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RESEARCH NOTE

The Effects of Not-for-Profit Hospital Reported Profits and Charitable Care on Perceptions of Tax-Exempt Status

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ABSTRACT

I investigate whether the hospital tax-exemption decision is a function of (1) reported profits and (2) the amount of charitable care provided. Tax practitioners from public accounting firms made decisions about whether the hospital should maintain federal and state income tax and local property tax exemptions. A between-subject design was used with cases at two dimensions: reported profits (high and low) and level of charitable care (high and low).

Findings revealed that the main effects of reported profits and charitable care do not independently appear to affect respondents' perceptions about tax exemption. However, when charitable care is low, respondents' perceptions about tax exemption were negatively influenced by high reported profits.

Recently, increased profits of not-for-profit (NFP) hospitals have resulted in intensified scrutiny of NFP hospital financial information for the tax-exemption decision (Gray 1991; Seay 1991; Young 1990). At the same time, recent litigation and legislation suggest that the amount of charitable care that a NFP hospital provides may be critical to maintaining its tax-exempt status (Wang and Wambsganns 1997; Potter and Longest 1994; U.S. Congress 1991a, 1991b; U.S. GAO 1990; Young 1990). Ultimately, profits may not matter if the NFP hospital provides sufficient charitable care.

Tax practitioners from public accounting firms and tax attorneys examined NFP hospital financial information that varied the level of reported profits and level of charitable care to make decisions about whether the NFP hospital should maintain federal and state income tax, and local

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property tax exemptions. A between-subject design was used with cases that varied two dimensions: reported profits (high and low) and level of charitable care (high and low). Findings reveal that the main effects of reported profits and charitable care do not independently appear to affect tax-exemption decisions. Yet, when charitable care is low, the local property tax exemption decision differed for high- and low-profit levels. This finding supports anecdotal evidence that suggests that low amounts of charitable care coupled with high reported profits may trigger challenges to a hospital's local property tax exemption.

The balance of the paper is organized as follows. The first section describes NFP hospital tax exemption and research hypotheses. Second is the research design, followed by results of the study. Conclusions and limitations are discussed in the final section.

NFP HOSPITAL TAX EXEMPTION

NFP hospital federal income tax exemption is governed by Internal Revenue Code Section 501(c)(3).¹ Federal income tax regulations do not require NFP hospitals to provide charitable care. Instead, the key factor is to provide services that benefit the community (Rev. Rul. 69-545, 1969-2 CB 117). In most states, federal exemption enables NFP hospitals to obtain state income tax exemption (Mancuso 1996). Property tax exemption is usually established by state constitutional law (Lashbrooke 1985), wherein states usually grant property tax exemptions to charitable organizations (Potter and Longest 1994; Bookman 1992). Tax-exemption criteria are often qualitative, rather than quantitative, and somewhat difficult to apply in practice (Bookman 1992; Seay 1991).

Tax exemption challenges began during the 1980s because NFP hospitals became profitable and attracted the attention of government officials at all levels (i.e., Internal Revenue Service [IRS], federal and state legislators, city and town officials) who needed to raise revenues to supplement tax rolls (Wang and Wambsganns 1997; Kane 1993; Bookman 1992; Gray 1991; Seay 1991). During that time, changes in Medicare laws (the prospective payment system) caused NFP hospitals to enjoy the highest profit margins ever recorded (Gray 1991). Additional scrutiny focused on the provision of charitable care by NFP hospitals, particularly as the number of uninsured Americans increased (Gaul and Borowski 1993; Gray 1991; Seay 1991). Estimates of losses from federal, state, and local taxes from healthcare organizations amounted to billions per year (Pound et al. 1995).

Tax-exemption court challenges and legislative activity has occurred in the federal government and in at least 20 states (Gray 1991; Hudson 1990).² At the federal level, the General Accounting Office (GAO) released a report that revealed that hospitals with the highest operating margins had the lowest rate of uncompensated care (U.S. GAO 1990). In 1991, two bills were introduced in the U.S. Congress (H.R. 790 and 1374), but did not pass, that linked the value of tax exemption to dollar amounts of charitable care provided. At the state level, recent litigation and legislation has linked local property tax exemption to reported profits and charitable care (Bellandi 1998; Potter and Longest 1994; Gaul and Borowski 1993; Hudson 1990; Young 1990). In Pennsylvania, a judicial decision required a hospital to operate at a loss or donate charitable care in an amount at least equal to 75 percent of its prior year profits to retain its tax-exemption status (Young 1990).

