

1990

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### Recommended Citation

Robert J. Hannen, *Nonprofit Hospitals: Should They Continue to Receive a Charitable Organization Tax Exemption Under Pennsylvania Law?*, 28 Duq. L. Rev. 727 (1990).

Available at: <https://dsc.duq.edu/dlr/vol28/iss4/8>

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# Nonprofit Hospitals: Should They Continue To Receive A Charitable Organization Tax Exemption Under Pennsylvania Law?

## I. INTRODUCTION

Local taxes come in a variety of forms and naturally include property taxes and city wage taxes. Of all the local taxes, the most significant source of local tax revenue generally is property taxes.<sup>1</sup> Despite the significant role which property taxes play in raising revenues for local municipalities, the Pennsylvania Constitution provides for an exemption from property taxes when certain criteria are satisfied.<sup>2</sup> Certainly, these property tax exemptions were designed to lessen the burden of the continued existence and operations of charitable organizations. However, these property tax exemptions may be somewhat damaging to the local municipalities themselves. "A liberal construction of exemption provisions results in the loss of a major source of municipal revenue and places a greater burden on nonexempt tax payers. . . ."<sup>3</sup> In the city of Pittsburgh, for instance, this phenomenon has apparently manifested itself in the form of an increased city wage tax. Yet, a sampling of hospitals located in Allegheny County during the fiscal year 1987-88 indicates that at least several of the hospitals sampled enjoyed substantial profits, yet contributed relatively little to the community in the way of charitable donations.<sup>4</sup> The tax exemption which these hospitals have enjoyed has resulted in sub-

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1. "Property taxes are the most important source of municipal revenue. For example, in 1970 to 1971 they comprised 64% of general revenue raised by local governments." *Utah County, Etc. v. Intermountain Health Care*, 709 P.2d 265, 268 n.5 (Utah 1985) citing Advisory Comm'n of Intergovernmental Relations, *The Property Tax in a Changing Environment* 99 (1974).

2. The Constitutional exemption from property taxes is founded in PA. CONST. art. VIII § 2 (a) which provides: "The General Assembly may by law exempt from taxation: (v.) Institutions of purely public charity, but in the case of any real property tax exemptions only that portion of real property of such institutions which is actually and regularly used for the purposes of the institution. PA. CONST. art. VIII § 2.

3. *Utah County, Etc. v. Intermountain Health Care*, 709 P.2d 265, 268 (Utah 1985).

4. The Pittsburgh Press, Feb. 4, 1990, at A13 col. 1. The Pittsburgh Press compiled a list of the "financial condition of 23 hospitals in Allegheny County during the fiscal year 1987-88. All dollar amounts are in millions." The list is set forth as follows:

stantial lost revenues for the local municipalities. For instance, Allegheny General Hospital experienced a profit of \$36.4 million in fiscal year 1988 on net revenues of \$248.1 million. If fully taxed, Allegheny General Hospital would have paid almost \$400,000 in county property taxes alone.<sup>5</sup>

The scope of this comment will explore whether nonprofit hospitals should continue to receive the "blanket" property tax exemptions which they currently enjoy. The analysis will center on the fact that the foundation of these exemptions is premised on charitable organization tax exemptions.

Hospital	Net revenue	Profit	Profit margin	Free care	Charity index
1. Allegheny General	\$248.1	\$36.4	14.7%	\$3.4	1.4%
2. Children's	\$108.5	\$13.8	12.7%	\$3.3	3.0%
3. Ohio Valley	\$25.8	\$2.8	10.7%	\$.04	0.2%
4. Sewickly Valley	\$59.1	\$6.2	10.5%	\$1.5	2.5%
5. St. Margaret Memorial	\$35.2	\$3.4	9.8%	\$.44	1.2%
6. Presbyterian	\$236.4	\$22.6	9.6%	\$2.1	0.9%
7. McKeesport	\$63.1	\$6.0	9.5%	\$.66	1.0%
8. N. Hills Passavant	\$51.3	\$4.0	7.8%	\$.46	0.9%
9. St. Clair	\$61.9	\$4.2	6.9%	\$.23	0.4%
10. Shadyside	\$96.5	\$4.5	4.6%	\$1.0	1.1%
11. Mercy Hospital	\$137.6	\$5.8	4.2%	\$2.6	1.9%
12. Magee-Womens	\$85.6	\$3.4	3.9%	\$3.0	3.5%
13. Allegheny Valley	\$44.3	\$1.7	3.9%	\$.12	0.3%
14. West Penn	\$129.8	\$4.9	3.8%	\$5.1	3.9%
15. Jefferson*	\$90.0	\$3.3	3.7%	\$4.0	4.4%
16. Suburban General*	\$25.8	\$.61	2.4%	\$1.0	3.9%
17. South Side*	\$36.6	\$.84	2.3%	\$1.1	3.0%
18. Montefiore	\$100.5	\$1.5	1.5%	NA	NA
19. Divine Providence*	\$23.5	\$.31	1.3%	\$1.1	4.6%
20. St. Francis	\$129.9	\$.21	0.2%	\$4.1	3.2%
21. Forbes Health	\$100.0	-\$95	-1.0%	\$3.6	3.6%
22. Braddock General	\$27.6	-\$63	-2.3%	\$.29	1.0%
23. Central Medical	\$36.9	-\$6.0	-16.2%	\$.7	1.9%
Total	\$1,954	\$118.8	6.1%	\$40.2	2.1%

\* Hospitals that include bad debt in free care figures.  
Source: Hospital financial statements and interviews.

