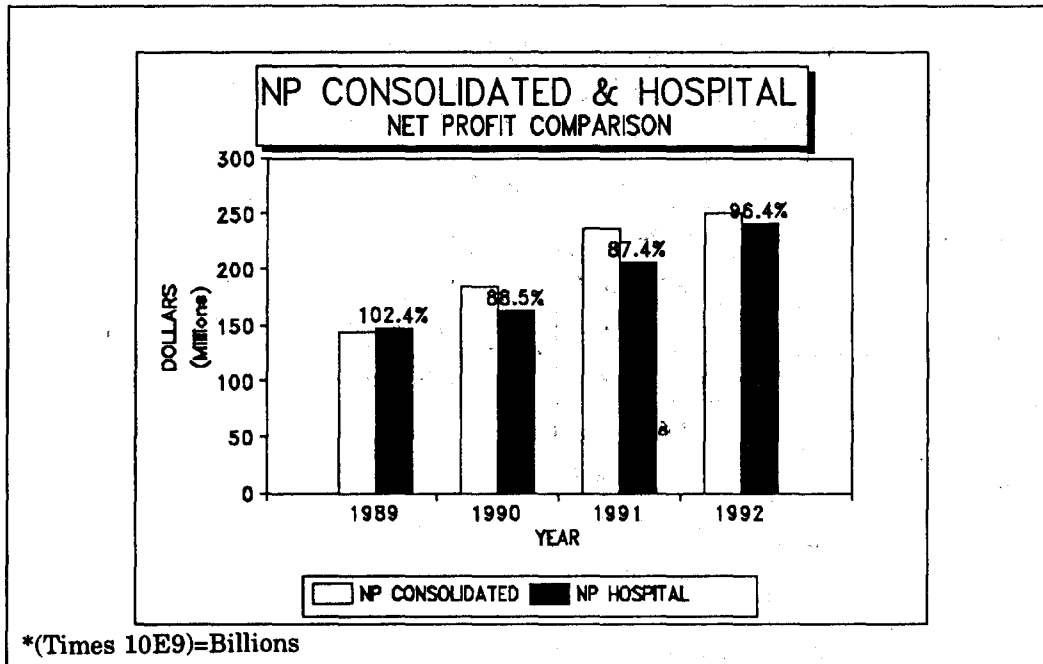
The most striking revelation is that nonprofit hospitals tend to dominate their consolidated organizations. In each year for which data is available, hospitals provided over 90 percent of gross revenues and over 85 percent of net profits to nonprofit organizations. (See Figures 3 and 4 below.)

FIGURE 3:



During 1989, hospital operations apparently subsidized the operations of consolidated organizations. As shown in Figure 4, hospitals provided more than 100 percent of net profits. This suggests that there were losses in affiliate activities that year.

FIGURE 4:



Interestingly, aggregate hospital assets and net equity comprise lower percentages of similar consolidated organization accounts. While in 1992 hospitals earned 96.4 percent of consolidated organization net profits, they held only 79 percent of assets and 78 percent of net equity.

FIGURE 5:

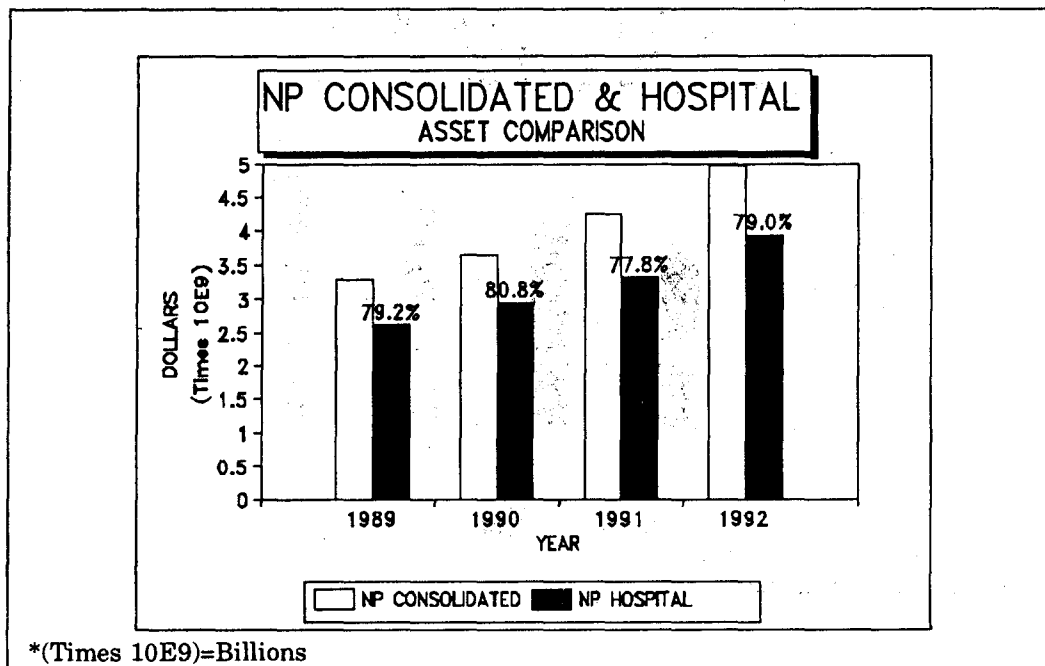
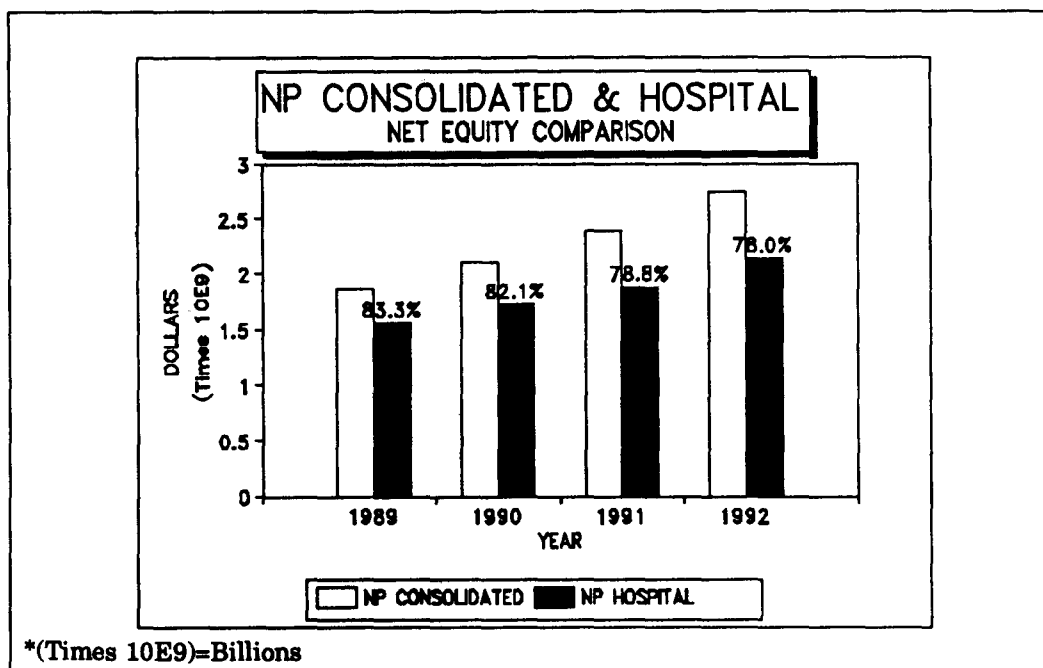


FIGURE 6:



The preceding suggests that assets and equity may not be employed as productively in affiliates as in hospitals. To gain further insight into this, the profitability ratios of hospitals and affiliates can be examined.

In fact, the median return on assets (ROA) and the median return on equity (ROE) have tended to be lower among affiliate organizations than among nonprofit hospitals. For example, the 1992 median ROA for nonprofit diversified hospitals was 5.8%, whereas the median ROA for their for-profit affiliates was 0.0% and the median ROA for their nonprofit affiliates was 1.7%. Only on the profitability ratio of net profit(loss)/revenue has the performance of nonprofit affiliates of nonprofit hospitals exceeded that of hospitals. Median profitability ratios are shown in Table 6 below.