Thus, one can make an argument that perceptions about NFP hospitals' tax-exempt status are linked to profits, and/or the amount of charitable care provided. Currently, federal income tax exemption laws and regulation, and many states, do not limit the level of profits that can be earned by tax-exempt NFP hospitals. However, the fact that legislation has been considered, coupled with adverse press coverage of for-profit activities by NFP entities suggests that there may be a perception that tax-exempt status at all levels (federal, state, and local) may be threatened by profitable

¹ I.R.C. § 501(c)(3) requires that the entity organize and operate for a charitable purpose, that its earnings not inure to any individual and that it not conduct political or substantial lobbying activities.

² The tax-exempt issue has arisen in the following states: Vermont, Rhode Island, Massachusetts, Pennsylvania, Maryland, Virginia, West Virginia, Tennessee, Florida, Illinois, Michigan, Minnesota, Iowa, South Dakota, Wyoming, Colorado, Nebraska, Kansas, Missouri, Utah, Washington, Oregon (Hudson 1990).

activities. Tax exemption costs more than \$36.5 billion per year in lost income tax revenues (not counting local taxes), which is equivalent to income taxes paid by 25 million taxpayers (Gaul and Borowski 1993).

Everyone knows that an entity subject to taxation quite legally and legitimately reports an amount of income different from the amount that would be reported by one that is tax exempt. For a decade, hospitals and their accountants have been told to produce the largest possible bottom line amounts in order to maintain their credit ratings; subject those surpluses to taxation, and the appropriate accounting procedure will make them disappear. (Seay 1991, 298)

Furthermore, anecdotal evidence suggests that hospitals may engage in activities to “hide” profits. For example, a NFP hospital might create a separate foundation to move cash and profitable investments off financial statements, so that the hospital itself would look unprofitable. In fact, some NFP hospitals may have formed complex organizational structures specifically to avoid tax-exemption challenges (Gaul and Borowski 1993; Kane 1993; American Hospital Association 1988). Hamot Medical Center in Erie, PA lost its tax exemption when its elaborate reorganization was discovered. Hamot moved hospital profits to a separate foundation that funded several related entities including condominiums, office buildings, and a marina (Levin 1989). Therefore, the first hypothesis is:

H1: The probability that NFP hospital tax exemption will be maintained is higher (lower) when profits are low (high).

On the other hand, decision makers may simply focus on the amount of charitable care and reported profits may not matter.³ Similar to profits, federal income tax laws and regulations and some state laws do not require hospitals to provide indigent care. However, at all levels (federal, state, and local), NFP hospitals are criticized about the amount of charitable care provided (Wang and Wambsganns 1997; Potter and Longest 1994; Gaul and Borowski 1993; Gray 1991; Seay 1991; GAO 1990). The GAO (1990) Report, proposed federal legislation, U.S. Congressional hearings (1993), state legislation (Texas and Pennsylvania), and judicial decisions (Young 1990) have proposed or reinstated a traditional charitable care model for tax exemption. In many states (e.g., Utah, Intermountain Health Care in 1985; Texas, Methodist Hospital in 1990; Pennsylvania, St. Luke’s Hospital in 1990), litigation changed state laws and the amount of charitable care provided by a NFP hospital became a critical issue for tax exemption (Coalition for Nonprofit Health Care 1999). The second hypothesis is:

H2: Regardless of the level of reported profits, the probability that NFP hospital tax exemption will be maintained is higher (lower) when there are high (low) levels of charitable care.

While the study examines all three types of tax, reported profits and charitable care amounts may not matter for federal and some states’ tax exemption if respondents simply follow existing rules.⁴ Existing IRS regulations and some state laws do not require certain levels of charitable care, nor limit for-profit activities. I test for an overall effect because although not legally mandated at all levels, there is at least anecdotal evidence to support the idea that tax status at the federal, state, and local levels may be affected by profits and the level of charitable care. In fact, local property tax exemptions are most likely to be affected by these variables, since some states have already

³ The attorney who prosecuted the case of Hamot Medical Center in Erie, PA, indicated that the most important factors for tax exemption were that substantial amounts of charitable care should be provided by the entity, and substantial amounts of charitable donations received.