Net revenue: Money hospitals collected for services and from investments. Profit: Money left over after hospitals paid all expenses. Hospitals call this "Excess of revenues over expenses." Profit margin: Percentage of net revenue remaining after expenses. Free care: Amount hospitals say they gave to people they knew had no means of paying. This figure is somewhat inflated because hospitals generally list it as full retail price, not the discounted price they collect from most insurers. Charity index: Free care measured as a percentage of net revenues. *Id.*

5. The Pittsburgh Press, Feb. 4, 1990, at A13, col. 2.

## II. THE PENNSYLVANIA APPROACH

The Pennsylvania State Constitution provides that the Pennsylvania Legislature may exempt institutions of purely public charity from taxation.<sup>6</sup> In Title 61 of the Pennsylvania Code, Section 32.1, public hospitals are included as examples of charitable organizations.<sup>7</sup> Likewise, in Title 72 of Pennsylvania Consolidated Statutes Annotated, Sections 5020 - 204, hospitals are exempted from property taxes in certain circumstances.<sup>8</sup>

The Pennsylvania courts have considered, on a number of occasions, the question of whether an institution is entitled to retain or receive tax-exempt status. The most significant case in this field,

6. *See supra*, note 2.

7. 61 PA. CODE 32.1 (1985) provides:

*Charitable Organization* - a charitable organization is a group or body of persons which is created and which exists predominantly for the purpose of performing a humane service; promoting the good and welfare of the aged, infirm, or distressed. . . .

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The persons entitled to benefit from services performed by the organization shall be chosen from a class of persons substantial and not predetermined in number. The funds of the organization shall be predominantly derived from public or private contributions, and the organization shall be operated without pecuniary benefit to any officer, member or shareholder, except as reasonable compensation for actual services rendered to the organization. The term does not include an organization whose predominant purpose is to conduct noncharitable events or activities, even though the proceeds derived are donated to an exempt organization as defined herein. The following constitute examples of charitable organizations.

- (i) Organizations such as . . . public hospitals . . . .

61 PA. CODE § 32.1 (1985).

8. 72 PA. CONS. STAT. ANN. § 5020-204 (Purdon 1989) is entitled "Exemptions from taxation" and provides:

- (a) The following property shall be exempt from all county, city, borough, town, township, road, poor and school tax, to wit:

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(3) All hospitals, universities, colleges, seminaries, academies, associations and institutions of learning, benevolence, or charity, including fire and rescue stations, with the grounds thereto annexed and necessary for the occupancy and enjoyment of the same, founded, endowed, and maintained by public or private charity: Provided, That the entire revenue derived by the same be applied to the support and to increase the efficiency and facilities thereof, the repair and the necessary increase of grounds and buildings thereof, and for no other purpose; . . .

72 PA. CONS. STAT. ANN. § 5020-204 (Purdon 1989).

however, is *Hospital Utilization Project v. Commonwealth*.<sup>9</sup> In *Hospital Utilization Project*, the Supreme Court of Pennsylvania stated that although the Pennsylvania Code set forth a definition of charitable organization,<sup>10</sup> the origin of charitable exemption in the Pennsylvania statutes was Article VIII, section 2 (a)(v) of the Pennsylvania Constitution. Accordingly, the Pennsylvania legislature was constitutionally limited to exempt only those charitable organizations which were institutions of "purely public charity." However, the legislative determination was to be given great deference.<sup>11</sup> Regardless of whether an institution would qualify as a "charitable organization," as defined by the Pennsylvania Code,<sup>12</sup> an institution must qualify as a "purely public charity" under the Pennsylvania Constitution.<sup>13</sup> Moreover, any institution or organization which sought tax-exempt status, had the affirmative burden to prove it was entitled to that status.<sup>14</sup>

Neither the Pennsylvania Constitution nor Pennsylvania statutes define exactly what constitutes a "purely public charity." But through Pennsylvania case law, a set of criteria has evolved for making such a determination.

As early as 1892, the Pennsylvania Supreme Court addressed the question of a "purely public charity" in *Episcopal Academy v. Philadelphia*.<sup>15</sup> In *Episcopal Academy*, the court stated:

[I]t may be safely said that whatever is gratuitously done or given in relief of the public burdens, or for the advancement of the public good, is a public charity. In every such case, as the public is the beneficiary, the charity is a public charity. As no private or pecuniary return is reserved to the giver or any particular person, but all the benefit resulting from the gift or act goes to the public, it is a "purely public charity;" the word "purely" being equivalent to the word "wholly".<sup>16</sup>

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9. 507 Pa. 1, 487 A.2d 1306 (1985).

10. See *supra*, note 2.

11. In *Hospital Utilization Project*, the court stated that there is a presumption that the legislature does not intend to violate the Pennsylvania Constitution. 487 A.2d 1306, 1312 (1985). Nonetheless, "[S]tatutory provisions exempting persons or property from taxation must be strictly construed." *Id.*

12. See *supra*, note 7.

13. *Id.*

14. *Id.*

15. 150 Pa. 565, 25 A. 55 (1892).

