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How to Make Money Being a Not-For-Profit, 51 J. Marshall L. Rev. 529 (2018)

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HOW TO MAKE MONEY BEING A NOT-FOR-PROFIT

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I. INTRODUCTION

Organizations organized and operated for charitable purposes qualify for a tax exemption. Contributors to these organizations are able to receive a tax deduction for their contributions. Tax-exempt organizations must comply with the framework established by Congress and the Internal Revenue Service (“IRS”) in order to keep their tax-exempt status. The IRS signifies to the public that the organization serves a socially beneficial purpose through the transmittal of an official exempt designation to qualifying organizations. These groups are also referred as charitable organizations or § 501(c)(3) organizations. The most prominent group of exempt organizations are religious, educational, and scientific entities. These exempt organizations, hereafter referred as “not-for-profit organizations,” receive tax benefits that for-profit counterparts do not, which includes exemption from federal income tax and offering individuals and corporations a charitable deduction for their contributions.¹

To qualify as a not-for-profit organization under § 501(c)(3) of the Internal Revenue Code (“IRC”), the organization must be organized and operated exclusively for charitable purpose. The IRC states a charitable purpose encompasses religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition or for the prevention of cruelty to children or animals.² Revenue

1. I.R.C. § 501(a) (1969); I.R.C. § 170(c) (1987).

2. Treas. Reg. § 1.501(c)(3)-1 (1954).

Rulings have expanded the definition to include various other purposes.

A not-for-profit organization is organized for charitable purposes if its articles of incorporation limit its purposes to one or more of the above-described permissible purposes, and it does not authorize the organization to engage in any substantial activities that do not further one of those purposes.³ If the not-for-profit organization were to distribute assets to its members or shareholders when it liquidates, those assets would not serve one of the exempt purposes. Therefore, the not-for-profit organization must demonstrate that it will distribute its assets either in service of one of the permissible purposes or to a government when it ceases to exist.⁴

The not-for-profit organization must also engage primarily in activities which accomplish one or more of the exempt purposes specified in § 501(c)(3). The not-for-profit organization fails to be tax-exempt if more than an insubstantial part of its activities is not in furtherance of its exempt purpose. The purpose of this test is to ensure that a not-for-profit organization does not stray from its permissible purpose as defined by the IRS.⁵ Moreover, the not-for-profit organization's net earning must not inure to the benefit of any private shareholder or individual, which is known as the non-distribution rule.⁶ This rule underlines the prohibition that a not-for-profit organization may not distribute any of its assets as profits to shareholders and may not pay any of its directors or staff at above-market rates.⁷ This rule serves the purpose to ensure that a not-for-profit organization does not distribute its assets that might resemble a for-profit company disbursing profits.⁸ A variety of practices banned under this rule include excessive salaries, excessive rental payments, unwarranted payments or reimbursements of personal expenses, unsecured interest-free loans, leases of the organization's property to insiders for less than fair rental value, unexplained transfers, and theft.⁹

This rule does not prohibit not-for-profit organizations from purchasing goods or services from organizational insiders if the not-for-profit organization pays fair market value for the goods or services. Since a not-for-profit organization may not pay its directors or staff at above-market rates, the non-distribution constraint rule allows the IRS to scrutinize charity compensation arrangements carefully. Salaries based on revenues resemble distributions of organizational profits, therefore the IRS

3. Treas. Reg. § 1.501(c)(3)-1(b) (1954).

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. Treas. Reg. § 1.501(c)(3)-1(b).

9. *Id.*

particularly monitors any salaries paid to charity directors or staff members that might depend on the organization's revenues.¹⁰ In addition to the non-distribution constraint rule, the exempt organization must serve a public rather than a private interest, which means that the exempt organization may not serve a private individual or group and instead must serve the broader public.¹¹

II. NOT-FOR-PROFIT EXEMPT PURPOSES UNDER § 501(C)(3)

For an organization to be exempt under § 501(c)(3), it must be organized and operated exclusively for one or more of the exempt purposes.¹² The exempt purposes include: religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals.¹³

“Charitable” has been broadly defined but is generally considered to be an activity that gives aid to those who are in need.¹⁴ The current regulations provide that “charitable” includes “relief of the poor and distressed or of the underprivileged.”¹⁵ A person does not need to be destitute to need aid, but is generally someone who is unable to entirely support themselves, such as the elderly.¹⁶ Charitable purposes commonly include organizations that give housing aid to low-income families, provide legal services, or assistance to the elderly.¹⁷ Assistance to the elderly includes organizations that provide housing, home delivery of meals, financial counseling, transportation, counseling, or vacations.¹⁸

Charitable purpose also includes organizations which satisfy the community benefits standard which operate to benefit the community as a whole, such as building and maintaining recreation facilities or making community improvements.¹⁹ The IRS has found that an organization whose activities urge residents to take care of their community and prevent deterioration has a charitable

10. Jean Wright & Jay H. Rotz, *Reasonable Compensation*, 1993 EO CPE (1993).

11. Treas. Reg. § 1.501(c)(3)-1 (1969).

12. *Id.* § 1.501(c)(3)-1(b), (c).

13. I.R.C. 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(d) (2008).

14. ROBERT J. DESIDERIO, *Planning Tax-Exempt Organizations* § 7.03 (LexisNexis Matthew Bender 2018).

15. Treas. Reg. § 1.501(c)(3)-1(d)(2) (2008); *see also* I.R.S. Priv. Ltr. Rul. 201135032 (Sept. 2, 2011) (explaining that a charitable activity must specifically target the poor, unemployed, elderly, children, or other charitable class).

16. Rev. Rul. 70-585, 1970-2 C.B. 115.

17. Rev. Rul. 78-428, 1978 C.B. 177.

18. Rev. Rul. 79-18, 1979-1 C.B. 194; Rev. Rul. 76-244, 1976-1 C.B. 15; Rev. Rul. 75-198, 1975-1 C.B. 157; Rev. Rul. 77-246, 1977-2 C.B. 190; Rev. Rul. 75-385, 1975-2 C.B. 205.