⁴ After the questionnaire was constructed and administered, the U.S. Congress passed laws to allow the IRS to impose excise taxes without revoking tax exemption for private inurement violations or excessive lobbying expenditures (Hallam 1998; IRS 1997, Publication 557).

adopted rules through judicial decisions or legislation where reported profits or charitable care do matter (Bellandi 1998; Potter and Longest 1994; Gaul and Borowski 1993).

Local property tax exemption policies, governed by state law, may diverge from federal tax-exemption policies because NFP hospitals are a burden on municipal resources (Coalition for Nonprofit Health Care 1999; Potter and Longest 1994). Thus, NFP hospitals may maintain federal tax exemption while state courts continue to decide independently about local property tax exemption (Potter and Longest 1994). Moreover, local property tax authorities may examine whether the amount of charitable care provided is sufficient in relation to profits.⁵ Hence, the focus on profits may be contingent on a reasonable level of charitable care; i.e., an interaction between profits and charitable care. Reported profits may matter for local property tax exemption when charitable care is low. On the other hand, if charitable care is high enough, then profits may not really matter. The third hypothesis is stated in two parts:

H3A: When charitable care is high, no difference between local property tax exemption decisions is expected when NFP hospital profits are high or low.

H3B: When charitable care is low, the probability that local property tax exemption will be maintained is lower if NFP hospital profits are high.

RESEARCH DESIGN

This study uses a between-subjects design with four cells. The decision task asked respondents to determine whether the hospital should maintain its tax-exempt status. There were two binary manipulations for this decision, so four cases were necessary. The first manipulation varied the level of profits (high and low) within the financial statements to examine the impact of reported profits on the tax exemption decision. A second manipulation varied charitable care at two levels (high and low) for each level of profits. Thus, four cases were used to examine two levels of charitable care and two profit levels.

Independent Variables

Respondents

The tax-exemption task was administered to tax accountants and tax attorneys, as they are experienced professionals⁶ with considerable understanding of accounting information and tax provisions. In fact, AICPA auditing objectives and procedures suggest that auditors consider the tax-exempt status of health care organizations (AICPA 1996, paras. 7–23).⁷ Furthermore, since tax accountants advise tax-exempt agencies, their assessment of factors that affect exemption is of interest in its own right.

A preliminary phone call was made to individual firm members or firm representatives to identify respondents with experience in analyzing NFP hospital financial information. Seventy-eight questionnaires were mailed to respondents sequentially, to ensure a proportionate assignment

⁵ In the case of Hamot Medical Center (Levin 1989), the judge ruled that the copious profit margin *in part* negates a claim by the hospital that it did provide uncompensated care. Although Hamot did provide emergency treatment to the poor, the court found that it did not donate or render gratuitously a substantial portion of its services.

⁶ Tax accountants were used rather than legislators for the following reasons. First, although legislators at all levels of government have the principal responsibility to establish tax-exemption criteria for NFP organizations, legislators may not be an appropriate respondent group since they come from a variety of backgrounds and professional experiences. Second, IRS field agents might be an appropriate respondent group, yet governmental policy precludes them from serving as respondents for academic research.

⁷ Tax accountants and tax attorneys provide information for a NFP entity that is needed by government agencies to determine the entity's tax-exempt status (e.g., Form 1023 and Form 990). Legislators may or may not rely on tax accountants or tax attorneys to write tax-exemption laws, although many legislators may be attorneys themselves. In tax-exemption court cases, judges may need to rely on the expert testimony of accountants, as in the case of St. Luke's Hospital (Young 1990).

of experienced people to all four cases. Thirty-four packets were individually mailed and six firm representatives distributed 44 individually sealed packets to firm members who they had identified as having the requisite knowledge to complete the task. For those who had not responded in approximately one month, second and, in some cases, third questionnaire packets were mailed.

Eight responses from individuals and 30 questionnaires distributed by firm representatives were returned. Responses were obtained from professionals in Connecticut, Florida, Kentucky, Massachusetts, New York, Ohio, Rhode Island, Pennsylvania, and North Carolina. One respondent decided that s/he did not have the proper expertise to complete the questionnaire. Thus, 37 usable responses were obtained for a usable response rate of 47.4 percent. Ten responses each were obtained in the high- and low-charitable-care conditions, respectively, for the high-profit-level condition. In the low-profit-level condition, eight responses were obtained for the high-charitable-care condition and nine responses for low-charitable care.

