
P A R T O N E

Introduction to
The Law of Tax-Exempt
Healthcare Organizations

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C H A P T E R O N E

Tax-Exempt Healthcare Organizations—An Overview

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The waxing and waning of tax policy, at the federal and state levels, has pushed nonprofit healthcare organizations to the fore in terms of scrutiny and into the heart of the debate over eligibility for tax-exempt status. No category of exempt organization has its tax exemption in greater jeopardy than hospitals, health maintenance organizations (HMOs), and other healthcare providers. Few other types of exempt organizations are raising as many unrelated income issues as these entities. Moreover, when it comes to the creation of new organizations and the triggering of new tax questions, no group of nonprofit organizations can top nonprofit healthcare organizations.

This high-profile position and the resulting predicament for healthcare entities are explicable on a very fundamental basis: government regulators, legislators, and the public are finding it increasingly difficult to differentiate the practice of healthcare by nonprofit organizations from that by for-profit organizations. Part of this confusion is attributable to the evolving forms of healthcare vehicles and the dramatic changes in the places where medicine is practiced and healthcare otherwise delivered. Other elements of the confusion are traceable to the alterations in the way healthcare is funded: the enactment of the Medicare and Medicaid programs greatly expanded the universe of individuals who could, directly or indirectly, “pay” for healthcare services; the injection of healthcare services into the realm of employment benefits forced greater funding of healthcare services by employers and shifted a large part of healthcare funding to commercial insurance companies.

TAX-EXEMPT HEALTHCARE ORGANIZATIONS—AN OVERVIEW

Much of *health law* evolved from the regulatory frameworks built up around government-financed healthcare benefits and the ways in which the insurance companies set about to reduce the amounts paid out to, or for the care of, benefits claimants. As these bodies of regulation grew (typified by *anti-abuse* and *patient dumping* rules) and inequitable insurance practices (highlighted by denials of coverage because of “preexisting conditions” and changes of employers) became more commonplace, the nation’s healthcare system became troubled.

Consumers became first perplexed and then angered by the rapidly evolving and shifting healthcare system’s institutional look. The role of freestanding hospitals declined, and massive *systems* took their place. The intricacies of HMOs had to be parsed, traditional private practices gave way to mysterious combinations of physicians with their ever-more-focused subspecialties, and the modern patient saw his or her illness treated through something called an “integrated delivery system.”

The last decade of the twentieth century brought much cacophony but little in the way of actual accomplishment as to healthcare legislation. Despite the frenetics of the healthcare marketplace, very little was translated into federal tax law. The Clinton Administration’s massive effort to reform the healthcare delivery system failed. The 103d Congress (1993–1994) spent a major portion of its second session struggling with many versions of healthcare legislation; not much came of that. Subsequent years saw Congress talk much about healthcare delivery law revision, including a substantial focus on managed care; nothing, however, was enacted.

As the debate in and outside Congress about the appropriateness, as a matter of tax policy, of tax exemption for nonprofit hospitals and similar entities has intensified,¹ greater attention has been given to the possibility of legislation on the topic. For example, legislation was introduced late in 2006 to deny exempt status and impose excise taxes on healthcare providers that fail to provide a minimum level of charitable medical care.² Not long thereafter, the Internal Revenue Service³ set the stage for the enactment of tax legislation concerning the exemption criteria for hospitals when it developed a wholly revamped annual information return (Form 990), including its Schedule H.⁴ This legislation emerged in 2010, as the legislative crown jewel of the Obama administration, in the form of the Patient Protection and Affordable Care Act,⁵ as amended by the Health Care and Education Reconciliation Act of 2010,⁶

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1. See Chapter 3.
 2. Tax Exempt Hospitals Responsibility Act of 2006 (H.R. 6420, 109th Cong., 2nd Sess. (2006)).
 3. The Internal Revenue Service is referenced throughout this book as the “IRS” or, occasionally, the “Service.”
 4. See § 35.4(xv).
 5. Pub. L. No. 111-148, 124 Stat. 119 (2010).
 6. Pub. L. No. 111-152, 124 Stat. 1029 (2010).

1.1 CONSTITUTIONAL LAW PERSPECTIVE

bringing, among a dazzling array of new laws, additional criteria to be satisfied by exempt hospitals as a condition of retention of exempt status.⁷

The absence of substantial federal healthcare legislation (until 2010) has not slowed the ongoing revision of and expansion in health law. Experiments at the state level and the forces of the marketplace are rapidly altering the way healthcare services are being provided in this country. Of great importance, the policymakers in the Department of the Treasury and in the IRS are continuing to reshape the role of nonprofit, tax-exempt healthcare providers and funders in the healthcare delivery process.

This book concerns the *law of tax-exempt healthcare organizations*. For the most part, this law consists of federal health law and tax law requirements. Other relevant federal and state laws that apply to tax-exempt healthcare organizations are referenced throughout the book.

§ 1.1 CONSTITUTIONAL LAW PERSPECTIVE

There is no explicit right to healthcare embedded in the United States Constitution.⁸ This is not surprising. The Constitution is a sketch of the structure and functioning of the federal government and its relationship with the states, not a framework for the entirety of U.S. society.⁹ Indeed, one commentator noted that the “provisions of the Constitution indicate that the framers were somewhat more concerned with guaranteeing freedom *from* government, rather than with providing for specific rights to government services such as for health care.”¹⁰

Yet Congress has repeatedly enacted healthcare legislation. The primary source of constitutional authority for these laws are Congress’s power to regulate commerce¹¹ and its power to tax and spend for the general welfare.¹² Bodies of healthcare law that have passed constitutional muster include the Hospital Survey and Construction Act, the Emergency Medical Treatment and Active Labor Act, the Medicare program, the Medicaid program, the Children’s Health Insurance Program, and many tax laws.

7. Internal Revenue Code of 1986, as amended, (IRC) section (§) 501(r). *See* § 26.10.

8. The Constitution of the World Health Organization (2006) defines *health* as a “state of complete physical, mental and social wellbeing and not merely the absence of disease or infirmity.” A Health Insurance Portability and Accountability privacy rule states that the phrase *healthcare* connotes the means for the achievement of health, as in the “care, services or supplies related to the health of an individual” (45 C.F.R. § 160.103).

