Federal Income Tax Exemption for Private Hospitals

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FEDERAL INCOME TAX EXEMPTION FOR PRIVATE HOSPITALS

I. INTRODUCTION

Private hospitals are exempt from federal income tax if they are "organized and operated exclusively for . . . charitable, scientific . . . or educational purposes," and if "no part of . . . [their] net earnings . . . inures to the benefit of any private shareholder or individual . . . ." By meeting substantially similar

1. The term "private hospital" as used herein means an organization the principal purposes or functions of which are the providing of hospital or medical care," Treas. Reg. § 1.170-2(b)(4) (1966), with two additional qualifications: it is not controlled by any unit of government (hence the adjective "private"); and, it is not a foundation which does no more than to contribute to a private hospital.


There are, however, other requirements set forth in the basic exempting provision of the Code under which private hospitals may claim exemption:

"(a) Exemption From Taxation.—An organization described in subsection (c) . . . shall be exempt from [income] taxation . . . unless such exemption is denied under sections 502, 503, or 504.

"(c) List of Exempt Organizations.—The following organizations are referred to in subsection (a):

"(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for . . . charitable, scientific . . . or educational purposes, . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." Int. Rev. Code of 1954, § 501(a), (c)(3). Additionally, Communist organizations required to register under the Internal Security Act of 1950, § 11(b), 59 U.S.C. 790(b), are not exempt. Int. Rev. Code of 1954, §§ 501(e). For a brief introduction to the general workings of Int. Rev. Code of 1954, § 501(c)(3), see Schoenfeld, Federal Tax Aspects of Non-Profit Organizations, 10 Vill. L. Rev. 487 (1965).

The denial of exemption mentioned in Int. Rev. Code of 1954, § 501(a), above quoted, by reason of §§ 502-04, largely does not apply to private hospitals, "[A]n organization the principal purposes of which are the providing of medical or hospital care or medical education or medical research," Int. Rev. Code of 1954, § 503(b)(5) is excluded from loss of exemption for participation in prohibited transactions, Int. Rev. Code of 1954, § 503 (see note 111 infra), and for unreasonable accumulation of income. Int. Rev. Code of 1954, § 504. Note that a foundation which contributes its funds to a hospital that provides the actual medical care does not itself share the hospital's exclusion from loss of exemption for prohibited transactions or unreasonable accumulation, Samuel Friedland Foundation v. United States, 144 F. Supp. 74, 90-91 (D.N.J. 1956); Rev. Rul. 54-137, 1954-1 Cum. Bull. 289, unless the money-feeding organization's active work is incidental (other than by providing funds) to the exempt hospital's functions. Hospital Bureau of Standards & Supplies v. United

747
qualifications, an exempt hospital usually enjoys several additional benefits, directly and indirectly provided by the federal tax laws. Direct benefits include freedom from the excise tax on wages imposed by the Federal Unemployment Tax Act and the right to elect whether or not to deduct social security payments from its employees' salaries. A "nonprofit hospital" is also exempt from certain other federal excise taxes. More significant, of course, are the indirect benefits conferred on exempt hospitals by those provisions of the Internal Revenue Code which allow special deductions to donors to exempt hospitals, thereby inducing greater gifts to those hospitals. An individual donor may reduce his taxable income by as much as 30 per cent by contributing to such hospitals; corporate

States, 158 F. Supp. 560 (Ct. Cl. 1958). A private hospital could not be a feeder organization, i.e., "operated for the primary purpose of carrying on a trade or business for profit . . . where all of its profits are payable to one or more organizations exempt under section 501 from taxation." Int. Rev. Code of 1954, § 502. By definition, a "private hospital," cannot support, as its primary purpose, any other exempt organization.

As to the political requirements for income tax exemption, not quoted in the text, see Note, The Revenue Code and a Charity's Politics, 73 Yale L.J. 661 (1964); 55 Calif. L. Rev. 618 (1967).

3. While the direct tax benefits necessarily follow when a hospital meets the income tax exemption qualifications (see notes 4-6 infra), there is no similar one-to-one correlation between income tax exemption and the indirect tax privileges. The correlation, however, is very high. Substantively, nearly identical qualifying language is employed (see notes 7-11 infra). Procedurally, the IRS will challenge, for an organization like a private hospital, both direct and indirect tax privileges when it challenges income tax exempt status. See, e.g., Robert C. Olney, 17 CCH Tax Ct. Mem. 982 (1958). Further, the practical effect of gaining income tax exempt status by application to the IRS (see notes 25-32 infra and accompanying text) is to be accorded the other tax privileges. See Rev. Proc. 64-25, 1964-1 Cum. Bull. 694; S. Weithorn, Tax Techniques for Foundations and Other Exempt Organizations § 45.03[5] (1966) (form letter IRS sends applicant upon exempt determination). The correlation is dramatized in Trenerry, A Literary Pilgrim's Progress Along Section 501(c)(3), 51 A.B.A.J. 252 (1965).

4. Int. Rev. Code of 1954, § 3306(c)(8) defines "employment" subject to the tax so as to exclude employers described in § 501(c)(3) of the Code.


6. E.g., Int. Rev. Code of 1954, § 4253(h) (telephone service tax). An exempt hospital may also be entitled to certain nontax federal privileges, such as preferential postage rates and the right to purchase surplus Federal property at bargain prices. See generally S. Weithorn, supra note 3, pt. IX.

7. Int. Rev. Code of 1954, § 170(a) allows individuals (including personal holding companies described in § 545(b)(2) of the Code) to deduct up to 20% of their taxable incomes, Int. Rev. Code of 1954, § 170(b)(1)(B), for "charitable contributions" to or for the use of organizations described in § 170(c)(2) with similar qualifications to those employed in the income tax exempting subsection, Int. Rev. Code of 1954, § 501(c)(3), supra note 2. Specifically, § 170(c)(2) quotes the purposes restrictions and the inurement prohibition found in § 501(c)(3), while merely simplifying the political non-activity requirements contained in the latter section; its sole addition to § 501(c)(3) is a requirement that the donee be
donors may deduct up to 5 per cent of their taxable incomes. An estate, for purposes of federal estate taxes, is diminished by the whole amount bequeathed to such hospitals. Finally, there are no federal gift taxes on assets transferred to income tax exempt hospitals.