16. 25 A. at 56. The court continued its analysis by stating:

[A]n institution that is in its nature and purposes a purely public charity does not lose its character as such under the tax laws, if it receives a revenue from the recipients of its bounty sufficient to keep it in operation. It must not go beyond self-support. When a charity embarks in business for profit, it is liable to taxation like any other business establishment. . . .

The Pennsylvania Supreme Court expanded upon its early concept of a "purely public charity" in *YMCA Ass'n of Germantown v. Philadelphia*.<sup>17</sup> In *YMCA*, the court stated:

In all our decisions on this subject there can be discerned as a prerequisite to the taxation exemption of an institution claiming to be benevolent or charitable that it, or the portion of its property in respect to which the exemption is claimed, must possess an eleemosynary characteristic not possessed by institutions or property devoted to private gain or profit. What is "given" must be more nearly gratuitous than for a price which impresses one as being proportionate to the services rendered.<sup>18</sup>

The court further set forth several characteristics of an organized charity.

First, whatever it does for others is done free of charge, or at least so nearly free of charge as to make the charges nominal or negligible; second, that those to whom it renders help or services are those who are unable to provide themselves with what the institution provides for them, that is, they are legitimate subjects of charity.<sup>19</sup>

The two characteristics set forth by the court were not arbitrary in nature. The underlying rationale or foundation, with respect to these two characteristics, concerns the burden placed on the government by society.

Every inhabitant and every parcel of property receives governmental protection. Such protection costs money. When any inhabitant fails to contribute his share of the costs of this protection, some other inhabitant must contribute more than his fair share of that cost. . . . Any institution which by its charitable activities relieves the government of part of this burden is conferring a pecuniary benefit upon the body politic, and in receiving exemption from taxation it is merely being given a "quid pro quo" for its services in providing something which otherwise the government would have to provide. . . . The measure of an institution's gratuitous aid to those requiring it is the measure by which the government is relieved of its responsibilities.<sup>20</sup>

"Although the *YMCA* language has not gone without modification throughout the years, its underlying philosophy has provided a sound base upon which to build the parameters for a 'purely public charity.'"<sup>21</sup> The Pennsylvania Supreme Court adhered to

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*Id.* at 57.

17. 323 Pa. 401, 187 A. 204 (1936).

18. 187 A. at 208.

19. *Id.* at 209.

20. *Id.* at 210.

21. *Hospital Utilization Project*, 507 Pa. 1, 487 A.2d 1306, 1314 (1985).

the YMCA rationale in *In re Ogontz School*.<sup>22</sup> Furthermore, although the Pennsylvania Supreme Court refused to adhere strictly to the language in YMCA, the underlying rationale of YMCA continued to provide the foundation for the court's decision in *Appeal of Vanguard School*<sup>23</sup> and in *West Allegheny Hospital v. Board of Property Assessment*.<sup>24</sup>

In *West Allegheny Hospital*, the issue on appeal was whether the health care facilities of West Allegheny Hospital, a non-profit corporation, were exempt from real estate taxes.<sup>25</sup> The court opined that the hospital, on the basis of several factors, had satisfied the "purely public" aspect of Article VIII, Section 2 of the Pennsylvania Constitution.<sup>26</sup> First, the "[b]ylaws of the corporation provide that 'no distinction shall be made in the admission or treatment of patients in regard to race, color, creed, national origin or sex,' a policy which has been adhered to in practice."<sup>27</sup> Second, the hospital provided comprehensive health care without regard to a patient's ability to pay.<sup>28</sup>

The court then addressed whether the hospital had been "endowed and maintained by public or private charity." Although the hospital received substantial donations, these donations were not sufficient to offset the costs of the hospital.<sup>29</sup> The operating expenses and capital expenditures which could not be covered by donations were then satisfied through revenues from patient billings.<sup>30</sup> The majority, however, stated that this was not a sufficient basis for denying tax-exempt status to the hospital<sup>31</sup> in light of the

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22. 361 Pa. 284, 65 A.2d 150 (1949). In *Ogontz*, the court determined that the Ogontz School, a non-profit corporation operating as a private school, did not relieve the government of any burdens and could not be classified, under any test, as a "purely public charity." *Id.* at 153.

23. 430 Pa. 378, 243 A.2d 323 (1968). In *Vanguard*, the court rejected the argument that YMCA stands for the proposition that only the measure of whether the tax-exempt status should be granted is the degree to which the institution relieves the government of its responsibilities. *Id.*

24. 500 Pa. 236, 455 A.2d 1170 (1982). In *West Allegheny Hospital*, the court rejected strict adherence to the notion that a "purely public charity" may charge only a nominal fee to its beneficiaries. *Id.*

25. *Id.*

26. *Id.* at 1171. The word "purely" in the context of "purely public charity" was designed to emphasize the word "public" and not "charity". *Id.*

27. *Id.*

28. *Id.*

29. *Id.* at 1172.

30. *Id.*

31. *Id.* at 1172-73.

language of the statute.<sup>32</sup> Thus, the court determined that West Allegheny Hospital was entitled to retain its tax-exempt status.

