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# Public Charity Update: Other Courts Weigh In

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## Public Charity Update: Other Courts Weigh In

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## PUBLIC CHARITY UPDATE: OTHER COURTS WEIGH IN

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By: **Lucinda E. Jesson and Myron L. Frans\***

### I. Introduction

On April 15, 2008, we published our article, *What Qualifies as a Public Charity? Minnesota Enters the National Debate*, describing the increased governmental scrutiny of nonprofits and Minnesota's significant entry into that national discussion. Our article concluded with practical suggestions, particularly for governing boards of the category of nonprofits known as "purely public charities", as they navigate uncertain waters due to state and national developments.

The short six months since publication featured continued debate. Four hundred colleges and universities began receiving compliance questionnaires from the IRS focused on unrelated business income, endowments and executive compensation practices, as part of the continued study of tax-exempt entities. Faced with increased scrutiny of the ban on political campaign activity by charities, some churches found themselves in court. The IRS issued the final redesigned 990 package, which includes a new section on governance, changes for nonprofit hospital reporting, and additional executive compensation disclosure requirements. Further, the Minnesota Legislature enacted a one-year moratorium on changes in assessment practices for a subset of public charities.

Against this flurry of legislative and regulatory activity, three cases from the judicial branch of government stand out: *Provena Covenant Medical Center v. Department of Revenue*; *New Habitat, Inc. v. Tax Collector of Cambridge*; and *HealthEast v. County of Ramsey*. In our update below, we analyze these cases against the backdrop of the ongoing national debate and the Minnesota Supreme Court's "clarification" of the six-factor test that is used to determine qualification as a purely public charity for purposes of state property tax exemption in *Under the Rainbow*. We then update our advice to nonprofit boards in light of these developments.

### II. Illinois Appellate Court holds that the Provision of Medical Care, in and of itself, Does Not Qualify a Non-profit Hospital for a Property Tax Exemption.

We reported in our initial article about a dispute that captured national attention, Provena Covenant Hospital's claim for property tax exemption in Illinois. We noted that the trial court ruled in favor of an exemption for Provena Covenant Hospital on July 27, 2007. The *Provena* decision was noteworthy in part because the administrative decision denying the exemption relied on a similar analysis to the *Rainbow* case in Minnesota. That is, did Provena provide a substantial portion of its services for free or at a substantially reduced fee?

Recently, however, the Illinois Appellate Court reversed that trial court's decision. The *Provena* case illustrates just how tortured the path to exemption, or non-exemption, can be. Below is the timeline:

- **Exemption Denied - February 2004.** The Illinois Department of Revenue denied a claim for property tax exemption by Provena for tax year 2002. Prior to its ruling, the Champaign County Board of Review recommended denial for Provena's property tax exemption request to the Illinois Department of Revenue. Provena appealed this administrative ruling. A hearing before an administrative law judge (ALJ) was held. The ALJ submitted findings of fact and law, and recommended approval for the property tax exemption request.
- **Exemption Denied - September 29, 2006.** The Director of the Illinois Department of Revenue rejected the ALJ recommendations and affirmed the Department's denial of the property tax exemption.
- **Exemption Granted - July 27, 2007.** The Illinois Circuit Court issued a one-paragraph decision reversing the Department, thereby granting the property tax exemption, as reported in our previous article.
- **Exemption Denied - August 26, 2008.** The Illinois Appellate Court issued a lengthy decision reversing the Circuit Court, thereby denying the property tax exemption.

The facts behind the lengthy court battle provide an interesting context for exemption decisions. Provena is a not-for-profit, general acute-care hospital, owned and operated as an apostolic mission and health-care ministry of the Catholic Church. The Hospital sought a property tax exemption for two reasons: first, that the hospital was used primarily for charitable purposes, and second, that the hospital was used primarily for religious purposes.

The facts behind the lengthy court battle provide an interesting context for exemption decisions. Provena is a not-for-profit, general acute-care hospital, owned and operated as an apostolic mission and health-care ministry of the Catholic Church. The hospital sought a property tax exemption, because the hospital functioned primarily for charitable and religious purposes.