Respondents were sophisticated in their ability to analyze hospital financial information. When asked how many years involved in analysis of hospital organizations, 71 percent selected time intervals greater than 0–5 years. Sixty-two percent of respondents spent 30 minutes or longer on the task, which indicates that the majority took the task seriously.

Not-for-Profit Hospital Reported Profits

For purposes of the present study, four cases were needed to test the proposed hypotheses. These cases included two forms of NFP hospital financial statement information (high and low profits) and two levels of charitable care for each profit form. The two forms of information were based on a set of financial statements from an actual NFP hospital. The levels of charitable care are described in the next section. Respondents received an instruction sheet and questionnaire, NFP hospital financial statements and brief footnotes (description of the organization and the amount of charitable care), and a table of ratios that compared the hospital (either high or low profits) with industry ratios for NFP, for-profit and government hospitals.

For both financial statement forms (high and low profits), the NFP hospital has the same economic substance. For the high-profit condition, financial information for profitable related entities (e.g., a foundation and property management company) of the NFP hospital was consolidated with the NFP hospital financial information to obtain high reported profits. In the low-profit condition, financial information for profitable related entities was disclosed in footnotes, which resulted in lower reported profits. Thus, based on reported earnings, profitability ratios (e.g., profit margin and return on assets) are higher in the high-profit condition than the low-profit condition (see Table 1).

Amount of Charitable Care

The present study examines charitable care at two levels: 1 percent of net patient service revenue (low) and 6 percent of net patient service revenue (high). For simplicity, percentages were based on Texas legislation, which requires hospitals to provide charitable care in an amount that is at least 4 percent of net patient service revenue to maintain tax exemption.

Other tax-exemption factors were held constant; i.e., respondents were told that no part of the hospital's earnings inured to any individual and that the hospital did not conduct any lobbying activities.

Dependent Variables

The dependent variable is each respondent's indicated level of agreement (seven-point Likert-type scale) about whether the hospital should maintain tax exemption for each of three types of tax, i.e., federal income tax, state income tax, and local property tax, where 1 indicated disagreement and 7 indicated agreement. Respondents were also asked about the reasons for each of their three decisions.

The three tax types are related, although tax-exemption criteria for each are not exactly the same. Most states require a federal income tax determination letter as a prerequisite for state income

TABLE 1
FINANCIAL STATEMENT RATIOS FROM NFP HOSPITAL CASES

	High Profit		Low Profit		Industry Ratios ^a		
					NFP	For-Profit	Government
	19x2	19x1	19x2	19x1	19x2	19x2	19x2
Profitability Ratios							
Profit Margin	6.81%	7.71%	(.08%)	1.03%	4.30%	4.22%	5.19%
Return on Assets	3.86%	4.30%	(.02%)	1.01%	4.05%	4.80%	5.12%
Leverage Ratios							
Debt to Equity	1.79	1.05	3.38	1.93	44	81	31
Debt to Total Assets	1.62	.95	2.83	1.61	36	70	28
Cash Flows							
Operating	\$4.886M	\$3.431M	\$4.246M	\$2.137M			
Inc. (Dec.) in cash	\$(92,045)	\$282,796	\$(129,191)	\$400,781			

^aIndustry ratios were obtained from Health Care Investment Analysts, Inc. (1992).

tax exemption (Mancuso 1996). In most states, property tax exemption is determined under independent state law provisions (Colombo 1993) and is based on the property's use for charitable purposes (Bookman 1992). Tests of H1 and H2 combine the three types of tax.

Alternatively, different perceptions of charity and different fiscal pressures result in divergent tax policies at different levels of government (Potter and Longest 1994). Thus, Potter and Longest (1994) propose that a NFP hospital may lose its local property tax exemption while it maintains its income tax exemption (federal and state). Tests of H3A and H3B examine the local property tax exemption decision separately from the federal and state income tax decisions.

RESULTS

Tests of Hypotheses

A multivariate analysis of variance (MANOVA) was used to compare groups that differ from one another along two dimensions; i.e., a two-way multivariate factorial experiment that includes an interaction term. Federal, state, and local tax variables are the dependent variables. For H1, the main factor of interest is reported profits at two levels (high and low). For H2, the main factor of interest is the level of charitable care (high and low).