19. DESIDERIO, *supra* note 14 § 7.04.

purpose.²⁰ Similarly, an organization which acts to combat potential problems in an upscale neighborhood has a charitable purpose.²¹

An organization that is designed to promote public advocacy and provide a broad benefit to the community by resolving through litigation a public interest issue may be organized for a charitable purpose. Public interests include environmental protection, urban renewal, prison reform, freedom of information, and governmental action or inaction.²² Generally, areas of public interest include areas ordinarily not provided by traditional private firms.²³ Revenue Ruling 92-59, 1992-C.B. 411, lists guidelines for what constitutes a public interest law firm.

Another type of charitable purpose includes acts that maintain public buildings or monuments lessen burdens of the government, or promote social welfare by lessening neighborhood tensions, eliminate prejudice and discrimination, defends human and civil rights secured by law, or combat community deterioration and juvenile delinquency.²⁴ A community based recreational facility has been treated as a public work for charitable purposes.²⁵ An organization formed to acquire and preserve the natural environment on undeveloped land has a charitable purpose.²⁶ However, an organization that provided solar panels did not have a charitable purpose because the environmental benefits were indirect and tangential to the community.²⁷ An organization formed to educate the public about homosexuality to foster understanding and tolerance has a charitable purpose and qualifies for exemption.²⁸

Beyond the charitable purpose, an organization may be exempt for having an educational purpose. Educational organizations generally include museums, zoos, planetariums, symphony orchestras, and other similar organizations.²⁹ Educational purposes are divided into two categories, (1) an organization dedicated to the

20. Rev. Rul. 76-147, 1976-1 C.B. 151; *see also* Monterey Public Parking Corp. v. United States, 481 F.2d 175 (9th Cir. 1973) (holding that an organization that constructed and operated a parking facility in a center-city business district had a charitable purpose because it helped to prevent deterioration of the city center).

21. Rev. Rul. 75-286, 1975-2 C.B. 210.

22. Rev. Rul. 75-74, 1975-1 C.B. 152.

23. Rev. Proc. 71-39, 1971-2 C.B. 575. Private firms generally do not represent broad public interest because it is not economically feasible. *Id.*

24. DESIDERIO, *supra* note 14 § 7.08.

25. *See* Rev. Rul. 59-310, 1959-2 C.B. 146 (classifying an organization that built and maintained public swimming pool and playground for children as a charitable organization).

26. Rev. Rul. 76-204, 1976-1 C.B. 152.

27. I.R.S. Priv. Ltr. Rul. 201210044 (Mar. 9, 2012).

28. Rev. Rul. 78-305, 1978-2 C.B. 172; *see also* Rev. Rul. 72-228, 1972-1 C.B. 148 (ruling that an organization that promotes women's rights by investigating workplace discrimination is considered to have a charitable purpose).

29. Treas. Reg. § 1.501(c)(3)-1(d)(2), (3)(i) (2008).

advancement of education, and (2) an organization that has an educational purpose which is separate from the advancement of education.³⁰

An organization advances education by furthering topics generally promoted in colleges, universities, or museums. Advancing education is not limited to teaching but can also include school provided services,³¹ scholarship, or services which support child development.³² Expanding on the idea of advancement, the IRS found that an organization which preserved historic buildings and made them open to the public had an educational purpose.³³

Educational exemptions are not limited to classroom instructions but may also include activities engaged outside of the classroom. While classroom instructions involve traditional teachings found in primary and secondary schools, colleges, universities and professional schools, non-classroom exempt purposes can include job training, seminars, and public debates.³⁴ An organization can qualify as an educational organization if it works to reduce unemployment by training individuals to find work.

Prior to the enactment of § 501(k), the IRS significantly limited the ability to run a not-for-profit child day care organization. Today, the Regulations provide a child day care center may qualify for exemption as an educational not-for-profit if it provides care for children away from their homes, the care allows the parents to be gainfully employed, and the day care is open to the public.³⁵

Other organizations that operate to promote the arts including theatre, jazz, and art exhibition qualify because they promote the education of the arts.³⁶ In addition to tax exemption, organizations that operate to promote the arts will benefit as a not-for-profit because they become eligible for private foundations. The promotion of arts is generally recognized as an educational purpose.³⁷

To operate under a scientific purpose, an organization can either work to advance a field of science or, in general, have a scientific purpose. An organization advances science if it promotes or disseminates scientific ideas or discoveries.³⁸ An organization that does not conduct scientific research but supports scientific ideas will qualify as advancing science.³⁹ For example, an organization that surveys and abstracts scientific or medical

30. *Id.*

31. DESIDERIO, *supra* note 14 § 8.03 (including university bookstores, school cafeterias, and college dormitories).

32. *Id.*

33. Rev. Rul. 76-204, 1976-1 C.B. 152.

34. Treas. Reg. § 1.501(c)(3)-1(d)(2)(ii) Example (2) (2008).

35. I.R.C. § 501(k) (1984).

36. DESIDERIO, *supra* note 14 § 8.06.

37. Treas. Reg. § 1.501(c)(3)-1(d)(3) (2008).

38. Treas. Reg. § 1.501(c)(3)-1(d)(5) (2008).

39. *Id.*

literature is advancing scientific ideas.⁴⁰ Even an organization that manufactures anthropological specimens for distributions to schools, at cost, is considered an organization that advances science by illustrating the development of human evolution.⁴¹

An organization with a scientific purpose includes organizations that conduct scientific research or similar activities. Scientific research has been interpreted to include scientific observations, performed by science experts using mathematical reasoning which seek to add knowledge to a scientific field or seek to systemize scientific knowledge to present it in a useful database.⁴² The IRS is skeptical of scientific exempt organization that are involved in commercial activities or operations. As a general rule, activities that are commercial in nature or are necessary for commercial operation are do not meet the definition of a scientific purposes.

III. OTHER NOT-FOR-PROFIT EXEMPT PURPOSES

Subsection 501(c)(3) is by far the most inclusive and well-known type of not-for-profit organizations. However, the IRC has other types of exempt organizations under § 501(c) which are subject to different rules and regulations. In some cases, organization may qualify for exemption as one of the several types of exempt organizations and will want to examine their differences.⁴³ For example, unlike a not-for-profit organization organized under § 501(c)(3), other types of not-for-profit organizations can engage in political campaigning. However, a major drawback is that these not-for-profits are unable to receive tax deductible contributions from donors.⁴⁴ Because of this drawback, organizations who anticipate receiving large donations from private donors may benefit from organizing as a charitable organization.