The dissent contended, however, that “[t]he majority appear[ed] to have centered its analysis upon the fact that [West Allegheny Hospital] is a hospital and conclude[d] that because a hospital promotes health, if it is public, it should be tax-exempt.”<sup>33</sup> But the dissent reasoned that in order to obtain/retain tax-exempt status, the burden was on the party claiming the exemption to show that the entire institution is (1) one of “purely public charity;” (2) was founded by public or private charity; and (3) is maintained by public or private charity.<sup>34</sup>

The dissent conceded that adherence by West Allegheny Hospital to its by-laws and its “open-admission policy” “may satisfy the public part of the first prong of the test,”<sup>35</sup> but, the dissent warned that the “first prong also required a pure charity element which is not satisfied merely by the dispensing of medical service.”<sup>36</sup>

With respect to the second prong of the test, the dissent, in contrast with the majority, stated that the key question “is not whether the institution’s activities comply with a definition of charitable purpose but, rather, was the institution begun or founded by gift, either public or private. The fact that the [hospital] is “non-profit” is not decisive of the issue.”<sup>37</sup> The dissent determined that this second factor was not satisfied.<sup>38</sup>

Finally, the dissent concluded that the third prong of the test was not satisfied. The dissent stated:

The majority’s use of the word “revenue” in the proviso to section 204(a)(3) [72 P.S. 5020 - 204] in order to overcome the blatant fact that Drs. Roberts and Grilli [the incorporators of West Allegheny Hospital] have passed the

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32. See *supra*, note 6. The majority determined that 72 PA. CONS. STAT. ANN. § 5020 - 204 permits the revenues from patient billing to be used to meet operating costs and capital expenditures. 455 A.2d 1170, 1172-73 (Pa. 1982).

33. 455 A.2d at 1173.

34. *Id.* at 1173-74.

35. *Id.* at 1174.

36. *Id.* at 1174 n.1.

37. *Id.*

38. *Id.* at 1174-75. The original property upon which West Allegheny Hospital is situated was purchased by Drs. Roberts and Grilli for less than \$40,000, was deeded to a corporation (Tioga Corporation) whose principal shareholders were Drs. Roberts and Grilli, and later sold to West Allegheny Hospital (a non-profit corporation incorporated by Drs. Roberts and Grilli and their wives) for \$590,000. *Id.*

Moreover, West Allegheny hospital had previously paid rent to Tioga Corporation, had not made its first capital acquisition until nine years after its incorporation and had not been founded by gift but rather had received loans which it repaid with interest. *Id.*



substantial operating costs and capital acquisition costs on to the patients and/or the public without any significant accompanying gifts at founding or for maintenance is not in accord with the required strict construction of the statute involved nor the constitutional concept of a "purely public charity."<sup>39</sup>

Thus, the dissent declared that West Allegheny Hospital should not be entitled to tax exemption under these circumstances.<sup>40</sup>

The Supreme Court of Pennsylvania, in *Hospital Utilization Project*, set forth a list of criteria which must be satisfied in order to qualify as a purely public charity. According to the court,

it can be concluded that an entity qualifies as a purely public charity if it possesses the following characteristics. . .

- (a) Advances a charitable purpose;
- (b) Donates or renders gratuitously a substantial portion of its services;
- (c) Benefits a substantial and indefinite class of persons who are legitimate subjects of charity;
- (d) Relieves the government of some of its burden; and
- (e) Operates entirely free from private profit motive.<sup>41</sup>

This multifactor test has also been used in cases subsequent to *Hospital Utilization Project*.<sup>42</sup>

According to the court in *Hospital Utilization Project*,<sup>43</sup> in order to satisfy the criterion requiring advancement of a charitable purpose an institution would have to satisfy the definitions set forth in *In re Hill School*.<sup>44</sup>

The word "charitable", in a legal sense, includes every gift for a general public use, to be applied, consistent with existing laws, for the benefit of an indefinite number of persons, and designed to benefit them from an educational, religious, moral, physical or social standpoint. In its broadest meaning it is understood "to refer to something done or given for the benefit of our fellows or the public."<sup>45</sup>

Although a "purely public charity does not cease to be such when

39. *Id.* at 1174-75. Patients paid or caused to be paid approximately 97% of the amounts billed for out-patient care. *Id.* Moreover, West Allegheny Hospital employed a collection agency to assist in collecting outstanding patient accounts. *Id.* Additionally, physicians at West Allegheny Hospital paid a "bed-tax" to the hospital; and West Allegheny Hospital received payments from the Commonwealth of Pennsylvania for treatment of those patients on welfare. *Id.* at 1175.

40. *Id.*

41. *Hospital Utilization Project*, 487 A.2d 1306, 1317 (Pa. 1985).

42. *See, e.g.*, *Scripture Union v. Deitch*, 109 Pa. Commw. 272, 531 A.2d 64, 66 (1987).

43. 487 A.2d 1306, 1315 (Pa. 1985).

44. 370 Pa. 21, 87 A.2d 259 (1952).