**TABLE 6: MEDIAN PROFITABILITY RATIOS OF
NONPROFIT DIVERSIFIED HOSPITALS AND THEIR AFFILIATES**

	1988	1989	1990	1991	1992
NP Div Hospitals					
ROA	-4.0%	3.9%	4.8%	5.3%	5.8%
ROE	8.6%	6.9%	8.4%	10.0%	9.9%
Net Profit(loss)/Rev	4.2%	3.6%	3.5%	3.7%	4.4%
NP Hospital Affiliates					
ROA					
FP Affiliates	-0.1%	3.7%	-1.4%	-2.6%	0.0%
NP Affiliates	5.3%	1.8%	3.2%	2.2%	1.7%
ROE					
FP Affiliates	-7.2%	-9.0%	-3.7%	-5.6%	0.0%
NP Affiliates	5.6%	0.0%	3.4%	6.2%	4.0%
Net Profit (loss)/Rev					
FP Affiliates	1.7%	-2.6%	-0.3	-2.8%	1.9%
NP Affiliates	15.2%	4.6%	5.5%	5.6%	3.3

There are interesting differences in the performance of affiliates by control. In general, the median profitability ratios of for-profit affiliates of nonprofit hospitals have been zero or negative over the years while the median profitability ratios of nonprofit affiliates have consistently been positive.

We are unable to determine why for-profit affiliates perform more poorly than nonprofit affiliates. Given the literature review, however, it is reasonable to ask if nonprofit hospitals have found ways of reducing their tax exposure by charging expenses to their for-profit affiliates that would otherwise be nondeductible.

Judging from median profitability ratios, for-profit affiliates are in a poor position to monetarily support the nonprofit activities carried out in the larger corporation. They may even require subsidization from the corporation. Nonprofit affiliates, on the other hand, seem to be profitable; however, we are unable to determine, from the available data, how excess of revenues over expenses are used.

6. Summary

Diversification is a popular strategy among Virginia nonprofit hospitals but tends to be more extensive in organizations having larger numbers of beds. Nonprofit hospitals engage in a number of different patient care related and

unrelated activities including: home health; outpatient radiology, CT scan, MRI; other outpatient services; urgent care; long term care; pharmacy; medical equipment; insurance; physician billing; collection; fitness and wellness; real estate; and management and consulting services. Competition may be most extensive, as judged from gross revenues earned, in the patient care related areas of: outpatient services other than radiology, CT scan and MRI; long term care services; and medical equipment and supplies; insurance and home health. In nonpatient care related activities competition may be strongest from holding company activities; and real estate management and rental; and management and consulting services. Unfortunately, the types of business activities undertaken by holding companies can not be determined from the data.

Virginia nonprofit hospitals tend to dominate their consolidated organizations. During 1992, they earned 92 percent of the gross revenues of all consolidated organizations and over 96 percent of net profits. The CDS indicate that assets and equity may not be employed as productively in affiliates as in hospitals. The median return on assets and return on equity tend to be lower among affiliate organizations than among nonprofit hospitals. For-profit affiliates of nonprofit hospitals perform more poorly than their nonprofit counterparts, as judged by median profitability ratios. In fact, the median profitability ratios of for-profit affiliates of nonprofit hospitals have been zero or negative over the years, while the median profitability ratios of nonprofit affiliates have consistently been positive.

No determination can be made regarding why for-profit affiliates perform more poorly than nonprofit affiliates; however, judging from median profitability ratios, for-profit affiliates seem poorly situated to monetarily support the nonprofit activities of the larger corporation or lower the cost of health care. While, nonprofit affiliates are profitable, it is impossible to determine how their profits are used.

VII. PUBLIC COMMENT

Responses from the mailings sent to individually affected organizations and advocacy groups was limited. Correspondence was received from the following organizations:

1. Oxygen Specialties Inc., Virginia Beach;
2. ConPharma Home Health Care Inc., Waynesboro;
3. Health First, Richmond;
4. Harry J. Hann and Associates, Limited, Norfolk;
5. Continuing Care Home Health Services, Harrisonburg, and;
6. Commonwealth Health Care, Inc., Virginia Beach.

The small for-profit business owners who did respond to the inquiry were profound about the negative effect that nonprofit hospitals have on their businesses. Each of these organizations indicated that this issue continues to be paramount in their viewpoint. Many indicated that there is a continuing need for more state involvement in the regulation and supervision of nonprofit hospitals on this issue. In particular, the need for a "level playing field" was stressed, and hospitals' referral practices were criticized.

Small business representatives made several phone calls to VHSCRC staff concerning the necessity for a level playing field. In addition, one caller raised the issue of state monies being used by a state hospitals for advertising, which resulted in direct competition with small for-profit businesses and with other nonprofit and for-profit hospitals.

The feedback from interested parties and advocacy organizations representing both small businesses and the nonprofit industry was not sufficient to enable the VHSCRC to fully respond to the issues raised in HJR 237.

IX. RECOMMENDATIONS

Because determination of "unfairness" requires value judgements, it will always be difficult to study the extent of unfair competition between nonprofit hospitals and for-profit business. However, specific questions related to competitive advantages that nonprofit hospitals may enjoy over for-profit competitors could be investigated if additional legislation is enacted.

Some of these questions include: (1) Do nonprofit hospitals limit referrals to their own affiliates (captive referrals)? (2) Do nonprofit hospitals charge lower prices than for-profit firms providing the same services in the market area? (3) How efficiently are services provided through affiliates? (4) Do nonprofit hospitals avoid taxes on income generated in their for-profit subsidiaries? (5) Are after-tax profits channeled back to the nonprofit hospital or a foundation that raises money for the hospital?

Recently collected information on related party transactions collected by the VHSCRC pursuant to SB 518 (1992) may be useful in answering some of these questions. It is therefore suggested that a continuing resolution be adopted to have the VHSCRC further study these issues.

In addition, to more fully address the questions specified above, legislation will be required to authorize the VHSCRC to gather information on: (1) the types of services offered by each subsidiary; (2) the amount or number of each type of service provided; (3) referral information; (4) capital investments (past and new); (5) labor information; and (6) information concerning mergers or sales of subsidiaries including the proceeds of such sales and uses of these funds.

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Appendix 1

GENERAL ASSEMBLY OF VIRGINIA--1992 SESSION

HOUSE JOINT RESOLUTION NO. 237

Requesting the Virginia Health Services Cost Review Council to study health care institutions' diversification into the commercial sector and its impact on small business and health care costs.

Agreed to by the House of Delegates, March 5, 1992

Agreed to by the Senate, March 3, 1992

WHEREAS, health care costs and the small-business climate are interrelated subjects of significant concern to the Commonwealth and its citizens; and

WHEREAS, the General Assembly has previously expressed its concern about these issues in House Joint Resolution No. 303 of the 1987 General Assembly, which established the Joint Subcommittee to study the Extent of Unfair Competition Between Non-Profits and the Commonwealth's Small Business Community; and

WHEREAS, the HJR 303 subcommittee proposed and the General Assembly enacted HB 1058 in its 1988 Session establishing the Virginia Health Services Cost Review Council (Cost Review Council); and

WHEREAS, the Cost Review Council is responsible for collecting and analyzing financial data from health care institutions throughout the Commonwealth and, in conjunction therewith, preparing an annual report to the General Assembly assessing the extent of commercial diversification by hospitals or their parent corporations; and

WHEREAS, the four annual diversification surveys published between 1988 and 1991 provide a source of comprehensive financial information about the impact of hospital commercial diversification on (i) tax revenues to the Commonwealth, (ii) small, independent businesses throughout the Commonwealth providing health-related services, and (iii) the cost of health care resulting from resource diversion to for-profit and nonprofit enterprises wholly unrelated to patient care; and

WHEREAS, the data contained in these four surveys reveals that commercial diversification by hospitals, particularly by those tax-exempt under the tax laws of this Commonwealth and the United States, is accelerating, suggesting that (i) enormous economic pressure is placed on small businesses to compete with commercial subsidiaries of tax-exempt hospitals, (ii) hospital resources are diverted from patient care to business investments at an ever-increasing pace, and (iii) diminished state tax revenues result therefrom; and

WHEREAS, the current availability of this data and the importance of these issues compel reexamination of the phenomenon of hospital expansion into the commercial sector and (i) its impact on small businesses, the communities these businesses serve and the people they employ, (ii) its effects on the escalating cost of health care to the citizens of the Commonwealth, and (iii) its likely impact on tax revenues to the Commonwealth; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the Virginia Health Services Cost Review Council be requested to examine health care institutions' diversification into the commercial sector and its impact on small business and health care costs. The Council shall analyze and evaluate its commercial diversification surveys together with such supplementary information as it may deem necessary. The Council shall also elicit testimony and comment about the impact of health care institutions' commercial diversification from citizens, small business owners, hospital representatives, and agencies of the Commonwealth.

