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**OPERATIONS AND OVERSIGHT OF
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Testimony of Thomas K. Hyatt

**Increased Complexity of Public Charity
Organizational Structures**

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Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee on Oversight, I greatly appreciate this opportunity to testify before you today on the topic of the increased complexity of public charity organizational structures. I am a partner in the law firm of SNR Denton, resident in the Washington DC office, where I head our health law practice group. I have been practicing law for 30 years, focusing on legal and policy issues relevant to nonprofit organizations. I currently serve as Chair of the Board of Directors of Maryland Nonprofits, a statewide nonprofit public charity that strengthens, educates, and engages other nonprofits so that they can successfully achieve their missions. I also serve on the Board of Directors of Appalachian Regional Healthcare, a 10-hospital nonprofit rural health system serving indigent communities in eastern Kentucky and southern West Virginia. In addition, I am a Senior Fellow for Public Policy for the Association of Governing Boards of Universities and Colleges. I am the co-author of the legal text, *The Law of Tax-Exempt Healthcare Organizations*, now in its Third Edition.

I. Complexity in the Organization and Operation of Public Charities

I have been invited today to testify as to the current state of complexity in the organization and operation of nonprofit, tax-exempt public charities. As has been reported previously to this committee, there are some 1.6 million tax-exempt organizations known to the Internal Revenue Service.¹ Over 60% of these are 501(c)(3) public charities. In 2010, public charities received over \$1.51 trillion in total revenues and incurred \$1.45 trillion in total expenses. They were charged with the stewardship of over \$2.7 trillion in total assets. Nonprofit organizations paid 9.2% of all wages and salaries in this country in 2010 and accounted for 5.5% of GDP. While many nonprofits are local organizations with small staffs and small budgets, we are usually most familiar with large institutional nonprofit organizations and those with regional and national reach. According to the Internal Revenue Service, large hospitals and universities dominate the financial activity of the nonprofit charitable sector; nine of the ten largest nonprofit organizations by assets were hospitals or university-affiliated organizations.² It is this class of organizations that I describe today.

There can be no denying that these large nonprofit public charities are more complex in their structures and operations than they were, say, 40 years ago. Today it is not uncommon to have multiple business entities operating within an integrated system. They may have a central parent organization charged with strategic oversight of the system; brother-sister companies; subsidiaries; and subsidiaries of subsidiaries. These

¹ National Center for Charitable Statistics, Urban Institute, NCCS Core Files 2010, <http://nccs.urban.org/statistics/quickfacts.cfm>.

² IRS Statistics of Income, Charities and Other Tax-Exempt Organizations, <http://www.irs.gov/pub/irs-soi/11esgiftsnap.pdf>.

entities may include nonprofit corporations, taxable for-profit corporations, nonprofit taxable corporations, limited liability companies, limited and general partnerships, and joint ventures. Most institutions understand the cost as well as the benefit of operating multiple corporations and try to err on the side of keeping it simple. Still, some organization charts appear to have been designed by engineers rather than business planners, and would make Rube Goldberg proud.

II. Joint Ventures

In addition to directly owned and operated business entities, there has been a substantial increase in the use of joint ventures by nonprofits to achieve their goals over the last 30 years. A joint venture is generally defined as a business enterprise that is undertaken by two or more persons in which the parties share profits and losses. Prior to that time, the IRS had taken the position that public charities could not enter into limited partnership-type joint ventures with for-profit taxable corporations consistent with their tax-exempt status. However, the United States Tax Court overruled that position in 1980 and the IRS has over time determined that joint ventures between public charities and for-profit businesses in many different forms are consistent with public charity status if properly structured and operated. The IRS has approved both whole-entity joint ventures and ancillary joint ventures as long as the joint venture participation is serving a charitable purpose; the joint venture permits the tax-exempt organization to operate exclusively in furtherance of its tax exempt purposes; and undue control is not vested in private parties.³

Joint ventures are an important form of business operation for nonprofit public charities for three primary reasons: 1) they provide the exempt organization with access to sources of capital that they are unable to generate themselves; 2) they provide the exempt organization with access to expertise from parties who have experience in the relevant area; or 3) they provide access for the exempt organization to a service area which may otherwise have high economic or logistical barriers to entry.

III. The Need for Complex Structures

There are many reasons for the increased complexity of corporate organizational structures in the modern nonprofit sector, often acting in concert. The following is an overview of the key factors now promoting complexity in the operation of nonprofit public charities.