45. 487 A.2d at 1315, quoting, *In re Hill School*, 87 A.2d at 262.

it receives some payment for its services,"<sup>46</sup> an institution is not considered charitable in the legal sense if the direct beneficiaries of the institution are its fee-paying clients and not the general public.<sup>47</sup>

With respect to the second factor, the court in *Hospital Utilization Project* looked to the fact that the institution did not offer any free services to clients.<sup>48</sup> Further, the court considered the fact that the institution charged its clients fees which approximated actual cost.<sup>49</sup> Additionally, the court noted that "[s]ince [the institution] provides no financial aid, an applicant who cannot afford to pay for its statistical reports will not be serviced."<sup>50</sup> The third factor requires that the entity benefit a substantial and indefinite class of persons who are legitimate subjects of charity. The court compared *Hospital Utilization Project* (HUP) with the language in *West Allegheny Hospital*<sup>51</sup> and found that, unlike West Allegheny Hospital, HUP did not satisfy this factor.<sup>52</sup>

The fourth factor requires the institution to relieve the government of some of its burden. The court determined that the service that HUP provides is not one traditionally done by the government and thus HUP did not relieve the government of its burden.<sup>53</sup>

The court also determined that HUP did not satisfy the fifth factor. The court determined that HUP did not operate entirely free from private profit motive. The essential elements in the court's determination were that "[HUP's] officers and directors are well paid and [HUP] is able to accumulate a profit which is invested to upgrade the computer equipment essential to its operation."<sup>54</sup>

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46. 487 A.2d at 1315, quoting, *In re Hill School*, 87 A.2d at 263.

47. 487 A.2d at 1317.

48. *Id.* at 1314, 1317.

49. *Id.* at 1317. In reference to institutions which charge fees approximating actual cost, the court cited to *In re Ogontz School*, *supra*, for the proposition that "[a]n organization which provides all its services for actual cost is engaged in a commercial enterprise." *Id.* at 1314.

50. *Id.* at 1316.

51. See *supra*, notes 24 and 25 and accompanying text.

52. *Id.* at 1316-17. The court noted that nothing in the record supported a finding that HUP provides services with regard to the client's ability to pay. *Id.* at 1316. Moreover, the court noted that "HUP's beneficiaries, hospitals and health care facilities are definite in number and, when viewed as administrative entities, are not legitimate objects of charity." *Id.* at 1317.

53. *Id.*

54. *Id.* at 1317-18.

## III. AN ALTERNATIVE APPROACH

The concept of reevaluating whether hospitals and health organizations actually satisfy charitable organization property tax exemption provisions has already been implemented in several jurisdictions in the United States. One jurisdiction which has undertaken such a task is Utah.<sup>55</sup> The watershed of this development is *Utah County v. Intermountain Health Care*.<sup>56</sup> The Supreme Court of Utah in *Intermountain Health Care* acknowledged that treatment of the ill had traditionally been regarded as charitable;<sup>57</sup> however, the court stated "we deem it important to scrutinize the contemporary social and economic context of such care. We are convinced that traditional assumptions bear little relationship to the economics of the medical-industrial complex of the 1980's."<sup>58</sup> According to the court, there had been a "revolution in health care that transformed a 'healing profession' into an enormous and complex industry, employing millions of people and accounting for a substantial proportion of our gross national product."<sup>59</sup> This, in turn, has resulted in an increase in the cost of medical care and services and a corresponding increase in competition between providers of medical services, thus transforming the "healing profession" into a highly competitive business.<sup>60</sup>

The Utah Supreme Court, in breaking from the approach of the vast majority of jurisdictions, appears to have been particularly concerned with the historical changes that have occurred in the field of health care. The magnitude of changes appears to have been greatest in the years between the late 19th century and the 1920's. During the 19th century, according to the court, hospitals were considered true charities. Hospitals provided custodial care for those who were both ill and poor. Likewise during this time, "[t]he hospitals' income was derived largely or entirely from chari-

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55. See e.g., *Yorgason v. County Board of Equalization*, 714 P.2d 653 (Utah 1986); *Utah County v. Intermountain Health Care*, 709 P.2d 265 (Utah 1985) (hereinafter *Intermountain Health Care*.)

56. 709 P.2d 265 (Utah 1985).

57. In *Intermountain Health Care*, the Utah Supreme Court noted that "the 'care of the sick' has traditionally been an activity regarded as charitable in American law. . . ." *Id.* at 270.

58. *Id.*

59. *Id.* at 272.

60. The Utah Supreme Court speculated that "perhaps as a further evolutionary response to the unceasing rise in the cost of medical services, the provision of such services has become a highly competitive business." *Id.*

table donations, not government subsidies, taxes or patient fees."<sup>61</sup> However, during this period of transformation, hospitals became decreasingly dependent on voluntary gifts with the result that hospitals "developed into market institutions financed increasingly out of payments from patients."<sup>62</sup>

To suggest that the change was one-dimensional would be inaccurate. In fact, "[t]he transformation was multidimensional: hospitals were redefined from social welfare to medical treatment institutions; their charitable foundation was replaced by a business basis; and their orientation shifted to 'professionals and their patients,' away from 'patrons of the poor.'"<sup>63</sup>

The manifestation of this transformation could be seen in a variety of factors. Starr, in his work entitled *The Social Transformation of American Medicine*, suggested several factors were representative of this transformation during the late 19th century to the 1920's. First, the social composition of hospital patients shifted away from being composed primarily of the poor, a composition which was more reflective/representative of the population at large.<sup>64</sup> Second, paying patients increased, in both number and percentage, as did the percentage of revenue derived from patient fees.<sup>65</sup> Third, during this period, for the first time, physicians were permitted to charge patients for their services in hospitals.<sup>66</sup> Fourth, before 1880, less than two percent of physicians enjoyed hospital privileges; yet by 1933, well over 80 percent of physicians enjoyed hospital privileges.<sup>67</sup> Fifth, an even more dramatic increase occurred in that, according to census figures, the number of hospitals increased from 178 in 1872 to over 4000 in 1910.<sup>68</sup> Sixth,

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61. *Id.* at 270; citing, P. STARR, *THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE* at 150 (1982) (hereinafter P. Starr).