While the precedent for these tax privileges is long-standing and the policy organized in the United States. An additional 10% deduction is available, under § 170(b)(1)(A)(iii), on “charitable contributions” from individuals to “a hospital or medical research organization referred to in subsection 501(b)(5).” The last named subsection, incorporated into the definition of “private hospital” as used herein (see note 1 supra), merely adds the requirement that the donee be actively benevolent as distinguished from being an organization which merely contributes funds to other exempt organizations. Finally, certain individuals may become entitled to 100% deductions for “charitable contributions” if they have donated 90% of their incomes for eight of the preceding 10 years to the class of organizations which includes hospitals. See Int. Rev. Code of 1954, § 170(b)(1)(C).

8. Corporate donors may deduct from their taxable incomes up to 5%, Int. Rev. Code of 1954, § 170(b)(2), for “charitable contributions” to organizations described in § 170(c)(2), which description differs from that found in § 501(c)(3), as specified in note 7 supra, and in the additional requirement that donees of corporate donations use the contributions in the United States or its possessions. (Care must be exercised to distinguish business deductions, Int. Rev. Code of 1954, § 162(b), from charitable ones.)

9. Under §§ 2001, 2101, the value of the taxable estate of a citizen or resident, § 2055, or of an alien non-resident, § 2106, is determined by deducting from the value of the gross estate, among other things, the amount of transfers “to or for the use of any corporation [Treas. Reg. § 20.2055-20 (1958) adds: “or association”] organized and operated exclusively for ... charitable, scientific ... or educational purposes, ... no part of the net earnings of which inures to the benefit of any private stockholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation ...” Int. Rev. Code of 1954, §§ 2055(a)(2), 2106(a)(2). Deductible charitable bequests are subject to territorial restrictions only in the case of a non-resident, non-citizen, whose transfers are deductible only if given to a domestic corporation. Int. Rev. Code of 1954, § 2106(a)(2).

10. Int. Rev. Code of 1954, § 2522 excludes from gift taxes donations from citizens or residents “to or for the use of ... a corporation or trust, or community chest, fund, or foundation,” § 2522(a)(2), and from alien non-residents “to or for the use of ... a domestic corporation,” § 2522(b)(2), or “a trust, or community chest, fund, or foundation, § 2522(b)(3), which is “organized and operated exclusively for ... charitable, scientific, ... or educational purposes, ... no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation.” Int. Rev. Code of 1954, §§ 2522(a)(2), (b)(2)-(3).

they reflect deep-rooted, their application requires continued pragmatic balancing. On the one hand, there exist private hospitals whose charitable organization and operation are but ruses executed primarily to capture tax privileges for their founders; whereas other private hospitals may be deterred from exercising their honestly charitable intentions because the complexity surrounding exemption may discourage or prevent them from enjoying the privileges which often make their charity possible. In defining the requirements for income tax exemption, and thus usually for the other federal tax privileges, the courts and the Internal Revenue Service must weigh, not so much the variances in human cupidity, but rather, the public value in stimulating private charity against the fiduciary duty to the public which tax privilege imposes.

II. REQUIREMENTS FOR EXEMPTION

The Internal Revenue Service has named four specific requirements for a private hospital’s exemption from income taxes. Three of them are derived directly from the general Code requirements governing all exempt charitable

12. The basic purpose of all such exemptions and privileges is to encourage and assist charity. C.F. Mueller Co. v. Commissioner, 190 F.2d 120, 122 (3d Cir. 1951).

13. Considerable debate has recently occurred concerning the tax privileges afforded foundations. See Staff of the Senate Comm. on Finance, 89th Cong., 1st Sess., Treasury Department Report on Private Foundations (Comm. Print 1965); Staff of House Comm. on Ways & Means, 89th Cong., 1st Sess., Written Statements by Interested Individuals and Organizations on the Treasury Department Report on Private Foundations (Comm. Print 1965); Foundations and the Law: A Symposium, 13 U.C.L.A.L. Rev. 933 (1966). While the debate has largely centered on certain activities of “foundations,” there is no legal reason why exempt private hospitals may not participate in similar activities. For example, a “foundation” may invest the funds contributed to it so as to overtly enhance its ability to contribute to such actively charitable organizations as hospitals. Covertly, by so investing, “foundations” may obtain control of the businesses in which they have invested. This control has been often criticized as unrelated to the charitable purposes of the foundations and as unfair to those taxpayers who may wish to control the business themselves. Of course, a private hospital may also purchase controlling shares of business concerns, if its receipts from donations and paying patients allow it, so as to add to its funds available to treat indigent patients. Thus the debate revolving around the foundations has a certain degree of relevance to the practices of private hospitals.


15. Such complexity is illustrated in Treas. Reg. § 1.501(c)(3)—1(b)(1)(iii)-(iv), which denies income tax exempt status to an organization which operates in a completely charitable manner merely because it is organized in such a conflicting way as to authorize one substantial non-charitable function while limiting its general purposes to solely charitable ones.


17. Rev. Rul. 56-185, 1956-1 Cum. Bull. 202-03: “[I]n regard to hospitals and similar organizations, the Internal Revenue Service takes the position that the term “charitable” in its legal sense and as it is used in section 501(c)(3) of the Code contemplates an implied public trust constituted for some public benefit, the income or beneficial interest of which may not inure to the benefit of any private shareholder or individual.”

organizations. Thus, to be free from income tax liability, a private hospital must, first, "be organized as a nonprofit charitable organization for the purpose of operating a hospital for the care of the sick." Second, "[i]t must be operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay." Third, "[i]ts net earnings must not inure directly or indirectly to the benefit of any private shareholder or individual." In addition, the Service has, on grounds of public policy, included a fourth requirement that an exempt hospital refrain from restricting "the use of its facilities to a particular group of physicians and surgeons, such as a medical partnership or association, to the exclusion of all other qualified doctors."