9. *See* CONSTITUTIONAL LAW, Chapter 1.

10. Swendiman, “Health Care: Constitutional Rights and Legislative Powers,” Congressional Research Service, 7-5700 (July 9, 2012).

11. U.S. Const., Art. 1, § 8, cl. 3.

12. *Id.*, cl. 1.

TAX-EXEMPT HEALTHCARE ORGANIZATIONS—AN OVERVIEW

The most recent health care law considered by the U.S. Supreme Court¹³ led to decisions that the individual health insurance mandate was unconstitutional as a breach of Congress's Commerce Clause power, but survived constitutional law scrutiny as a valid exercise of Congress' taxing power and that Congress cannot threaten the states with loss of all federal Medicaid funding if the states decline to expand Medicaid coverage as Congress mandated.¹⁴

§1.2 DEFINING TAX-EXEMPT ORGANIZATIONS

A *tax-exempt organization* is a unique entity.¹⁵ Almost always, it is a *nonprofit organization*.¹⁶ The concept of a nonprofit organization is usually a matter of state law;¹⁷ the concept of a tax-exempt organization is principally a matter of the federal tax law.¹⁸

The universe of nonprofit organizations in the United States comprises the nation's *nonprofit sector*—a name that has not been a totally comfortable fit for those within the sector. Over the years, it has been called, among other appellations, the “philanthropic sector,” “private sector,” “voluntary sector,” “third sector,” and “independent sector.” In a sense, none of these terms is appropriate.¹⁹

Essentially, there are three *sectors* in a democratic or civil society: governmental, for-profit, and nonprofit. Governmental entities are the branches, departments, agencies, and the like, of the federal, state, and local governments. For-profit entities comprise the business or commercial sector of a society. Nonprofit organizations constitute the nonprofit sector,²⁰ which is critical for

13. Patient Protection and Affordance Care Act. See Chapters 13 and 26.

14. *National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566 (2012). See CONSTITUTIONAL LAW § 4.8.

15. This body of law is discussed in detail in TAX-EXEMPT ORGANIZATIONS.

16. The term *nonprofit organization* is used throughout, rather than the term *not-for-profit organization*. The latter term is technically proper usage (e.g., in the federal tax setting) to describe activities (rather than organizations) the expenses of which do not qualify for the business expense deduction (IRC § 162) because they are not undertaken with the requisite “profit” motive (IRC § 183).

17. Nearly every state has a nonprofit corporation law; many have extensive laws pertaining to trusts and other unincorporated entities. Occasionally, a nonprofit organization is created by federal statute. See, in general, STARTING AND MANAGING, Chapters 2–4.

18. Nearly every state's tax law makes provision for some forms of tax-exempt organizations (and charitable contribution deductions), but these laws tend to follow the federal approach.

19. An excellent compilation and discussion of these and other such terms are available in HODGKINSON, LYMAN, AND ASSOCIATES, THE FUTURE OF THE NONPROFIT SECTOR (1989).

20. This summary is substantially oversimplified; the roles of the sectors are rarely so orderly and functionally classifiable. Instead, there is much overlap of functions among the sectors, such as when a nonprofit organization engages in a commercial activity (an unrelated business (see Chapter 24)) or when a for-profit organization engages in an activity thought by some to be exclusively in the domain of the nonprofit sector (such as scientific research or community services). One of the sources of the confusion about healthcare organizations is the fact that, in the United States, these organizations are found in all three societal sectors.

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the maintenance of freedom and as a bulwark against the excesses of the other two sectors.

In addition to confining the organization's purpose to *nonprofit* endeavors, the rules of state law concerning the creation of nonprofit organizations usually address subjects such as the origin and composition of the organization's governing board, the functions of the officers, the nature of committees, voting and document amendment processes, and mergers, liquidations, and dissolutions.

There is a substantial conceptual difference between *nonprofit* organizations and *tax-exempt* organizations. Almost all tax-exempt organizations are nonprofit organizations, but some types of nonprofit organizations are ineligible for forms of federal and/or state tax exemptions. Thus, certain types of nonprofit healthcare organizations cannot qualify as tax-exempt organizations.

Indeed, there is considerable misunderstanding as to what the word *nonprofit* means. The use of that descriptive does *not* mean that a nonprofit organization cannot earn a "profit"—an excess of revenue over expenses. Indeed, many nonprofit organizations—and the healthcare field is at the top of this list—generate considerable "profits." Rather the essential difference between a nonprofit organization and a for-profit organization is embedded in the *private inurement doctrine*.²¹ For the most part, this difference is rarely found in the organization's structure or operating characteristics: both categories of organizations require a legal form, almost always have directors and officers, pay compensation, face basically the same expenses, and are able to receive a "profit," make investments, and produce goods and/or services.

The concept of a nonprofit organization is best understood by comparing it with a for-profit organization. A for-profit entity has owners—those who hold equity in the enterprise, such as stockholders in a corporation or partners in a partnership. A nonprofit organization rarely has owners;²² however, both types of organizations have controlling persons or bodies. For-profit and nonprofit organizations are entitled to earn a profit, known as profit at the *entity level*. The chief feature differentiating these organizations is the purpose to which the entities' profits are directed.

The for-profit organization is operated for the purpose of generating a profit or benefit for its owners. The profits of the enterprise are passed through the organization to its owners for their private benefit and use, such as the

21. See Chapter 4.

22. A few states allow nonprofit corporations to issue stock; this is done for control purposes only. The stock does not carry with it any *rights* to dividends.

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payment of dividends to the stockholders of a corporation. This transfer of profits (the federal tax law defines them as *net earnings*) is termed *inurement* of the profits. A for-profit organization is intended to generate a profit for its owners. The passage of the profits from the for-profit organization to its owners is an inurement of net earnings to the owners in their private capacity.