62. *Id.* citing, P. Starr at 146.

63. *Id.* citing, P. Starr, at 147-48.

64. *Id.* at 271 citing, P. Starr at 159. Starr further suggested that the change from large wards to private rooms suggested the same movement away from the poor to the paying patients. *Id.*

65. *Id.*; citing, P. Starr at 161. This shift was dramatic: changing from revenues almost entirely constituted by charitable donations in the 19th century to revenues in proportions of over 65% derived from patients' fees; public appropriations accounting for 18%, endowment income accounting for 5.7%. *Id.*

66. *Id.*; citing, P. Starr at 163-164. The abandonment of the practice of not permitting physicians to charge private patients for their services in hospitals had a dramatic effect. In 1880, virtually no hospital permitted a physician to charge patients fees. However, in New England for example, by 1905, 47 of 52 hospitals surveyed permitted physicians to charge for service to private patients. *Id.*

67. *Id.*; citing, P. Starr at 162, 167.

68. *Id.*; citing, P. Starr at 169.

within the increase in the number of hospitals was a corresponding substantial growth in for-profit hospitals organized by physicians and corporations.<sup>69</sup>

The factors which Starr set forth in his work appear to lay the foundation for the court's rationale in *Intermountain Health Care*. The court, in reference to Starr's factors, stated that "[a]ll of the above factors indicate a substantial change in the nature of the hospital; a part of that change was the gradual disappearance of the traditional charitable hospital for the poor."<sup>70</sup>

The court further stated that "[a]lso of considerable significance to our review is the increasing irrelevance of the distinction between nonprofit and for-profit hospitals for purposes of discovering the element of charity in their operations."<sup>71</sup> The court relied upon two theories as evidence of the proposition that the distinction between nonprofit and for-profit was no longer a relevant distinction with respect to whether the hospital was engaged in charitable operations.

The first theory or model was referred to as the "physicians' cooperative" model.<sup>72</sup> It had been theorized that nonprofit hospitals operate primarily for the benefit of the participating physicians. According to this theory, physicians were able to exercise control, direct and indirect, over the nonprofit hospitals to which they bring the patients, and consequently, were able to enjoy great power and high income.<sup>73</sup> This basic theory had also had minor variations upon its basic theme.<sup>74</sup>

The second model was referred to as the "polycorporate enterprise" model.<sup>75</sup> The focus of the "polycorporate enterprise" model

69. *Id.*; citing P. Starr at 170. This increase in growth in for-profit hospitals can be linked to the improvement in the opportunity for profit in hospitals. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*; citing, Pauley & Redish, *The Not-For-Profit Hospital as a Physician's Cooperative*, 63 AM. ECON. REV. 87, 88-89 (1973). Pauley and Redish further theorized that "[t]he nonprofit form is believed to facilitate the control by physicians better than the for-profit form." *Intermountain Health Care* 709 P.2d at 271, citing Pauley and Redish, *The Not-For-Profit Hospital as a Physician's Co-operative*, 63 AM. ECON. REV. 87, 88-89 (1973).

74. See, e.g., Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416, 1436-37 (1980). Clark refers to the "physician's cooperative" model as the "exploitation hypothesis" and theorizes that the physician "income maximizing" system is hidden behind the nonprofit status of the hospital. *Id.*

See also, P. STARR, *THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE* at 438 (1982). Starr argues that many nonprofit hospitals are merely operating as "shelters" within which physicians are able to operate profitable businesses, such as laboratories. *Id.*

75. *Intermountain Health Care*, 709 P.2d at 271.

was on non-profit hospital chains. Unlike the "physician's cooperative" model, "power is largely in the hands of the administrators, not the physicians."<sup>76</sup> The focal point of this model though was not so much on the power structure of the hospital but rather on the business structure of the nonprofit hospitals. As a general proposition, nonprofit corporations can own for-profit corporations without losing their federal nonprofit tax status.<sup>77</sup>

The Supreme Court of Utah, as a basis for its rationale, heavily relied on this economic transition that hospitals and the medical profession have experienced. In addition to this historical, economic transition of hospitals as a factor in the court's rationale there was another factor which was of particular significance to the court's rationale: the requirement in Utah that every charity show an element of gift.<sup>78</sup> The economic reality of modern hospitals and the requirement of an element of gift in every charity are critical elements according to the Supreme Court of Utah. According to the court, the analysis of these factors was what distinguished its position and holding from that of other jurisdictions.<sup>79</sup>

In making a determination as to whether a hospital will retain its state constitutional tax exemption for property used for charitable purposes, the Supreme Court of Utah chose a case-by-case method of analysis using a multifactor test.<sup>80</sup> The multifactor test used by the court consisted of six factors:

