
Comment

TIFFANY KEB*

Redefining What It Means to Be Charitable: Raising the Bar with a Public Benefit Requirement

In the United States, both the federal government and state governments have struggled with the problem of how to ensure that all charities receiving the advantage of tax exemptions are using them to provide a public benefit. England and Wales recently attempted to solve this very problem by redefining what it means to be charitable in the Charities Act 2006 (the “Charities Act”), which requires every charitable organization to have a charitable purpose and provide a public benefit.¹ All organizations, including religious, educational, and poverty-relief charities, must demonstrate that they provide a public benefit at the time of registration and periodically throughout their existence in order to be classified as charitable.² Although the public benefit requirement existed before the Charities Act, this is the first time that religious, educational, and poverty-relief charities are affected by it; before the Charities Act these organizations benefited from a presumption

* J.D. Candidate, University of Oregon School of Law, 2008. Associate Editor, *Oregon Law Review*, 2007–08. I would like to dedicate this Comment to my parents, Rick and Donna Keb. I would like to thank Jacob Caton for always being there for me. Additionally, this Comment would not have been possible without Professor Susan Gary’s assistance.

¹ Charities Act, 2006, c. 50, §§ 2–3 (Eng.).

² See discussion *infra* Part III.B.

of a public benefit. Enacting a similar public benefit requirement in America would provide objective evidence that charities are using their tax exemptions for a public benefit.

While much discussion of reform has occurred at the federal level, thus far, little has been done. However, several states have led the way in enacting reforms which are effectively public benefit requirements in response to the actions of nonprofit hospitals.³ Nonprofit hospitals are a perfect example of charitable organizations that may not be providing a sufficient public benefit; they have been criticized for being virtually indistinguishable from for-profit hospitals in the fees they charge for services and their aggressive collection policies. These state reforms seek to eradicate such questionable practices of nonprofit hospitals by requiring them to provide a certain percentage of their gross income in charity care each year in order to remain exempt from state taxes. The details of these reforms will be valuable in creating an effective public benefit requirement on the federal level because they provide a working example of how a public benefit requirement might function. Enacting a public benefit requirement in America similar to the one in the Charities Act would ensure that charitable organizations are returning the benefit of their tax exemptions to the public.

This Comment seeks to explain how a public benefit requirement will improve the charitable sector in America. Part I explains what it means to be “charitable” in American tax law, and provides a general idea of what an organization must do to be exempt from federal taxes under the Internal Revenue Code (“I.R.C.”) § 501(c)(3). Part II describes the substantial benefits of being classified as a § 501(c)(3) organization. Additionally, possible rationales for preferential treatment of charitable organizations in the tax code are explored. Part III illustrates the need to reform current charity law, and explores what that restructuring might look like by examining reform occurring at the state level. It also examines charity reform recently passed in England and Wales in the Charities Act, which potentially offers a creative solution to reforming the American charitable sector. Part IV explores some of the concerns of government officials at the federal level regarding the charitable sector by

³ See discussion *infra* Part III.A.

summarizing a recent hearing before the House Committee on Ways and Means. Finally, Part V argues for the adoption of a public benefit requirement similar to the one in the Charities Act. Essentially, a public benefit requirement has already been adopted in several states, at least regarding the regulation of nonprofit hospitals. The success of these states in formulating public benefit requirements is evidence that doing the same at the federal level will not be unduly burdensome.

I

WHAT DOES IT MEAN TO BE CHARITABLE IN AMERICA?

Currently, to qualify as a charitable nonprofit, an organization must fit into one of the categories listed in I.R.C. § 501(c)(3).⁴ Section 501(c)(3) extends tax exemption to “[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes.”⁵ While the meaning of most of the designations listed in I.R.C. § 501(c)(3) can generally be understood with common knowledge, “charitable” has two distinct definitions.⁶ The first is the popular definition, generally thought to be “relief of the poor”; the second is the legal definition.⁷ In 1956 proposed Treasury regulations were unsuccessful in limiting the legal definition of “charitable” to the popular definition.⁸ The legal definition ultimately adopted in Treasury regulations is substantially more broad than the popular definition⁹ and is greatly influenced by the legal definition previously adopted by England in 1601 in the

⁴ *E.g.*, JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* 349–50 (3d ed. 2006).

⁵ I.R.C. § 501(c)(3) (2006).

⁶ For a thorough analysis of the confusion in defining “charitable” as it appears in § 501(c)(3), see BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 106–11 (8th ed. 2003) (stating that Congress’s failure to indicate whether it intended the “popular and ordinary” or the common law definition of “charitable” in § 501(c)(3) is responsible for much subsequent confusion).

⁷ FISHMAN & SCHWARZ, *supra* note 4, at 87.

⁸ *See id.* at 356.

⁹ *Id.*

Statute of Charitable Uses.¹⁰ In its legal sense, the definition of “charitable” has been explained as follows:

The term charitable is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of charity as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.¹¹

Congress has abstained from statutorily defining “charitable,” and in the absence of a statutory definition, the definition crafted by the Department of the Treasury and the Internal Revenue Service (“IRS”) has been the accepted authority in interpreting I.R.C. § 501(c)(3).¹²

Additionally, there are some common law principles that add to the legal definition provided by Treasury regulations. First, in order to be considered charitable, an organization’s activities must not violate a public policy doctrine.¹³ In *Bob Jones University v. United States*, the Supreme Court held:

[T]o warrant exemption under § 501(c)(3), an institution must fall within a category specified in that section and must demonstrably serve and be in harmony with the public interest. The institution’s purpose must not be so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred.¹⁴

Further, there is a charitable class requirement which requires that “an organization be organized to benefit a sufficiently large

¹⁰ See *id.* at 88–89. The Statute of Charitable Uses, passed by the British Parliament in 1601, is generally thought to be the beginning of modern charity law. *Id.* at 88. It sought to define categories of charitable uses, but these categories were not meant to be exclusive. *Id.* at 89.

¹¹ 26 C.F.R. § 1.501(c)(3)–(d)(2) (2007).

¹² See HOPKINS, *supra* note 6, at 110.

¹³ See *Bob Jones Univ. v. United States*, 461 U.S. 574, 586 (1983).

¹⁴ *Id.* at 592 (footnote omitted).

or indefinite class of people.”¹⁵ In addition, an organization must meet a community benefit requirement in order to be considered charitable.¹⁶ This means that an organization’s activities must benefit the community rather than just an individual.¹⁷ However, a limited number of people may be benefited if there is a community purpose; in these instances the benefited individuals are considered the “means” to a charitable end.¹⁸

Finally, in order to be considered charitable an organization must be “both organized and operated *exclusively*”¹⁹ for an exempt purpose.²⁰ To put it simply, the organizational test will be met as long as the purpose of the organization, as stated in the Articles of Organization, falls within I.R.C. § 501(c)(3).²¹ Of course, being organized for an exempt purpose is only the beginning of the inquiry; the organization must also meet the operational test. The operational test requires that the organization’s actions are primarily in furtherance of an exempt purpose.²² If more than an insubstantial part of an organization’s activities are in furtherance of a nonexempt purpose, then the operational test will not be satisfied.²³

¹⁵ JOINT COMM. ON TAXATION, JCX-29-05, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 63 (Apr. 19, 2005), available at <http://www.house.gov/jct/x-29-05.pdf>.

