William Mitchell College of Law
Journal of Law & Practice

What Qualifies as a Public Charity? Minnesota Enters the National Debate

By: Lucinda E. Jesson and Myron L. Frans[1]

Introduction

The last two years featured seismic shifts in nonprofit corporate law. With two recent cases, *Under the Rainbow Child Care Center, Inc. v. County of Goodhue* and *Afton Historical Society Press v. County of Washington*, the Minnesota Supreme Court entered the fray.[2] In this article, we first address the backdrop of federal and state scrutiny of nonprofit structure and governance. Next we examine the *Under the Rainbow* and *Afton Historical Society* cases.[3] We then suggest measures Minnesota nonprofits and their attorneys should consider preparing for potential challenges to tax exempt status as a "pure charity." Finally, we reflect on the potential for broader legislative and regulatory challenges to nonprofit structure and governance given the current scrutiny of nonprofits.

I. Regulators, legislators and the media set their sites on nonprofit structure and governance.

A. *The Array of Organizations under the Nonprofit Umbrella*

The term "nonprofit organization" casts a broad net. Organizations can take different forms: unincorporated associations, charitable trusts, or nonprofit corporations.[4] When for-profit entities generate profit, that profit is generally shared with its owners as soon as it is practicable and legal to do so. A nonprofit, on the other hand, cannot share its excess revenues or "profit" as it does not have

---

[1] Lucinda Jesson is an Associate Professor of Law at Hamline University School of Law where she also serves as Director of the Health Law Institute. Myron L. Frans is a partner in the Minneapolis office of Faegre & Benson.

[2] *Rainbow*, 741 N.W.2d 880 (Minn. 2007); *Afton*, 742 N.W.2d 434 (Minn. 2007).

[3] The third case in the triad of Minnesota's "purely public charity" cases, *HealthEast v. County of Ramsey*, 2007 WL 1319417 (Minn. Tax Regular Div. 2007), is currently pending appeal before the Minnesota Supreme Court. This article will be updated when the Minnesota Supreme Court issues the *HealthEast* opinion.

[4] *See* Nicholas P. Cafardi & Jaclyn Fabean Cherry, UNDERSTANDING NONPROFIT AND TAX EXEMPT ORGANIZATIONS (2006) at 12-19. A nonprofit's choice of structure is governed by State law. *Id.* at 19. In Minnesota, the organization, administration and dissolution of nonprofit corporations is governed by the Minnesota Nonprofit Corporation Act. MINN. STAT. § 317A (2006).

owners in the same sense and generally a nonprofit must use its excess revenues to further its mission. This principle is known as the "non-distribution constraint" and it both unifies the broad array of nonprofits and sets them apart from their for-profit counterparts.[5]

Any group of individuals can choose an activity and decide not to take a profit pursuing it. But in order to gain tax exempt status, the nonprofit organization must comply with a set of federal and state rules.[6] While there are many different types of tax exempt entities under the Internal Revenue Code,[7] most are encompassed by one of 28 categories of exempt organizations set out in Section 501(c)(3).[8] In order to avoid federal income tax on "exempt function income," most of these entities must apply for recognition of their tax exempt status and, in doing so, fully describe both their exempt purpose, how they plan to achieve that purpose, their anticipated sources of revenue and the nature of their contemplated expenditures. Of course, recognition of tax exempt status means that the organization must demonstrate on an ongoing basis that it is indeed using its revenues to fulfill its exempt purpose, rather than to personally benefit individuals or to primarily support political purposes.[9]

If the nonprofit organization wants not only tax exemption, but also the benefits of income tax deduction for charitable contributions to the organization, the rules become stricter. As a result, these deductions (through which the government even more directly subsidies these entities) are permitted only to organizations "operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international sports competitions . . .

---

[5] *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L. J.. 835, 838 (1980).
[6] Thus, although nonprofit status is accorded by state organizational law and is a requirement for tax exemption, such exemptions are conferred not by this state organizational law, but rather by state and federal tax law. John D. Columbo, *Federal and State Tax Exemption Policy, Medical Debt, and Healthcare for the Poor*, 51 ST. LOUIS U. L.J. 435, 459 (2007).
[7] *See* I.R.C. § 501 (2006).
[8] I.R.C. § 501(c)(3) exempts the following organizations from income taxation: Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, not part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.
[9] Cafardi and Cherry, *supra* note 4, at 69-70; Hansman, *supra* note 5, at 838-40.

or for the prevention of cruelty to children or animals."[10] These entities, sometimes referred to as "charities" (a subset of tax exempt nonprofits), must not only abide by the nondistribution constraint that applies to all tax exempt entities, but their political involvement is severely limited. Charities can only lobby to an insubstantial degree and may not participate in political campaigns.[11]

Finally, if a nonprofit organization seeks status as a private foundation, which is susceptible to the control of one or of a small group of donors, the rules grow stricter yet.[12] For example, private foundations must pay taxes if they either fail to distribute a minimum amount of their income every year to other charitable organizations or accumulate too large an ownership portion in a for-profit business.[13]

Each of these types of organizations attracts attention not only from the Internal Revenue Service, but also from state attorneys general and state and local revenue officials. State attorneys general typically become involved either because of their roles enforcing the state's nonprofit corporation statute or asserting their common law power to ensure that charitable trust assets are properly used.[14] Federal tax exemption often leads to qualification for exemption from state and local income taxes, which may bring an additional level of scrutiny. This is particularly true in the area of property tax exemptions, where states often apply their own (often stricter) criteria for exemption.[15]