Before these requirements can be meaningfully interpreted, a word on procedure is needed. While substantial fulfillment of all the requirements affords exempt status, in practice, a private hospital must secure an individual determination of exempt status from the Internal Revenue Service. To obtain it, an organization must submit a detailed "Exemption Application" along with whatever written instruments created the hospital organization, and certain other documents. On the basis of this information, where the organization is not yet in operation, or on the basis of such information plus evidence on operations, the Service will determine whether the private hospital merits exempt status. If merited, the Service sends a letter of determination stating that the hospital is exempt.

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24. Rev. Proc. 62-30, 1962-2 Cum. Bull. 512, 515. "Exemption is usually effective as of the date of formation of an organization if, during the period prior to the date of the ruling or determination letter, the purposes and activities of the organization were entirely consistent with the facts constituting the basis for the exemption." See Savings Feature of the Relief Dept. of the B. & O.R.R., 32 B.T.A. 295, 305-06 (1935).
25. The alternative is litigating the issue of exempt status, should an organization try to exert such status without first securing the IRS determination. Loss of the litigation would necessitate payment, not only by the organization but by its benefactors, of back taxes and penalties. On the difficulty of such litigation, see S. Weithorn, supra note 6, at § 30.01.
26. Form 1023, Rev. April, 1965, in S. Weithorn, supra note 6, at § 45.04[1][a].
exempt from federal income tax and reciting certain of the other federal tax privileges customarily co-existent with such exempt status. Such a private determination may be reviewed and revoked at the discretion of the Service, even retroactively under certain circumstances. From an unfavorable determination, of course, a private hospital may appeal within the Service and to the courts.

A. Organization

In derogation of prior interpretation, the current Treasury Regulations have made organization exclusively for exempt purposes a separate, substantive test.

30. Treas. Reg. § 1.501(a)-1(a)(2) (1959): "Subject only to the Commissioner's inherent power to revoke rulings because of a change in the law or regulations or for other good cause, an organization that has been determined . . . exempt under section 501(a) . . . may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation." See Rev. Rul. 54-146, 1954-1 Cum. Bul. 88.
31. Int. Rev. Code of 1954, § 7805(b) has been held to permit the Commissioner to apply revocations retroactively, even where an organization has relied on the prior ruling, unless such revocation constitutes an abuse of discretion. Dixon v. United States, 381 U.S. 68, 72-73 (1965); Automobile Club v. Commissioner, 353 U.S. 180, 183-85 (1957). In practice, when the IRS revokes a private exemption determination, it will assess all taxes which would have been paid had the prior determination been consistent with the revoking one. See, e.g., Davis Hospital Inc., 4 CCH Tax Ct. Mem. 312 (1945). If contested and the organization is found to have been not deserving of exemption during the years before the exempt ruling was revoked, courts have no hesitancy at rendering judgment for back taxes. See Kenner v. Commissioner, 318 F.2d 652, 636 (7th Cir. 1963); Lorain Ave. Clinic, 31 T.C. 141, 164-65 (1958). Occasionally where retroactive application of a revocation of exempt determination would be highly unfair, the courts have prohibited such application as an abuse of the Commissioner's discretion. See Lesavoy Foundation v. Commissioner, 238 F.2d 589 (3d Cir. 1956).
32. When the IRS, on district and national levels, determines an organization non-exempt, and assesses taxes against it, the organization may either not pay assessed taxes and appeal to the United States Tax Court and then to a United States Court of Appeals, or it may pay the tax assessment and sue for return in federal district court or the United States Court of Claims. I.R.S. Publ. No. 183, revised Sept., 1954; 3 CCH 1967 Stand. Fed. Tax Rep. ¶ 3025.165. See also Int. Rev. Code of 1954, § 7422.
33. Initially, the Service put such emphasis upon the articles of organization as to have effectively adopted the "new" organizational test. See O.D. 190, I Cum. Bull. 194 (1919): "The character of the corporation must be judged by its articles of incorporation, constitution and by-laws rather than the declarations of its officers or the method by which it conducts or has conducted its business." While this approach received early judicial sanction, see Sun-Herald Corp. v. Duggan, 73 F.2d 298, 300 (2d Cir. 1934), it was later usually rejected. See Roche's Beach, Inc. v. Commissioner, 96 F.2d 776, 778 (2d Cir. 1938); John Danz Charitable Trust, 32 T.C. 469, 476-77 (1959), aff'd, 284 F.2d 726 (9th Cir. 1960). The IRS seemed to have accepted this rejection, prior to 1959, when it advised, specifically in reference to hospital exemptions, that: "A non-profit hospital chartered only in general terms as a charitable corporation can meet the test as being organized exclusively for charitable purposes. See Commissioner v. Battle Creek, Inc., 126 F.2d 405 [9th Cir. 1942]." Rev. Rul. 56-185, 1956-1 Cum. Bull. 202, 203. In the cited case, the organization was, during the time in question, organized under Florida general corporation laws, with "broad powers
for all organizations, such as private hospitals, which seek to establish their exempt status after July 26, 1959.\textsuperscript{34} Organizations which were ruled exempt prior to that time are specifically excluded from the change;\textsuperscript{35} however, most would probably find it advantageous, should their exemption ever be questioned, to have conformed their organization to the new requirement.\textsuperscript{36}

The organizational test determines a private hospital's exemption solely\textsuperscript{37} on the basis of its "articles of organization," the "articles" being "any written in-

and privileges that [were] never intended to be used . . . ." The court found it exempt largely because its intent, established without reference to the articles, was to copy a similar, clearly exempt, sanitarium. Commissioner v. Battle Creek, Inc., supra, at 405-06.