The Council shall complete its work in time to submit its findings and recommendations to the Commission on Health Care for All Virginians, the Governor and the 1993 Session of the General Assembly as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents.

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.



COMMONWEALTH of VIRGINIA

Virginia Health Services Cost Review Council

805 East Broad Street

6th Floor

Richmond, Virginia 23219

(804) 786-6371 (V/TDD)

JOHN A. RUPP
Executive Director

October 1, 1992

TO: Members, National Federation of Independent Business

FROM: John A. Rupp, Executive Director *JAR*

RE: House Joint Resolution No. 237

House Joint Resolution (HJR) No. 237, adopted during the 1992 Session of the Virginia General Assembly, requires that the Virginia Health Services Cost Review Council study diversification by hospitals and nursing homes into the commercial sector, and to study its impact on small businesses, and health care cost. For your convenience, I have provided a copy of the resolution with this correspondence.

By way of background, in 1987, a joint subcommittee of the General Assembly investigated the extent of unfair competition between any non profit organization and small for-profit businesses in Virginia. The result of that study was the enactment of legislation which requires that the Cost Review Council measure the amount of commercial diversification by not-for-profit hospitals, any controlling corporation, and their affiliates. The Council has produced a report on such commercial diversification for the last four years. The 1992 survey will also include information concerning diversification by nursing homes.

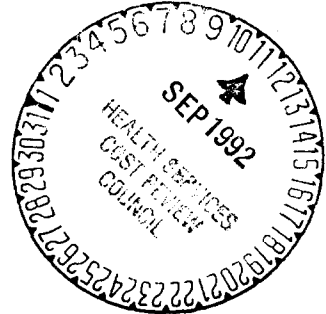
HJR 237 now requires that the Council examine all health care institutions' diversification into the commercial sector. As a part of the study, the Council is to elicit testimony and comment regarding the impact of such diversification from various groups including small business owners. I have discussed this matter with John R. Broadway, Jr., State Director of the National Federation of Independent Business, who suggested I contact members of the National Federation of Independent Business who are in a health-related business. If you or others who are familiar with or affected by this issue would like to comment in writing, I would appreciate you sending your comments to me at the above address by October 15, 1992.

If you have any questions, please feel free to contact me.

JAR/mam

Business Coalition For **FAIR COMPETITION**

1629 K Street, N.W. • Suite 400 • Washington, D.C. 20006 • (202) 887-5872



THE

MODEL STATE UNFAIR COMPETITION BILL

PUBLISHED BY

BUSINESS COALITION FOR FAIR COMPETITION

REVISION, APRIL, 1992

Section 1. LEGISLATIVE FINDINGS: The Legislature hereby finds and declares that the growth of small business is essential to the health, welfare and prosperity of the people of this state, and that government, public institutions of higher education and certain tax-favored organizations compete with the private sector when those institutions provide certain goods and services to the public. Recognizing this problem, it is the intent of the Legislature and the purpose of this Act to provide additional economic opportunities to private industry and to regulate competition by government agencies, public institutions of higher education and certain tax-favored organizations. The Legislature intends that, with limited exceptions, if government agencies, public institutions of higher education and certain tax-favored organizations engage in the sale of goods or services at retail, such sales shall be at a cost no less than that which would be borne by enterprises making similar sales in the private sector.

It is the further intent of the Legislature that tax-favored organizations shall not commence or carry on any commercial activity in competition with for-profit businesses in this State unless the commercial activity of the tax-favored organization pays all taxes and fees applicable to for-profit businesses.

It is the further intent of the Legislature that issues and complaints regarding competition between government, public institutions of higher education, or certain tax-favored organizations and the for-profit sector be addressed through a Private Enterprise Review Commission which shall be created by this Act.

Section 2. DEFINITIONS: As used in this Article, unless the context otherwise requires, the following words and phrases shall have the following meaning:

(a) "COMMERCIAL ACTIVITY" means performing services or providing goods which can normally be obtained from for-profit business including, but not limited to, the manufacturing, processing, managing, sale, offering for sale, rental, leasing, delivering, dispensing, distributing, or advertising, in whole or in part, of any goods or services.

(b) "COMMISSION" means the Private Enterprise Review Commission.

(c) "COMPETITIVE IMPACT STATEMENT" means a cost analysis using uniform accounting standards to determine:

(1) The total cost of the commercial activity, and

(2) The availability of the goods or services from for-profit business.

(d) "FOR-PROFIT BUSINESS" means an individual, firm, partnership, joint venture, corporation, association, or any other legal entity engaging in the manufacturing, processing, sale, offering for sale, rental, leasing, delivery, dispensing, distributing, or advertising of goods or services for profit.

(e) "GOVERNMENT AGENCY" means a department, office, division, authority, Commission, institution, board, or other agency of government, or any other governmental unit existing in the State or any other creation of the State, regardless of whether funds are appropriated to such agency.

(f) "INSTITUTION OF HIGHER EDUCATION" means a government-supported college, university, or community college.

(g) "INVITED GUESTS" means persons who enter onto a campus of an institution of higher education for an educational, research, or public service activity and not primarily to purchase or receive goods and services not related to the educational, research, or public service activity.

(h) "PUBLIC SERVICE" means an activity normally and generally associated with colleges and universities and other educational institutions in this State, a purpose or significant result of which is not to engage in competition with for-profit business.

(i) "STUDENT" means a person seeking a degree or a certificate from an institution of higher education.

(j) "TAX-EXEMPT ORGANIZATION" means an organization, other than a government agency, which has applied for and received exemption from specific taxation requirements from any taxing authority or jurisdiction within the state.

(k) "UNIFORM ACCOUNTING STANDARDS" means a system of accounting for costs and expenses which applies accepted accounting practices and customs (including those limited to specific industries) to provide a fair and complete total of the direct and indirect costs and expenses of or relating to any activity, including, but not limited to, the following items:

- (1) Direct and allocable indirect labor costs and compensatory benefits;
- (2) Direct materials costs;
- (3) Other allocable indirect costs, including (for example) indirect manufacturing or operational costs such as costs of utilities, parts and supplies, insurance and depreciation on plant and equipment; and
- (4) Selling, general and administrative expenses, including allocable portions of such expenses.

The term, "uniform accounting standards" also includes, for any activity, an imputed cost that represents the fair and complete total of the federal, state and local tax obligations, from which the activity is exempt in whole or in part, to the extent of such exemption(s).

Section 3. GOVERNMENT AGENCY COMPETITION WITH FOR-PROFIT BUSINESS PROHIBITED; EXCEPTIONS: (a) No government agency shall commence or carry on any commercial activity for its own use, the use of other government agencies, public institutions of higher education, tax-exempt organizations or for public use if such goods or services can be procured from for-profit business through ordinary business channels.

(b) A government agency is authorized to engage in a commercial activity when:

(1) The commercial activity is specifically authorized by statute; or

(2) The commercial activity is not available from any for-profit source; or

(3) Use of a for-profit business source would cause unacceptable delay or disruption of an essential program; or

(4) The commercial activity is inherently related to the state's defense; or

(5) The government agency can provide or is providing the commercial activity to government agencies, institutions of higher education, or tax-exempt organizations on a continuing basis at a lower total cost than if such commercial activity were obtained from for-profit business.

(c) If a government agency is authorized by statute to engage in a commercial activity, the government agency shall exact and set a fee for that activity which shall include all costs related to engaging in the activity by such government agency.

(d) If a government agency commences or continues to engage in a commercial activity, the government agency shall prepare a competitive impact statement for submission to the Commission.

(e) Within 90 days of enactment of the Act, each government agency shall adopt procedures for reporting agency compliance to the Commission.