The second most popular type of not-for-profit organizations are exempt under the social welfare standard. Like a charitable organization, social welfare organizations are exempt only if they are organized and operated exclusively for the promotion of social welfare.⁴⁵ As a general rule, “social welfare” is considered to be the promotion of the common good and general welfare of the people of a community including civic betterments or social improvements.⁴⁶

40. *Id.*

41. *Id.*

42. *Id.*

43. Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) (1990).

44. I.R.C. § 170(c) (1987).

45. I.R.C. § 501(c)(4) (1990).

46. *Id.* § 1.501(c)(4)-1(a)(2)(1) (1990); see *Vision Serv. Plan, Inc. v. United States*, 265 Fed. Appx. 650-51 (2008) (opining that an organization that provided vision services and supplies only to suppliers is not operated

In the past, social welfare organizations were popular among private groups and clubs, which claimed exempt status because they operated for the benefit of their private group. The IRS found this action contrary to the intent of the subsection. As a result, the IRS will pay particular attention to the size of the community receiving the social benefit and will likely deny or revoke exempt status unless the community as a whole is benefiting from the organization. Several cases discuss whether an organization is benefiting a group of private individuals rather than the community as a whole. In one instance where the benefit was found to extended to the community as a whole, an organization had developed and operated a parking structure in a busy downtown area with the intent to remedy the congested parking conditions.⁴⁷ The court found that the benefit extended to the community as a whole because it was open to the public thus allowing all members of the community to benefit from the improved conditions.⁴⁸

In general, social welfare organizations must be conducted primarily for noncommercial reasons.⁴⁹ However, partially commercial activities, such as charging a small fee to the public to recuperate its costs, is not enough for the IRS to deny or revoke tax exemption, as long as the facts can show a primary noncommercial operation.⁵⁰ For example, a common social welfare not-for-profit is organized with the purpose to encourage the community's interest in art and culture. If this type of not-for-profit operates art exhibits in the community and can show that the primary purpose is to promote art to the community, it can charge a small admission fee to cover the costs of operating the exhibit. The IRS website lists several other examples of social welfare organizations, each of which are clearly beneficial activities to a large group of individuals in a community, not private groups for their individual benefit.⁵¹

As discussed above, there is an overlap between organizations exempt under the social welfare standard and those exempt for a charitable purpose.⁵² Whether to organize as a charitable or social welfare organization depends on what, if any, political activities the entity intends to engage in and the possibility of attracting deductible contributions.⁵³

The IRC goes on to describe other specific organizations that are entitled to tax exemption such as labor organizations, agriculture organizations, and horticulture organizations. In

exclusively for promotion of general welfare).

47. Rev. Rul. 81-116, 1981-1 C.B. 333.

48. *Id.*

49. Rev. Rul. 78-131, 1978-1 C.B. 157.

50. *Id.*

51. *Social Welfare Organizations Examples*, IRS, www.irs.gov/charities-non-profits/other-non-profits/social-welfare-organizations-examples (last updated Apr. 2, 2018).

52. Treas. Reg. § 1.501(c)(3)-1(d)(2) (2008).

53. I.R.C. § 170(c) (1987).

general, these types of entities are entitled to exemption if they operate to better the conditions of those engaged in labor, agriculture, or horticulture businesses, such as to improve the grade of products or to develop more efficient working conditions.⁵⁴

Professional organizations, such as business leagues, chambers of commerce, real-estate boards, or professional football leagues are exempt under § 501(c)(6). Unlike a social welfare not-for-profit, a business league not-for-profit must operate to serve only its members' common business interests rather than the interests of a community or a commercial enterprise.⁵⁵

Social organizations are explicitly exempt under their own category. Social clubs include recreational organizations that operate for pleasure, recreational, or other similar purposes.⁵⁶ A social club must have established membership lists, where persons regularly engage with each other.⁵⁷ Not all recreational and social activities are allowed under a social club, such as a not-for-profit that seeks to be exempt as a club, primarily for dining at an organization's restaurant.⁵⁸

IV. NOT-FOR-PROFIT EMPLOYEES V. FOR-PROFIT EMPLOYEES

Evidence shows that not-for-profit and for-profit employees have "different observable characteristics."⁵⁹ Not-for-profit employees tend to be older and have more education and are much more likely to be female.⁶⁰ These differences indicate that not-for-profit and for-profit employees might respond differently to incentives, or that incentives differ in the two sectors.⁶¹ The education not-for-profit sector, where the U.S. median pay in 2013 was \$170,178 generally pays better than other not-for-profit sectors.⁶²

There is evidence of not-for-profits using a quasi-pay for performance compensation schemes. For example, a study of 727 United Methodist churches and 2201 ministers in the state of

54. Treas. Reg. § 1.501(c)(5)-1(a)(2) (1997).

55. Rev. Rul. 73-411, 1973-2 C.B. 180 (explaining that an organization of shopping center merchants was not exempt because it served the merchants' interest as tenants rather than the common business interest of the members).

56. I.R.C. § 501(c)(7) (1958).

57. Rev. Rul. 58-589, 1958-2 C.B. 266.

58. I.R.S. Priv. Ltr. Rul. 201313035 (Mar. 29, 2013).

59. James R. Hines Jr., Jill R. Horwitz & Austin Nichols, *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1197 (2010).

60. *Id.*

61. *Id.*

62. Jeane MacIntosh, *Study Looks at Nonprofit Groups with Millionaire CEOs*, NEW YORK POST (Oct. 14, 2013), www.nypost.com/2013/10/14/study-looks-at-nonprofit-groups-with-millionaire-ceos/.