¹⁶ See HOPKINS, *supra* note 6, at 129.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Although § 501(c)(3) uses the word “exclusively,” the law treats “exclusively” to mean “primarily” rather than “solely.” *Id.* at 76–77. The primary purpose test will be satisfied if an organization operates primarily for its exempt purpose. *Id.* For a more in-depth analysis of the primary purpose test, see *id.* at 76–82.

²⁰ *Id.* at 76. The subtleties of organizational and operational tests are not discussed herein.

²¹ See *id.* at 76–77. For a detailed explanation of the organizational test, see *id.* at 69–76.

²² *Id.* at 82. The operational test will not be satisfied if any of an organization’s net earnings inure to the benefit of private individuals or shareholders. *Id.* For additional information about the operational test, see *id.* at 82–87.

²³ *Id.* at 82.

II

HOW AND WHY DOES THE TAX CODE TREAT CHARITABLE ORGANIZATIONS FAVORABLY?

A. The Benefit of Being Considered Charitable

Once an organization has been granted exempt status under § 501(c)(3) it will receive significant government benefits, predominantly in the form of special tax treatment.²⁴ The privilege of receiving tax-deductible contributions for income, estate, and gift tax purposes²⁵ is perhaps the most well-known benefit. However, in addition to this benefit, charitable organizations may qualify to issue tax-exempt bonds,²⁶ avoid federal unemployment taxes,²⁷ and provide tax-deferred retirement plans for their employees.²⁸ In addition to federal tax benefits, charitable organizations are generally eligible to receive tax benefits at the state level, although the benefits vary by jurisdiction.²⁹ Alongside the many tax benefits are nontax benefits such as preferred postage rates and potential exemptions from regulatory regimes such as antitrust, securities, labor, and bankruptcy.³⁰ There are several competing theories that attempt to explain the policy underlying the generous governmental benefits afforded charitable organizations. These theories are discussed in detail below. Although a consensus as to which theory best explains the preferential treatment of charitable organizations may never be reached, the debate matters because the prevailing accepted theories may have the power to guide the direction of any reform of the charitable sector.³¹

B. Rationales for Charitable Tax Exemption

Four of the most well-known proposed rationales for charitable tax exemption are set forth below. None of these

²⁴ FISHMAN & SCHWARZ, *supra* note 4, at 327.

²⁵ See I.R.C. §§ 170, 2055, 2522 (2006).

²⁶ See *id.* § 145.

²⁷ See *id.* § 3306(c)(8).

²⁸ See *id.* § 403(b).

²⁹ FISHMAN & SCHWARZ, *supra* note 4, at 327.

³⁰ *Id.*

³¹ See *id.* at 327–28.

theories has been accepted in any official way as the rationale behind charitable tax exemption, and it is likely that multiple rationales have contributed to favorable tax treatment of charitable organizations.

1. *The Traditional Public Benefit Subsidy Theory*

The first rationale, public benefit subsidy theory, consists predominantly of the idea that charitable organizations provide beneficial public services that diminish the government's burden to provide services that it may be unwilling or unable to provide.³² The theory's advocates also articulate secondary reasons to justify the receipt of a public subsidy by charitable organizations.³³ First, charitable organizations are thought to contribute to a pluralistic society, which goes hand-in-hand with America's democratic ideals.³⁴ Second, they may be able to provide goods and services more innovatively or efficiently than other sources.³⁵ By providing a tax exemption to these organizations, the government is subsidizing these activities and their donors through "tax expenditures" rather than funding them directly.³⁶ Courts and commentators frequently refer to the public benefit subsidy theory when they are questioned about the purpose behind providing charitable organizations tax-exempt status.³⁷ In 2005 the Joint Committee on Taxation reported on the reasons for tax exemption, saying that "[f]or some organizations, exemption from tax may be explained based on the nature of its activities. For example, charitable activities or activities that provide a public benefit may be viewed as governmental in nature and therefore not appropriate subjects of taxation."³⁸

One criticism of the traditional public subsidy theory is that the IRS offers no easily identifiable standard to explain how it decides what a public benefit is.³⁹ In the absence of a

³² *Id.* at 328.

³³ See, e.g., Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395, 402–03 (1997).

³⁴ See *id.* at 403.

³⁵ See *id.*

³⁶ See FISHMAN & SCHWARZ, *supra* note 4, at 328–29.

³⁷ *Id.* at 328.

³⁸ JOINT COMM. ON TAXATION, *supra* note 15, at 3.

³⁹ Atkinson, *supra* note 33, at 404–06.

successfully articulated standard, it may appear that the decision to label something a public benefit “is a matter of naked and unprincipled political preference.”⁴⁰ Another criticism is that the charitable exemption applies to nonprofit organizations that seem to supply what are essentially private goods such as schools, hospitals, and nursing homes.⁴¹

2. *Income Measurement Theory*

A second rationale, income measurement theory, justifies tax exemption for charitable organizations by appealing to basic principles of federal income tax.⁴² Therefore, unlike other theories, income measurement theory does not involve value judgments about charitable organizations.⁴³ Under this theory, introduced by Professors Boris Bittker and George Rahdert, tax exemption is not a “special privilege” or a “hidden subsidy”; it is simply the appropriate result when tax principles are applied to organizations that do not seek a profit.⁴⁴

First, Bittker and Rahdert argue that taxing charitable nonprofits would be inappropriate because “computing their ‘net income’ would be a conceptually difficult, if not self-contradictory task.”⁴⁵ They assert that aside from including endowment income in net income, it is unclear what else should be considered net income.⁴⁶ Many other sources of income could potentially be classified under I.R.C. § 102 as tax-excluded gifts and bequests.⁴⁷ For example, are membership dues gifts, or are they business income?⁴⁸ Bittker and Rahdert suggest that a charitable organization could potentially be classified as a mere conduit that moves funds from donors to ultimate recipients with no tax consequences.⁴⁹ Arguably, “[i]f an individual puts funds into a separate bank account to be used by him for charitable

⁴⁰ *Id.* at 405.

⁴¹ *Id.* at 405–06.

⁴² See Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *YALE L.J.* 299, 304–07 (1976).

⁴³ See *id.* at 333.

⁴⁴ *Id.* at 357–58.

⁴⁵ *Id.* at 307.

⁴⁶ *Id.* at 308.

⁴⁷ *Id.* at 308–09.

⁴⁸ *Id.* at 308.

⁴⁹ *Id.* at 309.

purposes, the deposit itself (as distinguished from the interest thereon) could hardly be regarded as creating income.”⁵⁰

Bittker and Rahdert point out that once the problem of determining net income is solved, the IRS will be forced to determine what kinds of deductions to allow.⁵¹ What are “ordinary and necessary business expenses” under I.R.C. § 162 when the organization does not seek profits?⁵² In interpreting I.R.C. § 162, the IRS has been very clear that “expenditures not motivated by the desire for profit cannot be deducted as business expenses.”⁵³ Is a charitable organization “an enterprise whose ‘business’ is benevolence?”⁵⁴ Bittker and Rahdert argue that if this were the case, and charitable organizations could deduct amounts expended to advance their charitable objectives, the result would be nearly the same as tax exemption because the organizations’ income would be irrevocably used for nonprofit purposes.⁵⁵

Even if all of the difficulties in computing the tax of a charitable organization were resolved, Bittker and Rahdert maintain that the challenge of setting an appropriate tax rate would remain a major issue.⁵⁶ They argue that a charitable organization’s income should be imputed to the ultimate beneficiaries so it can be taxed at their personal rates because the economic burden will ultimately fall on them.⁵⁷ However, beneficiaries will be for the most part unknown, so imputation of the organization’s income will likely be inaccurate.⁵⁸ To correct this problem, Bittker and Rahdert suggest that Congress could forgo tax altogether, or tax the entity as a surrogate for its beneficiaries at the estimated rate that would likely be found if income could be imputed.⁵⁹ Since recipients of gifts can exclude them from gross income under I.R.C. § 102, foregoing the tax altogether seems appropriate where the gift is simply passing

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *See id.*

⁵³ *Id.* at 310.