- 1.) Whether the stated purpose of the entity is to provide a significant service to others without immediate expectation of material reward;
- 2.) whether the entity is supported, and to what extent, by donations and gifts;
- 3.) whether the recipients of the "charity" are required to pay for assistance received, in whole or in part;
- 4.) whether the income received from all sources (gifts, donations, and payments from recipients) produces a "profit" to the entity in the sense that the income exceeds operating and long-term maintenance expenses;
- 5.) whether the beneficiaries of the "charity" are restricted or unrestricted and, if restricted, whether the restriction bears a reasonable relationship to the entity's charitable objectives; and
- 6.) whether dividends or some other form of financial benefit, or assets upon dissolution,

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76. *Id.*

77. *Id.* at 271-272; citing, P. Starr, at 437. In order for a nonprofit corporation to maintain its nonprofit tax exempt status, however, the profits of the for-profit corporations must be used to further the nonprofit purposes of the nonprofit parent corporation. *Id.*

78. *Intermountain Health Care* 709 P.2d at 272.

79. *Id.*

80. *Id.* at 270, 272. The court emphasizes that each case must be decided on its own facts, and that the factors of the test are not of equal value. Moreover, a hospital or institution is not required to satisfy every factor in order to be eligible for an exemption. *Id.* at 270.

are available to private interests, and whether the entity is organized and operated so that any commercial activities are subordinate or incidental to charitable ones.<sup>81</sup>

In determining eligibility for charitable tax exemption, the burden of proof is on the party (nonprofit hospital) seeking the eligibility.<sup>82</sup>

With respect to its analysis of the first factor, the court looked to the articles of incorporation to determine the purpose of the entity. In *Intermountain Health Care*, the articles of incorporation identified corporate purposes as including the care and treatment of the "sick, afflicted, infirm, aged or injured." Moreover, the articles of incorporation restricted any portion of the net earnings from distribution to the benefit of any private individual. Likewise, the assets of the corporation upon dissolution were not to be distributed to benefit any private individual.<sup>83</sup> According to the court, these stated purposes satisfied the first element of the test.<sup>84</sup>

For the second factor, the court examined whether the hospitals were supported, and to what extent, by donations and gifts. The court noted that the current operating expenses were covered almost entirely by revenue from patient charges and although there was evidence of donations to the hospital, there was no evidence that the donations resulted in charges below the prevailing market rates.<sup>85</sup>

The Supreme Court of Utah rejected the dissent's notion that "the element of charitable giving from private donors and benefactors to a nonprofit entity, without more, satisfies the requirement of 'gift' in the definition of 'charitable purpose' under the Utah Constitution."<sup>86</sup> Rather, the majority turned its analysis to the third factor. That is, the majority considered the issue of whether the recipients of the services of an entity were required to pay for that assistance, in whole or in part.<sup>87</sup>

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81. *Id.* at 269-70.

82. *Id.* at 270.

83. *Id.* at 272-273.

84. *Id.* at 272.

85. *Id.* at 273. The court noted that the burden was on the party seeking the exemption to demonstrate the impact on the support, maintenance, and operation of the hospital in the year in question. *Id.*

86. *Id.* In rejecting the dissent's position the majority noted that "[m]any institutions are largely or partly created and supported by gifts but do not therefore automatically qualify for tax exemptions for their property." *Id.* at 273-74. As examples of their position, the court included private, nonprofit schools, museums, libraries and zoos. *Id.* at 274.

87. *Id.* at 274. The majority considered the third factor to be the most significant in the multifactor test. *Id.*

In analyzing this third factor the court examined the record, which showed that the vast majority of the services provided by the hospitals in question were paid for by government programs, private insurance companies or the individuals receiving care. The court construed this as a "mere reciprocal exchange of services for money" as opposed to charitable "giving" by the hospital to the patient.<sup>88</sup> The majority seized upon the fact that the value of services given away as charity by the hospitals in question constituted less than one percent of their gross revenue.<sup>89</sup>

The hospitals contended that the modern, economic realities of operating a hospital (with respect to the great expense of modern care and the wide availability of insurance and governmental subsidies) rendered the idea of a hospital solely supported by philanthropy an anachronism. It was this position, however, which the majority stated was evidence that the distinction between for-profit and nonprofit hospitals had eroded. As the majority pointed out, for-profit hospitals provided many of the same primary care services as nonprofit hospitals and did so at rates similar to those charged by nonprofit hospitals. Additionally the majority acknowledged that the "doctors and administrators of nonprofit hospitals have the same opportunity for personal remuneration for these services as do their counterparts in for-profit hospitals."<sup>90</sup>

The majority also rejected another position of the dissent with respect to this issue. The dissent suggested that the fact that the hospitals would admit patients without requiring them to show their ability to pay should be determinative of the question of charitable purpose regardless of the actual amount of free care provided by the hospital. The majority pointed out that for-profit institutions could implement similar policies as well. According to the majority, if the dissent's position were correct, the only means for determining charitable exemptions would be a bright-line test based solely on a for-profit/nonprofit distinction which the majority viewed as unacceptable.<sup>91</sup>

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88. *Id.*

89. *Id.* Also of significance to the majority was the fact that the free services which were available to the public were deliberately not advertised "out of fear of a 'deluge of people' trying to take advantage of it." *Id.* Instead, the hospitals made every effort to recover payment for services rendered, even affording patients the opportunity to obtain bank loans to finance their hospital expenses. *Id.*

90. *Id.* at 274-75 citing *Georgia Osteopathic Hospital, Inc. v. Alford*, 217 Ga. 663, 665, 124 S.E.2d 402, 403. (1962).