In contrast, a nonprofit organization generally is not permitted to distribute its profits to those who control and/or financially support it; that is, most nonprofit organizations are not permitted to engage in forms of private inurement. (This prohibition on private inurement is reflected in the criteria of several categories of tax-exempt organizations, including nearly all types of exempt healthcare organizations.) The nonprofit organization usually seeks to devote its profits to some end that is beneficial to society. Consequently, the private inurement doctrine is the substantive dividing line that separates, for law purposes, nonprofit organizations from for-profit organizations.

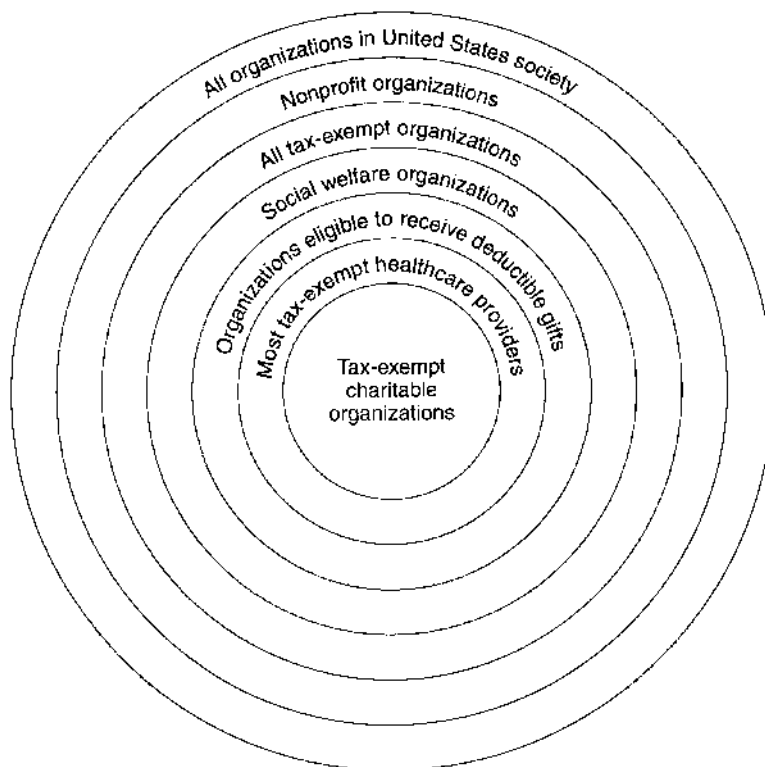


EXHIBIT 1.1

The Nonprofit Sector

1.3 RATIONALES FOR TAX EXEMPTION

The private inurement doctrine is applicable to many types of tax-exempt organizations, but it is most pronounced and developed with respect to charitable organizations.²³

Thus, there are subsets and subsets within the nonprofit sector. Tax-exempt organizations are subsets of nonprofit organizations. Charitable organizations are subsets of tax-exempt organizations. Many types of tax-exempt healthcare organizations are subsets of charitable organizations.²⁴

These elements of the nonprofit sector may be visualized as a series of concentric circles, as shown in Exhibit 1.1.

For a variety of reasons, the organizations comprising the nonprofit sector of the United States have been granted exemption from federal and state taxation and, in some instances, have been made eligible to receive contributions that are tax-deductible under federal and state law. Yet, despite the longevity of many of these exemptions and deductions, their underlying rationale is usually vague and varying. Nonetheless, the rationales for tax exemption (and the charitable contribution deduction) are long-standing public policy, an inherent tax theory, and unique and specific reasons that occasioned the enactment of a particular tax provision.

§ 1.3 RATIONALES FOR TAX EXEMPTION

One commentator astutely observed that the various categories of tax-exempt organizations “are not the result of any planned legislative scheme” but were “enacted over a period of eighty [now over 100] years by a variety of legislators for a variety of reasons.”²⁵

The federal income tax dates from 1913, when the Revenue Act of that year was passed, in the aftermath of ratification of the Sixteenth Amendment to the U.S. Constitution. Congress had attempted to create a corporate income tax in 1894; that enactment succumbed to a constitutional challenge.²⁶ Both measures contained some categories of tax-exempt organizations, including charitable, educational, and religious entities. (Prior to 1894, all customs and other tax legislation enacted by Congress specified the entities subject to taxation; thus, until that date, tax “exemption” existed by virtue of statutory omission.)

23. The federal law of tax exemption for charitable organizations requires that each of these entities be organized and operated so that “no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual” (IRC § 501(c)(3)). See, in general, Chapter 4.

24. The complexity of the federal tax law is such that the charitable subsector is also divided into two segments: (1) charitable organizations that are *private foundations* and (2) those that are *public charities* (the latter being all charitable organizations that are not private foundations). (See Chapter 5.)

25. McGovern, “The Exemption Provisions of Subchapter F,” 29 *Tax Lawyer* 523, 524 (1976).

26. *Pollock v. Farmers’ Loan and Trust Co.*, 157 U.S. 429 (1895), *overruled on other grounds*, *State of South Carolina v. Baker*, 485 U.S. 505 (1988).

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Although most of the legislative history accompanying the 1913 tax act and subsequent revenue acts is silent on the reasons for initiating and continuing tax exemptions (and, later, charitable contribution deductions), the rationale for tax exemption for charitable and similar organizations is relatively clear. It represented the extension of comparable practice throughout the whole of history. “[The] history of mankind reflects that our early legislators were not setting precedent by exempting [from tax] religious or charitable organizations.”²⁷ Presumably, Congress simply believed that these organizations should not be taxed and found the proposition sufficiently obvious as to not warrant extensive explanation.

For the United States and other democratic nations, the community of nonprofit organizations is a necessary ingredient of a civil society. Through these organizations, citizens can resolve societal problems and enhance the quality of life for all, without channeling all problem-solving efforts through government. In this sense, the nonprofit sector mirrors the traditional American wariness of the state; fear of “big government” is assuaged by the “pluralism of institutions.”²⁸ Therefore, the thinking underlying the tax policy in this setting was and has been that taxation of most nonprofit organizations would be antithetical to and frustrative of the political philosophy on which the nation is based.

