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Developments in the Law, "Nonprofit Corporations" (III. Tax Exemption)

Renee Jones

Boston College Law School, renee.jones.2@bc.edu

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They provide a solid model for nonprofit directors and have been embraced by the leading statutes that govern nonprofit activities.\textsuperscript{120}

Equally important, yet less often discussed by commentators, are the procedures used to enforce the fiduciary duties. More effective enforcement procedures would enable states to apply the business standards of care and loyalty to nonprofit directors.

In the context of mutual benefit nonprofits, enforcement of fiduciary duties should be left to the corporation’s members. The members should have the same rights as shareholders of business corporations, and member derivative actions should not be burdened by requirements not typically applied to shareholder actions.\textsuperscript{121} Successful derivative actions should yield the same benefits obtainable by shareholders (limited, of course, by the nondistribution constraint applied to nonprofits).

The appropriate enforcement mechanism is more problematic in the context of public benefit corporations. Instead of simply relaxing existing standing requirements, state legislatures should enact more powerful penalties for breaches of the fiduciary duties. Because of the underenforcement problem present in the nonprofit sector, a system of fines appropriately complements the disgorgement of impermissible profits. Such fines, however, should be used only for breaches of the duty of loyalty, when the director is presumably aware that he is engaging in a prohibited transaction. The fines must also be appropriately limited so as not to deter permissible activities undertaken by risk averse directors.

\section{III. Tax Exemption}

\subsection*{A. Introduction}

Many nonprofit organizations are exempt from various forms of taxation under federal and state law. In a debate that has largely focused on the commercial activity of nonprofits, many academics and tax analysts have openly questioned the merits of these exemptions. The central question posed is whether organizations with the ability to generate profits merit public subsidy.

Framing the debate is a lack of consensus regarding the rationale for tax exemption. Some commentators have observed that both the Treasury Department and the courts have administered the tax exemption for nonprofits in a haphazard and inconsistent manner.\textsuperscript{1} In

\textsuperscript{120} See supra pp. 1593–94.

\textsuperscript{121} Such requirements, which should be rejected, include a threshold number of members who must initiate the derivative action. See supra note 89 and accompanying text.

response to this apparent disarray, some have sought to develop a rationale that both explains the current system and offers guidance for reform. Unfortunately, much of the academic commentary on tax exemption has understated the significance of local government action to revoke the property tax exemption for certain types of nonprofits.

Because of the significant and tangible value of the local property tax exemption, local authorities have begun to challenge the exempt status of nonprofit organizations. Most of the litigation over the property tax exemption has revolved around interpreting the elusive term "charitable," upon which much of tax exemption law hinges. An examination of this conflict at the state level offers more guidance than exclusively focusing upon the positions of the IRS and the holdings of federal courts.

This Part argues that the most appropriate way to determine whether an organization is charitable for tax exemption purposes is by reference to community values. Section B lays out the current law of tax exemption at the federal and state levels. Section C discusses the conventional rationale for tax exemption, and introduces several theories that seek to provide a more rigorous explanation of the exemption. Section D argues that state courts should more frequently defer to local government action regarding property tax exemption, and that federal policymakers should be guided by such local activity. Finally, section E analyzes the debate over tax exemption for nonprofit hospitals, both to provide an illustration of the importance of local government activity and to demonstrate how the proposed judicial analysis can be applied in a specific case.

B. Overview of Basic Exemption Schemes

Charitable nonprofit organizations are exempt from federal income taxation under provisions of the Internal Revenue Code. In addition, the Code entitles qualifying charitable entities to receive tax deductible contributions from donors,\(^2\) and to issue bonds for which the interest accrued is excluded from the investor's taxable income.\(^3\) Furthermore, organizations that qualify as charitable under state constitutional or statutory provisions are exempt from state income and local property tax.

1. Federal Income Tax Exemption. — Not all nonprofit organizations are exempt from the federal income tax.\(^4\) Section 501(a) limits

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\(^{2}\) See I.R.C. § 170(a), (c) (1988); infra Part IV.

\(^{3}\) See I.R.C. §§ 103, 141(e)(1)(g) (1988).