³ See Rev. Rul. 98-15, 1998-1 C.B. 718; Rev. Rul. 2004-51, 2004-1 C.B. 974.

a) Protection from Liability. One factor is the erosion over the last 70 years of the doctrine of charitable immunity which provided protection from liability for nonprofit public charities. As a result, nonprofit organizations now rely upon the limited liability of the corporate form for protection of their assets and operations.

b) Operation in Highly Regulated Fields. It is not unusual even today to find some large institutional charities operating out of a single nonprofit corporation, using an often complex internal organizational structure to oversee different groups and service lines. However, it is now more common for public charities to use multiple business entities to facilitate operation in highly regulated fields, such as healthcare. Because hospital operating companies are state-licensed entities, they are subject to numerous legal restrictions which can impede their ability to undertake such important tasks as expanding operations, raising capital, protecting assets from lawsuits, and growing investments. Since the late 1970s, most hospitals have expanded beyond their single hospital operating corporation structure into a multi-corporate entity system. A common healthcare system organization chart might include a parent holding corporation with various subsidiaries including hospitals, home health agencies, cancer treatment centers, laboratories, management service organizations, and physician clinics.

Multi-corporate systems also enable healthcare providers to facilitate compliance with sometimes conflicting regulatory schemes. Medicare and Medicaid reimbursement requirements, Medicare and Medicaid fraud and abuse requirements, and tax-exempt organization requirements imposed by Congress, Health and Human Services, and the Internal Revenue Service sometimes dictate that separate corporations be established to ensure compliance.

Colleges and universities also typically employ multi-level organizational structures to optimize the operation and governance of multiple colleges, schools, campuses, and service lines. Healthcare provision and academic pursuits merge in the medical school/academic medical center which can create an especially complex structure involving separate incorporation of departments and faculty practices in order to maximize federal reimbursement and to more effectively manage operations.

c) Restrictions Imposed on Public Institutions. Public institutions, such as colleges and universities, frequently establish one or more related, nonpublic charitable foundations. These foundations enable these public institutions to accomplish projects in furtherance of their mission that would not otherwise be possible because of state restrictions imposed upon public assets. For example, these foundations may establish and grow endowments which fund needed campus improvements, fund research and faculty development, provide real estate development, and enhance bond issuance.

d) Restrictions Imposed by Overseers. Some nonprofit organizations, particularly in the higher education space, are subject to requirements imposed by one or more accrediting organizations which ensure that these nonprofits are providing services in accordance with agreed upon quality standards and best practices. These accreditation requirements may provide an incentive to organizations to separately incorporate various activities to maintain accreditation.

e) Chapter-Based Organizations. Multiple and sometimes quite complex corporate structures are also found in chapter-based organizations which have a regional or national network. These organizations may receive recognition of their tax-exempt status from the Internal Revenue Service through a group ruling procedure under which the national organization oversees and ensures the continuing compliance of the individual chapters with IRS requirements, or each chapter may be separately recognized as tax-exempt. Such well-known chapter based organizations as the YMCA, Girl Scouts of America, Boys & Girls Club of America, Audubon Society, Elks Club and Little League Baseball have multiple corporations carrying on the mission of the national organization in many states and often with several corporations in the same state. They are usually bound together by chapter agreements, bylaws, and a common vision.

f) Improved Governance. Another important factor promoting a multi-corporate system is the ability to more effectively govern far-ranging services by having separate boards of directors focusing on the discrete tasks of a specific corporation rather than using one large board responsible for all matters. This enables directors to serve on boards that can best utilize their expertise.

g) Federal Tax-Exempt Organization Law Compliance. Related nonprofit organizations are commonly used to ensure compliance with applicable federal tax law, most notably the restrictions on charitable organizations with respect to lobbying and political campaign activity. Thus, it is common for a charitable organization to have a related social welfare organization which can carry on unlimited amounts of lobbying and is permitted to have some level of political campaign activity, such as by operating a political action committee.

IV. Is Corporate Complexity in the Nonprofit Sector a Problem?

While corporate complexity is a reality in the institutional side of the nonprofit sector, in my view this is not a problem which requires a change in the law to resolve. Rather, it is an environment which both invites and deserves continuing scrutiny and

transparency to ensure that public charities are acting in accordance with their tax-exempt purposes and with applicable law.