There is a related, albeit secondary, rationale to be considered. Clues to it are found in the federal tax regulations, where *charitable* activities are defined as including purposes such as the relief of the poor, advancement of education or science, erection or maintenance of public buildings, and lessening of the burdens of government.²⁹ The exemption for charitable organizations is, then, a derivative of the concept that they perform functions that, in the absence of the organizations, government would have to perform. Therefore, government is willing to forgo the tax revenues it would otherwise receive in return for the public services rendered by charitable organizations (and, to some extent, social welfare organizations³⁰).

Since the founding of the United States and even in the earlier colonial period, tax exemption—particularly with respect to religious organizations—was common. Churches were openly and uniformly spared taxation. This practice has been sustained throughout the nation’s history—not only at the federal but at the state and local levels as well, most significantly with property taxation. The U.S. Supreme Court, soon after the commencement of the nation’s

27. McGovern, *supra* note 25, at 527. Also, Hansmann, “The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation,” 91 *Yale L.J.* 69 (1981); Bittker and Rahdert, “The Exemption of Nonprofit Organizations from Federal Income Taxation,” 85 *Yale L.J.* 299 (1976).

28. MILL, ON LIBERTY (1859).

29. Income Tax Regulations (Reg.) § 1.501(c)(3)-1(d)(2).

30. *See* § 1.9.

1.3 RATIONALES FOR TAX EXEMPTION

tax system, concluded that the foregoing rationalization was the basis for the federal tax exemption for charitable entities. In 1924, the Court noted that “[e]vidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain.”³¹ Many years later, the Court, in upholding the constitutionality of the tax exemption for religious organizations, observed that “[t]he State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification [tax exemption] useful, desirable, and in the public interest.”³²

In respect to the exemption for charitable organizations, a federal court of appeals wrote that “[o]ne stated reason for a deduction or exemption of this kind is that the favored entity performs a public service and benefits the public or relieves it of a burden which otherwise belongs to it.”³³ One federal court wrote that the reason for the charitable contribution deduction has “historically been that by doing so, the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government.”³⁴

One of the rare congressional pronouncements on this subject is further evidence of this public policy aspect of the rationale. In its committee report accompanying the Revenue Act of 1938, the House Committee on Ways and Means stated:

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.³⁵

In testimony before the Committee in 1973, the then-Secretary of the Treasury observed:

These [charitable] organizations are an important influence for diversity and a bulwark against over-reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair.³⁶

31. *Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santisimo Rosario de Filipinas*, 263 U.S. 578, 581 (1924).

32. *Walz v. Tax Commission*, 397 U.S. 664, 673 (1970).

33. *St. Louis Union Trust Co. v. United States*, 374 F.2d 427, 432 (8th Cir. 1967).

34. *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972).

35. H.R. Rep. No. 1860, 75th Cong., 3rd Sess. 19 (1939).

36. “Proposals for Tax Change,” Department of the Treasury, Apr. 30, 1973, at 72.

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One writer, focusing on what he termed “voluntarism,” stated:

Voluntarism has been responsible for the creation and maintenance of churches, schools, colleges, universities, laboratories, hospitals, libraries, museums, and the performing arts; voluntarism has given rise to the private and public health and welfare systems and many other functions and services that are now an integral part of the American civilization. In no other country has private philanthropy become so vital a part of the national culture or so effective an instrument in prodding government to closer attention to social needs.³⁷

The public policy justification for tax exemption (particularly for charitable organizations) was reexamined and reaffirmed by the Commission on Private Philanthropy and Public Needs in its findings and recommendations in 1975. The Commission offered this sketch of the function of and rationale for nonprofit organizations in America:

Few aspects of American society are more characteristically, more famously American than the nation’s array of voluntary organizations, and the support in both time and money that is given to them by its citizens. . . . The practice of attending to community needs outside of government has profoundly shaped American society and its institutional framework. While in most other countries, major social institutions such as universities, hospitals, schools, libraries, museums and social welfare agencies are state-run and state-funded, in the United States many of the same organizations are privately controlled and voluntarily supported. The institutional landscape of America is, in fact, teeming with nongovernmental, noncommercial organizations. . . . This vast and varied array is, and has long been, widely recognized as part of the very fabric of American life. It reflects a national belief in the philosophy of pluralism and in the profound importance to society of individual initiative.³⁸

There are other explanations for tax exemption, although they are not often pertinent to healthcare organizations, particularly healthcare providers. These rationales include the inherent tax theory, which holds that the operation of certain nonprofit organizations is not a *taxable event* and underlies the tax exemption for social clubs,³⁹ homeowners’ associations,⁴⁰ and political organizations.⁴¹ Tax exemption for some nonprofit membership organizations vests to some degree on the constitutionally protected right of association. Other provisions for tax-exempt status have been grafted onto the federal tax law as a by-product of other legislative efforts or as the handiwork of “special interests.”⁴²

37. Fink, “Taxation and Philanthropy—A 1976 Perspective,” 3 *J. Coll. & Univ. L.* 1, 6–7 (1975).

38. COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, *GIVING IN AMERICA—TOWARD A STRONGER VOLUNTARY SECTOR* 9–10 (1975).

39. Organizations that are tax-exempt under IRC § 501(a) by reason of description in IRC § 501(c)(7).

40. Organizations that are tax-exempt to the extent provided in IRC § 528.

41. Organizations that are tax-exempt to the extent provided in IRC § 527.

42. A more extensive analysis of these rationales is in *TAX-EXEMPT ORGANIZATIONS* §§ 1.3–1.6.

1.4 CATEGORIES OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS

Thus, exemption from taxation for certain types of nonprofit organizations is a principle that is larger than the vicissitudes of taxation. The action of citizens in combating problems and reaching solutions on a collective, non-governmental basis is inherent in the very nature of the American societal structure. Nonprofit entities are traditional in the United States, and their role and responsibility are not diminished in modern society. To tax nonprofit entities would be to flatly repudiate and contravene this public policy doctrine, which is so much a part of the nation's heritage and strength.