Oklahoma between 1961 and 2003 found that when a new member joins a church, its minister's annual compensation increased by just \$15.00.⁶³ When a member leaves the congregation, the minister's pay falls only by \$7.00.⁶⁴ The study argued that "ministers' incentives operate as a type of sharing rule, by which the pastor is paid close to 3% of the revenue that accrues to the church when a new member joins."⁶⁵

In a 2011 study, "median pay for executives at the largest not-for-profits and foundations increased 3.8% in 2011 to \$429,512 . . . whereas the inflation rate was about 3% during the year."⁶⁶ In 2009, the IRS published a survey of 500 not-for-profit hospitals, which stated that "hospital CEO compensation averaged \$500,000, but uncompensated care expenditures as a percentage of revenue averaged a mere 7%."⁶⁷

V. BENEFITS IN ESTABLISHING A NOT-FOR-PROFIT ORGANIZATION

While "for-profit entities or their owners are generally subject to federal and state income taxes, not-for-profit entities are generally exempt from those taxes."⁶⁸ Moreover, "not-for-profit entities that are committed to pursuing charitable, educational, religious, or other public-benefitting purposes," also enjoy other tax benefits, most conspicuously, the ability to receive tax-deductible contributions and possible exemption from state and local taxes.⁶⁹ Federal corporate tax rates combined with state corporate taxes can add considerable income savings for not-for-profit organizations. If the not-for-profit expects to earn large amounts of money from mission-related services or sales, an exemption can be worth millions of dollars.⁷⁰ Also, not-for-profits are often exempt from other types of state and local taxes such as real property taxes and

63. Jay C. Hartzell, Christopher A. Parson & David L. Yerkmack, *Is a Higher Calling Enough? Incentive Compensation in the Church*, 28 J. LAB. ECON. 509, 510-11 (2010).

64. *Id.* at 511.

65. *Id.*

66. Blaire Briody, *10 Insanely Overpaid Nonprofit Execs*, HUFFINGTON POST (Apr. 8, 2013) www.huffingtonpost.com/2013/04/08/10-insanely-overpaid-nonp_n_3038162.html.

67. Naomi Freundlich, *High CEO Salaries at Nonprofit Hospitals Under Scrutiny... Once Again*, HEALTH BEAT (Mar. 24, 2011), www.healthbeatblog.com/2011/03/high-ceo-salaries-at-nonprofit-hospitals-under-scrutinyonce-again/.

68. Lloyd Hitoshi Mayer & Joseph R. Ganahi, *Taxing Social Enterprise*, 66 STAN. L. REV. 387, 391 (2014).

69. *Id.*

70. Joanne Fritz, *Pros and Cons of Nonprofit Incorporation*, THE BALANCE, www.thebalance.com/the-pros-and-cons-of-nonprofit-incorporation-2502270 (last updated Apr. 11, 2017).

sales taxes.⁷¹

These benefits generally fall into two categories. The first category includes benefits that effectively reduce the costs of obtaining inputs for a charity's activities. This includes not only exemption from federal and state income taxes but also the tax deduction for contributions, access to tax-exempt bond financing, exemption from state and local taxes on real and personal property, and exemption from sales and use taxes on the purchase of goods or services. "Current estimates of the cost of the government of the tax-related benefits alone are between \$70 and \$80 billion per year."⁷²

The second category of benefits include "the partial or complete exclusion from the application of many federal and state laws, including securities laws, or other special accommodations."⁷³ These exemptions are justified by the belief that "charities by their nature are unlikely to engage in the bad acts these laws seek to prevent" and so are not the target of these taxes.⁷⁴

In health care, education, retirement communities, day care, and physical fitness activities there are significant numbers of for-profit and government providers, as well as not-for-profit providers.⁷⁵ Not-for-profit organizations may still sell goods and services in the marketplace.⁷⁶ With respect to activities that are considered inherently charitable, such as providing education and health care, not-for-profits are permitted to charge full market value.⁷⁷ Classification as an unrelated trade or business will often cause the loss of state and local property tax exemption for whatever facilities are involved in the sale.⁷⁸ "If an unrelated trade or business activity becomes too large a part" of the not-for-profit's overall activities, the status as a not-for-profit may be at risk of revocation by the IRS.⁷⁹ The vast majority of not-for-profits do not engage in these types activities.⁸⁰ The not-for-profits that do engage in unrelated trade or business activities must ensure that such activities are minimal in comparison (or qualify for exemption from unrelated business exceptions).⁸¹ "For example, the courts have . . . ruled and the IRS has accepted that religious publishing can be substantially related to the accomplishment of charitable or religious purposes even if the resulting publications are sold at or above cost if certain other indicia of non-commerciality are

71. *Id.*

72. Lloyd Hitoshi Mayer, *The "Independent" Sector: Fee-for-Service Charity and the Limits of Autonomy*, 65 VAND. L. REV. 51, 63 (2012).

73. *Id.*

74. *Id.*

75. *Id.* at 102.

76. *Id.* at 101.

77. Mayer, *supra* note 72, at 101.

78. *Id.* at 102.

79. *Id.*

80. *Id.* at 102-03.

81. *Id.* at 103.

present.”⁸²

A significant advantage of the incorporation of a not-for-profit is the protection of the organization’s members from personal liability. Like a for-profit organization, board members, officers, and employees of a not-for-profit organization receive protection from liability for corporate debts and lawsuits.⁸³ If incorporation is not feasible, as with a smaller not-for-profit, it may be beneficial to purchase liability insurance.⁸⁴

Not-for-profit corporations continue to exist beyond the lifetime or involvement of its founding members, which translates as an attraction for donors who want to fund a long-term cause.⁸⁵

Being a not-for-profit corporation also allows for employee benefits such as life insurance, health insurance, and a pension plan.⁸⁶ Other advantages of a not-for-profit organization include lower postal rates.⁸⁷ The United States Postal Service provides reduced prices for organizations authorized by service who can meet specific eligibility rules.⁸⁸ An organization exempt under § 501(c)(3) does not automatically qualify an organization for reduced postal rates.

Disadvantages of a not-for-profit organization include no pay for the organization’s directors, limits on political campaigning and lobbying, and if the organization dissolves, its assets must be given to another not-for-profit organization. Since a not-for-profit is dedicated to the public interest, its finances are therefore open to the public for inspection. The public may obtain copies of a not-for-profit organization’s state and federal filing, which will disclose salaries and expenditures.⁸⁹

VI. NOT-FOR-PROFIT UNDER SCRUTINY

The most vivid example that explains the high level of scrutiny of not-for-profit organizations is the Kamehameha School Bishop Estate (“KSBE”) scandal. This high-profile scandal resulted in “the removal of all trustees of a multi-billion-dollar charity charged with the operation of Hawaii’s Kamehameha Schools.”⁹⁰ The KSBE’s compensation practices led to forty million dollars in trustee fees over a ten-year period, or an average of \$900,000 in annual

82. Mayer, *supra* note 72, at 103.

83. Fritz, *supra* note 70.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. UNITED STATES POSTAL SERVICE NONPROFIT USPS MARKETING MAIL ELIGIBILITY: NONPROFIT AND OTHER QUALIFIED ORGANIZATIONS, Pub. No. 417 (2017).