The appellate court rejected both reasons and held that the hospital failed to demonstrate that it was entitled to either a charitable or a religious exemption in 2002. The standard of review used by the court was whether the Director's decision was based on clear error. Because the court found no clear error by the Director, it reversed the circuit court thereby denying the exemption.

In its decision, the appellate court primarily focused on whether Provena was owned and used for charitable purposes. While the court recognized that the hospital had no capital and did not profit from the enterprise, the court noted that "[i]t is far from obvious, however, that Provena is a gift to the public. . . [and] unclear to what extent Provena exercises 'general benevolence' as opposed to doing what a for-profit hospital does: selling medical services." The appellate court found the following to be significant reasons that the Director's decision was not clearly in error: Provena spent only 0.7% of its revenue on charity care in 2002; Provena's charity care program considered only the patient's income without considering the amount of the medical bill or other patient liabilities; Provena's collection policies for unpaid bills failed to exclude charity patients; and Provena's use of "average costs" to calculate charity care exaggerated the amount of charity care.

The appellate court also rejected the claim that Provena qualified for a religious exemption and found that more than 99.99% of Provena's patients entered into contracts to pay for medical treatment. Further, of the \$115 million in revenue in 2002, only \$6,938 came from donations. The court concluded that Provena resembled a business with religious overtones, not a property used primarily for religious purposes.

### III. Massachusetts Charts a Markedly Different Course in *New Habitat, Inc.*

In a decidedly different approach from the *Rainbow* and *Provena* decisions, the Massachusetts Supreme Judicial Court ruled in favor of a property tax exemption claim made by a non-profit housing entity. The court used a more liberal test for determining how "traditional charities" qualify as "literary, benevolent, charitable or scientific institutions." The timeline:

- **Exemption Denied.** The trial court denied a claim for property tax exemption by New Habitat for tax years 2004, 2005 and 2006.
- **Exemption Granted - July 3, 2008.** The Massachusetts Supreme Judicial Court reversed and granted the property tax exemption for New Habitat.

New Habitat is a nonprofit entity that provides long-term housing and supportive services for persons with acquired brain injury. The maximum number of residents is four. Like the hospital in *Provena* and the childcare center in *Rainbow*, New Habitat charges fees for its services to the residents.

The Massachusetts Supreme Judicial Court summarized the various non-determinative factors that a court must weigh to determine whether an organization qualifies as charitable and entitled to a property tax exemption. These factors include whether the organization provides low-cost or free services to those unable to pay and whether it charges fees for its services as well as the size of those fees. Although the factors listed are similar to those factors weighed by other courts, the Massachusetts Supreme Judicial Court provided a perspective markedly different from that taken in Minnesota. The Massachusetts Court stated that the significance of the various factors depends upon the dominant purposes and methods of the organization. Accordingly, the court stated, "we consider the charging of fees to be more significant the farther the organization's dominant purposes and methods are from traditionally charitable ones." In other words, the more an organization's dominant purposes and methods are close to traditional charities, the less significance the factors (including the charging and amount of fees of services) have in determining charitable status.

Applying this guiding principle to New Habitat, the Court found that New Habitat's purposes and methods are traditionally charitable. New Habitat's methods of charging fees for services and its small number of beneficiaries play a less significant role in determining its charitable status. In addition, the charitable status of New Habitat was not adversely affected, because its residents had the wealth to seek alternative treatment. The Massachusetts Supreme Court concluded that under its traditional charity analysis, New Habitat qualified as a charity.

The more liberal approach of the Massachusetts Supreme Court strongly favors traditional charities. New Habitat likely would have failed the exemption test, which focuses on the "gift" as described by the Minnesota Supreme Court in *Rainbow* and applied in *Provena*. In contrast, the *New Habitat* test creates close to a safe harbor for traditional charities.