⁵⁴ *Id.*

⁵⁵ *Id.* at 311–12.

⁵⁶ *Id.* at 314.

⁵⁷ *Id.* at 315.

⁵⁸ *Id.*

⁵⁹ *Id.*

through a conduit organization.⁶⁰ Due to foreseeable inaccuracies in setting a tax rate, and the ultimate recipient's exclusion of the service under § 102, Bittker and Rahdert maintain that the best option would be to refrain from taxing charitable organizations.⁶¹

The income measurement theory has received criticism, most notably by Professor Henry Hansmann in his article *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, which sets out his theory of tax exemption, capital subsidy theory. Hansmann argues that determining net income for tax purposes is not as difficult as Bittker and Rahdert make it out to be.⁶² He argues that "commercial nonprofits," nonprofits that get most of their income from sales of goods or services, could easily be treated the same way as for-profit corporations.⁶³ Further, Hansmann argues that "donative nonprofits," nonprofits that get most of their funds from donations, also sell services; for example, he asserts that when donors contribute to the Red Cross, they are buying "disaster relief."⁶⁴ Therefore, calculating net income for donative nonprofits is similarly possible.⁶⁵

3. Capital Subsidy Theory

Professor Hansmann advocates a third rationale, capital subsidy theory. Hansmann, relying on economic theory, argues that nonprofit corporations should be given a subsidy to compensate for the fact that they cannot earn capital effectively due to the nondistribution constraint placed on them.⁶⁶ He argues that a subsidy can promote efficiency in the market because nonprofit corporations generally exist to solve the problem of "contract failure," providing goods or services where

⁶⁰ *Id.* at 316.

⁶¹ *See id.* at 315–16.

⁶² Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *YALE L.J.* 54, 58–59 (1981).

⁶³ *Id.* at 59.

⁶⁴ *Id.* at 60–61.

⁶⁵ *Id.* at 62.

⁶⁶ *Id.* at 72. The nondistribution constraint requires nonprofit corporations to use all earnings for exempt purposes rather than distributing them to officers, members, etc. *Id.* at 56–57.

for-profit corporations cannot do so effectively.⁶⁷ Specifically, “contract failure” occurs when “ordinary market competition may be insufficient to police the performance of for-profit firms, thus leaving them free to charge excessive prices for inferior service.”⁶⁸ Rather than risk paying excessive prices, consumers turn to nonprofit corporations, which are generally thought to be less profit driven and more trustworthy than for-profit corporations due to the nondistribution constraint on profits.⁶⁹

Ideally, before tax-exempt status is granted to nonprofits, two economic conditions should be satisfied:

(1) [N]onprofit firms must be more efficient producers of the service than are for-profit firms; and (2) the nonprofit firms in the industry must not have expanded to the point at which the productivity of the capital they employ has fallen below the before-tax⁷⁰ rate of return being earned on capital in other industries.

However, Hansmann argues that it is not realistic to expect the Department of the Treasury to make these determinations.⁷¹ He believes that the current method of determining tax exemption does a reasonably good job of making these determinations, although the method is somewhat crude.⁷²

One criticism of Hansmann’s theory is that his model suggests that nonprofits which exist because they are the most efficient providers of a service will eventually take over the industries they participate in, and the exemption does nothing more than accelerate this domination.⁷³ In some cases, however, the reverse may be true: the exemption may do economic damage by propping up inefficient nonprofits that would not otherwise be able to compete with efficient for-profits.⁷⁴

⁶⁷ See *id.* at 69.

⁶⁸ *Id.* Ordinary market competition may be insufficient because consumers experience difficulty in “(1) comparing the quality of performance offered by competing providers before a purchase is made, or (2) determining, after a purchase is made, whether the service was actually performed as promised.” *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.* at 86.

⁷¹ *Id.*

⁷² See *id.* at 86–87.

⁷³ Atkinson, *supra* note 33, at 427–28.

⁷⁴ *Id.* at 428.

4. *Donative Theory*

Finally, the donative theory of tax exemption, first introduced by Professors Mark Hall and John Colombo, essentially argues that “donative institutions deserve a tax subsidy because the willingness of the public to contribute demonstrates both worthiness and neediness.”⁷⁵ Worthiness and neediness are the two distinct components of “deservedness,” which Hall and Colombo argue is “[t]he most important criterion for evaluating a theory of charitable tax exemption.”⁷⁶ Hall and Colombo assert that by choosing to donate to an organization, the donor communicates that the organization has “special worth” and is therefore deserving of a subsidy.⁷⁷ They argue that need for a subsidy is exhibited when the organization solicits donations.⁷⁸ Donations will likely never fulfill the organization’s needs because without a quid pro quo return on a donation, the free rider problem will ensure that charitable gifts will never financially reflect the value that the donor actually believes the organization’s services have.⁷⁹ Therefore, Hall and Colombo argue that when a charitable organization receives donative support, it can safely be assumed that the donations reflect only a fraction of how much the public values the organization, and it follows that an organization with substantial donative support is worthy of a subsidy to fill that gap.⁸⁰

Once deservedness has been shown, Hall and Colombo believe that a subsidy ideally should be given in proportion to deservedness.⁸¹ Unfortunately the tax exemption system cannot accurately accomplish this task, and it is questionable whether it is really a subsidy system at all. However, due to the problem of

⁷⁵ Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1385 (1991).

⁷⁶ *Id.* at 1384.

⁷⁷ *See id.* at 1385.

⁷⁸ *See id.*

⁷⁹ *Id.* The free rider problem occurs when people can benefit from a public good without contributing their fair share to support it. DAVID A. BESANKO & RONALD R. BRAEUTIGAM, *MICROECONOMICS: AN INTEGRATED APPROACH* 753 (2002). There is no incentive for free riders to contribute to the public good, so they rely on others to pay for it. *Id.* Free riders are a problem because the providers of public goods depend on receiving contributions that reflect the true value individuals place on their services in order to achieve optimum output. *See id.* at 753–54.

⁸⁰ Hall & Colombo, *supra* note 75, at 1385.

⁸¹ *Id.* at 1385–86.

government failure, Hall and Colombo argue that there is no better system.⁸² They assert that substantial philanthropy will only occur when neither private markets nor the government can provide a shared social benefit effectively, and this “political stalemate” renders an implicit subsidy through tax exemption the best option.⁸³

Hall and Colombo argue that donative theory is able to explain most or all benefits charitable organizations receive, from deductible contributions under I.R.C. § 170 to exemption from state property tax, while Bittker and Rahdert’s income measurement theory and Henry Hansmann’s capital subsidy theory are unable to account for all charitable benefits.⁸⁴ Further, Hall and Colombo argue that donative theory fits nicely with the historical understanding of “charitable” while income measurement theory and capital subsidy theory do not.⁸⁵

One criticism of donative theory is that Hall and Colombo’s insistence that an organization get, on average, at least one-third of its support through donations in order to receive tax exemption would potentially prevent many organizations that rely predominantly on fees, or are heavily endowed, from receiving exemptions.⁸⁶

III

ATTEMPTS TO REFORM THE DEFINITION OF CHARITABLE

A. State Reform

As mentioned above, in the midst of changing economic circumstances there may be a need to reevaluate some traditionally exempt entities to determine if they continue to be appropriate objects of tax exemption. A prominent, often discussed example is the healthcare industry, which has changed substantially in the last forty years due to the introduction of Medicare and Medicaid and an increase in employer-provided and private insurance.⁸⁷ Recent statistics reveal that nonprofit

⁸² *Id.* at 1386.