Section 4. INSTITUTIONS OF HIGHER EDUCATION COMPETITION WITH FOR-PROFIT BUSINESS PROHIBITED; EXCEPTIONS: (a) No institution of higher education shall commence or carry on any commercial activity for its own use, the use of other public institutions of higher education, government agencies, tax-exempt organizations or for public use if such goods or services can be procured from for-profit business through ordinary business channels.

(b) Institutions of higher education shall not, unless specifically authorized by statute:

(1) Engage in any commercial activity for students, faculty, staff, or invited guests, or the general public that can be procured from for-profit business through ordinary business channels, unless, as determined by the Commission, the commercial activity:

(A) Requires the participation of students as part of an educational program in order to obtain a degree or certificate; or

(B) Is a recognized and integral part of a teaching, educational, or research program leading to a degree or certificate; or

(C) Consists of on-campus activities including:

(i) Food service; or

(ii) Student housing; or

(iii) Sponsoring cultural and athletic events; or

(iv) Providing facilities for recreation to students, faculty and staff; or

(v) Sales of course books and course related supplies, excluding electronic equipment or devices and peripherals and software; or

(vi) Sale of personal items bearing the institution's insignia, which shall be incidental to the sale of textbooks and other items permitted in Subsection (v) above.

(2) Enter competitive bidding for a commercial activity rendering any goods or services unless, as determined by the Commission, the activity is performed by students and is a recognized and integral part of a teaching, educational, or research program leading to a degree or certificate from the institution of higher education rendering the goods or services; or

(3) Engage in any commercial activity for or through another institution of higher learning, government agency or tax-exempt organization; or

(4) Provide for the disposal by sale of services, products, or by-products which are part of research or instruction conducted by students and faculty of the institution of higher education and leading to a student degree or certificate unless:

(A) The sale is an integral part of the particular research project or instructional program; or

(B) There is no other practical way of disposing of the services, products, or by-products as determined by the Commission; and

(C) The services, products, or by-products are sold at their market value utilizing uniform accounting standards.

(c) In determining whether engaging in a commercial activity is directly related to teaching, educational or research programs leading to a degree or certificate, the following criteria shall be considered:

(1) Whether the commercial activity is necessary for the student to pursue a degree or certificate or for faculty or staff to engage in research or teaching; and

(2) Whether the commercial activity is not generally available to the public; and

(3) Whether the price charged for the commercial activity reflects the direct and indirect costs and overhead costs of such commercial activity and the price in the private marketplace; and

(4) Whether measures have been taken to ensure that the commercial activity pursuant to this subsection is available only for students, faculty or staff and not the general public.

Section 5. TAX-EXEMPT ORGANIZATIONS COMPETITION WITH PRIVATE ENTERPRISE PROHIBITED; EXCEPTIONS: (a) No tax-exempt organization shall commence or carry on any commercial activity for its own use, the use of other tax-exempt organizations, government agencies, public institutions of higher education, or for public use if such goods or services can be procured from for-profit business through ordinary business channels, unless the commercial activity pays of the tax-exempt organization pays all taxes and fees applicable to a corresponding for-profit business.

(b) A nonprofit organization is authorized to engage in a commercial activity when:

(1) The commercial activity is specifically authorized by statute; or

(2) The commercial activity is not regularly carried on; or

(3) No for-profit business source is capable of engaging in the commercial activity and the Commission has determined that it is in the public interest for the tax-exempt organization to engage in the commercial activity.

(c) If a tax-exempt organization is authorized by law to engage in a commercial activity, the tax-exempt organization shall set a fee or charge a price for that activity which shall include all costs related to engaging in the activity by such tax-exempt organization, including, but not limited to:

(1) The fair market value of the activity, and

(2) The direct and indirect costs incurred in engaging in the activity determined by utilization of uniform accounting standards.

(d) If a tax-exempt organization commences or continues to engage in a commercial activity, the tax-exempt organization shall prepare a competitive impact statement to be submitted to the Commission.

(e) Tax-exempt organizations which engage in a commercial activity shall adopt and implement procedures to monitor their compliance with this chapter.

Section 6. PRIVATE ENTERPRISE REVIEW COMMISSION -- MEMBERS, TERMS, DUTIES: (a) There is created the Private Enterprise Review Commission for the purpose of reviewing and making determinations concerning state statutes, state regulations, and practices of government agencies, institutions of higher education or tax-exempt organizations relating to their commercial activities which may be affected by this Act and to enforce the provisions of this Act against violations.

(b) The Commission shall develop procedures to:

(1) Regulate competition by government agencies and ensure compliance with this Act;

(2) Regulate competition by institutions of higher education and the use of facilities of institutions of higher education by students, faculty, staff, invited guests, and the general public and ensure compliance with this Act;

(3) Regulate competition by tax-exempt organizations and ensure compliance with this Act;

(4) Promptly hear and resolve complaints lodged under this Act.

(c) The Commission shall report its activities, determinations, and any proposed legislation to the Governor and members of the Legislature not later than December first of each year.

(d) The Commission shall consist of nine members including:

(1) Six members from for-profit business who are owners or officers of small businesses; the Governor, Speaker of the House and President of the Senate shall each appoint two members; and

(2) One member who shall be a chief executive or administrative officer of a government agency, who shall be appointed by the Governor; and

(3) One member who shall be appointed from an institution of higher education by the State Board of Regents; and

(4) One member from the State Legislature who shall be appointed by the Speaker of the House.

(5) The chairperson of the Commission shall be appointed by the Governor from the members representing for-profit business.

(e) All initial appointments to the Commission shall be made by no later than _____, 1990. Terms of office for all members of the Commission shall be two years and members may be reappointed up to an additional four terms. Each member who is a state agency employee shall remain on the Commission until the end of his term of office, but only so long as he remains a state agency employee. A vacancy on the Commission shall be filled within 60 days of the date the vacancy occurred in the same manner as the original appointment. Any member appointed to fill a vacancy occurring prior to the expiration of the term for which his predecessor was appointed shall hold office for the remainder of such term. Each member shall continue in office until his successor is appointed and qualified.

(f) Five members of the Commission shall constitute a quorum. No action shall be taken by the Commission without the concurrence of at least three members.

(g) The Commission shall adopt, and may amend or rescind, such internal management rules, subject to the _____ Administrative Procedure Act, as are necessary to govern its proceedings. Members of the Commission shall serve without compensation but shall receive the same reimbursement for actual travel expenses and per diem for official Commission meetings as members of the Legislature receive for legislative interim committees.

(h) Any person aggrieved by an activity of a government agency, institution of higher education or tax-exempt organization prohibited by this Act, may file a written complaint with the Commission stating the grounds for such complaint. Upon receipt of such complaint:

(1) The Commission shall immediately transmit a copy of such complaint to the head of the government agency, institution of higher education or tax-exempt organization which is the subject of the alleged violation;

(2) The head of the government agency, institution of higher education or tax-exempt organization named in the complaint shall respond to the Commission in writing within 30 days after receipt of a complaint. The government agency, institution of higher education or tax-exempt organization shall either admit or deny the allegations made in the complaint and it shall indicate whether remedial action will be taken;

(3) Within 30 days after receipt of the institution's response, the Commission shall hold a public hearing on the complaint where all parties are afforded an opportunity to present evidence unless the remedial action agreed to be taken by the government agency, institution of higher education or tax-exempt organization is acceptable to the complainant and the Commission. The Commission shall determine whether the government agency, institution of higher education or tax-exempt organization is authorized to engage in the commercial activity or is in violation of the provisions of this chapter.

(A) If a government agency or institution of higher education is found to be in violation of this Act, the Commission shall take the necessary steps to terminate the commercial activity and require, if appropriate, the government agency or institution of higher education to implement a contract with the private sector for such activity;

(B) If a tax-exempt organization is found to be in violation of this Act, such organization will be required to terminate the activity; in the case where such organization continues to engage in the commercial activity, the Commission shall take the necessary steps to seek the revocation of the tax exempt status of such organization;

(C) Notwithstanding the above, any tax-exempt organization found to be in violation of this Act shall be ineligible to participate in government contracts.

(4) Within 30 days after the public hearing, the Commission shall issue a report of its findings to the complainant and the government agency, institution of higher education or tax-exempt organization.

(5) If the government agency or institution of higher education or tax-exempt organization's commercial activity is to be terminated, the action shall take place within three months of the Commission's report or under a schedule set by the Commission.

