UPDATE: Provena Covenant Is Held To Be Neither Charitable Nor Religious For Ad Valorem Tax Purposes

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The Supreme Court of the State of Illinois has issued its long-awaited decision in the Provena Covenant saga – *Provena Covenant Medical Center v. Department of Revenue of State*, N.E.2d, 2010 WL 966858 (IL, March 18, 2010) – and, although the decision was a disappointment, many in the nonprofit community may take comfort in organizational and operational changes occasioned by increased scrutiny of tax-exempt organizations by the IRS in the last several years [1]. Of particular concern have been cases like that of *Provena Covenant* (the attached outline mentions the decision of the Illinois court of appeals in *Provena Covenant Medical Center v. Department of Revenue of State*, App. 4 Dist. 2008, 323 Ill. Dec. 685, 384 Ill.App.3d 734, 894 N.E.2d 452, appeal allowed, 326 Ill.Dec. 879, 229 Ill.2d 694, 900 N.E.2d 1126), in which the nonprofit was challenged as not being sufficiently "charitable" or even "religious" under Illinois law.

Provena was a tax-exempt healthcare organization of long-standing, formed by several religious orders affiliated with the Catholic church, and there was never any question that the organization was exempt from federal income tax under Internal Revenue Code §501(c)(3) or from sales and use taxes under Illinois law. The issue was whether the organization qualified for a property tax exemption based on "charitable" or "religious" grounds under Illinois law. The organization learned several years after the fact, in 2002, that, because of a 1997 restructuring constituting a change in ownership, a new application for exemption had to be filed with the State. The State's administrative board of review investigated the organization's operations and recommended denial of the exemption. After an administrative protest, ultimately, the Director of the state Department of Revenue issued a final decision denying the exemption contrary to the recommendations of an administrative law judge. The taxpayer prevailed in the lower court but the appeals court reversed. The appeals court questioned the charitable nature of the organization's primary purpose in light of the fact that only .7% of its total revenue was devoted to charitable activities. The assessor argued that the operation of the property was commercial or businesslike and more characteristic of a business activity than a facility devoted to religious purposes. The Illinois Supreme Court has now affirmed the reversal.

The Illinois Supreme Court's non-binding opinion (because it was issued as a plurality opinion by only three of the five participating justices) was that the organization was not charitable because the property was used to provide services for a fee and not for providing "gifts" to the community. The justices were persuaded by the

fact that even charity patients had to pay for their care in amounts (or were subsidized sufficiently in amounts) that permitted the hospital to recover its actual costs and so no "gift" was being made. The court noted that the organization's charity care policy was not "self-executing" and that it was designed to be a "payor of last resort" and that the accounts of most non-paying patients were sent to collection agencies and that legal action was often instituted against patients to recover fees. Only .027% of the hospital's annual patient census actually qualified for the organization's charity care program.

The court noted that the hospital's operational funds came primarily from providing services for a fee and not from "public or private charity." The court also observed that, while relieving the burdens of government can be a charitable purpose, it was not the duty of the local governmental tax recipient entity involved (unlike the federal and state governments which had undertaken such activities) to provide medical care for residents.

Further, the court found that the organization did not provide true "community benefit" in that their public education programs (a medical residency program and education for first responders) benefited the hospital. The court emphasized its understanding that benefit in the nature of a true uncompensated "gift" to the community was required. Ultimately, the decision was that the organization's property was not used for charitable purposes.

As mentioned above, this opinion is significant and should be considered in light of the new Form 990, Schedule H and other measures (such as in the new healthcare legislation) that require increasing levels of disclosure by nonprofit healthcare organizations. The new Form 990 requires an organization to report information much more extensively than in the past, and, when combined with the mandatory public disclosures under IRC § 6104(d) this has resulted in new and enhanced sources of publicly available information about nonprofits at a time when state and local governments are becoming increasingly aggressive in challenging exemptions. The new IRS return, through its detailed and pointed questions, is viewed by the IRS as both a tool for information gathering and an opportunity to educate organizations and their donors on the requirements for maintaining tax-exempt status. The goals of transparency and accountability are likely to be served by the new Form 990 and have caused many tax-exempt organizations to consider the availability of this information to state and local taxing agencies and to undertake to review their organizational documents, their policies and their actual operations, to ensure that they are compliant with state and local tax exemption rules.