\(^{4}\) See Hansmann, supra note 1, at 57 & n.15.
the exemption to specifically prescribed entities. Organizations described in section 501(c)(3), including those organized for "religious, charitable, scientific . . . or educational purposes," constitute the majority of the organizations that benefit from the exemption. Because most organizations receiving the exemption qualify under the section 501(c)(3) charitable exemption, the reach of that section is the focus of this analysis.

To qualify for tax exemption under section 501(c)(3) an organization must satisfy both the organizational and operational tests described in treasury regulation section 1.501(c)(3)-1. Thus, the organization must be "both organized and operated exclusively for the furtherance of one or more of the purposes" enumerated in section 501(c)(3).

(a) Organizational Test. — To satisfy the organizational test, the articles of organization (for example, trust instruments, corporate charters, or articles of association) must limit an organization's purposes to one or more of the listed exempt purposes, and must not expressly empower the organization (except to an insubstantial degree) to engage in any activities that are not in furtherance of an exempt purpose. Further, the articles of organization must provide for the distribution of assets for a public or charitable purpose upon dissolution of the organization.

(b) Operational Test. — Even if its articles of organization conform to the requirements of the organizational test, the organization must also satisfy the operational test. The regulations state that "[a]n organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3)." Activities other than those that further an exempt purpose are permissible. However, an organization will not be regarded as operating exclusively for exempt purposes "if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."

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6 I.R.C. § 501(c)(3) (1988). More precisely, section 501(c)(3) defines charitable tax-exempt organizations as "[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, 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." Id. Other organizations exempt under § 501 include civic organizations, labor or agricultural organizations, pension plans, chambers of commerce, and fraternal beneficiary societies. See I.R.C. § 501(c)(4)–(10) (1988).
11 Id.; see infra p. 1617.
(c) Exempt Purpose. — (i) Specified Exempt Purposes. — Although section 501(c)(3) authorizes a variety of qualifying exempt purposes, the most common include educational, religious and charitable. Defining the scope of activities deemed to further such purposes is the most contested aspect of tax exemption law. As defined in the regulations, education relates to "[t]he instruction or training of the individual for the purpose of improving or developing his capabilities [and the] instruction of the public on subjects useful and beneficial to the community." The regulations specify that an educational organization may advocate a particular position as long as it "presents a sufficiently full and fair exposition of the pertinent facts." An organization, however, is not considered educational "if its principal function is the mere presentation of unsupported opinion." Attempting to distinguish educational material from mere propaganda has embroiled the IRS in constitutional controversy. In Big Mama Rag, Inc. v. United States, the D.C. Circuit held that the full and fair exposition test was unconstitutionally vague and violated the First Amendment. However, other circuits have not followed Big Mama Rag, and the D.C. Circuit showed less sympathy for an analogous claim when it ruled in National Alliance v. United States that an organization that published racist propaganda could not sustain a valid First Amendment challenge to the same IRS regulation. The court determined that the group’s purposes could not satisfy "any definition of ‘educational’ conceivably intended by Congress."

Religion is specifically designated an exempt purpose by section 501(c)(3). Because of the constitutional separation of church and state, it may be difficult to advance a direct challenge to an organization’s claim to be organized and operated for religious purposes. Thus, the IRS must be careful not to discriminate against any religious group in the administration of tax exemptions. However,

12 See supra note 6.
13 Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (as amended in 1990). Examples of educational organizations include primary and secondary schools, colleges, universities, trade and professional schools, and organizations that present public forums or lectures, or correspondence courses. Also included as educational are museums, zoos, planetariums, symphony orchestras and similar organizations. See Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii) (as amended in 1990).
15 631 F.2d 1030 (D.C. Cir. 1980).
16 See id. at 1039–40.
17 See Martha H. Good, Recent Case, 53 U. CIN. L. REV. 277, 294 (1984) (noting that the D.C. Circuit “stands virtually alone . . . in its view that the Treasury regulation’s definition of ‘educational’ is unconstitutionally vague”).
18 710 F.2d 868 (D.C. Cir. 1983).
19 See id. at 875.
20 Id. at 873.
21 See generally Trevor A. Brown, Note, Religious Nonprofits and the Commercial Manner Test, 99 YALE L.J. 1631, 1639 (1990) ("[O]nly the religious exemption presents the possibility of
the IRS has revoked the exempt status of religious organizations when the organization conferred private benefits on its members, or when the organization did not serve an exclusively religious purpose.