Section 7. CEASE AND DESIST ORDERS: If the government agency, institution of higher education or tax-exempt organization fails to comply with the Commission's order, the Commission may file action in _____ Court of the state of _____ to restrain and enjoin the government agency, institution of higher education or nonprofit organization from engaging in the activity.

Section 8. CIVIL RIGHT OF ACTION: A for-profit business that suffers economic loss as a result of a government agency, institution of higher education or a tax-exempt organization violating this Act may bring a civil action in the superior court where the for-profit business is located for appropriate injunctive relief or damages, or both. Any damages awarded in a cause of action brought pursuant to this Act shall be assessed against the specific government agency, institution of higher education and specifically assessed against its budget, or tax-exempt organization which violated this Act. A for-profit business shall not have standing to seek injunctive relief or damages or to challenge violations of this Act in the courts of this State until the for-profit business has first made a complaint to the Commission and has received the decision of the Commission.

Section 9. SUPPORT STAFF: The Department of _____ is the designated government agency to provide staff support to the Commission. The state auditor shall provide performance audit and cost analysis to the Commission. The Commission may also utilize the State Legislative Research Office.

Section 10. APPROPRIATION: The sum of \$_____ is appropriated for the work of the Commission.

Section 11. SEVERABILITY: If any clause, sentence, paragraph or part of this Act shall for any reason be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair or invalidate the remainder thereof, but shall be confined in its operation to the clause, sentence or paragraph or part thereof directly involved in the controversy in which such judgment shall have been rendered; and any contract valid under and satisfying the remaining clauses, sentences, paragraphs, or parts of this Act shall be valid and enforceable in the courts of this State.

Section 12. EFFECTIVE DATE: This law shall become effective on _____.

Section 13. INTEGRATION WITH OTHER LAW: All laws and parts of laws in conflict with this Act are repealed.

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

**COMMENTS ON THE PROPOSED
MODEL STATE UNFAIR COMPETITION BILL
OF THE BUSINESS COALITION FOR FAIR COMPETITION**

August 7, 1992

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared by individual members of the Committee on Exempt Organizations. Principal responsibility was exercised by Wendell R. Bird, chair of the Task Force on State and Local Taxes. Principal revision was performed by Barbara L. Kirschten, co-chair of the Subcommittee on Museums, and Bonnie S. Brier, chair of the Committee on Exempt Organizations. The comments were reviewed by William B. McClure of the Section's Committee on Government Submissions.

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SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

**COMMENTS ON THE PROPOSED
MODEL STATE UNFAIR COMPETITION BILL
OF THE BUSINESS COALITION FOR FAIR COMPETITION**

August 7, 1992

SUMMARY

The Model State Unfair Competition Bill is sponsored by the Business Coalition for Fair Competition. It focuses on commercial activities of government, public higher education, and nonprofit organizations. It generally forbids competition by those entities with private enterprise, but contains limited exceptions. It creates a Private Enterprise Review Commission to enforce the law.

The bill contains an introduction describing one of its three purposes (p.3):

The bill creates a Private Enterprise Review Commission with broad powers to regulate all of the commercial activities of government entities and nonprofit organizations, to order them ceased, and, in cases of non-compliance, to go to court to enforce its decisions and take steps to have tax exempt status revoked. . . .

The following comments first discuss the policy issues raised by the proposed law, then specific wording, and finally an overall recommendation.

We respectfully recommend that the Model State Unfair Competition Bill should not be enacted so long as it continues to contain provisions regulating nonprofit organizations. We do not take any position on the proposed law to the extent it applies only to competition by government.

PRESENT LAW

The Internal Revenue Code imposes a tax on most trades or businesses of nonprofit organizations that are regularly carried on and not substantially related to the organizations' exempt purposes. Most states either incorporate the same provision or impose parallel taxes on unrelated trades or businesses of nonprofit organizations.

COMMENTS

INTRODUCTION

A. HISTORY

The Business Coalition for Fair Competition was formed in 1983, and has its headquarters at a trade association, the International Communications Industries Association.

The coalition consists of three dozen trade organizations, including ABCD: The Microcomputer Industry Association, the American Council of Independent Laboratories, the American Society of Travel Agents, the Association of Physical Fitness Centers, the Health Industry Distributors Association, the National Association of Chain Drug Stores, the National Federation of Independent Business, the National Hearing Aid Society, the Small Business Legislative Council, and the United Chambers of Commerce.

In recent years, numerous states have considered or passed legislation restricting the commercial activities of state agencies and state universities, or prohibiting them from competing with private enterprise. Certain legislative proposals have also targeted "commercial" activities of or sales by all nonprofit organizations.

B. UNFAIR COMPETITION

The bill does not define "unfair competition," but does define "commercial activity" of government or nonprofit organizations as "performing services or providing goods which can normally be obtained from private enterprise." (2(1).) The introduction gives the following categories of anticompetitive practices (p.5):

communications, computers, computer software and educational technology, pharmaceuticals and medical devices and equipment, day care, physical fitness centers, tourism, and professional services.

The annotations give the following examples of unfair competition (this is a comprehensive list except the preceding quotation):

hearing aids (p.5)
university sales of sweatshirts (p.11)
electronic equipment or devices and peripherals and software (p.17)
computers and software, small refrigerators, nonspecialty apparel, furniture, etc. [in university retail outlets] (p.19).

C. COMMITTEE CONSIDERATION

We note that most members of the Committee on Exempt Organizations represent businesses as well as nonprofit organizations, and that almost all members are part of a business (a law firm) along with representing exempt organizations. The Committee has a sincere concern about unfair competition between nonprofit organizations and businesses, but is equally concerned that fair competition and noncompetitive activities be protected.

The Committee is also concerned with the lack of reliable data analyzing the extent or impact of unfair competition. Although a 1989 publication by the

Business Coalition for Fair Competition states that unfair competition is "approaching crisis proportions," a 1987 study of the Government Accounting Office concluded that reliable data is limited even though the competitiveness issue is of increasing concern. Similarly, the June 1989 draft report of the Oversight Subcommittee of the House Ways and Means Committee was based on limited and anecdotal information, although the Subcommittee attempted to assemble relevant data. That attempt was unsuccessful because neither the IRS nor any other agency has the responsibility of gathering or maintaining information on the unrelated business activities of exempt organizations. Moreover, a 1986 survey addressing the importance of potential problems of small business, as reported in the Institute for Enterprise Advancement's *Small Business Problems and Priorities* (the Institute is an affiliate of the National Federation of Independent Business), indicated that competition from government or nonprofit organizations ranked 70 out of 75 issues. The survey also indicated that only 4% of those surveyed stated that this factor was a critical problem, and 60% did not believe that it was a problem at all.

I. POLICY ISSUES

A. IS THERE A SIGNIFICANT PROBLEM WITH UNFAIR COMPETITION BY NONPROFIT ORGANIZATIONS, AND IF SO, IS IT SECTOR WIDE OR IN POCKETS?

COMMENT 1: DEMONSTRATION OF A SIGNIFICANT PROBLEM

Section 4 of the bill (regulating nonprofit organizations) is not needed if there is not a significant problem with unfair competition by nonprofit organizations with private enterprise.

Not all "competition" between nonprofit organizations and private enterprise is "unfair."

Evidence of unfair competition that was offered during congressional hearings on the issue was primarily anecdotal and not comprehensive. Many things are defined by small business as competition that are traditional nonprofit activities that business have invaded, and that may be "competition" but not "unfair" competition. The bill assumes a significant problem of unfair competition, but does not cite any evidence of that significant problem.

Recommendation: The Business Coalition for Fair Competition or other organizations should be encouraged to conduct a careful study of the incidence and dollar significance of unfair competition.

COMMENT 2: DEMONSTRATION OF A SECTOR-WIDE RATHER THAN PRECISELY-REGULABLE PROBLEM

Assuming there is evidence of significant unfair competition, it may well be confined to pockets or categories that can be more uniformly subjected to unrelated business income tax (UBIT) or to narrow regulation. The bill cites primarily the examples of universities and nonprofit hospitals. Problems with unfair competition by some of those nonprofit organizations do not warrant regulation of secondary schools, educational institutes, churches, other charities, trade associations, veterans' organizations, etc., unless they are shown to engage in widespread unfair competition of different forms.