The main effects of reported profits and charitable care were not statistically significant. Additionally, no statistical significance was found for the interaction term. These results suggest that overall perceptions about tax-exemption standards may not be affected by reported profits or the level of charitable care, which is not surprising since current IRS regulations and some state laws do not limit profits or require specific amounts of charitable care. Despite the fact that excess profits or low charitable care may be viewed negatively, experts properly perceived existing income tax exemption rules and no overall effect was found. However, given that local property tax exemption rules in many states have explicitly linked tax-exempt status to profits and/or charitable care, I expect that perceptions about local tax-exempt status may be affected by profitability and charitable care levels. This is the focus of H3A and H3B.

For local property tax exemption, simple effects t-tests are used to test H3A and H3B. As seen in Table 2, when charitable care is high (H3A), no difference is expected between the high- and low-profit conditions. A two-tailed t-test shows that there is no significant statistical difference between high- and low-profit groups for local property tax exemption, which supports H3A.

TABLE 2
TESTS OF HYPOTHESES 3A AND 3B
 (simple t-tests for H3A and H3B)

	Charitable Care (High)					Charitable Care (Low)				
	Profits	n	Mean	t-test (two-tailed)	p	Profits	n	Mean	t-test (one-tailed)	p
Local Property Tax	High	10	4.40			High	10	3.40		
	Low	8	4.00	.402	.696	Low	8	5.25	-2.47	.0125

Mean: Scale to maintain exemption ranges from Disagree (1) to Agree (7).

On the other hand, when charitable care is low (H3B), a significant statistical difference between the high- and low-profit conditions is found for local property tax exemption in support of H3B. When charitable care is low, respondents are more likely to agree that the hospital should maintain its local property tax exemption when profits are low than when profits are high.

Other Data Analysis

After each tax-exemption decision was made, respondents were asked to number, in order of importance, reasons for their decision (see Table 3).⁸ Kendall’s coefficient W was used to measure agreement among respondents (Siegel and Castellan 1988). Table 3 summarizes mean ranks of decision factors for the local property tax exemption decision.⁹ For all subjects grouped together,

⁸ A blank line was included for an open-ended response. Since only five respondents ranked the open item as number 1, this factor is not included in Table 3. Some open-ended reasons included the NFP nature of the organization, the hospital meets federal standards, financial statements do not provide information for the decision, absence of ownership interests.

⁹ For federal and state income tax decisions, respondents chose “no earnings to individuals” as the most important reason for their decision and “level of charitable care” was second. The other two reasons, profitability and lobbying, were ranked the same for all types of tax. Note that “no earnings to individuals” is a primary criterion for federal tax exemption.

TABLE 3
RESPONDENTS’ REASONS FOR LOCAL PROPERTY TAX EXEMPTION DECISION

	Mean ranks of reasons (1 is most important)
Level of charitable care	1.58
No earnings to individuals	1.88
Profitability	3.25
No lobbying activities	3.29
	W = .484
	p = .000



the coefficient of concordance was statistically significant, which indicates agreement among the subjects about reasons for their decisions.

Respondents found "level of charitable care" to be the most important reason for the local property tax exemption decision, with the "no earnings" factor a close second. The level of charitable care provided has become an important factor, particularly at the local level where most tax-exemption challenges occur (e.g., Pennsylvania). Results reported for H3B suggest that when charitable care is low, profits become an important factor for local property tax exemption. Interestingly, "no lobbying activities," a primary criterion for federal income tax exemption, was the fourth most important reason for all tax types, after reported profits.

CONCLUSION AND LIMITATIONS

The most important finding was that changes in reported profits did affect professionals' perceptions of the local property tax exemption entitlement when charitable care was low. Specifically, it appears that when charitable care is low, profits are considered a factor in the likelihood of maintaining tax-exempt status. The finding is consistent with tax policy analysis, i.e., NFP hospitals are more likely to lose local property tax exemption as financially strapped local governments focus on profitable NFP hospitals and the amount of charitable care provided (Potter and Longest 1994).

One limitation of the study is that the dependent variable measures perceptions and does not indicate whether the NFP hospital would actually lose its tax-exempt status. Although few NFP hospitals lose exemptions, challenges to tax exemption (i.e., probability of audit, federal excise taxes, or loss of property tax exemption) are costly to NFP hospitals, particularly when its charitable care is low and its profits are high. Another limitation is that the study examines only two factors, reported profits and charitable care, while other factors may affect the tax-exemption decision. Extensions to the study might examine private inurement of earnings, lobbying expenditures, financial condition of a municipality, municipal resources used by the hospital, and other factors that may be related to tax-exemption challenges.

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