Consequently, it is erroneous to regard tax exemption (or, where appropriate, the charitable contribution deduction) as anything other than a reflection of this larger doctrine. Congress is not merely "giving" eligible nonprofit organizations "benefits"; this exemption from taxation (or charitable deduction) is not a "loophole," a "preference," or a "subsidy." Rather, this tax policy is reflective of the affirmative decision by government to not inhibit by taxation the beneficial activities of qualified tax-exempt organizations acting in community and other public interests.

Yet, no constitutional law protects tax exemption for healthcare organizations or for any other type of tax-exempt entities. Congress is essentially free to structure the rules for federal tax exemption and the incentives for charitable giving as it wishes.

§ 1.4 CATEGORIES OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS

Of the many categories of tax-exempt healthcare organizations, the ones that are the deliverers of healthcare services—the healthcare providers—are usually *charitable organizations*. This classification has three meanings in the federal tax law:⁴³

1. The charitable entity is tax-exempt because of its charitable focus—in contrast with other entities that are, for example, educational or religious.⁴⁴ These charitable organizations may have features of other exempt organizations, such as functions that are educational (teaching hospitals), religious (healthcare entities controlled by a church), or scientific (research entities).
2. The entity is charitable in the sense that it is subject to all of the general law pertaining to charitable, educational, religious, and similar entities.⁴⁵ (This general law includes the private inurement doctrine,⁴⁶ the distinction between public charities and private foundations,⁴⁷ the proscriptions

43. See, in general, § 1.5.

44. IRC § 501(c)(3).

45. *Id.*

46. See Chapter 4.

47. See Chapter 5.

TAX-EXEMPT HEALTHCARE ORGANIZATIONS—AN OVERVIEW

on lobbying and political campaign activities,⁴⁸ the unrelated business rules,⁴⁹ and the federal and state laws regulating fundraising.⁵⁰)

3. The charitable entity is eligible to receive contributions that are tax-deductible as charitable gifts.⁵¹

Some tax-exempt healthcare organizations qualify for federal tax exemption as social welfare organizations, not as charitable entities.⁵² In a given category of healthcare organizations, some may, under certain circumstances, constitute charitable organizations while others are social welfare organizations. The best case in point is the health maintenance organization.⁵³

The realm of exempt healthcare organizations includes other nonprofit entities. Healthcare organizations are members of business associations and other forms of business leagues that serve their policy and their other interests.⁵⁴ Organizations serving physicians and other healthcare practitioners often have the same federal tax status.⁵⁵ A healthcare organization may have a tax-exempt parent (or holding) corporation,⁵⁶ one or more supporting organizations,⁵⁷ a development foundation,⁵⁸ a title-holding company,⁵⁹ and the right to utilize tax-exempt benefit funds⁶⁰ or be involved in a tax-exempt cooperative organization.⁶¹ Tax exemption is available for qualified nonprofit health insurance issuers.⁶² Exemption may be provided for types of state or regional health benefit exchanges,⁶³ information organizations, accountable care organizations,⁶⁴ and state health insurance exchanges.⁶⁵

§ 1.5 CHARITABLE HEALTHCARE ORGANIZATIONS

Most healthcare organizations that are tax-exempt under federal law have that status because they are charitable organizations.⁶⁶ The types of these

48. See Chapter 7.

49. See Chapter 24.

50. See Chapter 31. See, in general, FUNDRAISING.

51. IRC § 170(c)(2). See, in general, CHARITABLE GIVING.

52. See § 1.8.

53. See § 2.9.

54. See Chapter 18, particularly § 18.2.

55. *Id.*, particularly § 18.3, and Chapter 19.

56. See § 20.2.

57. See § 5.5.

58. See Chapter 14.

59. See Chapter 15.

60. See Chapter 28.

61. See Chapter 17.

62. See § 13.3.

63. See § 19.5.

64. See § 13.5.

65. See § 13.4.

66. See § 1.4.

1.5 CHARITABLE HEALTHCARE ORGANIZATIONS

organizations and the legal basis for their exemptions are discussed throughout the book; this section provides only a brief overview.

A tax-exempt charitable healthcare organization is likely to be a provider of healthcare services because, in large part, the *promotion of health* is one of the principal rationales for this category of tax exemption.⁶⁷ The organizations that are tax-exempt because they qualify for this classification include hospitals,⁶⁸ certain managed care organizations,⁶⁹ certain home health agencies,⁷⁰ qualifying homes for the aged,⁷¹ a variety of ambulatory care providers,⁷² and integrated delivery systems.⁷³ Another justification for this form of tax exemption may be that the entity is operating for the purpose of *relieving the poor*.⁷⁴

Other types of charitable healthcare organizations are tax-exempt, not because they are healthcare providers, but because they are facilitators for organizations that do deliver healthcare services. Among them are development foundations,⁷⁵ supporting organizations,⁷⁶ private foundations,⁷⁷ holding corporations,⁷⁸ and cooperative hospital service organizations.⁷⁹

67. See § 1.8.

68. See Chapter 8.

69. See Chapter 9.

70. See Chapter 10.

71. See Chapter 11.

72. See Chapter 12.

73. See Chapter 23.

74. See § 1.6. There are altogether at least 15 rationales by which organizations can be considered charitable for federal income tax purposes (see TAX-EXEMPT ORGANIZATIONS, Chapter 7); these other ways are infrequently utilized in the healthcare context. In one instance, arguments that an organization ostensibly providing exempt-purpose services to hospitals failed; the organization claimed tax exemption on the ground of advancement of education and lessening the burdens of government (*University Medical Resident Services, P.C. v. Commissioner*, 71 T.C.M. 3130 (1996)).