⁸³ *Id.*

⁸⁴ *See id.* at 1386–87.

⁸⁵ *See id.* at 1387.

⁸⁶ Atkinson, *supra* note 33, at 422.

⁸⁷ *See* FISHMAN & SCHWARZ, *supra* note 4, at 357. For more information about the controversy surrounding nonprofit hospitals, see generally Robert Charles

hospitals, like for-profit hospitals, receive almost all of their revenue (ninety-two percent) from the sale of goods and services, and few of those sales are at subsidized prices to those who cannot pay.⁸⁸ The House Committee on Ways and Means has expressed concern over the state of nonprofit hospitals, but there has been no move toward reform. Although significant changes in the definition of charitable as applied to healthcare have not yet occurred on the federal level, some states are recognizing the need to reform the definition of charitable as it applies to hospitals. Within the last ten to twenty years several states such as Illinois, Utah, Texas, and Pennsylvania have enacted stricter guidelines that hospitals must meet in order to remain exempt from state taxes.⁸⁹

Utah was one of the first states to enact stricter standards for exemption of nonprofit hospitals, and many states reconsidered their own tax exemption policies after Utah denied property tax exemption to two nonprofit hospitals in *Utah County ex rel. County Board of Equalization v. Intermountain Health Care, Inc.*⁹⁰ In *Intermountain Health Care*, the Utah Supreme Court emphasized that the Utah Constitution requires an entity to provide a gift to the community in order to receive a property tax exemption.⁹¹ According to the court, a gift to the community is either “a substantial imbalance in the exchange between the charity and the recipient of its services” or “the lessening of a government burden through the charity’s operation.”⁹² The concept of a gift should not be confused with the concept of a

Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416 (1980); Douglas M. Mancino, *Income Tax Exemption of the Contemporary Nonprofit Hospital*, 32 ST. LOUIS U. L.J. 1015 (1988).

⁸⁸ *Overview of the Tax-Exempt Sector: Hearing Before the H. Comm. on Ways and Means*, 109th Cong. 53 (2005) [hereinafter *Overview of the Tax-Exempt Sector*] (statement of Douglas Holtz-Eakin, Ph.D., Director, Congressional Budget Office).

⁸⁹ See FISHMAN & SCHWARZ, *supra* note 4, at 372–73. Hospitals and other “charitable” entities receive federal tax exemption under § 501(c)(3), but exemption from state income, sales, and property tax is decided at the state level. John D. Colombo, *Hospital Property Tax Exemption in Illinois: Exploring the Policy Gaps*, 37 LOY. U. CHI. L.J. 493, 494–95 (2006). Therefore, an entity may be considered a nonprofit for tax purposes at the federal level, but not at the state level.

⁹⁰ 709 P.2d 265 (Utah 1985); FISHMAN & SCHWARZ, *supra* note 4, at 373.

⁹¹ *Intermountain Health Care*, 709 P.2d at 269.

⁹² *Id.*

community benefit.⁹³ For-profit enterprises, like nonprofit enterprises, provide a community benefit by providing healthcare, but the measure of a gift is not the entity's usefulness to the community; rather, the measure is whether the entity's contribution is nonreciprocal.⁹⁴ The court found that there was no "substantial imbalance" between the value of the services provided and the payment received.⁹⁵ The two hospitals in the case gave away less than one percent of gross revenue in charity care, did not advertise the charity care, and always attempted to recover payment for the charitable services.⁹⁶ Further, the hospitals collected remuneration from government programs, private insurance, and individuals for almost all services provided.⁹⁷ The court also held that the hospitals did not lessen the burden on the government because they refused services to indigent patients and generated a surplus of money from their operations.⁹⁸ Because the hospitals were not "passing along the benefit of the exemption" to the public by charging less for services than for-profits, they were not lessening the burden on the government; in fact, it could be argued that Utah's for-profit hospitals were lessening the government's burden more efficiently than nonprofit hospitals because they were providing the same services without public subsidies.⁹⁹ After this case, the Utah Tax Commission enhanced the gift requirement, which, as mentioned above, requires "a substantial imbalance in the exchange between the charity and the recipient of its services" or "the lessening of a government burden through the charity's operation,"¹⁰⁰ by mandating that the gift must be quantifiable and exceed the value of the property tax exemption.¹⁰¹

⁹³ See *id.* at 276–77.

⁹⁴ See *id.*

⁹⁵ *Id.* at 274.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ See *id.* at 277–78. Even if the hospitals used the surplus to expand their services, there was no evidence that the money was set aside for use only in Utah because its owners operated facilities throughout many states. *Id.* at 275. Regardless, by charging the same as for-profit entities, these hospitals were expanding at the expense of those they were created to serve. See *id.* at 278.

⁹⁹ See *id.*

¹⁰⁰ *Id.* at 269.

¹⁰¹ FISHMAN & SCHWARZ, *supra* note 4, at 373; PROPERTY TAX DIV., UTAH STATE TAX COMM'N, STANDARDS OF PRACTICE: STANDARD 2—PROPERTY TAX

Similarly, Illinois has seen abundant movement for reform in the healthcare industry.¹⁰² First, the Illinois Attorney General, Lisa Madigan, proposed that nonprofit hospitals in Illinois be required to spend at least eight percent of their total operating costs on charity care to retain state tax exemptions.¹⁰³ The Illinois General Assembly introduced the proposal as H.B. 5000, and if it passes, it will force Illinois nonprofit hospitals, which generally spend less than one percent of their revenue on charity care, to spend at least eight percent of their total operating costs on charity care, and also guarantee free or discounted service to low-income patients.¹⁰⁴ Second, several notable Illinois cases have revoked tax-exempt status from hospitals.¹⁰⁵ Most recently, on February 13, 2004, the Champaign County Board of Review found Provena Covenant Medical Center unfit for exemption.¹⁰⁶ “Provena had made headlines in [Illinois] by pursuing an aggressive collection policy, suing and even making civil arrests of people who did not pay the hospital’s bills.”¹⁰⁷ Additionally,

EXEMPTIONS 35 (June 2007), available at <http://propertytax.utah.gov/standards/standard02.pdf>.

¹⁰² For a thorough explanation and analysis of Illinois’s regulation of tax exemption of the healthcare industry, see Colombo, *supra* note 89, at 505–09.

¹⁰³ Elizabeth Schwinn, *Tax Watch: Hospitals Oppose Plan to Require Charity Care*, CHRON. OF PHILANTHROPY, Feb. 9, 2006, at 29. The federal test for exempting healthcare providers does not require any specific amount of charity care. See Colombo, *supra* note 89, at 498. Rather, an exempt provider must “have a community board, treat Medicare and Medicaid patients along with all privately insured patients . . . and engage in some other significant community ‘plus’ such as community outreach programs, health education, health research, and/or charity care.” *Id.*

¹⁰⁴ Schwinn, *supra* note 103, at 29.