34. Treas. Reg. § 1.501(c)(3)-1(a)(1) (1959): "If an organization fails to meet either the organizational test or the operational test, it is not exempt."

There is an important nuance in the "newness" of this current organizational requirement. While courts and the IRS have always imposed an organizational test, as they must under the Code section granting exemption, (see notes 2 & 11 supra), they have not until the 1959 change in the Treasury Regulations required that the organizational test be passed solely (see note 37 infra) on the basis of the instruments which have created the organization. See note 34 supra. Naturally, the change in the Treasury Regulations binds only the IRS. The courts can and possibly will continue to admit evidence extrinsic to the instruments in determining whether an organization passes this test. See Passaic United Hebrew Burial Ass'n v. United States, 216 F. Supp. 500, 502-03 (D.N.J. 1963). Apparently, only one court has used the new test, and it found the organization involved exempt. Lewis v. United States, 189 F. Supp. 950, 952-53 (D. Wyo. 1961). It would seem that the courts are inclined to exclude extrinsic evidence tending to contradict instruments which permit the inurement of the organization's assets to individuals (see notes 53-56 infra), but they reveal no tendency to exclude such evidence as to the other facets of the organizational test. However, whether or not the courts accept the change, the IRS will not grant exemption to any organization which fails the new test. Practically, this means that any organization which was not ruled exempt prior to the change, and which fails the new organizational test, can establish its exemption only by litigation in courts which have not made clear their intentions as to the new test.


36. Curiously, should an organization which was ruled exempt under prior Treasury Regulations alter its articles so as to conform them to the new organizational test, it would probably be required to reapply for exempt status. See Treas. Reg. § 1.501(a)-1(a)(2) (1959).

37. "An organization is organized exclusively for one or more exempt purposes only if its articles of organization . . . fulfill certain specified requirements. Treas. Reg. § 1.501(c) (3)-1(b)(1)(i) (1959). See text accompanying note 40 infra. The meaning is made more clear at Treas. Reg. § 1.501(c) (3)-1(b)(1)(iv): "The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes shall not be sufficient to permit the organization to meet the organizational test. Similarly, such an organization will not meet the organizational test as a result of statements or other evidence that the members thereof intend to operate only in furtherance of one or more exempt purposes." In discussing this subsection of the Treasury Regulations, one court has suggested that evidence of intentions or operations, extrinsic to the articles, may supplement the articles so as to allow them to pass the organizational test, unless the articles recite purposes which are broader than those permitted to exempt organizations under § 501(c)(3) of the Code. Lewis v. United States, 189 F. Supp. 950, 953 (D. Wyo. 1961).
strument by which an organization is created.\textsuperscript{38} While the form of the articles will depend upon state law,\textsuperscript{39} they must: "(a) [l]imit the purposes of such organization to one or more exempt purposes; and (b) . . . not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes."\textsuperscript{40} The surface contradiction between these two requirements can be logically negated by noting that "(a)" refers to the product of an organization while "(b)" refers to its source of income.

Exempt purposes, that is to say, the limitation on the organization's "product" in the articles, may be "as broad as, or more specific than"\textsuperscript{41} the general charitable, educational or scientific purposes enumerated in the Code;\textsuperscript{42} but "in no case" may they be broader.\textsuperscript{43} Apparently, organization "for charitable purposes" is sufficient limitation.\textsuperscript{44} However, where the word "charitable" does not appear, or delimit another such magic word of purpose, such as "educational" or "scientific," the "purposes should be detailed in the articles so as to effect meaningful limitation to the purposes detailed in the Code section."\textsuperscript{45} Moreover, it does not seem to matter if an organization, though strictly organized for only one exempt purpose, operates exclusively for another such purpose.\textsuperscript{46} For a private hospital, a purpose which would pass the organizational test must be more than merely "to care for the sick." Some clearly charitable purpose is necessary. Possibly the best language for the articles is that suggested by the Service as the operational test: The purpose of this hospital is to care "to the extent of its financial ability for those not able to pay for the services rendered."\textsuperscript{47} The addition of other

\textsuperscript{38} Treas. Reg. § 1.501(c)(3)-1(b)(2) (1959).
\textsuperscript{39} No general form of organization, be it business corporation, non-profit corporation, trust, fund, or whatever, is per se exempt or non-exempt; rather the Service and courts look to the stated powers and purposes in ruling on exemption under the organizational test. Hence, the peculiarities of state law and the circumstances of its organization will determine which form a private hospital assumes.
\textsuperscript{40} Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (1959).
\textsuperscript{42} Int. Rev. Code of 1954, § 501(c)(3).
\textsuperscript{44} Treas. Reg. § 1.501(c)(3)-1(b)(1)(ii) (1959).
\textsuperscript{45} Although the statements of purposes contained in the organization's charter and by-laws purport to limit the corporation's purposes to education in the field of government, the statement is only in broad and general terms. The activities . . . [are] not specified. On the basis of the charter provisions, it cannot be ascertained what the corporation deems to be within the scope of the term 'education in the field of government' and what would not be encompassed by that term. Thus, the corporation cannot be considered as organized exclusively for educational purposes within the contemplation of section 501(c)(3) of the Code." Rev. Rul. 60-193, 1960-1 Cum. Bull. 195, 197, modified by Rev. Rul. 66-258, 1966-2 Cum. Bull. 213 (affirming portion of ruling quoted).
\textsuperscript{46} Treas. Reg. § 1.501(c)(3)-1(d)(1)(iii) (1959): "If, in fact, an organization is organized and operated exclusively for an exempt purpose or purposes, exemption will be granted . . . regardless of the purpose or purposes specified in its application for exemption." Note that the articles of incorporation must accompany the application. Supra note 28.
exempt purposes would be advisable or possibly necessary under the state laws governing the organization of the hospital; however, the additional exempt purposes would probably be superfluous for purposes of federal tax exemption.