75. See Chapter 14.

76. See § 5.5.

77. See § 5.9.

78. See § 20.2.

79. See § 17.1. Despite decades of law development, there still is disagreement as to what the scope of the term *charitable* is, at the federal and state levels, in the healthcare context and in general. A case in point involved a public charity that operates a mental health center; it provides its services on an outpatient basis, principally to indigents. Its application for a real property tax exemption was denied by the state tax authorities, largely on the ground that the entity was not *charitable*, in that it received very little in the way of charitable gifts. This decision was overturned by a court, which held that "significant private donations are not required [for an organization to be considered *charitable*] as a matter of law" (*State Department of Assessments and Taxation v. North Baltimore Center, Inc.*, 743 A.2 d 759 (Md. Ct. Spec. App. 1999)). At the federal law level, at least, the extent of charitable contributions is basically irrelevant in determining whether an organization is charitable. In this case, the organization is clearly *charitable* in nature, in that it provides relief to the poor (see § 1.6) and promotes health (see § 1.7).

TAX-EXEMPT HEALTHCARE ORGANIZATIONS—AN OVERVIEW

§ 1.6 THE LAW OF CHARITABLE TRUSTS

The federal tax law providing tax exemption for charitable organizations has as its antecedents the English common law of trusts. That law, over the centuries, evolved to a recognition that entities other than individuals are to be recognized as persons in the eyes of the law. The first of these persons was the *trust*, itself influenced by advances in the law of property. (Other persons, such as corporations and partnerships, came much later.)

The first of the charitable persons was the *charitable trust*. Today, the charitable trust remains as one of the three basic forms that a tax-exempt charitable organization can take (the other two are corporations and unincorporated membership associations).⁸⁰ Because of issues relating to personal liability for trustees, directors, and officers,⁸¹ however, the contemporary tax-exempt charitable healthcare organization is likely to be a nonprofit corporation.

This use of the corporate form is particularly appropriate for an operating institution, such as a hospital or home for the aged. By contrast, the trust form may remain suitable for a development foundation, supporting organization, other separate endowment fund, scholarship or research fund, or private foundation.

§ 1.7 RELIEF OF POVERTY

The federal tax law provides income tax exemption for organizations that are organized and operated exclusively for charitable purposes. The term *charitable* is used in this context in its “generally accepted legal sense” and is, therefore, not to be construed as limited by other purposes that may fall within the broad outlines of *charity* as developed by the courts.⁸² The most traditional of these definitions is embraced by the concept of *relief of poverty*. Many of the tax exemptions for healthcare organizations were initially based on this rationale; some still are.

The federal tax regulations define the term *charitable* as including “[r]elief of the poor and distressed or of the underprivileged.”⁸³

The relief of poverty is the most basic and historically founded form of charitable activity. Assistance to the poor (but not necessarily the absolutely destitute) is the common concept of giving *charity* or assisting by “[distributing] money or goods among the poor, by letting land to them at low rent, by making loans to them, by assisting them to secure employment, by the establishment of a home or other institution, by providing soup kitchens and the like.”⁸⁴ The

80. See TAX-EXEMPT ORGANIZATIONS § 4.1(a).

81. See PLANNING GUIDE, Chapter 1.

82. Reg. § 1.501(c)(3)-1(d)(2). Also Reg. § 1.501(c)(3)-1(d)(1)(i)(b).

83. Reg. § 1.501(c)(3)-1(d)(2).

84. RESTATEMENT OF TRUSTS (2nd ed. 1959) § 369, comment a.

1.7 RELIEF OF POVERTY

layperson's concept of charity (or philanthropy) is very much the money-dispensing or soup-kitchen approach to easing the burdens of the underprivileged.

As society progressed, organizations recognized as tax-exempt because they relieved the poor, distressed, or underprivileged began to emphasize the provision of services and to deemphasize the "handout" type of charitable work. Rulings by the IRS provide a wide range of illustrations of these organizations.⁸⁵

Among the entities that are especially visible in the healthcare setting are those that perform the following activities: home delivery of meals to the elderly,⁸⁶ transportation services for the elderly and handicapped,⁸⁷ operation of a service center providing information, referral, and counseling services in the health field,⁸⁸ vacations for the elderly poor at a rest home,⁸⁹ and provision of rescue and emergency services to individuals suffering because of a disaster.⁹⁰

The view that charity consists of assistance to the poor has had a major role in the formation of tax policy applicable to nonprofit healthcare organizations. Indeed, for years, the tax exemption for nonprofit hospitals and similar entities rested on that justification.⁹¹ This rationale, which was resurrected in the 1990s, is termed the *charity care standard*.⁹²

In 1969, however, the IRS issued revised criteria as to what constitutes a *charitable hospital*.⁹³ In that year, the IRS concluded that the *promotion of health* was itself a charitable purpose as long as the requisite charitable class was present; specifically, the ruling enabled a nonprofit hospital to qualify for tax exemption where it simply provided emergency room services to all individuals requiring healthcare, irrespective of their ability to pay. This standard became known as the *community benefit standard*.⁹⁴

A lawsuit ensued, and a federal district court held that a hospital, to be tax-exempt as a charitable entity, must significantly serve—without full charge or with no charge—the poor.⁹⁵ The court concluded that "Congress and the judiciary have consistently insisted that the application of . . . [the charity tax exemption and contribution deduction rules] to hospitals be conditioned upon a demonstration that ameliorative consideration be given poor people in need of hospitalization."⁹⁶ To find otherwise, wrote the court, would be "to disregard

85. See TAX-EXEMPT ORGANIZATIONS, §§ 7.1, 7.2.

86. Rev. Rul. 76-244, 1976-1 C.B. 155.

87. Rev. Rul. 77-246, 1977-2 C.B. 190.

88. Rev. Rul. 75-198, 1975-1 C.B. 157.

89. Rev. Rul. 75-385, 1975-2 C.B. 205.

90. Rev. Rul. 69-174, 1969-1 C.B. 149.

91. See § 26.1.

92. See § 26.3.

93. Rev. Rul. 69-545, 1969-2 C.B. 117.

94. See Chapter 6 and § 26.3.

95. *Eastern Kentucky Welfare Rights Organization v. Shultz*, 370 F. Supp. 325 (D.D.C. 1973).

96. *Id.* at 332.