B. *Who is Responsible for Nonprofit Governance?*

---

[10] *See* I.R.C. § 501(c)(3); *see generally*, Cafardi and Cherry, *supra* note 4, at 70-83 (describing the private inurement and political activities tests).
[11] *See* I.R.C. §501(c)(3), (h).
[12] The reason for the special scrutiny given private foundations is that it is easier in these organizations (as opposed to publicly supported charities such as churches and universities) to use revenues to benefit the donors, thus breaching the nondistribution constraint.
[13] I.R.C. §§ 4942-4943 (2006).
[14] *See generally* Marion R. Fremont-Smith, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION, 305-21 (Harvard Press 2004). In Minnesota, the Attorney General has the authority to investigate (even without filing a lawsuit) unlawful business practices including practices which the Attorney General reasonably believes may violate the Nonprofit Corporation Act. MINN. STAT. § 8.31 (2006). In addition, the Attorney General may conduct investigations that are reasonably necessary for the administration of Chapter 501B, The Supervision of Charitable Trusts and Trustees Act, and Minnesota Statutes section 309 which regulates the solicitation of charitable funds. He or she may also sue in state court to enjoin and redress violations of these statutes.
[15] *See* Beaufort B. Longest, Jr., *The Divergence of Federal and State Policies on the Charitable Tax Exemption of Nonprofit Hospitals,* 19 J. HEALTH POL. POL'Y & L. 393 (1994); Nina J. Crimm, *Why All is Not Quiet on the "Home Front" for Charitable Organizations,* 29 N.M.L.REV. 1 (1999).

For-profit entities are accountable to owners who directly benefit (or not) from the having an efficiently run business. For publicly traded companies, the SEC also provides oversight. But with nonprofits, oversight is more tenuous. Who monitors, for example, whether the entity is putting its revenues into the exempt mission rather than the hands of individuals, thus breaching the nondistribution constraint?

The Board of Directors of a nonprofit corporation is charged with this oversight. Boards are bound by fiduciary duties of care and loyalty and (according to some courts and state attorneys general) a duty of obedience as well.[16] Typically, directors of a nonprofit are held to what courts label a corporate standard of care. In short, if the director exercised sound business judgment in making a decision (such as entering into a transaction or awarding employees a bonus) and acted without conflicts of interest, courts will defer to the "business judgment" of the director.[17] This is not universally the case, however, as decisions in Minnesota and New York demonstrate.[18]

Who oversees the Board to determine if it is, indeed, abiding by these fiduciary duties? The IRS plays an indirect role in that it confers (and maintains the corresponding ability to revoke) tax exempt status which may be implicated by extreme board action. Realistically, however, entry into the exempt sector is rarely restricted and the revocation of exempt status rarely sought.[19] The ability to impose intermediate sanctions (a tool provided to the IRS in 1996) provides more effective oversight.[20] This permits the imposition of excise taxes where an

[16] Nonprofit Corp. Comm. ABA Sec. of Bus. Law, GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATION (Jeannie Carmedelle Frey ed., ABA Publishing, 2d ed. 2002) [hereinafter "GUIDEBOOK"]. The duty of care requires a director to be reasonably informed, to participate in decisions and to exercise independent judgment. *See* Revised Model Nonprofit Corp. Act § 8.30-8.42 (1987). The duty of loyalty (also known as the duty of fair dealing) required directors to make decisions based on the interest of the corporation rather than in their own interest or in the interest of another. *See* GUIDEBOOK, supra note 17. The duty of obedience refers to the duty of the Board to follow the mission set forth in the corporate articles in making decisions and expenditures. *See* Manhattan Eye, Ear and Throat Hosp. v. Spitzer, 715 N.Y.S. 2d 575, 593 (Sup. Ct. 1999).

[17] Fremont-Smith, *supra* note 15, at 201-211. *See also*, Stern v. Lucy Webb Hayes Nat. Training School for Deaconesses, 381 F. Supp. 1003, 1013 (D.D.C. 1974). The business judgment rule generally requires a board to decide issues only after proper deliberation; to read, study and request materials, as appropriate; participate in the discussions leading up to the decision; maintain proper records of discussions and materials relied upon; ask for expert opinions in complex decision; and, if the information relied on is prepared in-house, make sure it is independent and reliable. Smith v. VanGorkom, 488 A.2d 858 (Del. 1985).

[18] *Compare* Janssen v. Best & Flanagan, 662 N.W.2d 876 (Minn. 2003) *with* Scheuer Family Foundation v. 61 Associates, 582 N.Y.S.2d 662 (App. Div. 1992), *and Manhattan Eye*., 715 N.Y.S.2d at 583.

[19] Fremont-Smith, *supra* note 15, at 262 (referencing I.R.C. § 4958).

[20] I.R.C. § 4958 (2006), codified by Taxpayer Bill of Rights Act.

organization has provided "excessive benefits" to corporate insiders.[21]

While the IRS plays an increasingly active role, most enforcement of the fiduciary duties of nonprofits falls to state attorneys general. In most states, it is the attorney general who is responsible for overseeing charitable solicitation regulation and the mergers and acquisitions between charities and other nonprofits.[22] Taxpayers and others generally lack the standing to legally challenge board activity.[23] While debate ranges across the country about the uneven (and in some states nonexistent) enforcement work of state attorneys general,[24] recent Minnesota Attorneys General have been particularly active in this area.[25]

As demonstrated below, the past two years have witnessed increased focus—and scrutiny – on nonprofit governance from these regulators and beyond.

C. *Spotlights on Mission Oversight, Executive Compensation and Community Contributions*

Corporate scandals grabbed the headlines and the attention of regulators and boards of directors in 2006 and 2007. While the scandals involving WorldCom and Enron shaped the landscape that led to the enactment of Sarbanes-Oxley in 2002, this backdrop led to more recent increased scrutiny and calls for reform in the nonprofit sector as well.[26] For nonprofits, however, the governance focus did not end with reporting and accounting reforms. Rather, they led to a broader discussion of how nonprofit entities should govern in accordance with