¹⁰⁵ See, e.g., *Riverside Med. Ctr. v. Dep’t of Revenue*, 795 N.E.2d 361, 366–67 (Ill. App. Ct. 2003) (finding that Riverside was not eligible for a charitable exemption from property tax because the clinics were not used primarily for charitable purposes and that writing off bad debts was not considered charitable: Riverside billed all its patients for services, did not advertise a charity care program, and did not provide any precare screening program to determine whether a patient should be a charity patient); *Alivio Med. Ctr. v. Dep’t of Revenue*, 702 N.E.2d 189, 191–93 (Ill. App. Ct. 1998) (finding that Alivio did not qualify for charitable exemption because Alivio did not waive fees regardless of inability to pay, did not advertise charity care, and that simply writing off bad debts is not enough to be considered a charitable purpose).

¹⁰⁶ See Lucette Lagnado, *Hospital Found ‘Not Charitable’ Loses Its Status as Tax Exempt*, WALL ST. J., Feb. 19, 2004, at B1.

¹⁰⁷ Elizabeth Schwinn, *Tax Watch: Hospital Loses State Tax Exemption*, CHRON. OF PHILANTHROPY, Mar. 4, 2004, at 34. The Board cited a case “in which the hospital charged a former fast-food worker \$34,500 for outpatient kidney-stone

Provena spent less than one percent of its revenue on charity care¹⁰⁸ and used for-profit companies to accomplish important hospital functions.¹⁰⁹ Provena has appealed the Champaign County Board of Review's decision, but thus far the state has upheld the ruling.¹¹⁰ According to Provena, the ruling has cost it \$4.8 million in property taxes thus far.¹¹¹

While Utah and Illinois have been at the forefront of reform of nonprofit hospitals, states such as Pennsylvania and Texas have also taken action by enacting statutes requiring nonprofit hospitals to provide a certain percentage of charity care in order to remain tax-exempt.¹¹²

What can we learn from the reform of tax exemption standards enacted at the state level?¹¹³ Arguably, the reforms initiated at the state level reflect a need for reassessment of the process of tax-exemption on the federal level. If states no longer consider these organizations charitable enough to deserve exemption from state taxes, then more than likely these organizations should not be privileged with exemption from federal taxes.¹¹⁴ States may be better able to assess the current status of charitable entities because they are responsible for the oversight of only the entities in their states, while the federal government is theoretically responsible for oversight of all nonprofit entities. Unfortunately, the federal government does

removal." *Id.* When the patient was unable to pay, Provena tried to garnish his retirement savings. *Id.* The debt was only forgiven after press inquiry. *Id.*

¹⁰⁸ See Elizabeth Schwinn, *Illinois Hospital Appeals Property-Tax Decision*, CHRON. OF PHILANTHROPY, Nov. 9, 2006, at 16.

¹⁰⁹ Lagnado, *supra* note 106.

¹¹⁰ Schwinn, *supra* note 108, at 16.

¹¹¹ *Id.*

¹¹² See, e.g., 10 PA. CONS. STAT. ANN. § 375 (West 1999); TEX. TAX CODE ANN. § 11.1801(a) (Vernon 2001).

¹¹³ Of course, some states are reforming their tax exemption standards for fiscal reasons. However, even if a prominent consideration in enacting reform is financial, protecting the underlying purpose of the tax exemption is likely still a primary concern. This Comment will not analyze states' financial concerns.

¹¹⁴ State reform alone is not enough to prevent less than charitable organizations from receiving exemptions. Even if all fifty states enact successful reforms, the organizations found not to qualify for exemption at the state level may still qualify for exemption under federal tax law. Whether an organization is exempt from federal taxes is a separate question from whether the organization is exempt from state taxes. One determination does not affect the other. For an overview of state and local tax exemptions, see FISHMAN & SCHWARZ, *supra* note 4, at 470–76.

not seem to have the resources to review tax-exempt organizations as thoroughly or as frequently as it would like and therefore may be slow to recognize the need for change or how to make that change. Former IRS Commissioner Sheldon Cohen expressed concern to the House Committee on Ways and Means that the IRS does not have adequate personnel for the appropriate oversight of tax-exempt entities.¹¹⁵ In fact, the IRS examines tax-exempt entities at a rate far below that of for-profit entities.¹¹⁶ Therefore, reform at the state level is a valuable tool for assessing what reform needs to be made at the federal level, and what it might look like.

Congress has recognized that a change needs to be made regarding the regulation of nonprofit entities, but thus far it has not settled on what that change should be. A more robust system is needed to ensure that organizations receiving federal tax exemptions are indeed charitable. In addition to state reforms, innovative legislation recently enacted in England and Wales, which will require charities to demonstrate that they provide a public benefit, might provide guidance on how to reform federal law.

B. *Charities Act 2006*

On November 8, 2006, after “three years, three Queen’s Speeches and 80 hours of debate to get the Charities Bill through Parliament,”¹¹⁷ England and Wales substantially reformed their charitable sector by passing the Charities Act 2006.¹¹⁸ The Charities Act, which is “perhaps . . . one of the most debated Acts in history,”¹¹⁹ addresses a fundamental issue: what

¹¹⁵ See *Overview of the Tax-Exempt Sector*, *supra* note 88, at 69–71 (statement of Sheldon S. Cohen, Partner, Morgan, Lewis, & Bockius, and Comm’r, Internal Revenue Serv., 1965–69).

¹¹⁶ *Id.* at 7–8 (statement of David M. Walker, Comptroller General, U.S. Gov’t Accountability Office).

¹¹⁷ Stephen Cook, *The Charities Act: Charity Law Finally Enters the Modern Age*, THIRD SECTOR, Nov. 22, 2006, <http://thirdsector.co.uk/News/620297/Charities-Act-Charity-law-finally-enters-modern-age/>.

¹¹⁸ *An Act for All: The New Charities Act*, CHARITY COMMISSION NEWS (Charity Comm’n Direct, Liverpool, Eng.), Autumn 2006, at 2, 2 [hereinafter *An Act for All*], available at <http://www.charity-commission.gov.uk/Library/tcc/pdfs/cnews25.pdf>.

¹¹⁹ STEWARDSHIP, CHARITIES ACT 2006 EXPLAINED 5 (2006), available at http://www.stewardship.org.uk/documents/charities_act_2006.pdf.

is charity?¹²⁰ The passage of the Charities Act was a result of a report commissioned by the Prime Minister in 2001 outlining the strengths and weaknesses of the law and regulatory framework of the nonprofit sector and providing recommendations for improvements.¹²¹ The report emphasized the importance of ensuring that the benefits of charitable status go to charities that provide a benefit to the public, and recommended that the public benefit test be applied more consistently.¹²² The government sought public review of the recommendations before accepting any of them, and the majority of governmentally accepted recommendations are codified in the Charities Act.¹²³

The *Times* called the Charities Act the first major legislative reform of the definition of charity since the Statute of Charitable Uses in 1601,¹²⁴ which is often considered the first statutory definition of charitable purposes.¹²⁵ Prior to the Charities Act, charitable purposes were developed solely through case law.¹²⁶ The Charities Act defines a charity as a body or trust that is for a charitable purpose and for the public benefit.¹²⁷ It expands the

¹²⁰ See Stephen Lloyd, *What Does 'Charity' Mean?*, *TIMES* (London), Dec. 12, 2006, at LAW 2. Of course, the Charities Act 2006 enacts many other changes in the nonprofit sector that will not be discussed in this Comment. For a comprehensive overview of the Charities Act 2006, see generally OFFICE OF PUB. SECTOR INFO., THE NAT'L ARCHIVES, CHARITIES ACT 2006 EXPLANATORY NOTES (2006), available at http://www.opsi.gov.uk/acts/en2006/ukpgaen_20060050_en.pdf [hereinafter CHARITIES ACT NOTES].