A more difficult problem than exempt purpose is that of exclusivity.48 To pass the organizational test, the articles of a private hospital must both limit the organization to exempt purposes and empower no substantial engagement in activities which do not further such exempt purposes.49 The conjunction of the two requirements demonstrates that “exclusivity” does not mean “exclusively” in the usual sense but, rather, “substantially” or “primarily,”50 degree words naturally fraught with operational difficulties. However, any attempt in the articles to confer specific powers on a private hospital, where those powers are not clearly necessary to the hospital's fulfillment of its avowed purpose, may at least require litigation to pass the organizational test.51 Probably the safest course is to parrot an equivalent of the treasury regulation: “Notwithstanding any other part hereof, the purposes of said hospital are limited to the above stated charitable purposes, and said hospital may not engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of such charitable purposes.”52

The articles of an exempt private hospital must also clearly prohibit any inurement of benefit to any private shareholder or individual. This aspect of the organizational test is particularly important where, as with a hospital, profits are usually necessary to charitable operations.53 Any hint of profit-sharing by those in control may cost the exemption. For example, in one case where the articles provided for a salary formula based on stock ownership, an organization failed the organizational test even though the salaries were reasonable.54 But where the articles divorce stock ownership from the payment of dividends, thus making it merely an implement of control, exemption has not been denied, though the articles empowered a sole stockholder to set her own salary.55 If not otherwise contradicted in the articles, the inclusion of a provision that “all net profits and net gains arising from the operation and conduct of said business shall be devoted

49. See text at note 40 supra.
51. See Lewis v. United States, 189 F. Supp. 950 (D. Wyo. 1961), where a foundation was held to meet the organizational test since “[t]he trustees have the power to conduct a business only if that operation will aid them in carrying out ‘the express purposes of this Trust.’” Id. at 953. See also Huron Clinic Foundation v. United States, 212 F. Supp. 847 (D.S.D. 1962), vacated per stipulation, 324 F.2d 43 (8th Cir. 1963); 6 J. Merton, Federal Income Taxation § 34.07, at 10 (Supp. 1967).
53. See text at note 90 infra.
exclusively to charity and applied to the expense of care and treatment of charitable and indigent patients\textsuperscript{56} would probably result in tax exemption.

Finally, the organizational test requires that the articles provide for distribution of the organization’s assets for exempt purposes in the event of dissolution.\textsuperscript{57} The articles may directly require such distribution or, by reference, incorporate state law requiring it.\textsuperscript{68} In the latter case, to establish its exemption, an organization must, in effect, submit a legal brief on the relevant state law.\textsuperscript{69} At any rate, “an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.”\textsuperscript{60}

While the organizational test “cannot completely be divorced” from the operational test,\textsuperscript{61} there are both benefits and liabilities from the IRS attempt to separate the two. An independent organizational test is obviously necessary in order to permit exemption rulings prior to beginning operations. Also, insistence on substantive organizational requirements probably makes exemptions more secure since organizations are presumably bound under state law to obey their articles of organization; and, hence, where articles prohibit the doing of anything which would jeopardize exempt status, the organization is likely to remain exempt.\textsuperscript{62} But the necessarily arbitrary nature of the requirements and the requisite of fulfilling them in written articles tend to induce standardized forms which tell the IRS and the public little.\textsuperscript{63} This lack of disclosure, in turn, tends to negate the benefit of utilizing a separate organizational test which relies on the articles. Little reliance can intelligently be placed on a sterile form. However, the requirement that organizations such as private hospitals submit to the IRS detailed applications for determinations, along with their articles and other documents, which materials are usually available to the public,\textsuperscript{64} compensates somewhat for the lack of disclosure in the articles themselves. But, in general, the organizational test’s value lies in its ability to force prohibition of possibly non-charitable future operations.

\textsuperscript{56} Goldsby King Memorial Hospital, 3 CCH Tax Ct. Mem. 693, 696-97 (1944).

\textsuperscript{57} Treas. Reg. § 1.501(c)(3)-1(b)(4) (1959): “An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose.”

\textsuperscript{58} Treas. Reg. § 1.501(c)(3)-1(b)(4) (1959).


\textsuperscript{63} See Eliasberg, Sections 170 and 501(c)(3)—Some Charitable Loose Ends, 43 Taxes 433, 436 (1965).

\textsuperscript{64} Int. Rev. Code of 1954, § 6104(a)(1).
B. Operation

The way in which a private hospital is operated naturally provides the most telling clue to its true purposes. Like any exempt charitable organization, it must, for exemption, be operated "exclusively" for charitable purposes. As under the organizational test, "exclusively" means "primarily" rather than "solely." But the guideline specified for meeting the operational test requires far less than primarily charitable operation for a private hospital: "It must be operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay." The word "exclusively," as used in the Code, "relates to the purpose to which the income is ultimately devoted, and not to the manner of activity by which such income is obtained." Hence it may, of course, charge at any profitable rate those recipients of its services who can afford to pay. As a natural corollary, most of its gross income may go to provide services to paying patients. Indeed, all but a nominal part of its total income may, "for a time," be applied to the needs of paying patients. Thus, a private hospital may receive and disburse income in primarily non-charitable operations.