Recommendation: The Business Coalition for Fair Competition or other organizations should be encouraged to specify the categories of organizations that it concludes are guilty of unfair competition, and to consider whether pinpoint legislation would be effective or to demonstrate why sector-wide legislation is necessary.

B. OUGHT NONPROFIT ORGANIZATIONS BE FORBIDDEN FROM COMMERCIAL ACTIVITY, RATHER THAN SUBJECTED TO UNRELATED BUSINESS INCOME TAX OR CORPORATE TAX?

COMMENT 1: RELATED ACTIVITIES

Federal tax law has the premise that some commercial activities are necessary or sufficiently related to exempt purposes, either because exempt organizations carried on the functions before businesses found them profitable, or because exempt organizations must carry on the activities to fulfill their purpose. However, federal tax law scrutinizes commercial pricing, if tax is not paid on the related activities, to ensure that the activities are designed to further exempt purposes rather than to raise money.

The Model State Unfair Competition Bill offers a different and inconsistent standard: Nonprofit organizations are forbidden generally to carry on related activities that are also carried on by private enterprises, and if a specific exception applies, are required to carry on the activities at commercial prices. It applies to taxable subsidiaries as well as to nonprofit parents (p.21):

Section 4 subjects nonprofits and agencies or subsidiaries under their control to the provisions of the bill. . . .

This would bring about inconsistent federal and state laws for the same organizations in two ways. First, federal tax law recognizes that nonprofit organizations may carry on related activities, such as hospitals charging for care, schools charging tuition and interest on tuition loans, ministries charging for books and tapes, relief of poverty organizations charging for thrift house clothes and food and low-cost housing, other charities charging for magazines, etc. The bill would forbid that unless an exception applied. Second, federal law has exceptions for passive investment income (Internal Revenue Code §§ 512(b)), which could be deemed a commercial activity under the bill even though it is not in competition with private enterprise, and in fact provides capital for private enterprise. There are some other carefully crafted exceptions under federal law to taxable UBI, which also should be treated consistently.

Inconsistency between federal and state law has a number of disadvantages, that in general require a reduction in charitable activities and an increase in administrative expenses. Inconsistent laws require more administrative personnel to comply, and inconsistent tax laws impose more accounting costs. Inconsistency also makes it more difficult for new nonprofit organizations to start up, and for one level of regulation to ensure simultaneously the compliance with another level.

Recommendation: The bill should add an exception for related activities as defined under federal tax law (i.e., those not taxable as unrelated trade or business activities under Internal Revenue Code §§ 511-513), and should

apply only to taxable unrelated trade or business activities (under Code §§ 511-513).

COMMENT 2: FIRST AMENDMENT ACTIVITIES

Federal constitutional law has overridden various forms of regulation of the ideological activities of nonprofit organizations, such as Federal Election Campaign Act regulation in *Massachusetts Citizens for Life*, federal labor law in *Catholic Bishop*, state charitable solicitations regulation in *Riley*, federal and state unemployment compensation regulation in *St. Martin Evangelical Lutheran Church*, and state education law in *Pierce*. While ideological activities are not immune for regulation or taxation, they are subject to a narrower scope of regulation and taxation than purely commercial activities. For example, the sponsorship of candidate debates by a league of voters may be subject to less permissible regulation than a commercial speakers' bureau, and the sale of Bibles by a religious denomination may be subject to less regulation than the sale of books by a commercial bookstore.

The bill applies to any nonprofit organization activity that the state's new commission deems to be commercial activity, without mention of or provision for constitutional rights. Most agencies deem constitutional defenses to be outside their jurisdiction or competence, so that constitutional issues cannot be considered until a court challenge is filed after exhaustion of administrative remedies. The adverse consequence for nonprofit organizations is that their important constitutional rights underlying ideological activities can be chilled and not even considered until after administrative exhaustion. The adverse consequence for state commissions is that nonprofit organizations, forced to litigate, will bring civil rights suits under 42 U.S.C. § 1983, and claim attorneys' fees along with costs under 42 U.S.C. § 1988. Such a constitutional exception would be parallel to the "state's defense" exception for commercial activities by governmental agencies (3(3)(d)).

Recommendation: The bill should add an exception for related activities, which would subsume related ideological activities, of the nonprofit organizations. Alternatively, the bill could add an exception for ideological activities for which constitutional protections exist.

COMMENT 3: UNRELATED BUSINESS ACTIVITIES AND TAXABLE SUBSIDIARY ACTIVITIES

Federal tax law has the premise that unrelated business activities are permissible, in two ways that place nonprofit organizations on an equal footing with for-profit businesses. First, unrelated business activities may be carried on directly by a nonprofit organization if UBIT is paid. Second, they may be carried on by a taxable subsidiary if it pays corporate tax. In either case, expenses should be allocated so that there is not cross-subsidization of taxable activities by exempt activities.

The Model State Unfair Competition Bill offers a different and inconsistent standard here too: No unrelated business activities are permissible unless they fall within a specific exception, and unless they use commercial prices.

The consequence would be inconsistent federal and state standards: Federal tax law allows unrelated business activities by payment of UBIT or establishment of a taxable subsidiary, while state law would not. (The disadvantages of

inconsistency are discussed at I.B.1 above.)

Recommendation: The bill should not forbid unrelated trades and businesses of nonprofit organizations, but should require payment of taxes at business rates and even allocation of expenses to all activities. No further requirement for commercial pricing would be necessary, once the tax playing field was levelled, and no cost impact paperwork or commission review of prices would be necessary.

C. OUGHT A NEW COMMISSION BE CREATED TO REGULATE NON-PROFIT ORGANIZATIONS AND TO SEEK REVOCATION OF EXEMPTIONS?

The Model State Unfair Competition Bill creates a Private Enterprise Review Commission to prohibit commercial activities by nonprofit organizations (p.3):

The bill creates a Private Enterprise Review Commission with broad powers to regulate all of the commercial activities of government entities and nonprofit organizations, to order them ceased, and, in cases of non-compliance, to go to court to enforce its decisions and take steps to have tax exempt status revoked. . . .

Nonprofit organizations already face tax regulation by the IRS and their state(s) where activities occur, corporate regulation by any federal funding agency and their state(s) of incorporation and operation, charitable solicitations laws of the states and cities where they solicit, and most of the various laws applicable to businesses. To the extent the private sector is overregulated, the nonprofit sector is overregulated, along with the added layer of federal and state nonprofit tax limitations. The proposed commission would add a new layer of regulation, which would be inconsistent (disadvantages of inconsistency are discussed at I.B.1 above).

The concerns about the commission are bound up with concerns about the bill, which are described below, such as whether it ought to be able to prohibit commercial activities rather than merely seeing that they are taxed, whether it ought to be able to hear citizen complaints without the standing required for a court action, and whether it ought to be able to seek revocation of tax exemptions.

Recommendation: If the bill is not amended to delete section 4 on nonprofit organizations, it should be limited to regulating those activities that are not substantially related to exempt purposes (an exception described in II.D.2), and should be limited to ensuring that nonprofit organizations pay unrelated business income tax on unrelated activity profit.

II. SPECIFIC WORDING

A. SECTION I: LEGISLATIVE DECLARATION

The statement of intent requires that when non-business entities "engage in sales of goods or services at retail," those "sales shall not be for less than the costs that would be borne by persons making similar sales in the private sector." (1.) In view of the definition of "uniform accounting standards" (2(10)), this is a requirement to use commercial pricing with full allocation of overhead and a markup equal to what taxes would be for a business.

COMMENT 1: NEED FOR ACCURATE STATEMENT OF PROHIBITION

The legislative declaration does not say it, but the comment clarifies that "[p]ublic and nonprofit organizations are not permitted to engage in commerce in competition with private enterprise." (P.7.)

Recommendation: The prohibition should be made clear in the text of section 1.

COMMENT 2: NEED FOR ACCURATE DEFINITION OF MINIMUM SALES PRICE

The legislative declaration refers to prices "not . . . less than . . . costs," but sections 3 and 4 make clear that prices must "include the true and total cost related to engaging in the activity including . . . fair market value . . . and . . . direct and indirect costs" (including what taxes would be for a business).

Recommendation: The pricing requirement should be made clear in the text of section 1.