---

[21] Fremont-Smith, *supra* note 15, at pages 252-60.
[22] *Supra* at note 12.
[23] Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries*?, 23 J.CORP.L. 655 (1998).
[24] Thomas L. Greaney & Kathleen Boozang, *Mission, Margin and Trust in the Nonprofit Health Care Enterprise*, 5 YALE J.HEALTH POL'Y, L. & ETHICS, 1, 44-46 (2005) (explaining that "attorneys general lack resources, access to information, and expertise to effectively monitor conduct of the extensive nonprofit sector"); Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937 (2004).
[25] *See e.g.*, *Charities and Charitable Giving – Proposals for Reform: Hearing Before the S. Comm. on Finance*, 109th Cong. 224 (2005) (Statement of Attorney General Mike Hatch); Bill Catlin, *A Breakup for Allina*, Minn. Pub. Radio (July 20, 2001), *available at* http://news.minnesota.publicradio.org/features/200107/20_catlinb_allina/; Press Release, Minnesota Attorney General, Agreement Between Attorney General and Minnesota Hospitals Will Provide Fair Pricing to Uninsured Patients, Establish Code of Conduct for Debt-Collection Practices (May 5, 2005).
[26] *See* Francie Ostrower, The Urban Institute Center on Nonprofits and Philanthropy, NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY, 3-7 (2007) (noting that even if Sarbanes-Oxley is not formally extended to nonprofits, the act has raised expectations for nonprofit governance and providing examples).

their mission.[27]

The media focused on several high profile cases, starting with the dispute between Richard Grasso, former chairman of the nonprofit New York Stock Exchange, and the New York Attorney General, who claimed that Grasso's compensation between 1995 and 2003 was unreasonable and accumulated in a premeditated, unapproved fashion.[28] More recently, other stories of executive compensation at nonprofits raised concerns, including the Director of the New York Museum of Modern Art, Glenn D. Lowry, who was the largest earner among museum and library leaders; his compensation was $875,301, almost double the earnings of executives in similar positions.[29] During his seven years running the Smithsonian, former secretary Lawrence M. Small took nearly ten weeks of vacation a year and was absent from his job 400 workdays, while earning $5.7 million on outside work.[30] Nor were media reports on allegations of wrongdoing limited to compensation. The Robin Hood Foundation dealt with investment controversies;[31] the board chair of the James Beard Institute resigned over conflict of interest issues;[32] and elite colleges and universities with large endowments faced inquiries over their tuition increases in light of those endowments and the institution's tax exempt status.[33]

At the state and local level, the focus was on property tax exemption in general and exemptions for hospitals in particular. Starting in 2004, state and local

---

[27] *Id*. at 3.

[28] While the New York Supreme Court dismissed four of the six causes of action, the case remains pending. *See*, People ex. rel. Spitzer v. Grasso, 2008 WL 638247 (N.Y. App. Div. March 11, 2008); People ex. rel. Spitzer v. Grasso, 836 N.Y.S.2d 40 (N.Y. App. Div. 2007). For a discussion of recent nonprofit scandals, see James J. Fishman, *Improving Charitable Accountability*, 62 MD.L.REV. 218, 219 (2003).

[29] Noelle Barton et al., *Top Nonprofit Executives See Healthy Pay Raises*, THE CHRONICLE OF PHILANTHROPY (September 28, 2006), *available at* http://www.philanthropy.com/free/articles/v18/i24/24003901.htm.

[30] James V. Grimaldi, *Report Slams Small's Tenure*, WASHINGTONPOST.COM, June 20, 2007), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/06/19/AR2007061902351_pf.html.

[31] Robin Hood Foundation: most of the money invested in a rainy-day fund, which has grown significantly in the last decade, is in hedge funds run by Robin Hood donors or board members who receive a fee of 2 percent of assets and 20 percent of profit for managing the funds. (July 2007 Bloomberg.com).

[32] James Beard Institute: the chairwoman for the board, Dorothy Cann Hamilton resigned because projects such as Chef's Story on PBS would be ineligible for awards as long as she was a board member. (NY TIMES, October 2007).

[33]Tuition increases for colleges and universities continues to be of interest in Washington. The endowments to 76 colleges and universities reached over $1 billion each while tuition prices continue to increase (CHRISTIAN SCIENCE MONITOR, January 2008). Tuition has gone up, college president's salaries have gone up, and endowments have increased. The Senate Finance Committee is seeking more information on how these colleges are allocating money and how to afford more relief to families for tuition (NY TIMES, January 2008).

officials stepped up enforcement challenges of hospital behavior and tax exempt status.[34] Illinois led the charge with three major property tax exemption cases. In 2004, the Illinois Department of Revenue denied exemption for Provena Covenant Hospital.[35] The issue in Provena Covenant was essentially how much charity care a hospital had to provide in order to be "charitable" and qualify for a property tax exemption for its real estate. The final administrative decision found that neither the medical center nor the hospital dispensed charity to all who needed it and in fact placed obstacles in the way of those needing the medical services and hospitalization.[36] The Illinois Circuit Court, however, reversed the administrative decision and granted the property tax exemption for both charitable and religious uses by Provena.[37] These decisions were followed by increased challenges not only to hospitals, but to nonprofit medical clinics as well, particularly in Ohio and Michigan.[38]

Legislative battles followed these high profile court cases in several states. In Illinois, legislation would have required hospitals to spend at least 8% of their annual operating costs on free care.[39] While this legislation failed, other states sought similar legislative changes. New York restricted nonprofit billing and collection activities, as did California. Texas tied charity care to property tax exemptions with mandatory reporting and Rhode Island imposed charity care conditions on licensure.[40] In Minnesota, similar obligations were imposed through agreements between nonprofit hospitals and the Minnesota Attorney General's

---

[34] Nancy M. Kane, *Tax-exempt Hospitals: What is Their Charitable Responsibility and How Should It Be Defined and Reported?* 51 ST. LOUIS U.L.J. 459, 460 (2007) (providing examples of challenges from New Hampshire to Utah).

[35] *See* Provene Covenant Med. Ctr., No. 04-PT-0014 (Ill. Dep't. of Revenue Sept. 29, 2006) (final admin. Decision), *available at* http://www.revenue.state.il.us/legalinformation/hearings/pt/pt06-26.pdf.

[36] *Id.*

[37] Bruce Japsen, *State to Appeal Rulings on Provena*, CHICAGO TRIBUNE, Sept. 8, 2007, at 1, *available at* http://www.pharmacychoice.com/news/article.cfm?Article_ID=67304 (noting that the Circuit Court's restoration of Provena's tax exempt status will be appealed to the Illinois Appellate Court, Fourth District, by Illinois Attorney General Lisa Madigan).