¹²¹ CHARITIES ACT NOTES, *supra* note 120, at 3.

¹²² See STRATEGY UNIT, CABINET OFFICE, PRIVATE ACTION, PUBLIC BENEFIT: A REVIEW OF THE CHARITIES AND THE WIDER NOT-FOR-PROFIT SECTOR 40 (2002), available at http://www.cabinetoffice.gov.uk/strategy/work_areas/~media/assets/www.cabinetoffice.gov.uk/strategy/strat%20data%20pdf.ashx.

¹²³ CHARITIES ACT NOTES, *supra* note 120, at 3–4. For the results of the public consultation and to view recommendations accepted by the government, see HOME OFFICE, CHARITIES AND NOT-FOR-PROFITS: A MODERN LEGAL FRAMEWORK (July 2003), available at http://www.cabinetoffice.gov.uk/third_sector/law_and_regulation/charities_act_2006/~media/assets/www.cabinetoffice.gov.uk/third_sector/charitiesnotforprofit_eng%20pdf.ashx.

¹²⁴ See Lloyd, *supra* note 120.

¹²⁵ CHARITIES ACT NOTES, *supra* note 120, at 4. Technically, the four charitable purposes set forth in the Statute of Charitable Uses 1601 were not statutory law because they were in the preamble rather than the body of the statute. *Id.* Nonetheless, this list of charitable purposes, mentioned above as the four accepted categories of charitable purposes, formed the foundation of charity law. *Id.*

¹²⁶ See Lloyd, *supra* note 120.

¹²⁷ *An Act for All*, *supra* note 118, at 2.

four accepted categories of charitable purposes, “the relief of poverty, the advancement of education, the advancement of religion and other purposes beneficial to the community,” to thirteen.¹²⁸ Once an organization satisfies the requirement of fitting into a charitable category, it must demonstrate that it exists for a public benefit in order to be considered charitable.¹²⁹ Previously, unless evidence to the contrary existed, religious, educational, and poverty-relief charities were presumed to exist for a public benefit.¹³⁰ Because charities existing outside of these categories did not receive the benefit of this presumption, some thought it appropriate to withdraw the presumption and level the playing field.¹³¹ Under the Charities Act, every charity—including religious, educational, and poverty relief charities—will have to show that it provides a public benefit when

¹²⁸ Cook, *supra* note 117. The thirteen charitable purposes are as follows:

- (a) the prevention or relief of poverty;
- (b) the advancement of education;
- (c) the advancement of religion;
- (d) the advancement of health or the saving of lives;
- (e) the advancement of citizenship or community development;
- (f) the advancement of the arts, culture, heritage or science;
- (g) the advancement of amateur sport;
- (h) the advancement of human rights, conflict resolution or reconciliation, or the promotion of religious or racial harmony or equality and diversity;
- (i) the advancement of environmental protection or improvement;
- (j) the relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage;
- (k) the advancement of animal welfare;
- (l) the promotion of the efficiency of the armed forces of the Crown, or the efficiency of the police, fire and rescue services or ambulance services;
- (m) any other purposes . . .

. . . .
 . . . recognized as charitable purposes under existing charity law . . . ; any purposes that may reasonably be regarded as analogous to, or within the spirit of, any purposes falling within [this Act]; and any purposes that may reasonably be regarded as analogous to, or within the spirit of, any purposes which have been recognized as under charity law [after the new law comes into force].

Charities Act 2006, c. 50, §§ 2(2)(a)–(m), 4(a)–(c) (Eng.).

¹²⁹ *Charities Act 2006—A Guide to the Main Provisions Which Affect Charities*, CHARITY COMM’N, Nov. 2006, <http://www.charity-commission.gov.uk/spr/ca2006prov.asp#1>.

¹³⁰ Cook, *supra* note 117.

¹³¹ STEWARDSHIP, *supra* note 119, at 7.

registering.¹³² Furthermore, the burden of demonstrating a public benefit will not only be on new charities; existing charities will also be under rolling review by the Charity Commission¹³³ to ensure that they are providing a public benefit.¹³⁴

Currently, the major remaining issues are first, what is public benefit; and second, how it can be demonstrated. “Public benefit” is not defined in the Charities Act; instead, the Charities Act gives the Charity Commission the objective of issuing guidance based on common-law standards to promote understanding of the public benefit requirement.¹³⁵ However, despite this guidance, the legal definition of public benefit will continue to be settled by common law; guidance provided by the Charity Commission will not be legally binding on charity trustees, although such guidance must be taken into consideration when it is relevant.¹³⁶

The Charity Commission has promised that in terms of what will be required to fulfill the public benefit requirement, “[o]ne size won’t fit all, and public benefit will look different for different groups of charities.”¹³⁷ The Charity Commission provides general guidance about the public benefit requirement.¹³⁸ This guidance sets forth five main principles of the requirement:

¹³² Cook, *supra* note 117. Prior to the Charities Act 2006, only organizations that were not religious, educational, or poverty-relief charities had to provide evidence that their purpose was a public benefit. CHARITIES ACT NOTES, *supra* note 120, at 5–6.

¹³³ The Charities Act establishes the Charity Commission “as a body independent of Government Ministers and Departments but responsible to the Crown.” STEWARDSHIP, *supra* note 119, at 11. It has six functions under the Charities Act. *Id.* A few of the Charity Commission’s functions include: (1) “[d]etermining whether institutions are or are not charities,” (2) “[e]ncouraging and facilitating the better administration of charities,” (3) “[i]nvestigating misconduct or mismanagement of charities and taking appropriate action to protect charities,” and (4) “[d]isseminating information in relation to the Commissions [*sic*] objectives or functions.” *Id.*

¹³⁴ Cook, *supra* note 117.

¹³⁵ See STEWARDSHIP, *supra* note 119, at 6.

¹³⁶ *Id.* at 10.

¹³⁷ *An Act for All*, *supra* note 118, at 2.

¹³⁸ See CHARITY COMM’N FOR ENG. & WALES, PUBLIC BENEFIT—THE LEGAL PRINCIPALS, at pt. 3 (2005), <http://www.charity-commission.gov.uk/spr/pbpl.asp> (last visited Feb. 4, 2008).