B. SECTION II: DEFINITIONS

COMMENT 1: NEED FOR "COMMERCIAL ACTIVITY" TO EXCLUDE TRADITIONAL ACTIVITIES

The definition of "commercial activity" (2(1)) is as follows:

(1) "Commercial activity" means performing services or providing goods which can normally be obtained from private enterprise.

Almost anything can normally be obtained from private enterprise: education (which nonprofit schools offer), healthcare (which nonprofit hospitals offer), food and clothing (which charities offer the needy), etc. The comment mentions with approval "continuing a traditional government service in another community," and thereby points to an important distinction: the nonprofit activity that has been undertaken by businesses. While something that is a traditional nonprofit activity may not be immunized from unfair competition considerations, a good argument can be made that it should be presumed not to constitute unfair competition with business.

Recommendation: The definition of "commercial activity" should be modified to provide that "commercial activity" means performing services or providing goods which are primarily offered by private enterprise and are unrelated to the exempt purposes of nonprofit organizations."

COMMENT 2: NEED FOR "GOVERNMENT-SUPPORTED" TO BE DEFINED IN CONNECTION WITH "INSTITUTION OF HIGHER EDUCATION"

An "institution of higher education" is defined, but "government-supported" is not:

(3) "Institution of higher education" means a government-supported college, university, or community college

"Government-supported" could mean anything from state colleges and universities to private colleges and universities that receive any grants or whose students

receive any government loans. The *Grove City College* decision of the United States Supreme Court is one of several that have grappled with the meaning of governmental support, and it was legislatively overturned by the Civil Rights Restoration Act of 1986, showing the controversiality of the issue.

Recommendation: "Government-supported" should be defined to refer to state institutions of higher learning that qualify for sovereign immunity. Other institutions of higher learning would be treated under the general rules for nonprofit organizations.

COMMENT 3: NEED FOR "IMPUTED TAX IMPACT" TO BE DEFINED

The bill requires "uniform accounting standards" to include "imputed tax impact," but does not define "imputed tax impact" (2(10)):

(10) "Uniform accounting standards" means an accounting method which allows government agencies and institutions of higher education to identify the true and total cost of supplying goods and services in the same manner as private enterprise would identify true and total costs, including, but not limited to, the following:

...
(f) The imputed tax impact of the activity if such entity were required to pay federal, state and local taxes

The comment explains that "[t]he object is to require an increase in prices by the amount that would be needed to cover taxes if they were applicable." (P.12.)

Federal and state corporate tax rates vary from 15% to 34% depending on taxable income, loss carryforwards and other adjustments, foreign source income and IC-DISC or FSC sheltering, and a host of other considerations. Is the \$1,000 exemption from UBIT considered or ignored? If a nonprofit organization has total income that would subject a business to the 34% rate, but unrelated income that would be subject to the 15% rate, which rate is meant by "imputed tax"? If it carries on unrelated activities through a taxable subsidiary, is the imputed tax the actual tax owed by the subsidiary? (The recommendation of redefining "uniform accounting standards" as "pricing standards" is discussed in II.D.3 below.) There are advantages to adopting the federal UBIT treatment to measure imputed tax: many states currently incorporate most federal income tax requirements including federal UBIT; different calculations and tax return numbers would not be required for state UBIT; multiple methods would not be necessary for multistate nonprofit organizations.

Recommendation: "Imputed tax impact" should be defined for nonprofit organizations as "unrelated business income tax properly computed after the federal UBIT exemption for a nonprofit organization, or corporate tax properly computed for its taxable subsidiary."

C. SECTION III: GOVERNMENT COMPETITION WITH PRIVATE ENTERPRISE

The bill imposes a full spectrum of requirements on government competition parallel to those imposed on nonprofit organizations. We do not address this portion of the bill, because it does not affect nonprofit organizations, and note that most of the objections to the bill as it affects nonprofit organizations are not applicable to the bill as it affects government

competition.

Recommendation: No position should be taken on the bill as it affects government competition, but only as it applies to nonprofit organizations.

D. SECTION IV: NONPROFIT COMPETITION WITH PRIVATE ENTERPRISE

COMMENT 1: NEED FOR ACCURATE DEFINITION OF PURPOSE TO PROHIBIT COMPETITION RATHER THAN TO REQUIRE TAX PAYMENT

The statement of policy (4(1)) states that nonprofit organizations should not carry on commercial activities without paying taxes:

(1) It is general policy of the state of _____ that a nonprofit organization as defined in Section 1 of this title, shall not start or carry on any commercial activity in competition with for-profit businesses in the state unless the commercial activity of the nonprofit organization pays all taxes and fees that are applicable to a corresponding for-profit business.

Yet the bill clearly forbids all commercial activities unless they fall within a specific exception, as the comments state (pp. 7, 21):

[N]onprofit organizations are not permitted to engage in commerce in competition with private enterprises. . . . Any exceptions to allow public and nonprofit commercial activity are to be specified. . . .

Although it does not directly prohibit commercial activity by nonprofits, it limits such activity to four specific cases.

Recommendation: If the bill retains its current prohibition on commercial activities by nonprofit organizations, unless an exception specifically applies, it should state its policy accurately.

COMMENT 2: NEED FOR AN EXCEPTION FOR RELATED ACTIVITIES INCLUDING CONSTITUTIONALLY PROTECTED ACTIVITIES

The bill gives three exceptions to the strict prohibition on commercial activities (4(2)):

- (2) A nonprofit organization is authorized to perform or provide a commercial activity when:
- (a) The activity is specifically authorized by statute; or
 - (b) The activity is not regularly carried on; or
 - (c) No private enterprise source is capable of providing the needed goods or services and the Commission has determined that it is in the public interest for the nonprofit to provide such goods or services. In any case, the efforts made to solicit such sources shall be documented to the Commission and made available to the public upon request.

The comment inexplicably refers to a fourth exception (p.21):

those [activities] found by the Private Enterprise Review Commission to be directly related to the organization's exempt purposes (e.g., fundraising items) . . .

Apparently, an earlier draft of the bill had a fourth exception for related activities. Such an exception is needed to allow most nonprofit organizations to carry on their exempt activities that involve fees: nonprofit hospitals charge non-poverty patients, nonprofit schools charge tuition, nonprofit athletic associations charge gate fees, nonprofit religious organizations sell books and tapes with religious messages, trade associations such as ICIA charge for booklets such as the Model State Unfair Competition Bill, etc.

The body that determines whether activities are related would be the commission if the old exception were restored to the bill. That raises the real possibility of conflicting determinations by the commission and the IRS and state departments of revenue. There is already a substantial body of federal tax regulation, ruling, and decision on which activities are related and unrelated. Advantages come from consistency (I.B.1).

A second concern is lack of an exception for constitutionally protected activities of nonprofit organizations, since 4(2) involves a general prohibition and not merely a uniform tax. Some of those activities involve charges, such as for ideological magazines, religious denominational publications, university tuition, etc. The decisions discussed in I.B.2 acknowledge or imply that some nonprofit organization activities that involve costs are protected by the first amendment. These activities would be adequately protected by an exception for related activities. If such an exception is not added, it is important to add an exception for protected constitutional activities in order to avoid their abridgment and litigation.

A third concern is that 4(2)(c) skims profitable activities off for business enterprises and excludes charitable unrelated activities. If commercial prices are used and full UBIT is paid, is there a rationale for exclusion? With commercial activities becoming variously profitable or unprofitable over time, the commission will be busy and new impact statements will be costly.

Recommendation: A fourth exception should be added to the bill, if "The activity is substantially related to the nonprofit organization's exempt purposes under federal tax law." If that is not added, an exception should be added if "The activity is constitutionally protected."

COMMENT 3: NEED FOR REPLACEMENT OF "UNIFORM ACCOUNTING STANDARDS" WITH GAAP (WITH OR WITHOUT DEPRECIATION) AND UNIFORM PRICING CALCULATIONS

The bill requires an authorized commercial activity to be carried on at a price based on "uniform accounting standards" (4(3)(b)):

- (3) If a nonprofit organization is authorized by law to engage in a commercial activity, the nonprofit shall set a fee or charge a price for that activity which shall include the true and total cost related to engaging in the activity by such nonprofit organization, including, but not limited to:

"Uniform accounting standards" are defined without reference to generally accepted accounting principles (GAAP) or FASB 5, and instead with reference to "true and total costs, including . . . imputed tax impact." (2(10).)