The minimum amount of charitable operations required for exemption has never been clearly determined. Certainly, if a hospital operates with an expectation of full payment from all, the failure of some to pay all or part will not allow it to pass the operational test. Equally, a policy of refusing to accept non-paying

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65. Passaic United Hebrew Burial Ass'n v. United States, 216 F. Supp. 500, 505 (D.N.J. 1963). "[I]n the final analysis the purposes of an organization can best be drawn from a consideration of the manner in which it has been operated." Id.
70. Indeed, it must realize a profit on those able to pay in order to provide the free care essential to its exempt status, unless it can rely on contributions. Mere service at cost for all does not afford exemption; Medical Diagnostic Ass'n, 42 B.T.A. 610 (1940). The requirements of operating "exclusively for charity . . . are not met by charging moderate, compared to high, fees, or by giving free services to only a small per cent of all persons receiving treatment." Lorain Ave. Clinic, 31 T.C. 141, 161 (1958).
72. Rev. Rul. 56-185, 1956-1 Cum. Bull. 202, 204. This is true at least for hospitals supported by contributions from government or the general public.
patients is enough to defeat exemption. Minimum charitable service must, at least, be more than is "customary for reputable physicians." Where less than 5 per cent of the total patients were given free service, private hospitals have been found non-exempt, and the converse has been found where 6-8 per cent were treated without charge. However, in the absence of local demand, so long as no one is denied admission because of his inability to pay, a hospital might actually pass the operational test without evidence of any actual charity. In making this concession, the IRS distinguishes between private hospitals "supported partly by contributions from the general public," to which the concession applies, and those formed and controlled by one or more doctors. The latter apparently must seek out indigent patients, if they wish to retain exempt status. This pointless attempt to distinguish in applying the concession shows the meaninglessness of the general guideline for hospital-exemption: charitable operation "to the extent of its financial ability." Presumably "financial ability" means net available income, and clearly a hospital need not disburse all its net available income to the service of those unable to pay. A private hospital may even accumulate its net income without fear of losing its exemption because of "unreasonable accumulation" under the Code. Indeed, only the requirement that the hospital must, usually, perform some charitable service cuts into its "profit" accumulation. Accumulations may be saved for capital improvements in equipment and facilities without raising any doubts as to exemption. Thus, most accumulated earnings from paying patients may be invested in new facilities to be used largely by future paying patients.

One limitation on the exemption from federal income tax enjoyed by organizations such as private hospitals does exist. The exemption does not extend to

76. E.g., Sonora Community Hospital, 46 T.C. 519 (1966); Lorain Ave. Clinic, 31 T.C. 141 (1958).
80. The IRS probably justifies its distinction by citing the practical concept that public support usually acts in itself as a policeman upon the quantity of charitable service performed. Whether or not this is usually so, the distinction is necessarily an empty one in as much as a hospital may or may not be controlled by founder-doctors whether or not it is supported by public contributions. Surely a hospital which is controlled by founder-doctors and receives public support should be permitted to exercise no relatively lower ratio of free to paid-for care than a hospital which lacks the benefit of public support.
82. See note 2 supra.
83. See Goldsby King Memorial Hospital, 3 CCH Tax Ct. Mem. 693 (1944). One case has gone so far as to suggest that there could be no problem of accumulation where the assets had, in the inevitable ultimate liquidation of a temporal institution, to go to a charitable purpose. Huron Clinic Foundation v. United States, 212 F. Supp. 847 (D.S.D. 1962), vacated per stipulation, 324 F.2d 43 (8th Cir. 1963). See note 57 supra and accompanying text.
"unrelated business" income generated by the hospitals' operations.\textsuperscript{84} Unrelated business income means "the gross income derived \ldots from any unrelated trade or business \ldots regularly carried on by it, less [certain deductions and exclusions\textsuperscript{85}].\ldots\textsuperscript{86} In addition, in the case of a private hospital, "all income derived from research\textsuperscript{87} performed for any person, and all deductions directly connected with such income" are excluded.\textsuperscript{88} Neither test, relationship or regularity, is clearly defined. Unrelated business means "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise \ldots of its charitable \ldots function constituting the basis for its exemption \ldots except \ldots any trade which is carried on \ldots primarily for the convenience of its \ldots patients \ldots.\textsuperscript{89} An unrelated "trade or business is regularly carried on when the activity is conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity.\textsuperscript{90} Since a private hospital usually derives most of its income from and, presumably, spends most of it on paying patients, it might seem that much of its activity would be subject to tax, despite its exempt status. However, such clearly non-charitable activity would seem to fit a special\textsuperscript{91} relational category: "In some cases, the business may be substantially related because it is a necessary part of the exempt activity.\textsuperscript{92} In practical terms, hospital care for paying patients is a necessary part of care for charitable patients in as much as paying patients usually provide the facilities which enable care for the indigent. In any event, the issue of unrelated business taxation on profits from central and necessary activities for

\textsuperscript{84.} Int. Rev. Code of 1954, § 501(b).
\textsuperscript{85.} In computing "unrelated business taxable income," a specific deduction of $1000 is granted along with the usual charitable deductions (but not the 100\% deduction mentioned at note 7 supra) permitted under Int. Rev. Code of 1954, § 170 on gifts to other (see Treas. Reg. § 1.512(b)-1(g)(3) (1958)) exempt organizations, while certain other income is excluded, such as all dividends, interest, annuities, royalties, and most rent (see § 514 of the Code). Int. Rev. Code of 1954, § 512(b).
\textsuperscript{86.} Int. Rev. Code of 1954, § 512(a).
\textsuperscript{87.} "The term 'research' does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations \ldots \ldots." Treas. Reg. § 1.512(b)-1(f)(4) (1958).
\textsuperscript{88.} Int. Rev. Code of 1954, § 512(b)(8).
\textsuperscript{89.} Int. Rev. Code of 1954, § 513(a)(2).
\textsuperscript{91.} "Ordinarily, a trade or business is substantially related to the [exempt] activities \ldots if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. In the usual case the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption." Treas. Reg. § 1.513(a)-1(a)(4) (1958).
any hospital has not been litigated or ruled upon. However, peripheral activities, unless they are of service to patients, like gift shops and cafeterias, may, where profit-making, be subject to tax. The basic criteria in deciding what is peripheral appear to be whether the activity competes with operations by non-exempt organizations and whether it provides a substantial proportion of the exempt hospital's income.