[38] Wexford Med. Group v. City of Cadillac, 713 N.W.2d 734 (Mich. 2006); Sarah Treffinger, Ruling Presents New Challenge to Hospitals' Tax-Exempt Status, CLEVELAND PLAIN DEALER, Nov. 27, 2005, *available at* http://www.nonprofithealthcare.org/documentView.asp?docID=257 (addressing Ohio Tax Commissioner decision to deny exemption to a new clinic that is part of Cleveland Clinic system). For an excellent discussion of how this debate is playing out in the context of continuing care retirement communities, *see* David A. Brennen, *The Commerciality Doctrine as Applied to the Charitable Tax Exemption for Homes for the Aged: State and Local Perspectives*, 76 FORDHAM L. REV. 833 (2007).

[39] H.R. 5000, 94th Gen. Assem., Reg. Sess. (Ill. 2006). See Illinois Press Release from Attorney General Lisa Madigan proposing legislation that would require hospitals to spend eight percent on free care. http://www.ag.state.il.us/pressroom/2006_01/20060123.html.

[40] Rhode Island, http://www.allbusiness.com/accounting-reporting/corporate-taxes-corporate/218016-1.html.

office.[41]

State governments were not alone in questioning the level of community benefit provided by nonprofits. The Senate Finance Committee, in particular Senator Charles Grassley, has been aggressively questioning nonprofits about governance practices with regard to corporate mission. American University, the American Red Cross, nonprofit hospitals and, most recently, Ivy League universities faced searing questions and comments about their spending and commitment to mission.[42] With regard to tax exempt hospitals, Senator Grassley criticized the lack of charity care and community benefit (compared to that provided by for-profits) as well as hospitals executive compensation and for-profit joint ventures and subsidiaries.[43] In his latest missive Senator Grassley attacks the nation's 136 wealthiest (and tax exempt) universities, stating "[t]uition has gone up, college presidents' salaries have gone up, and endowments continue to go up and up. . . We need to start seeing tuition relief for families go up just as fast."[44]

Not surprising, nonprofit stakeholders and, finally, the IRS stepped fully into the controversy over the past few months. In October 2007, the Panel on the Nonprofit Sector released its "Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations."[45] These guidelines go beyond the nonprofit corollaries to Sarbanes-Oxley to provide "best practices" on 33 principles that are grouped into the following four categories: (1) Legal Compliance and Public Disclosure (2) Effective Governance (3) Strong Financial Oversight, and (4) Responsible Fundraising.[46]

In December the IRS issued the new Form 990 which addresses board size and structures, director independence, audit committee practice, and written conflict of interest and governance practices. Its focus on expanded disclosure of executive pay and perks (such as first-class travel and housing allowances provided to officers and directors) and detailed compensation breakdowns for highly paid employees reflect growing skepticism among state and federal

[41] Statement from Att'y Gen. Hatch regarding Fairview's agreement, http://www.senate.gov/~finance/hearings/testimony/2005test/mhtest040505.pdf.
[42] Michael W. Peregrine & James R. Schwartz, CORPORATE GOVERNANCE, "Key Non y Nonprofit Corporate Law Developments in 2006," Volume 16, Number 2, Jan. 11, 2007. Karen W. Arenson, *Senate Looking at Endowments As Tuition Rises*, N.Y. TIMES, Jan. 25, 2008.
[43] Letter from Charles E. Grassley, Chairman, Committee on Finance, U.S. Senate, to Richard J. Davidson, President, American Hospital Association (Mar. 8, 2006), *available at* http://finance.senate.gov/press/Gpress/2005/prg030806aha.pdf.
[44] *Id.*
[45] http://www.nonprofitpanel.org.
[46] *Id.* at 5.

regulators over the level of compensation paid by tax exempt entities.[47] In Schedule H of the new Form 990, tax exempt hospitals are subject to expanded reporting of subsidized care and services provided to justify their tax breaks. They face six multipart questions on charity care policies, as well as a required cost breakdown for eight charity care and community benefit expenses such as research, free care, and Medicaid loses.[48]

In summary, 2007 ended with new IRS reporting obligations which (when they go into effect) will better enable regulators, Congress and an increasingly skeptical media to more readily assess the governance, compensation, and charity care/community benefit practices of nonprofits. At the same time, on the state level, the Minnesota Supreme Court issued two decisions which rapidly became part of this national discussion.

II. The Minnesota Supreme Court Enters the Fray

A. *Introduction*

Much of the national concern over nonprofit governance and structure focuses on whether entities that look and act very much like their for-profit counterparts merit exemption from federal income tax.[49] At the state level, a similar debate focuses on whether certain nonprofits merit property and sales tax exemptions.

Measured in dollars, it is not a small question. The Internal Revenue Service, the largest regulator of nonprofit entities, oversees 1.6 million tax-exempt organizations which hold $2.4 trillion in assets.[50] In a recent study of the value of

[47] 2008 Form 990. *See generally*, Background Paper for Form 990 Redesign (Dec. 20, 2007), *available at* http://www.irs.gov. *See* Kane, *supra* note 35, at 463-464; Nina J. Crimm, *supra* note 16..

[48] The eight expenses are charity care; cash and in-kind contributions to community groups; community health improvement and community benefits; health profession education; research; subsidized health services, unreimbursed Medicaid and other unreimbursed public, means-tested programs; as well as an "other benefits" category. Form 990 separately requires disclosure of community building, bad debt and Medicare losses as well as an estimate of how much of these costs could be considered community benefit. *See* "Internal Revenue Service Releases Tougher Form 990: Schedule H aims to end variability, manipulation of community benefits reporting by hospitals," MODERN HEALTHCARE January 7, 2008.

[49] An example of this concern manifested itself in a request by the House Ways and Means Committee to the Government Accountability Office for a report comparing charity care practices between government, private nonprofit, and for-profit hospitals. See David M. Walker, U.S. Gov't Accountability Office., Comptroller General of the United States, Nonprofit, For-Profit, and Government Hospitals; Uncompensated Care and Other Community Benefits (May 2005).