The term "uniform accounting standards" is a misnomer, because it has nothing to do with accounting. If it means accounting, it would require massive

contradictions of GAAP, and most nonprofit organizations use GAAP (except the developing inventory standard) and must use GAAP-like rule for tax reporting, for charitable solicitations reporting, and for unqualified audit opinions. The term really is a pricing standard. The bill should not be concerned about inventory treatment, because the developing change would reduce rather than increase nonprofit income.

Recommendation: The term "uniform accounting standards" should be replaced by "uniform pricing standards," and if any reference is made to accounting, it should refer to "generally accepted accounting principles consistently applied (except at the nonprofit organization's option for inventory)."

COMMENT 4: NEED FOR REASONABLE LIMITS ON THE "COMPETITIVE IMPACT STATEMENT REQUIREMENT"

The bill requires a "competitive impact statement" for any commercial activity (4(4)):

- (4) If a nonprofit organization continues to engage in a commercial activity or proposes to begin engaging in a commercial activity, the nonprofit organization shall:
- (a) Prepare a competitive impact statement to be submitted to the Commission, and
 - (b) Prepare a detailed request for proposal which will be widely disseminated within segments of private enterprise which normally engage in the commercial activity in order to obtain firm bids or proposals for the activity requested. A reasonable time frame approved by the Commission shall be given to private enterprise to submit bids or proposals, including time to obtain financial supply commitments. Bids received from the request for proposal shall be used in the preparation of the competitive impact statement.

The competitive impact statement (loosely defined in 2(11)) could be later defined by the commission as anything from a bid from a business to a massive document generated by expensive consultants. Environmental impact statements are extremely costly and time consuming. The possibility of the commission defining competitive impact statements to resemble environmental impact statements is a grave concern for nonprofit organizations, because it would divert their contributions and personnel from program activities to red tape.

Recommendation: The competitive impact statement should be limited to the exceptions permitting commercial activities if "authorized by statute" or permitted by the commission, and should not apply to the exceptions permitting commercial activities if "not regularly carried on" or "substantially related to the nonprofit organization's exempt purposes." The "competitive impact statement" should be defined as "a one-page form (prescribed by the commission) with one or more bids attached (in whatever complete form businesses submitted them)."

E. SECTION V: PRIVATE ENTERPRISE REVIEW COMMISSION

COMMENT 1: NEED TO CIRCUMSCRIBE CAREFULLY THE COMMISSION'S REGULATORY POWERS

The bill gives a blank check to the Private Enterprise Review Commission to regulate (5(3)(c)):

- (3) The Commission shall develop procedures to: . . .
- (c) Regulate competition by nonprofit organizations and ensure compliance with this Act

This gives a virtual blank check to the state commissions. A blank check allows enormously intrusive regulation, and allows inconsistent regulation among jurisdictions where a nonprofit organization carries on activities.

Recommendation: Regulatory power should instead be to "enact regulations to define reasonably the terms in the Act."

COMMENT 2: NEED TO BALANCE THE COMMISSION, WHICH EXCLUDES NONPROFIT ORGANIZATIONS AND HAS A BUSINESS MAJORITY

The bill provides that the commission consists of 6 private enterprise representatives, 1 governmental agency representative, 1 higher education representative, and 1 legislator. (5(5).) The comment notes that "the Commission is to consist primarily of appointed business members" (p.25). There is no representative of a nonprofit organization. Even 1 representative of a nonprofit organization would be nugatory, because the commission is stacked with a two-thirds majority from business.

Recommendation: The commission should instead consist of 4 representatives from private enterprise who are financial officer, 4 representatives from nonprofit organizations who are financial officers, and 1 representative from higher education who teaches or has taught both business and nonprofit organizations courses.

COMMENT 3: NEED TO EMPLOY JUDICIAL RULES OF STANDING

The bill provides that "any person" may bring about an administrative proceeding before the commission, without any requirement for standing (5(9)):

- (9) Any person who believes that a government agency, institution of higher education or nonprofit organization has violated any provision of this Act may file a written complaint with the Commission stating the grounds for such complaint. . . .

Courts have used standing rules to require real rather than hypothetical complaints, and to weed out frivolous complaints, in order to protect courts from overload and to protect defendants from harassment. The same concerns call for adding a standing requirement to the complaint procedure, and the clearest standing requirement would be that necessary for complaints in state trial courts. Otherwise, an irate citizen could submit a list of the nonprofit organizations that he or she dislikes, and the commission would be obligated to hold hearings and the organizations would be obligated to waste resources defending.

Recommendation: A standing requirement should be added, such as "if such person meets the standing and case or controversy requirements for filing suit against the defendant in the superior courts of the state."

COMMENT 4: NEED TO ELIMINATE POWER TO SEEK REVOCATION OF TAX EXEMPTIONS

The bill gives the commission the power to seek revocation of tax exemptions, and in fact obligates it to seek revocation if a nonprofit organization litigates or otherwise refuses to comply with its order (5(9)(c)(ii)):

(ii) If a nonprofit organization is found to be in violation of this Act, such organization will be required to terminate the activity; in the case where such organization continues to engage in the commercial activity, the Commission shall take the necessary steps to seek the revocation of the tax-exempt status of such organization

This revocation power is draconian. While a state law would not confer standing for the commission to challenge the federal exemption, it probably would allow the commission to challenge the state tax exemption. That is a power already enjoyed by the state department of revenue and attorney general. It seems sufficient for the commission to send a recommendation to the state department of revenue and attorney general for revocation, without having the power itself to sue for revocation. If the commission can sue for revocation, it is the more important that its membership be balanced, rather than stacked in favor of business, and that the bill's prohibition of commercial activities be limited to unrelated business activities.

Recommendation: The power to "seek the revocation of the tax-exempt status" should be changed to the power to "recommend to the appropriate state authorities the revocation of the tax-exempt status" of the organization.

F. SECTION VII: PRIVATE RIGHT OF ACTION

COMMENT 1: NEED TO ELIMINATE PRIVATE RIGHT OF ACTION

The bill creates a private right of action to sue nonprofit organizations (7):

7. Civil Right of Action.

A private enterprise that suffers economic loss as a result of a government agency, institution of higher education or a nonprofit organization violating this Act may bring a civil action in the superior court where the private enterprise is located for appropriate injunctive relief or damages, or both. Any damages awarded in a cause of action brought pursuant to this Act shall be assessed against the specific government agency, institution of higher education and specifically assessed against its budget, or nonprofit organization which violated this Act. A private enterprise shall not have standing to seek injunctive relief or damages or to challenge violations of this Act in the courts of this State until the private enterprise has first made a complaint to the Commission and has received the decision of the Commission.

Such a right of action will create extensive litigation, much like the *Allen* suit seeking revocation of the tax exemption of the Catholic Church. Litigation will divert nonprofit organization contributions from exempt activities to legal defense. Litigation will also impose on courts the very difficult issue of determining whether nonprofit competition caused business losses, and if so the portion of those losses, vis-a-vis other causes such as bad management, an economic downturn, business competition, reduced sector demand, etc. The playing field will be nonlevel in two senses. First, plaintiffs will enjoy cost-free representation through contingency fee arrangements, while defendant nonprofit organizations will be burdened with

legal costs. Second, businesses can sue nonprofits, but nonprofits cannot sue businesses that invade a historical domain of nonprofit organizations (such as healthcare or education), although perhaps parity is not logically necessary.

Recommendation: The private civil right of action should be deleted.

COMMENT 2: NEED TO EMPLOY JUDICIAL RULES OF STANDING

The bill's private right of action does not require normal rules of standing and case or controversy, when it allows a private enterprise "that suffers economic loss" to sue.

Recommendation: If the private right of action is retained, a standing requirement should be added, such as "if such person meets the standing and case or controversy requirements for filing suit against the defendant in the superior courts of the state."

III. OVERALL RECOMMENDATION

Recommendation: The Committee on Exempt Organizations, of the Section of Taxation of the American Bar Association, oppose the enactment of the Model State Unfair Competition Bill, with or without the changes recommended above, with any provisions applying to nonprofit organizations. However, it is also recommended that the Committee take no position on the Bill's provisions applying only to competition by government.

Thank you for the opportunity to submit these comments.