89. *Id.*

90. Peter Frumkin, Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 HAW. L. REV. 425, 425 (1999).

compensation per trustee.⁹¹

The KSBE case highlights the limited power donors have in shaping not-for-profit compensation practices, which explains the high level of scrutiny of not-for-profits by the IRS and the public.⁹²

VII. THE NOT-FOR-PROFIT HOSPITAL

Hospitals are the “largest and best known institutions in the continuously growing not-for-profit sector,” but the private sector still dominates the market.⁹³ Under § 501(c)(3) of the IRC, hospitals are exempt from federal taxation as a charitable organization if they meet the community benefit standard.⁹⁴ Under this standard, hospitals must promote health in a manner that benefits the whole community and are prohibited from acting in ways that solely benefit the organization.⁹⁵ The IRS considers multiple factors, with no one factor being determinative.⁹⁶ Not-for-profit hospitals may act in ways that violate the community benefits standard.⁹⁷ When a hospital “does not meet the standard,” the IRS has the authority to revoke the hospital’s tax-exempt status.⁹⁸ However, revocation is an extreme action that is not appropriate for every infraction.⁹⁹ As a result, many not-for-profit hospitals may eventually violate the community benefits standard but will not be subject to revocation.¹⁰⁰

To qualify as a not-for-profit hospital, it must meet both an organizational test and an operational test.¹⁰¹ A not-for-profit hospital “satisfies the organization test if its articles of organization limit its purpose to one or more of the exempt purposes listed in § 501(c)(3) and restrict the hospital from engaging in more than an insubstantial amount of non-exempt activities.”¹⁰² A not-for-profit hospital “satisfies the personal test if it engages primarily in activities that accomplish one or more of the exempt purposes listed in § 501(c)(3) and its net earnings do not inure to the benefit of private individuals or shareholders.”¹⁰³ If a not-for-profit hospital at

91. *Id.*

92. *Id.* at 426.

93. *Justifying the Nonprofit Hospital Tax Exemption in a Competitive Market Environment*, 13 WIDENER L.J. 383, 540 (2004).

94. I.R.C. § 501(c)(3) (1986).

95. Rachel Weisblatt, *Uncharitable Hospitals: Why the IRS Needs Intermediate Sanctions to Regulate Tax-Exempt Hospitals*, 55 B.C. L. REV. 687, 687 (2014).

96. *Id.*

97. *Id.*

98. *Id.* at 688.

99. *Id.* at 688-89

100. Weisblatt, *supra* note 95, at 689.

101. *Id.* at 690.

102. Treas. Reg. § 1.501(c)(3)-1(b) (1954); Weisblatt, *supra* note 95, at 690.

103. Treas. Reg. § 1.501(c)(3)-1(c) (1954); Weisblatt, *supra* note 95, at 690.

any time fails either, or both, the organizational and operational tests, the IRS may impose sanctions in lieu of revocation of the hospital's exempt status.¹⁰⁴ Of course, the severity of the hospital's transgression plays a key role in the IRS's decision in which course of action is appropriate.

Under the community benefit standard, a not-for-profit hospital can maintain its exempt status by operating for the benefit of the community as a whole.¹⁰⁵ According to the IRS, a not-for-profit hospital's emergency room must offer emergency treatment for charity patients.¹⁰⁶ Other than this restriction, the not-for-profit hospital may limit its services to community members that are willing and able to pay, so long as this class is not so small that its services are not of benefit to the community.¹⁰⁷ Since Medicare-participating for-profit hospitals that have emergency rooms are required to treat all emergencies, the restriction placed on not-for-profit hospitals is not more of a burden than on most for-profit hospitals in the United States.¹⁰⁸

A 1995 study examining 2800 not-for-profit hospitals reported an estimated aggregate value of federal tax-savings to be approximately \$4.6 billion and state tax-savings of \$500 million.¹⁰⁹ Not-for-profit hospitals in the United States also realized approximately \$1.7 billion dollars in tax savings from property tax exemptions.¹¹⁰ In 2002, "the total value of exemptions from federal, state, and local taxes [was] estimated to be \$12.6 billion" for all not-for-profit hospitals.¹¹¹

Tax-exempt hospitals may also issue tax-exempt bonds and receive tax-deductible contributions.¹¹² While the tax savings available for these activities do not accrue directly to the benefit of tax-exempt hospitals, their availability does potentially increase tax-exempt hospitals' access to capital.¹¹³ Accordingly, "tax-exempt bond financing and the availability of a charitable deduction for contributions to tax-exempt hospitals can enhance the financial position of tax-exempt hospitals" in relation to for-profit hospitals.¹¹⁴ The 1995 hospital study estimated that "the combination of tax-exempt bonds issued by exempt hospitals and

104. Weisblatt, *supra* note 95, at 689

105. Rev. Rul. 69-545 1969-2 C.B. 117.

106. *Id.*

107. *Id.*

108. *Id.*

109. Terri L. Brooks, *Billions Saved in Taxes While Millions Underserved - What Has Happened to Charitable Hospitals?*, 8 HOUS. BUS. & TAX L.J. 391, 394 (2008).

110. *Id.* at 394-95.