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what has been held to be the underlying rationale for allowing charitable deductions.⁹⁷

This construction of the term *charitable* was, however, reversed.⁹⁸ On finding that the law of charitable trusts has promotion of health as a charitable purpose, the appellate court held that the term *charitable* is “capable of a definition far broader than merely relief of the poor.”⁹⁹ After reviewing the changes in the financing of healthcare in the United States over past decades (including the advent of Medicare and Medicaid), the court found that the rationale by which the charitable status of hospitals is confined to the extent they provide for the poor “has largely disappeared.”¹⁰⁰ The court observed that “[t]oday, hospitals are the primary community health facility for both rich and poor.”¹⁰¹

In a similar development, the IRS based a finding of charitable status for an organization solely on the ground that it relieves the “distressed, irrespective of whether they are also poor. The occasion was the consideration by the IRS of the tax treatment of a nonprofit hospice that operated on both inpatient and outpatient bases to assist individuals of all ages, who have been advised by a physician that they are terminally ill, in coping with the distress arising from their condition.”¹⁰² Thus, the classification of the organization as a charitable entity was predicated on the fact that the hospice “alleviat[ed] the mental and physical distress of persons terminally ill.”¹⁰³

Consequently, a charitable purpose is not necessarily dependent on a showing that the poor are being relieved. As one writer stated, it is “a general rule in the construction of exemptions from taxation that the word ‘charity’ is not to be restricted to the relief of the sick or the poor, but extends to any form of philanthropic endeavor or public benefit.”¹⁰⁴ Previously, another commentator had observed that, “[a]lthough the relief of the poor, or benefit to them is, in its popular sense a necessary ingredient in the charity, this is not so in the view of the law.”¹⁰⁵

97. *Id.* at 333.

98. *Eastern Kentucky Welfare Rights Organization v. Simon*, 506 F.2d 1278 (D.C. Cir. 1974).

99. *Id.* at 1287.

100. *Id.* at 1288.

101. *Id.* The *Eastern Kentucky* case was heard by the U.S. Supreme Court, which never ruled on the substance of the case, holding only that the plaintiffs lacked standing to bring the action (*Simon v. Eastern Kentucky Welfare Rights Organization*, 426 U.S. 26 (1976)). This conclusion was subsequently reached by the court of appeals for the Sixth Circuit in *Lugo v. Miller*, 640 F.2d 823 (6th Cir. 1981), *rev'g* (on the issue) *Lugo v. Simon*, 453 F. Supp. 677 (N.D. Ohio 1978).

102. Rev. Rul. 79-17, 1979-1 C.B. 193. A similar discussion, concerning comparable forms of distress facing the elderly, appeared in an IRS ruling concerning homes for the aged (*see* Chapter 11). An IRS analysis of the distress confronting the physically handicapped is contained in Rev. Rul. 79-19, 1979-1 C.B. 195.

103. Rev. Rul. 79-17, 1979-1 C.B. 193.

104. BLACK, A TREATISE IN THE LAW OF INCOME TAXATION 40 (2nd ed. 1950).

105. ZOLLMAN, AMERICAN LAW OF CHARITY 135-136 (1924).

1.8 PROMOTION OF HEALTH

§ 1.8 PROMOTION OF HEALTH

As discussed, the promotion of health is recognized in the federal tax law as an independent basis for classification of a nonprofit organization as a charitable entity.¹⁰⁶ The promotion of health as a charitable purpose includes the establishment or maintenance of hospitals, clinics, homes for the aged, and the like; advancement of medical and similar knowledge through research; and the maintenance of conditions conducive to health.

Some of the various entities in the healthcare setting that are tax-exempt on this basis, as recognized by the IRS, include those with the following activities: assistance in securing a private room at a hospital;¹⁰⁷ facilitation of visits to hospital patients by family and friends;¹⁰⁸ operation of a health club for individuals in a community;¹⁰⁹ operation of a mobile cancer screening program;¹¹⁰ sale of hearing aids by a hospital;¹¹¹ interpretation of diagnostic tests by one hospital for another, where the latter lacks the necessary resources;¹¹² sale of pharmaceuticals to a hospital's patients;¹¹³ operation of a gift shop by a hospital;¹¹⁴ operation of a cafeteria and coffee shop by a hospital;¹¹⁵ and operation of a parking lot by a hospital.¹¹⁶

106. Rev. Rul. 69-545, 1969-2 C.B. 117. See TAX-EXEMPT ORGANIZATIONS § 7.6.

107. Rev. Rul. 79-358, 1979-2 C.B. 225.

108. Rev. Rul. 81-28, 1981-1 C.B. 328.

109. Tech. Adv. Mem. 8505002.

110. Priv. Ltr. Rul. 8749085.

111. Rev. Rul. 78-435, 1978-2 C.B. 181.

112. Priv. Ltr. Rul. 8004011.

113. Rev. Rul. 68-375, 1968-2 C.B. 245.

114. Rev. Rul. 69-267, 1969-1 C.B. 160.

115. Rev. Rul. 69-268, 1969-1 C.B. 160.

116. Rev. Rul. 69-269, 1969-1 C.B. 160. Because promotion of health also occurs in the for-profit sector, for that activity to be sheltered from taxation by reason of being charitable, it must be in a nonprofit organization (*see* § 1.1). This reflects the fact that a healthcare activity in a for-profit entity can be made an exempt function simply by transferring it to a nonprofit entity (e.g., Priv. Ltr. Rul. 9710030, in which a transfer of activities from a physicians' group medical practice to an exempt charitable organization converted the activities to exempt functions, and, as explained in Priv. Ltr. Rul. 9747040, gave rise to a charitable contribution deduction).

It should be noted, however, that the IRS has recognized for-profit professional corporations of physicians as tax-exempt charitable organizations where they are otherwise organized and operated for exempt purposes and state law requires that such practices be maintained in a professional corporation under the corporate practice of medicine doctrine. *See, e.g.,* IRS determination letters issued to Saint Vincent Medical Education and Research Institute; North Shore Medical Specialists; Physicians Network, P.C.; and Marietta Health Care Physicians. It should be noted, however, that the IRS has recognized for-profit professional corporations of physicians as tax-exempt charitable organizations where they are otherwise organized and operated for exempt purposes and state law requires that such practices be maintained in a professional corporation under the corporate practice of medicine doctrine. *See, e.g.,* IRS determination letters issued to Saint Vincent Medical Education and Research Institute; North Shore Medical Specialists; Physicians Network, P.C.; and Marietta Health Care Physicians.