- i. There must be an identifiable benefit, but this can take many different forms.
- ii. Benefit is assessed in the light of modern conditions.
- iii. The benefit must be to the public at large, or to a sufficient section of the public.
- iv. Any private benefit must be incidental.
- v. Those who are less well off must not be entirely excluded from benefit.¹³⁹

The Charity Commission also provides that when demonstrating a public benefit, any tangible benefits should generally be presented before intangible benefits.¹⁴⁰ Tangible benefits are usually measurable, and where they exist, a benefit will likely be obvious.¹⁴¹ However, if an organization provides only intangible benefits, they will suffice where the public benefit is clear, even though it may not be measurable.¹⁴²

Although the Charity Commission has not yet issued official guidance about demonstrating a public benefit, it has created a tentative timetable regarding the creation and release of such guidance. In January 2007, the Commission will begin a three-month consultation to explore “principles of public benefit,” how charities might demonstrate public benefit, and how this process might be assessed.¹⁴³ The next step of the process on the timetable, scheduled for March 2007, is the Commission’s analysis of the responses from the consultation.¹⁴⁴ In March 2007 the Commission will also begin talking to charity subsectors about application of the principles.¹⁴⁵ The Committee will then publish the principles of public benefit and begin a pilot assessment of public benefit, producing specific guidance for

¹³⁹ *Id.*

¹⁴⁰ *Id.* at pt. 9.

¹⁴¹ *Id.* at pts. 7–8. “For example, if a charity relieves a person’s sickness or financial hardship, the person’s health or financial circumstances are measurably improved.” *Id.* at pt. 8.

¹⁴² *Id.* at pt. 9. Examples of intangible benefits include things like “benefits of education, or the appreciation of a historic building or a beautiful landscape.” *Id.* When determining whether something is an intangible benefit, the Charity Commission, court, or tribunal will consider the “general consensus of fair-minded and unprejudiced opinion,” but public belief alone cannot determine what is charitable. *Id.*

¹⁴³ Indicative Programme: Taking Forward Public Benefit, <http://www.charity-commission.gov.uk/library/spr/pdfs/timetable.pdf> (last visited Feb. 5, 2008).

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

various types of charities in the process.¹⁴⁶ After the Committee publishes results of the pilot assessment, it will begin formal assessment, and by summer 2008 it will report progress to Parliament.¹⁴⁷

Some commentators have expressed concern regarding the revocation of the presumption of a public benefit from religious, educational, and poverty-relief charities. “Religious charities and fee-charging charities, such as private hospitals and schools, have expressed [the] most concern” about the new public benefit requirement.¹⁴⁸

Religious charities are concerned that their benefit to the public is intangible and therefore not easily demonstrated.¹⁴⁹ During debate of the bill there was some assurance “that removing the presumption . . . is not intended to lead to a narrowing down of the range of religious activities that are considered charitable.”¹⁵⁰ However, at the end of the debate it remained unclear how the public benefit of prayer could and would be demonstrated.¹⁵¹ Some members mentioned the possibility of using existing objective studies, such as one intended to analyze the affect of prayer on the health of patients going into surgery.¹⁵² However, reliance on an objective study may not be necessary. During the debate, Edward Miliband pointed out that:

Religion has an important role to play in society through faith and worship, motivating charitable giving and contributing in other ways to stronger communities. Both those dimensions will thus usually be apparent from the doctrines, beliefs and practices of a religion. The Charity Commission is clear that most established religions should not have any difficulty in demonstrating their value to society from their beliefs.¹⁵³

The House of Commons debate also focused on how the public benefit requirement would affect private schools. In a briefing, the Charity Commission emphasized that an indirect

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ Cook, *supra* note 117.

¹⁴⁹ STEWARDSHIP, *supra* note 119, at 8.

¹⁵⁰ *See id.* at 9–10.

¹⁵¹ *See* 450 PARL. DEB., H.C. (6th ser.) (2006) 1583.

¹⁵² *Id.*

¹⁵³ *Id.* at col. 1609.

benefit such as savings in public expenditures on education likely will not meet the public benefit requirements.¹⁵⁴ Schools must provide direct benefits that extend beyond a narrow class of people.¹⁵⁵ In the House of Commons debate, members of Parliament expressed that the intention behind leaving the public benefit requirement to be defined by the Charity Commission was to avoid creating a rigid, unwavering standard, thus allowing standards to be tailored to fit the realities of various nonprofit organizations.¹⁵⁶ Therefore, hypothetically, an urban school may be expected to provide different benefits to the public than a rural school.¹⁵⁷

The expanded public benefit requirement guidelines will not be finalized or routinely in effect until early 2008,¹⁵⁸ so measuring the success of this innovative method of regulating charitable organizations will not be possible for some time. However, there is assurance of a formal review within three years of the requirement's enactment, because such a commitment was made during the passage of the Charities Bill.¹⁵⁹ Further, the Charities Act will be reviewed in its entirety within five years of its passage and its impact will be reported to Parliament.¹⁶⁰

Even though the expanded public benefit requirement has not yet been implemented, as mentioned above, a public benefit requirement was in use before the Charities Act in a more limited scope, so it therefore is not entirely experimental. The government chose to expand the public benefit requirement only after evaluating its usefulness.¹⁶¹ Further, the requirement seems to have public support. A poll showed that eighty-eight percent of those asked, including ninety-five percent of those eighteen to twenty-four years old, thought that "a registered charity should

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *See id.*

¹⁵⁷ *See id.*

¹⁵⁸ STEWARDSHIP, *supra* note 119, at 11.

¹⁵⁹ OFFICE OF THE THIRD SECTOR, CABINET OFFICE, CHARITIES ACT 2006: UPDATED IMPLEMENTATION PLAN 5 (2007), *available at* http://www.cabinetoffice.gov.uk/third_sector/law_and_regulation/~media/assets/www.cabinetoffice.gov.uk/third_sector/charities_act_2006_updated_implementation_plan%20pdf.ashx.

¹⁶⁰ *Id.*

¹⁶¹ *See* STRATEGY UNIT, *supra* note 122, at 39–40.

be able to demonstrate that its activities provide a benefit to society.”¹⁶² The presence of data suggesting that the public benefit requirement has been a success in the past is useful in predicting its future success. Therefore, the public benefit requirement, though not yet fully implemented in its expanded form, is a useful model for American legislators to study when reforming the charitable sector.

IV

DISCONTENT WITH THE CHARITABLE SECTOR AT THE FEDERAL LEVEL

In April 2005 the House Committee on Ways and Means conducted a comprehensive overview of the tax-exempt sector.¹⁶³ Chairman Bill Thomas argued that the hearing was especially important because nearly two decades had passed since the last comprehensive hearing, and revenue from the tax-exempt sector had grown from \$3 billion in 1975 to \$1.2 trillion in 2001.¹⁶⁴ The stated goal of the hearing was not to discuss specific proposals for reform, but to develop a good foundation of knowledge regarding “the concept, the theory, and the practice of charity and tax exemption.”¹⁶⁵ Much of the discussion focused on the need to clarify the tax code with regard to exempt organizations and the need to increase oversight of the nonprofit sector.¹⁶⁶ One specific goal of the hearing was to determine what makes tax-exempt organizations—whose goods and services are nearly identical to those of the for-profit sector—deserving of their exempt status.¹⁶⁷

In his address to the Committee, Professor John Colombo pointed out that the operation of some charities, such as nonprofit hospitals, has changed greatly over the years.¹⁶⁸ He argued that these charities, as they are currently run, may no

¹⁶² *Id.* at 39.

¹⁶³ *Overview of the Tax-Exempt Sector*, *supra* note 88, at 1.

¹⁶⁴ *Id.* at 3 (statement of Rep. Bill Thomas, Chairman, H. Comm. on Ways & Means).

¹⁶⁵ *Id.* at 6.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* at 4.