#### IV. Minnesota Moves Forward after *Rainbow in HealthEast v. County of Ramsey*.

At the conclusion of our earlier article, we suggested that public charities review their activities in light of all the recent changes affecting public charities. We also noted a pending case before the Minnesota Supreme Court that was released on May 22, 2008, *HealthEast v. County of Ramsey*. In *HealthEast*, the Minnesota Tax Court denied a property tax exemption. The Supreme Court reversed the Tax Court and remanded the case for further proceedings, which are pending. The *HealthEast* case illustrates the complexities involved when a not-for-profit health care provider leases its facilities to another non-profit health care provider. First, the timeline:

- **Exemption Denied - May 1, 2007.** The Minnesota Tax Court denied a claim for property tax exemption by HealthEast for tax years 2002, 2003 and 2004.
- **Exemption Undecided (remand for further proceedings) - May 22, 2008.** The Minnesota Supreme Court reversed the Tax Court's denial of property tax exemption and remanded for additional proceedings.
- **Exemption Undecided - July 7, 2008.** The Tax Court issued an order for the remand proceedings.

Generally property tax exemptions require that an exempt entity *own and use* the entity for an exempt purpose. But in the *HealthEast* case, there was not a concurrence of ownership and use. HealthEast is a not-for-profit corporation that owned the property and operated Bethesda Clinic on the site. Bethesda Clinic is a separate legal entity and a not-for-profit corporation. During the years at issue, the University of Minnesota (a constitutionally tax exempt entity) leased and operated Bethesda Clinic. For the last two years at issue, University of Minnesota Physicians (a not-for-profit corporation) assumed the lease and operated Bethesda Clinic. Thus, HealthEast owned the property and the University of Minnesota Physicians used it.

HealthEast relied on a specific exception to the own and use requirement. Under Minnesota Statute section 273.19, subdivision 1, when a tax-exempt entity leases tax-exempt property for longer than one year, the property remains tax-exempt. First, HealthEast argued that it qualified for exemption under this statute because HealthEast (and its subsidiaries, including Bethesda Clinic) were tax-exempt when considered as a whole, not separate entities (which they are legally). Second, the property (Bethesda Clinic) was held under a lease for longer than one year by a tax-exempt entity, University of Minnesota Physicians, and it was used for a tax-exempt purpose.

The Minnesota Supreme Court found that the Tax Court applied the statutory exception incorrectly. The court ruled that the tax court must first consider whether the separate legal status of HealthEast and its subsidiaries should be disregarded, because the corporation (HealthEast) had no purpose or existence apart from the operations of the healthcare system of which it was a part (including its subsidiaries, such as Bethesda Clinic). Since the record was not complete on this issue, the Minnesota Supreme Court ordered a remand for further proceedings. If on remand, HealthEast meets its burden to prove that it did not have a purpose or existence apart from its healthcare system, then the Minnesota Supreme Court directed the tax court to conclude that for purposes of section 273.19, the HealthEast care system was the owner of the property. Such a conclusion would result in a property tax exemption if the lease agreement was determined to be between two tax-exempt entities, HealthEast and the University of Minnesota Physicians. Surprisingly, the Court did not address the issue of whether the University of Minnesota Physicians qualified as a purely

public charity, despite the tax court ruling that the physician group failed to satisfy the North Star factors.

On July 7, 2008, the Minnesota Tax Court issued an order for additional proceedings precisely on the following questions: (1) whether HealthEast had a purpose or existence apart from its healthcare system, (2) whether HealthEast performs services outside the HealthEast care system, and (3) the nature of HealthEast's relationship as the parent corporation to the public hospitals and clinics in its care system. All responses to the Tax Court's order were due by August 26, 2008, and the parties are awaiting the Court's decision.

## V. Conclusion

We conclude by reiterating our original advice to Minnesota Board of Directors of public charities. The different approaches taken by the *Provena* and *New Habitat* courts illustrate the continued uncertainty faced by charities that charge for their services, particularly where the charities seek state property tax exemptions. They reinforce the renewed need to examine whether an entity's current practices reflect the underlying charitable mission of the organization. In addition, we urge non-profit entities that serve as umbrella organizations for other corporate entities to examine carefully the corporate structure in light of the *HealthEast* decision. Finally, we urge all to stay tuned for further developments and - perhaps - much needed clarification.