The law of tax exemption cannot be understood without interpreting the term charitable. The term implies both a statutory definition of a category of exempt activities, and a common law requirement that the organization must advance charitable ends. The first meaning of charitable is, as previously noted, reflected in the Code's enumeration of certain specific categories of activities that presumably justify exemption. The term "charitable," as used in section 501(c)(3), is a catch-all phrase encompassing all activities that, although not specified in the subsection, can reasonably be claimed to serve a charitable purpose.

Unfortunately, neither the statute nor the regulations explicitly define "charitable." According to the treasury regulations, the term "charitable" is used "in its generally accepted legal sense . . . [and includes] [r]elief of the poor . . . ; 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." This list, however, does not purport to be exhaustive.

Concerning the second use of "charitable," the Supreme Court has held that all organizations exempt from taxation under section 501(c)(3) must be charitable in practice, regardless of their specifically enumerated purpose. In Bob Jones University v. United States, the Court held that, "underlying all relevant parts of the Code, is the intent that entitlement to tax exemption depends on meeting certain common-law standards of charity — namely, that an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy." For example, discrimination on the basis of race violates public policy, and will deprive an otherwise charitable educational organization of exempt status. Similarly, evidence of engaging in illegal activity jeopardizes an organization's exempt status.

infringements on the constitutional norms against entanglement of government and religion, free religious exercise, and government establishment of religion." (footnotes omitted)).

22 See, e.g., Church of Scientology v. Commissioner, 823 F.2d 1310, 1322 (9th Cir. 1987) (upholding the revocation of an organization's exempt status on the grounds that the organization's income inured to the benefit of founder and his family), cert denied, 488 U.S. 1015 (1988).
23 See Smith v. Commissioner, 800 F.2d 930, 934-35 (9th Cir. 1986); First Libertarian Church v. Commissioner, 74 T.C. 396, 404 (1980).
24 The term "charitable" is "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." Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 1990).
25 Id.
27 Id. at 586.
28 See id. at 595 ("[R]acial discrimination in education is contrary to public policy.").
29 See, e.g., Synanon Church v. United States, 820 F.2d 421, 427 (D.C. Cir. 1987) (finding
(ii) Commercial Activity. — Engaging in commercial activity does not preclude an organization from being deemed to serve an exempt purpose. However, the commercial activity cannot constitute the organization's primary purpose. Income generated from commercial activity that is unrelated to the organization's exempt purpose may be subject to the unrelated business income tax.

The IRS carefully scrutinizes the activities of nonprofit organizations engaging in commercial activity. If an organization charges consumers a price covering more than the full cost of its product or service, the alleged charitable nature of the activity is called into question. For example, a nonprofit pharmacy organized and operated to sell prescription drugs to the elderly at a modest discount was denied tax-exempt status. Similarly, income earned by a consulting firm organized to advise other nonprofits at fees set to cover more than costs was held to be taxable. The fact that a nonprofit competes directly with for-profit entities is often cited as evidence that exemption is not warranted.

(iii) Unrelated Business Income Tax. — A nonprofit's exemption from federal income tax is limited to income derived from activity substantially related to the organization's exempt purpose. Income derived from unrelated activities is subject to the unrelated business income tax. The rationale underlying the unrelated business income tax is to limit unfair competition between for-profit businesses and tax-exempt nonprofits.

Unrelated business taxable income (UBTI) is the "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions . . . directly connected with the carrying on of such trade or business." Unrelated trade or business means "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption." Exceptions to this general provision cover work performed by volunteers, revenue from business conducted for the convenience of the nonprofit's members or that evidence regarding a group's incitement and perpetration of violence and illegal acts is relevant for determining its tax-exempt status).