There are already important checks and balances in play to ensure that a complex corporate structure does not impede achievement of charitable goals and legal compliance. At the state level, this is primarily accomplished by the oversight of the state attorney general. In recent years, state attorneys general have been extremely active in overseeing the activities of nonprofit organizations within their state. It is not unusual for a state attorney general to become involved at the level of overseeing membership on the board of directors, governance practices, compensation of senior leadership, transparency of operation, investment of endowments, and expenditures in furtherance of charitable purposes. State attorneys general are effective watchdogs that have a primary responsibility with respect to the operation of charities within their states and have sought to expand their jurisdiction in this area with legislatures and courts.

The Internal Revenue Service plays an important oversight role through its enforcement of the Internal Revenue Code's tax exemption requirements and its implementation of the annual information return filed by most tax-exempt organizations, the Form 990, with an increasing focus on transparency and accountability. The Form 990, now more than ever, requires transparency with respect to corporate structure and relatedness. For example, Schedule R of Form 990 requires disclosure of related organizations and unrelated partnerships of a tax-exempt organization, including transactions with related organizations. Schedule H, which pertains to hospitals, requires full disclosure of management companies and joint ventures that the hospital is participating in, including ownership by physicians and members of the board of directors. The transparency created through these schedules, albeit at the cost of a greater filing preparation burden, sheds light on complex structures that will facilitate oversight and action by legislators, regulators, courts, donors and funders, the media, and the public at large. Transparency also helps to ensure that legal compliance is maintained, including preserving the separateness of corporations and the observance of corporate formalities so that appropriate activities under one area of the law do not become improper activities under another area of the law because of aggregated operation.

It also should be noted that the IRS has undertaken a considerable effort in the last few years to learn more about the large institution segment of the nonprofit sector through a series of what it calls "compliance checks." These checks involve gathering large amounts of data about all aspects of the institutions' operation, reporting their findings to the public, and acting on their findings through their continuing examination and enforcement activities. The IRS conducted a compliance check on hospitals and

health systems in 2006, with a final report issued in 2009, and one on colleges and universities in 2008, with an interim report in 2010.

The Internal Revenue Service and the courts have also played an important role in ensuring that corporate complexity does not lead to an impermissible transition from nonprofit tax-exempt activity into commercial activity. Under a legal principle known as the commerciality doctrine, the IRS would not recognize tax-exempt status, or could revoke exemption, for an organization that has a substantial non-exempt purpose and operates primarily in a commercial fashion. While most organizations would have commercial activity addressed under the unrelated business income rules which are being discussed at this hearing, enforcement of the commerciality doctrine ensures that unrelated business activity does not reflect the primary purpose of a complex organization or system and, ideally, ensures that you can tell the difference between a nonprofit, charitable organization's provision of a service and the same provision of service by a for-profit enterprise.

A potential adverse consequence of a complex corporate structure is an increased possibility that a member of the board of directors may have an conflict of interest as to a transaction involving a related corporate entity. This situation requires continued vigilance by these organizations with respect to ongoing disclosure of conflicts and compliance with the organization's conflict of interest policy and applicable state law. This is squarely within the fiduciary duty of care and loyalty responsibilities of any director of a public charity, enforceable by both federal and state regulators.

Governance of multi-corporate public charities is also improving thanks to the continuing work of such organizations as the Association of Governing Boards of Universities and Colleges, Maryland Nonprofits Standards for Excellence Institute, BoardSource, Independent Sector, Commonfund Institute, and others to ensure that best practices are being developed, shared, and implemented.

When a change in the law is warranted, Congress has not hesitated to step in. For example, one type of public charity, the supporting organization, has in recent history been used in ways and for purposes other than those intended by the Internal Revenue Code. The complicated statutory provisions for public charities lent themselves to significant abuse by organizations and individuals other than the charity which was supposedly being supported. The Pension Protection Act of 2006 largely eliminated the possibility of continuing this type of abuse, including through the expansion of the IRS's intermediate sanctions penalties authority.

V. Conclusion

On balance, corporate complexity is a necessary consequence of the efforts of large public charities to operate effectively and with economic sustainability in the modern nonprofit sector, and their need to comply with multiple federal and state regulatory schemes and third party standards in their operations. Important and largely effective checks and balances, as well as the oversight of the nonprofit sector itself, are present to keep this level of complexity from becoming a problem under the law. Nevertheless, continued emphasis on transparency regarding these structures is critical and continued scrutiny is warranted.

Thank you for the opportunity to testify today and I would welcome any questions that you may have.