[50] I.R.S., Tax Exempt & Government Entities Division At-a-Glance, *available at* http://www.irs.gov/irs/article/0,,id=100971,00.html.

nonprofit hospitals' tax exemptions in Minnesota, the Minnesota Department of Health made the following comparison:

Value of Tax Exemptions for Nonprofit Hospitals for 2005[51]

	Millions of Dollars
	All Nonprofit Hospitals
State and Local Taxes	
Property tax	$99.8
Sales tax	$77.1
State income tax	$28.2
Tax deductibility of contributions	$19.8
Federal Taxes	
Federal income tax	$124.2
Tax-exempt bond financing	$52.7
Tax deductibility of contributions	$79.3
Total estimated value of tax exemptions	$482.0

While the data above only addresses one segment of the nonprofit community—hospitals—the overall dollars and percentages bluntly convey the collective magnitude of the state tax exemptions for nonprofits.

In December of 2007, the Minnesota Supreme Court issued two opinions that addressed tax exemptions for one part of the nonprofit community: purely public charities. In *Under the Rainbow Child Care Ctr., Inc. v. County of Goodhue*,[52] the Tax Court held that Rainbow qualified as a purely public charity.[53] The Supreme Court reversed, holding that Rainbow failed to show that it provided a substantial proportion of its services for free or at considerably reduced rates.[54]

[51] Minnesota Hospitals: Uncompensated Care, Community Benefits, and the Value of Tax Exemptions, January 2007 Report to Legislature, Minnesota Department of Health, *available at* http://www.health.state.mn.us/healtheconomics.
[52] 741 N.W.2d 880 (Minn. 2007).
[53] *Id.* at 882.
[54] *Id.* at 892-93.

Thus, despite never realizing a profit since the child center's existence, Rainbow did not qualify as a purely public charity.[55] Second, in *Afton Historical Soc'y Press v. County of Wash.*,[56] the Tax Court held that Afton did not qualify as a purely public charity.[57] The Supreme Court again reversed, holding that Afton qualified (in part by giving books to schools and students) and that Afton's commercial publishing activity was incidental to Afton's charitable activities.[58] Looking at these two cases in more detail, we examine how they have changed whether an institution is a "purely public charity" qualifying for state tax exemptions.

B. *The Factual Backdrop*

Rainbow, a state-licensed child care center, located in Red Wing, served as a nonprofit corporation with the mission "to provide care [for] children away from their homes."[59] Rainbow never realized a profit during its existence.[60] Rainbow charged tuition for every child and the rates were based on the average rates charged in Goodhue County.[61] The Tax Court made a finding that Rainbow's rates were "at or just below market rates."[62] If a family had difficulty in paying the tuition, they were referred to social services for assistance.[63] But the tuition charges were the same regardless of whether paid by the family or by social services.[64] Rainbow offered evidence that it wrote off "several thousand dollars of childcare every year," but it did not offer any scholarships and had a history of pursuing collection efforts for past-due tuition.[65] The Tax Court held that Rainbow qualified as a purely public charity.[66] However, the Supreme Court reversed, holding that Rainbow failed to show that it provided a substantial proportion of its services free or at considerably reduced rates.[67]

Afton was a publishing house that sought the exemption as institution of purely public charity under Minnesota law.[68] Like Rainbow, Afton was a Minnesota nonprofit corporation.[69] Afton published books about Minnesota

[55] *Id.* at 883.
[56] 742 N.W.2d 434 (Minn. 2007).
[57] *Id.* at 436.
[58] *Id.* at 437.
[59] *Rainbow Child Care*, 741 N.W.2d 880 (Minn. 2007).
[60] Rainbow has been in existence since 1995.
[61] 741 N.W.2d 880.
[62] *Id.* at 883.
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.* at 883.
[67] *Id.* at 892-93.
[68] MINN. STAT. § 272.02, SUBDIV. 7 (2006).
[69] *Afton Historical Soc'y Press*, 742 N.W.2d 434.

history and culture.[70] As a publisher, Afton was involved in the development of book ideas, locating authors, editing the work, locating illustrations for the book, and marketing the book after it is completed.[71] Afton sold its books for less than its costs, and also published learning and activity books that were donated to schools.[72] In addition to this charitable activity, Afton produced some books on a contract basis and the proceeds from those sales are used to offset publishing costs. Typically, the sales of its charitable works and its contract works cover less than half of its publishing costs.[73] Afton solicited donations to make up this difference.[74] The Tax Court held that Afton did not qualify as a purely public charity.[75] The Minnesota Supreme Court reversed, holding that Afton qualified (in part by giving books to schools and students) and that Afton's commercial publishing activity was incidental to Afton's charitable activities.[76]

C. *The Court's Analysis*

The Minnesota Constitution sets out which nonprofits qualify as tax exempt entities. Article 10, Section 1 provides that taxes shall be uniform but that the following entities "shall be exempt from taxation except as provided in this section": "[p]ublic burying ground, public school houses, public hospitals, academies, colleges, universities, all seminaries of learning, all churches, church property, houses of worship, *institutions of purely public charity*, and public property used exclusively for any public purpose.[77]

Minnesota has more than 80 categories for real property tax exemptions and while "purely public charities" is just one, it is a critical one.[78] The category includes theatre and arts organizations, public television, health clinics, day care centers, nursing homes, research entities and much more. And while the legislature took the term "purely public charity" and inserted it into the statute, it did not define the term.[79] Rather, that has been left to a series of court decisions.

[70] *Id.* at 436.
[71] *Id.*
[72] *Id.* at 441.
[73] *Id.* at 436.
[74] *Id.*
[75] *Id.*
[76] *Id.* at 437.
[77] MINN. CONST. art. X, § 1 (emphasis added). In 1913, the legislature took the term "purely public charity" and inserted it into MINN. STAT. § 272.02.
[78] Minnesota Council of Nonprofits, Charitable Tax Exemption Education Campaign Issue Update, *available at* http://www.mncn.org/index.htm.
[79] MINN. STAT. § 272.02, SUBDIV. 7.