30 See Federation Pharmacy Serv. v. Commissioner, 625 F.2d 804, 809 (8th Cir. 1980).
31 See B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352, 360-61 (1978).
32 See, e.g., id. at 358.
employees,\textsuperscript{38} sale of donated goods,\textsuperscript{39} certain hospital services,\textsuperscript{40} and certain activities of conventions and trade shows.\textsuperscript{41}

The law has not yet clearly resolved when income received by exempt organizations should be considered UBTI.\textsuperscript{42} The regulations set out the three factors to be considered in determining whether income should be taxed as UBTI. Revenue is includable in UBTI if, “1) it is income from a trade or business; 2) such trade or business is regularly carried on by the organization; and 3) the conduct of such trade or business is not substantially related . . . to the organization’s performance of its exempt functions.”\textsuperscript{43}

The term trade or business, as used in section 513, means any activity carried on to produce income from the sale of goods or the performance of services.\textsuperscript{44} Regularly carried on activities are those that “manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.”\textsuperscript{45} To constitute a substantially related activity, the commercial activity from which the income is derived must “contribute importantly” to accomplishing the exempt charitable purpose.\textsuperscript{46}

(iv) General Prohibitions. — In addition to meeting the specific criteria enumerated above, an organization must abide by two additional general prohibitions in order to qualify for tax exemption. Regardless of its particular purpose, no organization can be granted tax-exempt status if part of its earnings inure to the benefit of private

\textsuperscript{40} See I.R.C. § 513(e) (1988).
\textsuperscript{41} See I.R.C. § 513(d) (1988).
\textsuperscript{42} See generally Marcus S. Owens, Current Developments in the Unrelated Business Area — IRS Perspective, 4 EXEMPT ORG. TAX REV. 923 (1991) (detailing the complex factors involved in determining when a nonprofit’s revenues are unrelated business taxable income).
\textsuperscript{43} Treas. Reg. § 1.513-1(a) (as amended in 1983).
\textsuperscript{44} See I.R.C. § 513(c) (1988). Trade or business has the same meaning as used in § 162 of the Code. See Owens, supra note 42, at 925. In United States v. American Bar Endowment, 477 U.S. 105 (1986), the Supreme Court held that the sale of life insurance was a “trade or business” within the meaning of § 512, see id. at 110. The Court held that, because the insurance business competed with other for-profit vendors of insurance, Congress intended that such revenue should be taxed. See id. at 114.
\textsuperscript{45} Treas. Reg. § 1.513-1(c)(1) (as amended in 1983); see also NCAA v. Commissioner, 914 F.2d 1417, 1424 (10th Cir. 1990) (holding that revenue generated from the sale of advertising in basketball tournament programs was not UBTI because the activity was not sufficiently long lasting to constitute a regularly carried on trade or business).
\textsuperscript{46} See Treas. Reg. § 1.513-1(d)(2) (as amended in 1983); see also American Postal Workers Union v. United States, 925 F.2d 480, 482-83 (D.C. Cir. 1991) (holding that revenue from dues paid by nonmembers to purchase health insurance was UBTI because helping nonmembers was not a part the organization’s stated purpose; National Ass’n of Postal Supervisors v. United States, 21 Cl. Ct. 310, 324 (1990) (finding that the provision of benefits to “limited benefit” members who were not postal supervisors was not substantially related to organization’s exempt purpose), aff’d, 944 F.2d 859 (Fed. Cir. 1991).
shareholders. This prohibition of private inurement is not limited to the distribution of dividends, but also applies to the conferral of any direct or indirect benefit to a private interest.

The Code specifically provides that a section 501(c)(3) organization must not carry on propaganda, attempt to influence legislation, or participate or intervene in political campaigns. The regulations define any organization that violates this provision as an “action organization” that is not exempt from income taxation.

2. Tax Exemption and State Law. — All states with a corporate tax provide an exemption for nonprofit charitable organizations. In administering the corporate income tax exemption, most states simply follow federal practice either by granting a statutory exemption to any organization exempt under section 501(c)(3), or by using statutory language similar to that used in the Code without specific reference to it.

Real and personal property that is owned by nonprofit charitable organizations and is used for a charitable purpose is also exempt from taxation under state constitutional and statutory provisions. To qualify for property tax exemption under most state schemes, an organization must, at a minimum, meet two organizational requirements. First, the entity must be organized as a nonprofit that pays out no dividends or income other than wages. Second, its assets must be irrevocably committed to serving charitable purposes. In addition, the property in question must be used primarily for an exempt purpose that benefits an indefinite, non-exclusive class of people.