111. Cong. Budget Office, Pub. No. 2707, NONPROFIT HOSPITALS AND THE PROVISION OF COMMUNITY BENEFITS 5 (2006).

112. Brooks, *supra* note 109, at 395.

113. *Id.*

114. *Id.*

charitable deductions cost the government in excess of \$1.4 billion in annual revenues.”¹¹⁵ The 2002 study suggested that “tax-exempt bonds and charitable contributions to not-for-profit hospitals cost the federal government approximately \$3.6 billion.”¹¹⁶

A not-for-profit hospital may also have for-profit subsidiaries “if it can be proven to be an ‘integral part’ of the exempt activities of the parent entity.”¹¹⁷ For example, it is permissible for the subsidiary to provide funds that “are used for a particular aspect of the parent” not-for-profit hospital.¹¹⁸ However, it is not permissible for the subsidiary to carry on an unrelated trade or business that is not related to the parent’s exempt purpose.¹¹⁹ Nevertheless, the subsidiary may establish that it meets the requirements of § 501(e).¹²⁰ Even if the activity or the income producing service of the subsidiary is carried on for the production of income, then it comes within the scope of § 162.¹²¹

The not-for-profit hospital is not situated similarly to the for-profit hospital company because of the organizational and operational advantages regarding the transfer of liquidated capital out of communities where the facilities are located.¹²² Another organization comparison that negatively affects not-for-profit hospitals’ efficacy in the market, is their ability and need to generate service revenues in excess of amounts needed merely to pay expenses.¹²³

VIII. THE NOT-FOR-PROFIT ORGANIZATION AND THE ELDERLY

In a 2002 report, the U.S. Department of Health estimated that by 2030 older populations, (those 65 years or older) will double to more than 70 million, representing about 20% of the US population.¹²⁴ Historically the IRS significantly limited charitable exemptions for elderly persons. Over time, the IRS found that senior citizens from all socio-economic backgrounds faced some type of hardship to obtain basic support needs.¹²⁵ As a result, relief of the aged was recognized as a charitable exemption for reasons other

115. *Id.*

116. *Id.*

117. Jack E. Karns, *Justifying the Nonprofit Hospital Tax Exemption in a Competitive Market Environment*, 13 WIDENER L.J. 383, 465 (2004) (quoting Treas. Reg. § 1.502-1(b)).

118. *Id.*

119. *Id.*

120. I.R.C. § 501(e) (1986).

121. I.R.C. § 162 (2017); Karns, *supra* note 117.

122. *Id.* at 515-16.

123. *Id.* at 537.

124. Elizabeth C. Kastenberg & Joseph Chasin, *Elderly Housing*, 2004 EO CPE Text (2004).

125. Rev. Rul. 72-124, 1972-1 C.B. 145..

than the socio-economic status of the elderly.¹²⁶ In general, a charitable residence for the elderly, whether for health care or residence, must provide some type of special needs for its residents to qualify as a charitable not-for-profit.¹²⁷

An organization that provides housing, nursing care and other facilities to the elderly can benefit from tax exemption savings which can be reinvested into the services and facilities provided.¹²⁸ To qualify, an organization must be dedicated to (and actually furnish) care and housing to aged individuals who would otherwise be unable to provide for themselves in some manner, such services are to a reasonable proportion of its residents at a rate substantially below cost, and those services are those that give relief to the hardship of the aged individual.¹²⁹

The demand for home healthcare services has also increased in response to the growth in the elderly population. Certain home health care organizations may qualify for exemption as an organization described under the social benefits standards, provided they are formed to provide low-cost health care for people of the community.¹³⁰ Ancillary services provided in connection with the home health care such as personal care, housekeeping and meal preparation exclusively for the elderly are treated as an inherent part of the healthcare program and are not treated as unrelated business income.¹³¹

IX. SALES TAX EXEMPTION FOR NOT-FOR-PROFIT ORGANIZATION

In addition to federal tax exemption, not-for-profit organizations may also qualify for state and local tax exemption. In Illinois, tax exemption has saved not-for-profit organizations from paying both state and local sales and use tax on retail purchases of tangible goods. This exemption can be very valuable to a not-for-profit organization, especially in a city like Chicago, which has a 10.25% tax.

Without tax exemption, a not-for-profit organization will be subject to sales taxes under several state statutes including the Retailers Occupation Tax Act (“ROTA”), Use Tax Act, and the Service Occupation Tax Act (“SOTA”).¹³² In general, ROTA imposes tax liability on sales at retail, which are considered any transfer of tangible personal property to a purchaser for the purpose of use or

126. *Id.*

127. *Id.*

128. Rev. Rul. 61-72, 1961-1 C.B. 188.

129. I.R.C. § 501(c)(3).

130. Rev. Rul. 72-209, 1972-1 C.B. 148.

131. I.R.S. Tech. Adv. Mem. 94-05-004 (Aug. 31, 1993).

132. 35 ILL. COMP. STAT. 120/1 (2018); 35 ILL. COMP. STAT. 105/1 (2018); 35 ILL. COMP. STAT. 115/1 (2018).

consumption, and not for the purpose of resale.”¹³³ The Use Tax Act, imposes a retail tax on purchases from out-of-state sellers who generally are not otherwise liable under the ROTA. SOTA, 35 Illinois Comp. Stat. 115/1, *et seq.*, imposes taxes on individuals engaged in services who sell tangible personal property at retail connected therewith. Additionally, a Use Tax may be imposed on individuals engaged in services on the purchase of tangible personal property if they are not liable under SOTA.¹³⁴

Sales tax exemption works in two directions as to a buyer and seller of tangible personal property. A qualified not-for-profit organization will be exempt from paying sales taxes on its purchases by giving a merchant their state issued exemption number. In a few limited situations a not-for-profit organization may also be exempt from sales tax liability on the sale of retail tangible personal property.

There is a common misconception that tax exempt status from the IRS renders an organization automatically tax exempt for all state purposes. While a 501(c)(3) organization is automatically exempt from Illinois Income Tax, an organization must qualify under the state’s sales tax exemptions standards.¹³⁵ The state sales tax exemption is stricter than the IRS’s federal exemption standard. Illinois requires that an organization demonstrate its qualification by clear and convincing evidence with all debatable facts resolved against exemptions.

To qualify for sales tax exemption, a not-for-profit must be organized and operated *exclusively* for a charitable, religious, or educational purpose.¹³⁶ The definitions of charitable, religious, and educational purpose are different from the federal definitions. The exclusivity requirement works to preclude many organizations from becoming tax exempt. While it does not require the organization to engage solely in one of the exclusive categories, it does require that the organization operate primarily for one of the three exclusive categories.¹³⁷ Organizations that do charitable, religious, or educational work, but are not organized and operated primarily for that reason will not qualify for exemption.¹³⁸

133. 35 ILL. COMP. STAT. 120/1.

134. Service Use Tax Act, 35 ILL. COMP. STAT. 110/1 (1961).

135. 35 ILL. COMP. STAT. 5/205(a) (2018); 35 ILL. COMP. STAT. 5/201(c) (2018).

136. 35 ILL. COMP. STAT. 5/201 (2018); ILL. ADMIN. CODE tit. 86, § 130.2005(a)(1)(A) (2000).