Until last December, the expected analysis of whether a nonprofit entity qualified as a "purely public charity" was made under the well-known *North Star* Factors, taken from *North Star Research Foundation v. County of Hennepin*:[80]

> *(1) whether the stated purpose of the undertaking is to be helpful to others without immediate expectation of material reward;*
>
> *(2) whether the entity involved is supported by donations and gifts in whole or in part;*
>
> *(3) whether the recipients of the "charity" are required to pay for the assistance received in whole or in part;*
>
> *(4) whether the income received from gifts and donations and charges to users produces a profit to the charitable institution;*
>
> *(5) whether the beneficiaries of the "charity" are restricted or unrestricted and, if restricted, whether the class of persons to whom the charity is made available is one having a reasonable relationship to the charitable objectives; and*
>
> *(6) whether dividends, in form or substance, or assets upon dissolution are available to private interests.*

Factors one, four and six represent the essential threshold test for exemption from federal income taxation under I.R.C. section 501(c)(3).[81] Clearly, the *North Star* test anticipated that an entity exempt under federal law might have

[80] 236 N.W.2d 754, 757 (Minn. 1975)

[81] Section 501(c)(3) of the I.R.C. exempts entities "organized and operated exclusively for religious, charitable, scientific, . . . literary or educational purposes, or to foster . . . amateur sports competition . . . or for the prevention of cruelty to animals…." To qualify for tax exempt status an organization must insure that:
(1) no part of its net earnings may inure to the benefit of any private shareholder or individual;
(2) no substantial part of its activities may consist of certain activities aimed at influencing legislation; and
(3) it may not participate or intervene in any political campaign on behalf of any candidate for public office.
I.R.C. § 501(c)(3).

to meet a higher standard in order to qualify as a purely public charity entitled to preferential tax treatment under Minnesota law.[82]

Applying these factors in the past, the court emphasized that they were only guides for analysis, not a rigid test.[83] No one factor was essential and every case must be decided on its own particular facts.[84] Yet the court recognized that despite these repeated caveats, it had referred to all six factors in subsequent cases and "may have created the impression that all six factors must be examined in every case addressing the charitable exemption issue."[85] While all six must be examined, the court did not say that all six were required. The court noted in *Rainbow* that it had often stated in the past that not all of the *North Star* factors must be satisfied in order to qualify for tax-exempt status.[86] The court then took the significant step of explicitly stating that while each factor need not be satisfied, factor three (whether the organization *gives* anything away) must be satisfied in order for an organization to be deemed an institution of purely public charity.[87]

Noting that it had never found an organization that did not satisfy the third factor to be a "purely public charity," the court said, "because this is a core characteristic of an institution of public charity, we now clarify that the third factor *must be satisfied* if an organization is to be deemed as an institution of purely public charity."[88]

Examination of factor three looks to whether a charity charges for its services to its clients or recipients.[89] If the answer is yes, then the inquiry is whether those services were provided free of charge or at considerably reduced rates.[90] Stated another way, the organization must show that its intended purpose is to provide a substantial proportion of its goods or services on a charitable basis.[91] To measure factor three, the *Rainbow* court compared Rainbow's

---

[82] *See Rainbow*, 741 N.W.2d at 886. The Court reiterated this point in *Rainbow* noting that "we have never treated an organization's tax-exempt status for federal income tax purposes as determinative of our inquiry." 741 N.W.2d at 889 (citing Share v. Comm'r, 363 N.W.2d 47, 50 (Minn. 1985)).
[83] Cmty. Mem'l Home at Osakis, Minn., Inc. v. County of Douglas, 573 N.W.2d 83, 86 (Minn. 1997) (noting that the factors are only guidelines).
[84] Croixdale, Inc. v. County of Washington, 726 N.W.2d 483, 488 (Minn. 2007) (stating not all six factors must be satisfied); Chateau Cmty. Hous. Ass'n v. County of Hennepin, 452 N.W.2d 240, 242 (Minn. 1990) (noting all exemption cases must be decided on the facts of each case) (citing Mayo Found. v. Comm'r, 306 Minn. 25, 36, 236 N.W.2d 767, 773 (1975)).
[85] *Rainbow*, 741 N.W.2d at 886.
[86] *Id.*
[87] *Id.*
[88] *Id.* (emphasis added).
[89] *Id.* at 887.
[90] *Id.*.
[91] *Rainbow*, 741 N.W.2d at 892 (Hanson, J., dissenting).

published rates to the rates of the two other child care centers to establish a "market rate."[92]

In this decision, the Court made clear that the fundamental definition of a charity is *not* the nature of what is provided but whether what is provided is a *gift.*[93] As a result, the nonprofit nursing home in rural Minnesota or the community clinic in an underserved area cannot assume that providing healthcare while barely breaking even in an underserved area will qualify them as a charity. The arts organization that charges for admission cannot assume that only providing access to local theatre and art will qualify it as a charity.

Moreover, in assessing what constitutes a gift ("services provided free of charge or at considerably reduced rates"), the nonprofit should take heed of several points made by the majority. First, operating at a loss is not equivalent to providing a gift.[94] As the court pointed out, "losses could be caused by numerous factors presumably including poor management."[95] Second, accepting direct payments from government for services does not constitute a gift.[96] The question of whether, with a documented "discounted" rate for government, the amount of the discount might count as a gift was not directly addressed by the *Rainbow* Court. However, the court went out of its way to note that in *Community Memorial Home*[97] and *Chisago Health Services v. Comm'r*,[98] it did not consider

[92] *Id.* at 901-02 (Hanson, J., dissenting). Considering the fact that the other two child care centers in Red Wing besides Rainbow are nonprofit, tax-exempt organizations, the dissent points out several questions of validity that arise from factor three. *Id.* at 901. For example, if each of the child care centers were to charge equal rates, would all three be denied tax exemption because none could meet the requirement that rates be "considerably below market"? *Id.* The dissent also asks whether the "market rate" should be based on actual rates charged by nonprofit organizations, which operate at low cost and benefit from volunteer labor and donations to cover part of their expenses. *Id.* Thus, while the majority states that factor three must be established in order for an institution to be considered a purely public charity, the dissent points to strong evidence that the court placed too much importance on factor three. *Id.* at 900 (noting the majority opinion's emphasis on factor three "dilutes the goal of tax exemption.").