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47 See Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 1990); supra Part II.
50 See Treas. Reg. §1.501(c)(3)-1(c)(3)(ii) (as amended in 1990). For a discussion of the constitutional implications of the prohibition against political activity, see infra Part V.
52 See id. at 121–22; see also id. app. A (providing a state-by-state analysis of tax exemptions for nonprofits).
53 Thirty-six states have constitutional provisions that either guarantee exemption or permit the legislature to grant an exemption at its discretion. The remaining state constitutions expressly permit the legislature to grant property tax exemptions for any reason or have been interpreted to allow for exemption. See id. at 122.
54 See id.
55 See id. at 123–25.
The property tax exemption differs from income tax exemption in that it is granted by the state, yet the impact from lost revenues falls upon local governmental entities. If a state legislature authorizes an exemption broader than one deemed appropriate by municipal officials, courts must frequently mediate the conflict.

C. Rationale for Tax Exemption

Commentators have offered a number of theoretical frameworks to explain the tax exemption for nonprofits. None of these theories, however, satisfactorily explain the tax exemption system. It is helpful, however, to begin with Professor Henry Hansmann's distinction between donative nonprofits and commercial nonprofits. Donative nonprofits receive most of their income from donations. Examples include CARE, the Salvation Army, and the United Way. In contrast, commercial nonprofits, such as the Educational Testing Service, nursing homes, and hospitals, receive most of their income from prices charged for the goods and services they provide. The law treats commercial nonprofits as the more suspect form of nonprofit for meriting tax exemption. Thus, much of the debate regarding the nonprofit tax exemption focuses on the exemption of commercial nonprofits and attempts to explain why some commercial nonprofits deserve subsidy while others do not.

1. Conventional Rationale. — The subsidy theory is the traditional rationale for the tax exemption. Courts often opine that tax exemption is a means for providing a government subsidy to organizations that relieve governmental burdens by providing essential services. Despite its general acceptance, the subsidy rationale is an incomplete explanation for tax exemption. Even if one accepted that the provision of certain goods and services deserves to be subsidized, it remains unclear why a subsidy should be granted through the tax system rather than through direct subsidies or government provision of the goods or services in question.

Viewing the nonprofit tax exemption as a tax expenditure invites an examination of the propriety of providing government subsidies through the tax system. Tax expenditures "represent government spending for favored activities or groups, effected through the tax system." The list of tax expenditures includes well recognized preferences to individual taxpayers, such as the home mortgage interest

57 See id.
58 See supra p. 1617.
Critics of tax expenditures point to the inefficiency of tax expenditures in allocating scarce government resources. They note an “upside-down” effect, by which those least in need of assistance benefit from tax subsidies the most.62 In the case of tax exemptions, clear distributional inequities exist. Only organizations with significant net profits or that own valuable property, benefit from a tax break.63

Furthermore, embedding substantive policy programs in the tax system forces ill-equipped tax administrators and legislative tax committees to make substantive policy decisions.64 Congressional spending eludes proper scrutiny by substantive policy committees whenever Congress includes such spending programs in tax legislation. Similarly, this practice forces the IRS to make substantive policy decisions when formulating regulations that interpret legislation.65

Tax expenditure analysis reveals the weakness of the subsidy theory as a rationale for tax exemption. However, the tax expenditure concept provides no basis for proceeding with the exemption as it exists, because tax expenditure critique fails to inform policy makers and administrators of how to administer the tax exemption.

2. Academic Theories. — Although the subsidy theory comports with common sense, it is an imprecise and inadequate tool for analyzing tax exemption. A number of commentators have sought to develop a more rigorous theory to justify tax exemption and to prescribe its proper scope.

(a) Income Measurement Theory. — Boris Bittker and George Rahdert offered one of the first academic attempts to provide a more coherent explanation of the income tax exemption.66 In their view, nonprofits are exempted from income taxation because there is no practical way to measure their net income.67 The authors point to difficulties in defining income and deductible expenses for nonprofit groups. For example, they question whether membership dues or donations to nonprofit organizations should be counted as gifts, which

61 See id. at 77–79.
62 See id. at 71–82.
63 See Hall & Colombo, supra note 1, at 355–57.
64 See Surrey & McDaniel, supra note 60, at 106.
65 See id. at 95–96. For example, the IRS implicitly sanctioned the practice of patient dumping by nonprofit hospitals when it ruled in 1969 that hospitals were no longer required to treat all patients regardless of their ability to pay. See Daniel C. Schaffer & Daniel M. Fox, Tax Administration as Health Policy: The Exemption of Nonprofit Hospitals, 1969–1990, 53 TAX NOTES 217, 218 (1991) (discussing how Revenue Ruling 69-545 removed an obstacle to "patient dumping" by nonprofit hospitals).
67 See id. at 333.
are not includable as income under the tax code, or as taxable revenue. Also, given the redistributive function served by many non-profit organizations, they argue that it is unclear whether the services and goods they provide would be considered deductible expenses, which, under the Code, must be motivated by a desire for profit.