137. *People ex rel. Nordlund v. Ass’n of Winnebago Home for Aged*, 237 N.E.2d 533, 539 (1968); *see also Yale Club of Chicago v. Dep’t of Revenue of State of Illinois*, 574 N.E.2d 31, 36 (1991) (elaborating that the exemption may also apply to purposes which are reasonably necessary for the accomplishment and fulfillment of an exempt purpose).

138. ILL. ADMIN. CODE tit. 86, § 130.2005 (2000).

A religious not-for-profit must be organized and operated primarily for religious activities that are more than traditional worship activities to qualify. Generally, an organization that operates a church will qualify for sales tax exemption even if it offers teaching or training to its members.¹³⁹ However, a religious organization that primarily or exclusively sells goods of a religious nature will not be exempt for several reasons. First, commercial retail is not considered a traditional form of worship, and, unless otherwise provided, an organization is not tax exempt for purchasing inventory they intend to sell.¹⁴⁰

An organization that operates exclusively for educational purposes, while not specifically defined, applies to school purposes or as defined by the Supreme Court as a place where systematic instruction in useful branches of learning is given by methods common to school and institutions of learning.¹⁴¹ This list of activities that are not exempt under this category is extensive. Many organizations that apply for exemption for an educational purpose will fail either because it is not a common branch of learning or the instruction is not a systematic method of learning typically found in traditional institutions. Dance classes and riding classes are not educational because they are not traditional courses offered by a public school.¹⁴² Even traditional courses offered by institutions may not qualify as an educational purpose if they don't use comparable teaching methods. Accelerated or short-term sessions may be excluded because the scope and intensity of the course represents only a superficial or brief survey of the course. Consequently, flying schools, driving schools, and modeling schools are not educational, for purposes of exemption, because they are not offered using traditional methods. Contrary to the several limiting factors, when comparing course content, all grade levels may be used from grade school to college, private school, government-owned programs, tax-supported schools, vocational or trade schools, and even an organization that provides services to improve educational standards. Surprisingly, literary societies are excluded from educational purposes because the primary benefit is for its members and is presumed to be a hobby rather than an educational program. Finally, only limited liability companies are eligible for exemption if organized under an educational purpose.¹⁴³

Under the final category, a charitable purpose may refer to almost anything as long as it promotes the well-being of society, it is operated as a not-for-profit, the benefit reaches an indefinite

139. *See generally* Evangelical Teacher Training Ass'n v. Novak, 454 N.E.2d 836 (1983) (detailing an exemption for education of ministers, preparing Bible course materials, distributing religious publications).

140. C. O. Baptista Films v. Cummins, 137 N.E.2d 393, 396 (1956).

141. ILL. ADMIN. CODE tit. 86, § 130.2005.

142. *Id.*

143. 35 ILL. COMP. STAT. 120/2-5(11) (2018).

number of the public, and there is no private inurement to anyone as a result of the operation.¹⁴⁴ Moreover, while an organization can restrict the group of individuals who may benefit from their charitable activity, the services rendered to that group must in some way be charitable in a way such that relieves the public of a burden to confer such benefit on those individuals or the public in general.¹⁴⁵ A major reason why an organization is denied sales tax exemption is because of its capital structure or salaries paid. While a reasonable salary paid to employees for services actually rendered does not make it a for-profit entity, unreasonable salaries, distributions of stock or dividends or other profit or payment to directors will easily disqualify an organization.¹⁴⁶ Hospitals and similar institutions have recognized substantial benefit from sales tax exemption statutes, a benefit which generally is reallocated back to the general public. Not-for-profit hospitals, clinics, and nursing homes qualify as exclusively charitable organizations as long as they do not discriminate against hiring doctors or admittance of patients because of race, color, religion or inability to pay.¹⁴⁷

Other qualified organizations, as determined by the Department of Revenue, may qualify for sales tax exemption, including senior citizen organizations, county fair associations, and certain licensed day care centers.

Turning now to sales tax exemption for a not-for-profit seller, as a general rule even an exempt organization must collect and remit sales tax on items it sells, unless one of the three exceptions apply. The exceptions include items sold only to the organization's members, students, or patients; sales that are from occasional dinners open to the general public; and sales that are not in direct competition with businesses in the community.¹⁴⁸ The income generated must still be intended to further the charitable purpose of the organization for the exemption to apply. Under the first exception, organizations are exempt from collecting sales taxes on the sale of goods such as uniforms, insignia, and bibles, if limited to its members.¹⁴⁹ Nursing homes and hospitals are also not subject to sales tax when selling food or medicine to their patients but only for goods that are necessary for basic hospital services.¹⁵⁰ As to the second exception, the exemption extends to proceeds from sales if such selling is noncompetitive with businesses in the community. The purpose of this exemption is to prevent sales tax on fundraising activities, so only annual or seasonal sales that are incidental to its

144. ILL. ADMIN. CODE tit. 86, § 130.2005.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. ILL. ADMIN. CODE tit. 86, § 130.2005.

150. *Id.*

exclusive purpose will benefit from this exception. The third exception also requires that the events or dinners be occasional and not more than twice in one year.

X. NOT-FOR-PROFIT ORGANIZATIONS TO QUALIFY FOR PROPERTY TAX EXEMPTION

In addition to federal and state sales tax, not-for-profit organizations may qualify for property tax exemption. Property tax exemption is provided for in the Illinois Constitution, and exempts certain property used for school, religious, cemetery and charitable purposes.¹⁵¹ To qualify an organization must demonstrate that the property is both owned by the organization and is exclusively used for a qualified purpose.¹⁵² Like the sales tax exemption, the burden of proof is on the applicant who must prove clearly and conclusively that they have met both prongs of the test.¹⁵³

To qualify for property tax exemption a not-for-profit organization must first prove that it is the clear owner of the property.¹⁵⁴ Secondly, it must prove that it is organized and operated for a qualified exempt purpose and that the property and is actively used for such purpose.¹⁵⁵ To satisfy the strict burden, an organization can submit evidence that the property is not leased or owned with the intent to make a profit, and that the property is primarily used to further the exempt purpose with only incidental non-exempt uses.¹⁵⁶ Vacant land cannot qualify for tax exemption because it is not actively engaged in the charitable purpose.¹⁵⁷ However, certain periods of development or remodeling may qualify for exemption.¹⁵⁸ In general, an organization can be exempt and still collect fees to cover or reimburse the organization for property expenses.¹⁵⁹ However, charging rent or fees using commercial standards may cause an organization to look like a for profit entity, unless certain steps are followed to justify the charges through a

151. Ill. Const. art. IX § 2.

152. 35 ILL. COMP. STAT. 200/15-65(a) (2018).