[93] *Rainbow*, 741 N.W.2d at 890. The court points to the Pennsylvania Supreme Court decision, *Hosp. Utilization Project v. Commonwealth*, 487 A.2d 1306 (Pa. 1985) to make the point that this position is not unique. 741 N.W.2d at 890 n 4. In *Hosp. Utilization Project*, the court limits the definition of purely public charity to an organization that "[d]onates or renders gratuitously a substantial portion of its services." *Id.* (citing *Hosp. Unitarian* Project, 487 A.2d at 1317) (alteration in original). The decision is not without criticism. For several years after the decision, charities and local assessors engaged in "relentless litigation" which resulted in legislation, the Institutions of Purely Public Charity, 10 P.S. 371 *et seq*. (2000) where the legislature sought to settle the question of what constituted a public charity by using a fiscal approach to the amount of community care provided by the charity. *See* Penina Kessler Lieber *Does the New "Charities Act" End the War?* 69 PA. B. ASS/N Q. 47, 47-53. *See generally* Penina Kessler Lieber, *1601-2001: An Anniversary of Note*, 62 U. PITT. L. REV. 731 (2001).

[94] *Rainbow*, 741 N.W.2d at 891.

[95] *Id.*

[96] *Id.* at 898 (discussing *Cmty. Mem'l Home*, 573 N.W.2d at 85-87.

[97] 573 N.W.2d 83 (Minn. 1997).

acceptance of discounted rates as evidence of a charitable endeavor.[99] Finally, forgiving an unpaid charge, if the charge was based on the market rate, is not a gift.[100]

The Minnesota Supreme Court provided some—but not much—needed clarity in *Afton*.[101] Afton was found to qualify as a charity by the Minnesota Supreme Court, identifying that Afton's beneficiaries of its charity were the schools and students.[102] Afton gave the schools and students books free of charge.[103] Afton received donations to support its Books-for-Schools program.[104] Also, Afton sold some books to the general public, but these were sold substantially below cost.[105] Afton was incorporated as a charity and, just like Rainbow, never earned a profit in the years at issue.[106]

The Tax Court erroneously denied Afton's exemption claim in large part because Afton received contract publishing *revenue* apart from its Books-for-Schools program and its donations.[107] By focusing on the revenue from the contract publishing, the Tax Court misdirected its inquiry according to the Minnesota Supreme Court.[108] The North Star factor three (3) requires the court to analyze whether the beneficiaries receive something for free or at a substantially reduced price.[109] In this case, the Tax Court applied too broad of an analysis by not limiting the analysis to Afton's beneficiaries, but wrongly including Afton's contract publishing activity in its factor three (3) analysis as well.[110] The Minnesota Supreme Court reversed the Tax Court and directed that the proper inquiry for a charitable entity was to examine whether any commercial activity was incidental to its charitable purpose.[111] The Supreme Court found that Afton's contract publishing contributed only to overhead expenses, and did not generate a profit.[112] Finally, Afton's contract publishing activities were subordinate to Afton's charitable publishing activity in terms of the number of books published each year.[113] Thus, the Minnesota Supreme Court held that incidental commercial

---

[98] 462 N.W.2d 386 (Minn. 1990)
[99] 741 N.W.2d at 895.
[100] *Id*. at 891 (discussing *Chisago Health Services*, 462 N.W.2d at 391).
[101] 742 N.W.2d 434.
[102] *Id.* at 441-42.
[103] *Id.* at 442.
[104] *Id.* at 436.
[105] *Id*.
[106] *Id.* at 442.
[107] *Id.* at 436.
[108] *Id.* at 441.
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] *Id.*.
[113] *Id.* at 442.

benefit does not stop an institution from being considered a purely public charity.[114]

In sum, these two cases provide some general guidance as to the *North Star* factors, but create no small amount of confusion as to how to measure when services are provided at considerably reduced rates. The *Rainbow* court held that not all of the *North Star* factors need to be considered in every exemption case; however, *North Star* factor three must be satisfied in order for an institution to be considered a purely public charity.[115] Yet how an entity can provide a "substantial portion" of its goods/services free of charge or at considerably reduced rates raises a number of questions. What counts as "substantial"? When is a rate "considerably reduced?" And how is the "market" defined, particularly where the competitors in the "market" are other nonprofits?

The *Afton* decision provides limited insight into these questions. In *Afton*, the Court applied *North Star*'s third factor and held that a charity can engage in incidental, commercial activity and still qualify as a purely public charity.[116] Given the *Rainbow* Court's emphasis on a traditional definition of charity, the *Afton* decision reaffirmed that nontraditional entities may qualify as "purely public charities" even where the public benefit would be indirect. Moreover, in *Afton* the court approved tax exempt status for an entity that provided some goods for free, but other goods at reduced costs and yet other goods at commercial rates.[117] Without answering the questions regarding what counts as "substantial" and "considerably reduced costs/rates," the decision begins to provide a context for predicting tax enforcement strategies.

III. Moving Forward in a Post-*Rainbow* World

The *Rainbow* decision has been described by the Minnesota Council of Nonprofits as "a significant narrowing of the property tax exemption" and "a clear departure from 30 years of previous case law in Minnesota."[118] Not surprisingly,

[114] *Id.* at 441.
[115] 741 N.W.2d at 886.
[116] 742 N.W.2d at 441
[117] *Id.* at 442-43
[118] MINNESOTA COUNCIL OF NONPROFITS, CHARITABLE TAX EXEMPTION EDUCATION CAMPAIGN, FACTS AND QUESTIONS (2007), *available at* http://www.mncn.org/doc/Charitable%20Tax%20Exemption%20Education%20Campaign%20FAQ.pdf. In contrast, the Minnesota Department of Revenue has expressed the opinion that this decision does not change anything. The Department of Revenue indicated that the analysis it used to grant tax exemption to organizations prior to *Rainbow* is the same analysis articulated in the *Rainbow* opinion. Memorandum from Anna Schifsky, Hamline University School of Law Student, March 4, 2008. Ramsey County has also indicated that the *Rainbow* opinion has little impact. Memorandum from the Office of the Ramsey County Manager, David J. Twa, *Minnesota*

this Council and others initially called for legislative action to overturn the decision.[119] Yet given the legislative activity in Congress and other states to set a higher bar for defining charity care and community benefit, legislation poses both risks and opportunities. Another alternative is to simply wait for future cases to provide needed clarification.