The tax imposed on unrelated business income points up the general purpose of the organizational test of a hospital's exempt status. Like any charitable organization which seeks exemption, it cannot operate as a business—even if it devotes its whole business profit to clearly charitable purposes. Basically, the tax on unrelated business income allows an exempt hospital to retain its exemption despite its conduct of business activities.

In general, the organizational test is applied to hospitals in a necessarily compromising manner. A private hospital, though exempted as a "charitable" organization, is not thus required to operate for primarily charitable purposes. Rather, the actual "charity," in its traditional meaning, is but an incident of its paid-for services. Evidently, general public welfare is the motivation behind the exemption for hospitals; and the value of making available medical facilities to the affluent as well as the indigent is deemed sufficiently important to allow exemption for hospitals which operate primarily for profit. Although "charity of purpose" is a misnomer, the liberality of the operational test is justified by necessity and guarded strictly by the inurement test, which qualifies the liberal operational test so as to conserve from individual, private benefit the funds afforded by tax privilege.

93. Apparently, the only consideration given to the possibility that income from paying patients might be deemed unrelated income eliminated the problem. The Senate Finance Committee reported, on the bill (H.R. 8920), which inaugurated the tax on unrelated income, that "... in the case of a non-profit hospital, where some patients are charity patients and some pay their own way, the income from patients in either category is considered related income and, therefore, not taxable." S. Rep. No. 2375, 81st Cong., 2d Sess. (1950), in 1950-2 Cum. Bull. 483, 559.


95. In discussing the bill (H.R. 8920) which created the tax, the House Committee on Ways and Means reported: "The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition." H.R. Rep. No. 2319, 81st Cong., 2d Sess. (1950), in 1950-2 Cum. Bull. 380, 409. See, e.g., Rev. Rul. 57-313, 1957-2 Cum. Bull. 316, where an exempt medical research foundation was ruled taxable on income from a medical illustration department and an electroencephalography clinic it ran because the operation was "conducted in a manner similar to a commercial undertaking and, in addition, the income derived therefrom [about 75% of the foundation's gross receipts] is disproportionate when compared with the size and extent of its exempt activities."

96. In such a case, the organization would be either a nonexempt feeder (see Int. Rev. Code of 1954, § 502) or subject to the tax on unrelated business income to such an extent that it would be in the same position as if it were non-exempt.
C. Inurement

In deriving an inurement test for hospitals from the Code, the Internal Revenue Service has merely added the adverbs "directly or indirectly" to the general Code provision that net earnings must not inure to the benefit of any private shareholder or individual. This test is both organizational and operational. It denies exemption to any private hospital which is organized so as to facilitate, or operated so as to effect distribution of profits, payment of excessive rents or excessive salaries, or use of facilities to serve private interest.

The Code's inurement test for exempt hospitals is cast in broad terms and simply prohibits the inurement of any part of "net earnings" to any private shareholder or individual. In practice, the test functions to negate charitable purpose rather than directly to negate exemption, where net earnings are found actually to inure to private individuals. Thus, practical employment of the test requires a balancing between actual charitable use and inurement to individuals of net earnings. Only the more flagrant, and not petty or aberrant instances of inurement have been considered so to contradict actual charitable purposes of a hospital as to be the primary cause for denial of exemption.

The inability of this general test to curb abuses of self-dealing was recognized

99. See Rev. Rul. 56-185, 1956-1 Cum. Bull. 202, 203: "If provision is made in the bylaws for dividends, exemption will not be allowed even though no dividends have been declared." Inurement is naturally the test which is failed where an organization's assets are not indefeasibly vested by its articles in charitable uses. Davis Hospital, Inc., 4 CCH Tax Ct. Mem. 312, 315 (1945) (dicta).
100. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1959): To be exempt "it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests . . . ."
101. See Fort Scott Clinic & Hospital Corp. v. Brodrick, 99 F. Supp. 515 (D. Kan. 1951) where, although the articles read: "No dividends shall ever be declared or paid . . . .", the compensation method used by the trustees was found to inure to the benefit of the doctors involved, thus denying exemption. Id. at 516. See also Lorain Ave. Clinic, 31 T.C. 141, 162 (1958): "where, as here, the method for fixing compensation for [doctor's] services is predominantly one which compensates the individual on the basis of the ratio of his fees and activity to the whole, so that each [doctor] is in competition with the other, the operation is one for profit and the exemption . . . cannot be allowed."
102. E.g., Cleveland Chiropractic College v. Commissioner, 312 F.2d 203 (8th Cir. 1965); Mahee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953); Gemological Institute of America, 17 T.C. 1604, aff'd, 212 F.2d 205 (9th Cir. 1954).
by Congress more than seventeen years ago when it passed a Code section 106 denying exemption where an otherwise exempt organization participated in so-called "prohibited-transactions." 107 To mollify the House version of this section, 108 the Senate added a provision that made the section inapplicable to various organizations, including those which provide "hospital care." 109 In doing so, however, its report did not comment upon the House committee's suggestion that: "The fact that the . . . standards [defining prohibited transactions] are made applicable to certain organizations does not imply that similar criteria may not be used in determining whether other . . . organizations are operated exclusively for exempt purposes." 110 Hence, employing prohibited transactions standards, where the creator or a "substantial" contributor to a private hospital receives anything substantial or any preferential service from it, without making just compensation, there is a possibility that the private hospital may lose its exemption. 111 Because of the specific exception granted hospitals, however, the courts are reluctant to admit that their vision of inurement vis à vis hospitals has been sharpened by the section on prohibited transactions and prefer to fall back upon "the more basic provisions" of the general inurement test to the