153. *Chicago & Northeast Illinois Dist. Council of Carpenters Apprentice & Trainee Program v. Illinois Dep't of Revenue*, 688 N.E.2d 721, 725 (1997).

154. 35 ILL. COMP. STAT. 200/15-10 (2018).

155. *Id.*

156. *Childrens Dev. Ctr., Inc. v. Olson*, 288 N.E.2d 388, 390 (1972).

157. *People ex rel. Pearsall v. Catholic Bishop of Chicago*, 142 N.E. 520, 522 (1924).

158. *Id.*

159. 35 ILL. COMP. STAT. 200/15-35, 13-40, 15-65 (2018); *see e.g.*, *Chicago Patrolmen's Ass'n v. Dep't of Revenue, State of Illinois*, 664 N.E.2d 52 (1996) (allowing an exemption for a charitable museum even though non-charitable organization owned and used 50% of the property; use of the property was undivided between organizations); *see also Decatur Sports Found. v. Dep't of Revenue of State of Illinois*, 532 N.E.2d 576 (1988) (granting an exemption when major donor incidentally used facility that was otherwise primarily used for charitable recreational activities).

written agreement.¹⁶⁰ Even not-for-profit organizations that do not qualify for full property tax exemption may be eligible to receive partial exemption.¹⁶¹ For example, if a portion of exempt property is leased with a view for profit, vacant, or not used for exempt purpose it may be entitled to an exemption based on the percentage of qualified and non-qualified use.

The Property Tax Code provides its own definitions of qualified exempt purposes. Property used exclusively for religious purposes will qualify as long as it is not used with a view to profit.¹⁶² Property owned by a religious organization for a religious purpose includes the use of property for churches, religious schools, orphanages, convents, and applicable housing facilities for qualified officials.¹⁶³ The courts have liberally applied the term religious use as long as it is reasonably similar to other related worship activities.¹⁶⁴

Not-for-profit organizations with an educational purpose will qualify for property tax exemption on property used for school purposes. Two qualities are necessary to qualify a private institution as a school.¹⁶⁵ First, the course of study must fit within the general education scheme provided by a traditional institution. Second, the course must have the effect of lessening a government function or obligation. In addition to the primary building, property used exclusively for school purposes such as housing facilities, research or special use buildings that are interconnected with the primary purpose may benefit from the exemption.¹⁶⁶

Illinois courts have so far rejected the argument that child care centers and preschools, even with an educational undertone, do not qualify as an educational purpose. The reasoning is that “educational purpose” encompasses education that would relieve a government burden (i.e. grammar school).¹⁶⁷ Historically, churches with such programs have qualified for exemption, however the Department of Revenue became increasingly hostile to this application.¹⁶⁸ The court then foreclosed on exemption for church-run child care programs. Under the particular facts, while it did have a valid religious purpose, the program was in furtherance of

160. *See* Vill. of Oak Park v. Rosewell, 450 N.E.2d 981, 983 (1983) (providing exempt property that is leased for non-exempt purposes did not defeat exemption if income or benefit of the lease is incidental profit).

161. *The Streeterville Corp. v. Dep’t of Revenue State of Illinois*, 714 N.E.2d 497, 498-99 (1999).

162. 35 ILL. COMP. STAT. 200/15-40(a) (2018).

163. Property Tax Code, 35 ILL. COMP. STAT. 200/15-40(b) (2001).

164. *See Pearsall*, 142 N.E. at 521 (stating that religious use included church-owned property, 140 acres with lake and boathouse, where swimming, and other boating activities took place including wooded land and paths used for seminary training purposes for students).

165. 35 ILL. COMP. STAT. 200/15-35 (2018).

166. 35 ILL. COMP. STAT. 200/15-35 (2018).

167. *Faith Builders Church, Inc. v. Dep’t of Revenue of State of Illinois*, 882 N.E.2d 1256 (2008).

168. *Id.*

the primary religious purpose.¹⁶⁹

A majority of not-for-profit organizations are likely eligible for exemption as a charitable organization. With the recent scrutiny of hospitals and other large not-for-profit entities, recently the term “charity” has been more narrowly defined. For property tax purposes, the definition of charity has been considered by the court and developed into a six-part test based on the particular facts and circumstances. The court will weigh each factor, no one of which is determinative, including: the benefits derived for an indefinite number of persons, lack of capital stock or shareholders and no profits or dividends, funds derived mainly from public or private charity, dispenses charity to all who need and apply for it, no obstacles are in place against those who need the benefit, and the property is actually and exclusively used for such charitable purpose.¹⁷⁰

Recently in 2010, the Illinois Supreme Court applied a more restrictive interpretation of charity and held that a healthcare provider was not entitled to exemption even though it provided reduced fee services because it charged fees for its services, received minimal charitable contributions, engaged in collection efforts, and made a profit.¹⁷¹ The court reasoned that these practices were not aligned with the charitable view of giving nor did they relieve any government burden. In 2012, the Illinois General Assembly enacted detailed standards for charitable exemptions for not-for-profit hospitals and its affiliates.¹⁷² It provides an exemption if the services provide healthcare to low-income or underserved individuals, or relieves the government of a burden, as long as the value of the services provided equals to or exceeds the property’s estimated property tax liability.¹⁷³ Under the more restrictive regime, a charity must establish that it has a significant and quantifiable charitable purpose. An organization is more likely to be exempt if it relieves some type of government burden or obligation.

169. *In re 2006 Property Tax Exemption Application of Zion Lutheran Church of Hinsdale*, U.S. PT 08-10, 1 (2008).

170. *Methodist Old Peoples Home v. Korzen*, 233 N.E.2d 537, 541-42 (1968).

171. *Provena Covenant Med. Ctr. v. Dep’t of Revenue*, 925 N.E.2d 1131 (2010).

172. 35 ILL. COMP. STAT. 200/15-86(a)(5).

173. *Id.* at 86(e).