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Lucinda E. Jesson and Myron L. Frans, *What Qualifies as a Public Charity? Minnesota Enters the National Debate*, William Mitchell Journal of Law and Practice, Apr. 15, 2008, <http://lawandpractice.wordpress.com/2008/04/15/what-qualifies-as-a-public-charity-minnesota-enters-the-national-debate/> *Id.* See Press Release, Internal Revenue Service, IRS Sends Compliance Questionnaires to 400 Colleges and Universities (Oct. 1, 2008), <http://www.irs.gov/irs/article/0,,id=187328,00.html>.

See, e.g., Jon Tevlin, *In Court, Brooklyn Park Church Argues IRS' Reach Goes Too Far*, Star Tribune, Oct. 3, 2008.

See also Internal Revenue Service, Political Activities Compliance Initiative (2008 Election), July 28, 2008, <http://www.irs.gov/charities/charitable/article/0,,id=181565,00.html> (discussing the components of the IRS' Political Activities Compliance Initiative, which "seeks to educate section 501(c)(3) organizations . . . about the federal ban on political activity").

Internal Revenue Service, Redesignated Form 990 - Form and Instructions (September 2008), Sept. 11, 2008, <http://www.irs.gov/charities/article/0,,id=185561,00.html>.

S. 2869, 2008 Leg., 85th Sess. (Minn. 2008). The Minnesota Department of Revenue was directed to report to the legislature in February 2009 after studying the issue of qualification of purely public charities.

Provena Covenant Med. Ctr. v. Dep't of Revenue, 894 N.E.2d 452 (Ill. App. Ct. 2008).

New Habitat, Inc. v. Tax Collector of Cambridge, 889 N.E.2d 414 (Mass. 2008).

Health East v. County of Ramsey, 749 N.W.2d 15 (Minn. 2008).

Under the *Rainbow Child Care Center, Inc. v. County of Goodhue*, 741 N.W.2d 880 (Minn. 2007). As discussed in detail in our original article, the Minnesota Supreme Court reviewed the six factor test (the "North Star factors") that is used to determine qualification as a purely public charity. See *supra* note 1. The court held that these factors generally must be applied to the facts of each case. *Id.* The third factor, which looks to whether the intended purpose of the charity is to provide a substantial portion of its goods or services without charge or for a substantially reduced fee, must be satisfied in every case. *Id.* The court stated that the essence of a charity requires that the charity give something away. *Rainbow*, 741 N.W.2d at 884, 887. We note that the North Star factors, as interpreted by *Rainbow*, only apply to the category of nonprofits known as "purely public charities." See *supra* note 1. As discussed in our original article, the Minnesota Constitution sets out which nonprofits qualify as tax-exempt entities. *Id.* In addition to "institutions of purely public charities", public hospitals, colleges and universities, churches and houses of worship, public schools and burying grounds, seminaries, and public property used exclusively for public purposes are explicitly named as exempt from taxation. Minn.Const. Art. X §. 1.

See *supra* note 1.

Provena Covenant Medical Center, 894 N.E.2d 452 (Ill. App. Ct. 2008).

See *Id.*

*Id.*

*Id.* at 455-56.

*Id.*

*Id.*

*See supra* note 1

Provena Covenant Medical Center, 894 N.E.2d 452 (Ill. App. Ct. 2008).

*Id.* at 456-57.

*Id.* at 456.

*Id.* at 482.

*Id.* at 459.

*See Provena Covenant Medical Center*, 894 N.E.2d at 482.

*Id.* at 459.

*Id.* at 461. The appellate court applied the factors set forth in *Methodist Old Peoples Home v. Korzen*, 233 N.E.2d 537, 541-42 (Ill. 1968), which inquire into whether, "(1) the institution bestows benefits upon an indefinite number of persons for their general welfare, or the benefits in some way reduce the burdens on government; (2) the institution has no capital, capital stock, or shareholders and does not profit from the enterprise; (3) the funds of the institution are derived mainly from private and public charity and are held in trust for the purposes expressed in the charter; (4) charity is dispensed to all who need it and apply for it; (5) the institution puts no obstacles in the way of those seeking the charitable benefits; and (6) the primary use of the property is for charitable purposes." *Provena Covenant Medical Center*, 894 N.E.2d at 460. Although the appellate court discussed the ambiguity of the factors and the lack of guidance as to how to apply them, nonetheless, the court found that Provena only satisfied factor two in that it had no capital stock and did not profit from the enterprise. *Id.* at 461.