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Health, for this purpose, includes “mental health” and would include, were it not for a separate enumeration in the federal tax law description of charitable organizations, the prevention of cruelty to children.¹¹⁷ This rationale for tax-exempt status, particularly for hospitals, has, as discussed, become known as the community benefit standard.¹¹⁸

§ 1.9 SOCIAL WELFARE ORGANIZATIONS

Federal tax law provides exemption from income taxation for social welfare organizations.¹¹⁹ This type of organization was originally conceived as a civic entity; thus, the exemption is for “[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare. . . .”¹²⁰

There is no precise definition of the term *social welfare* for these purposes. The federal tax regulations accompanying this category of tax-exempt organization offer only these basic precepts: (1) social welfare is commensurate with the “common good and general welfare” and “civic betterments and social improvements,”¹²¹ and (2) the promotion of social welfare does not include activities that primarily constitute “carrying on a business with the general public in a manner similar to organizations which are operated for profit.”¹²²

An exempt social welfare organization must function for the benefit of those in a *community*. Thus, for example, homeowners’ associations that maintain common areas for the residents and enforce architectural covenants qualify as tax-exempt social welfare organizations.¹²³ Where there is significant benefit for the individual members, however, tax exemption may not be available.¹²⁴ Thus, an organization operating a vision care plan by contracting with subscribers was held to not qualify for tax-exempt status as a social welfare organization, in part because the membership-based structure caused the entity to not serve the requisite community.¹²⁵ An organization claiming to be an agency providing home healthcare services to residents of five facilities in various locations was found by the IRS to be merely a registry, matching the needs of residents with independent service providers for a fee; the organization was denied recognition of exemption as a social welfare entity primarily because it did

117. RESTATEMENT OF TRUSTS (2nd ed. 1959) § 372, comment b.

118. See § 1.7, text accompanied by notes 93–94.

119. IRC § 501(a), for organizations described in IRC § 501(c)(4). See, in general, TAX-EXEMPT ORGANIZATIONS, Chapter 13.

120. Reg. § 1.501(c)(4)-1(a)(1).

121. Reg. § 1.501(c)(4)-1(a)(2)(i).

122. Reg. § 1.501(c)(4)-1(a)(2)(ii).

123. Rev. Rul. 72-102, 1972-1 C.B. 149, modified by Rev. Rul. 76-147, 1976-1 C.B. 151.

124. Rev. Rul. 74-99, 1974-1 C.B. 131.

125. *Vision Service Plan v. United States*, 2006-1 U.S.T.C. ¶ 50,173 (E.D. Cal. 2005), *aff’d*, 2008-1 U.S.T.C. ¶ 50, 160 (9th Cir. 2008), *cert. den.*, 129 U.S. 898 (2009).

1.9 SOCIAL WELFARE ORGANIZATIONS

not serve the requisite community.¹²⁶ Essentially, whether a particular community is being served is to be determined according to the facts and circumstances of each case.¹²⁷

Historically, prepaid healthcare plans have been categorized as tax-exempt social welfare organizations.¹²⁸ Some health maintenance organizations can qualify as exempt charitable organizations; others are relegated to social welfare status.¹²⁹

The experience with HMOs in this regard is illustrative. The concept of *social welfare* is broader than that of *charitable*; thus, any exempt charitable organization can qualify as an exempt social welfare organization, although the reverse is not the case. For this reason, many organizations that cannot qualify as tax-exempt charitable organizations become tax-exempt social welfare entities. For example, an organization that is precluded from charitable status solely because of excessive legislative activities¹³⁰ can constitute a social welfare organization because these entities are not circumscribed as to lobbying efforts. In short, these organizations can engage in more advocacy efforts than charitable ones. Exempt social welfare organizations, however, cannot attract charitable contributions that are deductible for federal income, estate, and gift tax purposes.

Consequently, the contemporary use of the social welfare organization category of tax exemption is generally for the healthcare organization that cannot qualify as a charitable entity or for the nonprofit organization that could constitute an exempt charitable entity but for its extensive advocacy activities.

The IRS has a considerable propensity to import federal tax law principles applicable to tax-exempt charitable organizations to shape the law applicable to exempt social welfare organizations.¹³¹ For example, the agency asserted that the private benefit doctrine¹³² is applicable with respect to social welfare organizations, in denying recognition of exemption on this basis to an organization seeking to increase the number of women in public service and politics.¹³³ Likewise, the IRS is of the view that the commerciality doctrine¹³⁴ applies

126. Priv. Ltr. Rul. 200544020.

127. Rev. Rul. 80-63, 1980-1 C.B. 116. The private inurement proscription (*see* Chapter 4) is expressly applicable to tax-exempt social welfare organizations (IRC § 501(c)(4)(B)).

128. For example, this was the tax exemption category for most Blue Cross and Blue Shield Associations (*see* § 13.1), until the enactment of IRC § 501(m) (*see* § 9.3).

129. *See* § 9.1.

130. *See* § 7.1.

131. Congress is doing the same; an example is the treatment of both IRC § 501(c)(3) and (4) organizations as applicable tax-exempt organizations (*see* § 4.9).

132. *See* § 4.6.

133. Exemption Denial and Revocation Letter (Ex. Den. and Rev. Ltr.) 20044008E.

134. *See* § 3.3.

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as part of the federal tax law concerning social welfare organizations;¹³⁵ for example, an organization that facilitated the sale of health insurance by for-profit insurance companies to participating employers and their employees, and provided administrative services to these companies for a fee, failed to be recognized as an exempt social welfare organization because it engaged in commercial activities.¹³⁶

135. The first time this was done was in Priv. Ltr. Rul. 200501020.

136. Priv. Ltr. Rul. 200512023.