Regardless of any legislative solutions that may or may not materialize, we suggest that Boards of Directors for public charities reassess their provision of goods and services.[120] The broad consequence of the *Rainbow* decision is that simply providing a needed, worthwhile public service in a way that no profits inure to the benefit of private individuals *is not enough*.[121] Doing so while operating at a loss *is not enough*, even though it may be adequate for tax-exempt status for federal income tax purposes.[122] The Minnesota Supreme Court has set a higher standard.

In assessing the status of a current public charity under this standard, a board should consider whether any of the following issues can be addressed and, if so, to what practical effect:

- Does the organization provide a substantial amount of goods/services for free or at a considerably reduced cost?

  The dilemma is that what counts as a "substantial amount" and "considerably reduced" is largely undefined. Boards proactively should consider different approaches to this measurement. With regard to the "substantial amount" question, the board could measure this in terms of a percentage of net operating income and/or total operating expenses. Alternatively, an entity that primarily serves financially challenged individuals could count this in terms of numbers of people served. In addition, the board could look at this

Supreme Court Opinion on Tax-Exempt Status of the Under the Rainbow Day Care Center (Dec. 17, 2007) (on file with author). The County has stated that it currently operates consistently with the opinion. *Id.*

[119] Minnesota Council of Nonprofits, *Charitable Tax Exemption Education Campaign Issue Update, available at* http://www.mncn.org. During the legislative discussion in early March 2008, the Department of Revenue agreed to a moratorium on existing property tax exemption for primarily public charities until new laws and guidelines are in place. *Id*.

[120] The *Rainbow* decision does not affect the other categories of constitutional exemption such as schools, public hospitals, colleges, universities, churches, etc. Only those nonprofits that qualify as purely public charity should undertake the assessment we suggest below.

[121] *See, Rainbow*, 741 N.W.2d at 886.

[122] *Id*. at 891.

issue through the lenses of quantifying the amount of government "burden" relieved through the charity's efforts.[123]

Certainly, these measures are not all-inclusive. One bottom line measure of the "substantial amount" is to assess the extent the value of your charity exceeds your organizations state tax exemptions.[124] In doing so, keep in mind that Minnesota law establishes an identical test for both property and sales tax purposes.[125]

- How public is the charity policy of the organization?

  The board should also consider how publicly available it makes its "gifts." Potential beneficiaries need to be able to learn of their eligibility for a charitable benefit. Precedent here and elsewhere suggest that having a publicized "charity" policy is significant.[126]

- What is the market, and accordingly, what are "considerably reduced costs," for the goods and/or services your organization provides?

  One of the challenges which played out in *Rainbow* is defining the market. When doing so, an organization should consider whether the competitors in its geographic region are for profit or non-profit. If they are all non-profit, it may behoove the board to look beyond the geographic confines for "for profit" price comparisons. Moreover, think broadly about what goods or services could be substitute "products." For example, are certain assisted living facilities "competitors" for a nonprofit nursing home? If so, perhaps cost comparisons to establish the "market" should include these products.

- How much bad debt does your organization incur and how do you go about collections?

---

[123] *Id.* at 890 n. 4 (citing Utah County v. Intermountain Health Care, Inc., 709 P.2d 265 (Utah 1985) (identifying features of a "gift" to include "the lessening of a government burden through the charity's operation")).

[124] *See* Grassley, supra at n. 44 ("usually there is a quid pro quo expectation that the nonprofit will provide social benefit commensurate with their consumption of government services and taxes").

[125] Sales and Use Tax-Charitable Organization Exemption-Exempt Status Revocation After Adverse Property Tax Exemption Determination, Minn. Dept. of Rev. Notice # 07-12 (Oct. 15, 2007).

[126] This is one of the inquiries on the new IRS Form 990. *See generally,* Kane, supra at n. 35, p. 471 (recommending that health charities ensure that patients are aware of the availability of charity care).

Boards will be well advised to keep track of how they offer charity, or its gift equivalent, to recipients; but they should not stop there. Review collection practices to determine if aggressive tactics (inconsistent with the entity's mission) are in use. Consider collection principles that meet the guidelines set out in the Attorney General/Fairview settlement agreement and which are more likely to carry weight if an argument over property tax exemption ensues.[127]

- How much does your organization attract in terms of donations?

  Keep track of the donation of professional services and report the value of those donated services. Maintain records of volunteer activity in addition to donations of money. Think broadly about the many ways individuals support your organization.

- Does your organization break even or lose money each year?

  Consider how monies are spent in better financial years in order to demonstrate how these expenditures support the organization's mission.

- How does the organization account for commercial income?

  Be clear of purpose and define the set of intended charitable beneficiaries. Next, consider what safeguards are in place to insure that commercial activities are subordinate to the nonprofit activities. Have this issue periodically reviewed by the Board to ensure mission supremacy.

IV. Conclusion

Pending any legislative "fix," *Rainbow* provides an important opportunity and impetus for a purely public charity to examine its practices and consider whether they are reflective of the organization's charitable mission. Society's expectations of nonprofits are shifting. Accountability, transparency and demonstrated mission primacy will be increasingly important hallmarks for the nonprofit which seeks to maintain public charity status.

[127] Mike Hatch, Minn. Att'y Gen., FAIRVIEW COMPLIANCE REVIEW (2005), *available at* http://www.ag.state.mn.us/consumer/PDF/Charitycare.pdf. The agreements require hospitals to tell patients of financial assistance programs and prohibit certain collection practices, including reporting debt to credit reporting agencies and executing prejudgment garnishments. *Id*. at 22.