*Id.* at 469, 474.

*Id.* at 480.

*Id.*

*Id.* In a very recent decision involving state sales and use taxes (as opposed to the property tax exemptions at issue in *Provena* and *Rainbow*), the West Virginia Supreme Court ruled that a nonprofit hospital is not exempt from paying the taxes because it is not supported primarily by gifts, grants, or charitable contributions. *Davis Mem'l Hosp. v. W. Va. Tax Comm'r*, No. 33862, 2008 WL 4613409 (W.Va. Oct. 14, 2008). The West Virginia law governing exemption from the sales and use taxes requires that an exempt entity "annually receives more than one half of its support from any combination of gifts, grants, direct or indirect charitable contributions or membership fees." *Id.* (quoting W. Va. Code § 11-5-9(a)(6)(C) (2007 & Supp. 2008)). Looking at legislative history to interpret what constitutes "support", the court held that the hospital must include receipts from patient revenues as part of its gross receipts. *Id.* Thus, the hospital was not entitled to a refund of the nearly \$800,000 it paid in state consumer sales and use taxes. *Id.*

*See Infra* note 23.

New Habitat, Inc. v. Tax Collector of Cambridge, 889 N.E.2d 414 (Mass. 2008).

*Id.* at 418-19

*Id.* at 417.

*Id.*

*Id.* at 417.

*New Habitat, Inc.*, 889 N.E.2d at 417.

*Id.* Monthly charges range from \$17,000 to \$18,000 per month. *Id.*

*Id.* at 418.

*Id.* Other factors include whether the entity offers its services to a large or "fluid" group of beneficiaries; whether the organization provides its services to those from all walks of life; and whether the entity limits its services to those who fulfill certain qualifications and how those limitations help advance its charitable purposes. *Id.* at 418-19.

*Id.*

*New Habitat, Inc.*, 889 N.E.2d at 419.

*Id.*

*Id.* at 419-20.

*Id.* at 420.

*Id.*

*Id.* at 422.

*See supra* note 1.

HealthEast v. County of Ramsey (HealthEast II), 749 N.W.2d 15 (Minn. 2008).

*Id.*

*Id.*

HealthEast v. County of Ramsey (HealthEast I), Nos. C4-03-4664, C3-04-4505, CO-05-4553, 2007 WL 1319417 (Minn. T.C. 2nd Jud. Div. May 1, 2007), rev'd 749 N.W.2d 15 (2008).

*HealthEast II*, 749 N.W.2d 15.

*HealthEast I*, Nos. C4-03-4664, C3-04-4504, CO-05-4553 (Minn. T.C. 2nd Jud. Div. July 7, 2008) (order setting briefing schedule and determining scope on remand) available at <http://www.taxcourt.state.mn.us/published%20orders/2008/healtheast%20v%20ramsey%20county%202007-07-08.doc> [hereinafter Remand Order].

*HealthEast II*, 749 N.W.2d at 18.

*Id.* at 17.

*Id.*

*Id.*

*Id.* at 16-17.

*HealthEast II*, 749 N.W.2d at 17.

*Id.* at 19.

*Id.* at 20.

*Id.* at 19.

As a matter of complication, section 273.19 provides its own definition of tax exemption. The Tax Court interpreted the definition under this section to require that only the owner, or HealthEast, could be considered in determining whether it is (1) a benevolent society or institution, or (2) a corporation whose property is not taxed in the same manner as other taxable property is. The Tax Court found that HealthEast by itself failed to qualify under either test. Thus the Tax Court found that HealthEast failed the definitional test of a tax-exempt entity. Under the Tax Court's analysis, HealthEast's claim for property tax exemption under section 273.19 failed. *Id.* at 19.

*HealthEast II*, 749 N.W.2d at 20-24.

*Id.* at 23-24.

*Id.* at 24.

*Id.*

Remand Order, *supra* note 26.

*Id.*

*See supra* note 1.