Most state and local challenges to-date have taken place in the property tax area and have involved hospitals, nursing homes, residential housing for the elderly and affordable housing charities for the poor and, in some states, sales and use tax exemptions. Nevertheless, although many states automatically grant state income tax exemption to nonprofits based on a federal determination of exemption, applicable statutes in other states have state-specific rules for granting exemption from income tax. The 2006 Pension Protection Act authorized the IRS to disclose to State taxing agencies certain proposed actions with respect to nonprofit organizations including when the IRS issues a notice of proposed deficiency with respect to certain taxes, a notice of proposed refusal to recognize exemption, a notice of proposed revocation of exemption and the names and identifying information of taxpayers who have applied for exemption as well as returns and return information for organizations to which any of the foregoing apply. Nevertheless, most of the recent litigation involving exemption challenges has involved denial of property tax exemptions by local governments for organizations that are considered tax-exempt for both federal and state income tax purposes.

Hospitals around the country have found themselves particularly vulnerable to exemption challenges as a result of billing and collection practices and flexible federal standards for when a hospital is considered to be sufficiently benefiting the community as compared to for-profit hospitals, so as to merit exemption from tax. The new Form 990 contains "Schedule H" for hospitals which requires the disclosure of significant additional information to the IRS. The IRS has indicated that it plans to use this information to create standards for use in determining the extent to which bad debt, Medicare shortfalls, and community building should be considered when determining whether the organization has satisfied the community benefit standard.

Further, nonprofit organizations may be required to have audited financial statements in a number of situations including where the organization has issued tax-exempt bonds or if it receives federal funds or in those states in which organizations are required to register before making solicitations and must file audited financial statements as part of the registration process. FIN 48 may require the reporting of any activity which would impact an organization's tax-exempt status on those financial statements. The new Form 990 requires an organization to "[p]rovide the text of the footnote to the organization's financial statements that reports the organization's liability for uncertain tax positions under FIN 48." Since the Form 990 becomes a publicly available document, the disclosure of the tax risk, as required by FIN 48, becomes available to all.

The availability of all of this information is perhaps one reason for an increase in activity on the part of local governments questioning property tax exemptions afforded to nonprofit organizations. The availability of property tax exemptions to nonprofit hospitals is based on the hospital's satisfaction of a facts and circumstances "community benefit" test. The additional information now required to be reported and made public by hospitals on Schedule H of the new Form 990 will give state and local tax authorities new sources of information to determine a hospital's satisfaction of this test.

Similarly, local governments have been increasingly challenging property tax exemptions and even sales tax exemptions for charities that provide housing for the elderly. Likewise, in Louisiana and elsewhere, affordable housing projects and particularly mixed-income developments (that include units rented to tenants who do not strictly qualify as low income under federal guidelines) have been having their exemption for property taxes challenged.

This new transparency is undoubtedly a good thing for tax-exempt organizations, their volunteers and employees, the altruistically-minded and the public, in general. Nevertheless, in order to protect the organization's budget and ability to fulfill its mission, the organization's leadership would be wise to include a quick review of the organization's compliance with state and local tax rules in addition to federal tax concerns.

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[1] Although many organizations are taking steps to ensure compliance with federal law, as discussed in a presentation we made to the American Bar Association Section on Taxation at its meeting in Washington, DC, in May of 2009 ("State and Local Tax Challenges for Nonprofits and Charities," – a copy of the outline from that presentation is attached), nonprofits should not take their exempt status for granted when it comes to state and local taxation.