106. This section is now Int. Rev. Code of 1954, § 503.
109. This is now Int. Rev. Code of 1954, § 503(b)(5). The reason offered by the Senate for giving such special treatment to organizations like hospitals is of questionable application to private hospitals: "The organizations excluded from the application of these provisions are in general what might be called 'public' organizations and because of this characteristic are not believed likely to become involved in any of these prohibited transactions." Sen. Rep. No. 2375, 81st Cong., 2d Sess. (1950), in 1950-2 Cum. Bull. 483, 511. The only truly "public" character which a private hospital need show for exemption is that it "serves a public rather than a private interest." Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1958). Yet, it may without contest by the IRS and with support from the courts give primary service to the private needs of its paying patients.
111. The Code lists six "prohibited transactions" which occur where an exempt organization: "(1) lends any part of income or corpus, without receipt of adequate security and a reasonable rate of interest, to; (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to; (3) makes any part of its services available on a preferential basis to; (4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from; (5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or (6) engages in any other transaction which results in a substantial diversion of its income or corpus to;" the creator, substantial contributor, family member of either, or a corporation controlled (owns or controls 50% of the corporation) by either. Int. Rev. Code of 1954, § 503(c).
TAX EXEMPT PRIVATE HOSPITALS

Code section granting charitable organizations exemption from income tax.\(^{112}\) The broadness of the general inurement test is preferable to one more sharply defined. It allows the Service and courts wide latitude in determining a private hospital's exempt status by evaluating all relevant circumstances. More meaningfully, it prevents anyone seeking to effect private gain from exempt status from hiding behind the shield of technical conformity with legal requirements. The broadness of the test can be used as a key to fiduciary duty—at least with regard to the negative aspects of that order of duty. Though the courts have been slow to pinpoint their criteria, most often an organization’s performance of this duty has been the underlying element in granting or denying exemption.

D. Use of Facilities

A private hospital must not restrict the use of its facilities to a particular group of doctors.\(^{113}\) To do so would be inconsistent with the public service requirements and would tend to violate the test for inurement.\(^{114}\) Of course, a hospital is afforded a reasonable degree of discretion in placing qualifications upon its need for doctors;\(^{115}\) and, even arbitrary restrictions, where they are not onerous or prejudicial, may qualify the right to practice in an exempt hospital.\(^{116}\) However, limiting use of the hospital to a regular staff, with few or no outsiders may cost the exemption. Invariably, where the exemption is lost, other requirements than restricted use of facilities are involved.\(^{110}\) Hence, the practical probative force of this requirement is difficult to ascertain. Probably, the test is most useful as a measure of the charitable intent of the hospital, in as much as exclusivity of association is often used to retain “a good thing.”

A similarly hazy line distinguishes instances when a hospital may or may not lose its exemption because of restrictions on the use of facilities benefiting classes of patients. If a private hospital contracts with an employer to care solely for his employees, it is not exempt, at least under the general Code requirements for charitable organizations.\(^{120}\) However, where a hospital secures only a part

119. In Lorain Ave. Clinic, 31 T.C. 141 (1958), for example, not only was the use of facilities restricted to a small salaried staff, but also the articles did not restrict the clinic to charitable purposes, id. at 159, free service was given only a “small per cent” of all patients, id. at 161, and each doctor was compensated “on the basis of the ratio of his fees and activity to the whole.” Id. at 162. See also Fort Scott Clinic & Hospital Corp. v. Brodrick, 99 F. Supp. 515 (D. Kan. 1951); I.T. 2421, VII-2 Cum. Bull. 150 (1928).
of its patients under such contracts, and accepts the rest without financial discrimination, it may be exempt.\(^{121}\) This does not apply, apparently, to a membership hospital which opens its facilities to non-members with the motive of reducing the cost of care to members, even though charity was accorded some non-members.\(^{122}\) Because restrictions on classes of patients are of greater relevance than those on doctors to the basic public welfare justification for allowing private hospitals exemption as charitable organizations, they are of more probative force in determining exempt status. This same reasoning generally leads to more facile exemption for hospitals which receive significant contributions from the general public, however pointless this distinction.

### III. Conclusion

Private hospitals are given several federal tax privileges because they perform a service for the public. Hence the requirements which they must fulfill, in order to be given the tax privileges, must assure their recognition and performance of the duties which those tax privileges impose.

The procedural requirements of the IRS do not permit a hospital to become exempt without at least formally recognizing its duties in its articles of organization. However, dutiful performance may require increased vigilance since the present state of the law allows operation that is more business-like than charitable. Indeed, the impetus of providing enough charity to support exemption probably does little more than to force up the cost of hospital care for those able to pay. Also, the special exemption of hospitals from the prohibited transactions provision makes self-dealing attractive to the doctor-founder who is willing to risk that legal ambiguities will not inure against him. This may be particularly true where the hospital is profitable enough to allow such substantial charity as may appeal to courts determining exemption.

In general, the “charitable” as opposed to “public welfare” basis for exemption is an unfortunate though traditional choice. At best, it merely affords confusion. At worst, it tends to dissipate the availability of medical excellence in hospitals for the average citizen by imposing such restrictions of an inurement nature that, where they are enforced, doctors may be induced to abandon exempt hospitals for those of a more extravagant variety than the majority of “paying patients” can afford.

Further difficulty with the “charitable” rationale for exemption arises from the increasing incidence of governmental support for indigents. Medicare, medicaid, and public programs for mandatory hospitalization insurance, as well as the ever increasing coverage of private insurance plans, threaten to leave hospitals without patients who require free or below-cost care. While such a threat is still more potential than actual, it nonetheless suggests a growing need to re-examine the traditional “charitable” basis for exemption in light of the public welfare value in securing high-quality, low-cost hospitalization for all.

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\(^{121}\) See Intercity Hospital Ass'n v. Squire, 56 F. Supp. 472 (W.D. Wash. 1944).

\(^{122}\) See United States v. La Societe Francaise de Bienfaisance Mutuelle, 152 F.2d 243 (9th Cir. 1945), cert. denied, 327 U.S. 793 (1946).