91. *Intermountain Health Care*, 709 P.2d at 275. The majority stated that it would not adopt the dissent's position because the Supreme Court of Utah had previously rejected



The fourth factor was whether the income received from all sources by the hospital was in excess of their operating and maintenance expenses. In answering the question, the court looked to a number of factors. One of the factors was that because the vast majority of services were paid for, the nonprofit hospitals in this case were able to accumulate capital.<sup>92</sup> A second factor was directed towards organizations which own more than one hospital or health care facility. The primary focus with respect to this element was whether surplus funds were channeled to for-profit entities or to entities or facilities outside the taxing jurisdiction.<sup>93</sup> A third query was whether a large portion of profits was used for capital improvements and new, updated equipment.<sup>94</sup>

With respect to whether income exceeded the operating and maintenance expenses of a hospital, the primary concern of the court was that non-profit hospitals receiving a charitable exemption would receive an undue advantage over their competitors, for-profit hospitals. The majority stated that "there is a serious question regarding the constitutional property of subsidies from [county]taxpayers being used to give certain entities a substantial competitive edge in what is essentially a commercial marketplace."<sup>95</sup>

The final two factors in the test were whether the beneficiaries of the services of the hospital were restricted in any way and whether private interests were benefitted by the organization or operation of the hospital. The court did not elaborate on what types of restrictions would be necessary in order to satisfy the fifth factor. With respect to the final factor the primary inquiry was whether an officer, employee, or shareholder of the hospital or entity controlling the hospital received any distribution of the assets.<sup>96</sup>

The approach taken by the Supreme Court of Utah did not revolve entirely around the charitable tax exemption afforded nonprofit hospitals. The court, instead effectively restricted the availa-

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a unilateral test, based on a for-profit/nonprofit distinction, as the sole means of identifying "charitable purposes" under the Utah Constitution (see, William Budge Memorial Hospital v. Maughan, 79 Utah 516, 3 P.2d 258 (Utah 1931)). 709 P.2d at 275.

92. *Id.* The significance of this factor, apparently, is that accumulation of profits is a characteristic of for-profit hospitals in the opinion of the court. *Id.*

93. *Id.*

94. *Id.* at 275-76. Again, the court was concerned with the nonprofit hospital exhibiting a characteristic often found in for-profit hospitals. *Id.*

95. *Id.* at 276.

96. *Id.*

bility of the charitable tax exemption by declaring that "[p]roperty used exclusively for hospital purposes is not *automatically* being used for charitable purposes, even where the hospital is non-profit."<sup>97</sup> Rather, in order to obtain/retain the exemption, the burden was on the hospital to show that it satisfied the multifactor test set forth by the Supreme Court of Utah.

#### IV. CONCLUSION

Many of the concerns expressed by the Supreme Court of Utah in *Intermountain Health Care* likewise have been expressed by the Supreme Court of Pennsylvania in cases concerning charitable organizations.<sup>98</sup> In general, both jurisdictions have expressed concerns regarding organizations which receive charitable organization tax exemptions and whether or not these organizations are truly charitable in nature and thus warrant the receipt of such tax exemptions. Both jurisdictions have promulgated multi-factor tests in order to evaluate whether an organization is truly charitable. The tests set forth by each jurisdiction center on similar concerns and contain similar factors as well.<sup>99</sup> Among the common concerns are whether the organization relieves the government of some of its burdens,<sup>100</sup> whether there has been an accumulation of profits which is invested to upgrade equipment<sup>101</sup> and the degree of compensation available to officers, directors and administrators.<sup>102</sup>

As the Supreme Court of Utah and other authorities have suggested, there has been a revolution in the health care profession which has transformed the healing profession into big business. Many nonprofit hospitals are currently enjoying substantial profits yet providing relatively little charity to the communities in which they are located.<sup>103</sup> Moreover, in addition to substantial profits, officers of these hospitals are enjoying substantial revenues.<sup>104</sup> In light of these trends and evolutions, the time has come to reevalu-

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97. *Id.* at 287.

98. Compare e.g. *Intermountain Health Care*, 709 P.2d 265 (Utah 1985) with *Hospital Utilization Project*, 487 A.2d 1306 (Pa 1985).

99. See *supra*, notes 38 and 77 and accompanying text.

100. See e.g., *Yorgason v. County Board of Education*, 714 P.2d 653, 660 (Utah 1986) and *Hospital Utilization Project*, 487 A.2d 1306, 1315 (Pa. 1985).

101. See *supra*, notes 51 and 90 and accompanying text.

102. See *supra*, notes 51 and 86 and accompanying text.

103. See *supra*, note 4.

104. See *supra*, note 4. According to an article in *The Pittsburgh Press*, the president of Allegheny General Hospital earned \$ 258,866 in fiscal year 1988. *The Pittsburgh Press*, Feb. 05, 1990, at A 13, col. 1.

ate, on a case by case basis, the charitable organization tax exemption which nonprofit hospitals in Pennsylvania currently enjoy. The result of such a reevaluation would be to bring nonprofit hospitals within the same guidelines to which other organizations seeking charitable tax exemptions are subject.

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