¹⁶⁸ *Id.* at 58 (statement of John D. Colombo, Professor, Univ. of Ill. Coll. of Law, Urbana-Champaign, Ill.).

longer be providing a public benefit, and that they therefore are not deserving of tax-exempt status.¹⁶⁹ Douglas Holtz-Eakin, Director of the Congressional Budget Office, suggested that entities that no longer provide a public benefit continue to receive exemptions because “[t]here is an attempt to apply a bright-line exemption to entities when it is, in fact, activities that are either public purpose or charitable in nature, and these entities have a great mixture of activities within them and it would be useful to distinguish between those two things.”¹⁷⁰ Advocating for better oversight of tax-exempt organizations, Professor Francis Hill argued that although “exemption depends upon providing a public benefit to a defined class of beneficiaries,” Congress’s oversight thus far had been ineffective in guaranteeing that a public benefit was provided and instead focused on preventing private benefit.¹⁷¹ She argued, “The idea of preventing impermissible private benefits is important, but preventing these impermissible private benefits will not in itself assure that exempt entities operate for a public benefit, and that is what I am urging the Committee to focus on as its work goes forward.”¹⁷²

There was a consensus among the speakers that federal tax law was unclear and full of gaps concerning the law of tax-exempt organizations. Bruce Hopkins suggested that Congress should lay the framework for the law of exempt organizations, and that the IRS could provide “meaningful guidance.”¹⁷³ On the topic of improving federal tax law, former IRS Commissioner Sheldon S. Cohen suggested that in order to relieve the IRS Commissioner from wearing two hats, “one to encourage and move charity forward and the other one to restrict it and audit it,” the Committee on Ways and Means should consider following England’s system of creating and enforcing charitable rules.¹⁷⁴ England has one body to write the

¹⁶⁹ *See id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 61 (statement of Francis R. Hill, Professor, Univ. of Miami Sch. of Law, Coral Gables, Fla.).

¹⁷² *Id.* at 61–62.

¹⁷³ *Id.* at 78–79 (statement of Bruce R. Hopkins, Att’y, Polsinelli Shalton Welte Suelthaus, P.C., Kansas City, Mo.).

¹⁷⁴ *Id.* at 70 (statement of Sheldon S. Cohen, Partner, Morgan, Lewis and Bockius, and Comm’r, Internal Revenue Serv., 1965–69).

charitable rules and encourage charity, the Charities Commission, and enforcement is left to England Revenue.¹⁷⁵ Cohen's proposal was initially given to the Committee on Ways and Means in the seventies, but it did not receive support.¹⁷⁶

The discussion at the hearing suggests that change is needed in the laws regulating the charitable sector. As the laws currently operate, they may not be providing adequate regulation of charitable organizations. In the absence of adequate regulation, nonprofits that are no longer providing a public benefit will continue to reap the advantages of tax exemption at the expense of taxpayers.

V

REDEFINING THE MEANING OF CHARITABLE: A SUGGESTION FOR REFORM

As Professor Hill argued before the Committee on Ways and Means, a central problem in the current regulation of charitable nonprofits is the emphasis on preventing a private benefit rather than assuring the provision of a public benefit. Of course, the problem is that preventing a private benefit does not assure that there is public benefit. For example, a nonprofit hospital may not be guilty of private inurement or benefit, and still charge fees for services similar to those charged at for-profit hospitals and provide limited charity care. Where is the public benefit? If there is no public benefit, then the only thing setting a nonprofit apart from a for-profit is the nondistribution constraint. Therefore, verifying that charitable organizations are providing an acceptable public benefit is just as important as confirming that they are not guilty of private inurement.

Implementing a public benefit requirement similar to the one included in the Charities Act is a viable option for assuring that charitable organizations are actually providing a public benefit. One minor issue is that the Charities Act is in its infancy, and the public benefit requirement likely will not be in full force until 2008, so at this time there are no reports of its success or failure. It is undeniable that monitoring how this requirement unfolds in England and Wales, and more specifically how the Charity

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

Commission sets up the standards for demonstration of a public benefit to accommodate various charitable entities, will be beneficial to successful implementation of a similar requirement in America. However, even without empirical data from the new public benefit requirement's operation in England and Wales, there is reason to believe that such a requirement will work in America. It should be noted that even before the Charities Act, all charitable organizations in England and Wales, aside from religious, educational, and poverty-relief charities, were abiding by the public benefit requirement. As mentioned above, before going forward with the Charities Act, the government put together a report analyzing the state of the current public benefit requirement alongside other charitable sector laws and invited public comment. The provisions of the Charities Act were a result of this report and public opinion of the ideas in the report. Therefore, considering that the public benefit requirement was expanded only after careful review of its role in charitable sector law and public opinion of that role, there is reason to believe that it is a workable requirement that could be successful in America.

Further, several states have already implemented what are essentially public benefit requirements that hospitals must meet in order to remain exempt from various state taxes. These states require hospitals to spend a certain percentage of their gross income on charity care, effectively creating a public benefit requirement. Utah's constitution actually incorporates a public benefit requirement, although it is not referred to as such. As mentioned above, Utah requires organizations to provide a gift to the community in order to be exempt from property tax. The gift is either "a substantial imbalance in the exchange between the charity and the recipient of its services" or "the lessening of a government burden through the charity's operation."¹⁷⁷ If a public benefit requirement can be enforced successfully in several states for charities providing tangible benefits, then surely it can be enacted at the federal level for charities providing tangible benefits.

The more difficult issue is determining how charities that provide intangible benefits will demonstrate a public benefit. As

¹⁷⁷ Utah County *ex rel.* County Bd. of Equalization v. Intermountain Health Care, Inc., 709 P.2d 265, 269 (Utah 1985).

mentioned above, the general rule provided by the Charity Commission is to look at tangible benefits first, and if there are none, to look at intangible benefits where the public benefit is clear. The Charity Commission's position has been that although they are more difficult to measure, intangible benefits, like the value of art, are discernable, and the "general consensus of fair-minded and unprejudiced opinion" will be considered in making this type of judgment.¹⁷⁸ Generally, charitable organizations will be able to provide some type of tangible benefit, and where that is not possible, a public benefit will likely be obvious.

The adoption of a public benefit requirement will likely change little about the exemption process for charitable organizations providing intangible benefits; they will probably just have to describe their public benefit. However, organizations providing tangible benefits will have to carefully account for the public benefit they offer using measurable criteria. Therefore, enacting a public benefit requirement will ensure that fee-charging nonprofits like hospitals pass the benefit of exemption to the public. Criticism of the nonprofit sector by Congress and others has focused on fee-charging nonprofits whose services seem indistinguishable from those of for-profits. The public benefit requirement will solve this problem by demanding measurable criteria that differentiate charitable organizations from for-profit organizations. As the Chair of the Charity Commission argued, "Charities are precious, and play a vital and unique role at the heart of our society, but like all bodies in which the public places its trust, they should be accountable to everyone for what they do."¹⁷⁹

CONCLUSION

Congress has clearly stated that some type of reform of the charitable sector must take place to ensure that nonprofits are still deserving of tax exemption at the federal level. Adopting a public benefit requirement modeled on the one in the Charities

¹⁷⁸ CHARITY COMM'N FOR ENG. & WALES, *supra* note 138, at pt. 9.

¹⁷⁹ Suzi Leather, Letter to the Editor, *Charities Should Be Accountable to Everyone for What They Do*, FIN. TIMES (London), Feb. 19, 2007, at 16 (Suzi Leather is Chair of the Charity Commission).

Act will force charities to provide objective proof, where it is possible, that they are indeed providing a public benefit.