Although the income measurement theory provides some insights into the nonprofit tax exemption, the theory has several problems. First, not all nonprofits rely on donations for revenue. Many generate income through the sales of goods and services in a manner similar to for-profit companies. In the case of commercial nonprofits, it would be easy to adopt the tax accounting rules that apply to for-profit corporations. With donative nonprofits there is also a feasible way of measuring income. Hansmann argues that donations from the public can be viewed as implied contracts for the delivery of goods and services to needy people. For example, he asserts that sending money to CARE for famine relief is analogous to sending money to Tiffany's for the store to send a wedding gift to a friend. Donations from the public, construed as "purchases" of aid for the needy, could be included in gross income, and the costs of providing the services could be construed as deductible business expenses. Finally, the income measurement theory does not address property tax exemption, for there is no measurement problem with valuing the property owned by a nonprofit organization.

(b) Capital Formation. — In response to the perceived weaknesses of Bittker's and Rahdert's theory, Hansmann has offered a rationale that justifies the income tax exemption as a mechanism that compensates nonprofit organizations for the constraints they face in capital markets. He notes that a definitional characteristic shared by nonprofits is the nondistribution constraint, which prohibits the organization from distributing its earnings to shareholders. Because nonprofits cannot issue ownership shares, they lack access to equity markets, a common source of capital. Moreover, nonprofit organizations suffer from inadequate access to debt financing. In the absence of some type of preference or subsidy, nonprofits might face undercapitalization. The income tax exemption enables nonprofits to finance growth through retained earnings, and primarily because re-

68 See id. at 308–09.
69 See id. at 310.
70 See Hansmann, supra note 1, at 59–61.
71 See id. at 61–62.
72 See id.
73 See id. at 61.
74 See Hall & Colombo, supra note 1, 386.
75 See Hansmann, supra note 1, at 72.
76 See id.
77 See id. at 73.
tained earnings (or capital goods obtained from retained earnings) can serve as security for loans, they thereby expand nonprofits' access to debt financing.

Hansmann has also argued that nonprofits are the most efficient providers of goods and services that are commonly subject to contract failure. Contract failure occurs when "consumers" cannot readily compare services before "purchase," or cannot adequately evaluate performance, as may occur in the case of home nursing care and day care services. Hansmann argues that tax exemption may encourage the development of nonprofit firms in industries characterized by contract failure. He concludes by recommending that the exemption should be limited to industries in which nonprofits are undercapitalized and in which an economic rationale exists for preferring nonprofit providers.

Critics have pointed out that Hansmann's theory ignores concepts of charity and philanthropy that are the intuitive bases for the exemption. Hansmann's theory also lacks historical consistency. He offers no evidence of congressional intent that tax exemption should serve as a subsidy to capital formation. Finally, like the income measurement theory, Hansmann's theory fails to address the property tax exemption. In fact, the property tax exemption operates in a manner inverse to Hansmann's theory. Organizations with the most property have the least need to raise capital, yet they receive the greatest amount of subsidy.

(c) Donative theory. — More recently, Mark Hall and John Colombo have offered a refined theory that builds on the works discussed above. They argue that "the primary rationale for the charitable exemption is to subsidize those organizations capable of attracting a

78 See Hansmann, supra note 56, at 868-72.
79 See Hansmann, supra note 1, at 69-71.
80 See id. at 74.
81 Hansmann questions the merit of the exemption for nonprofit hospitals because they tend to be overcapitalized. See id. at 75.
82 See Hall & Colombo, supra note 1, at 388 ("[Hansmann's] theory ignores the statutory language by failing to develop a workable definition of charity; the only concept it offers is those socially valuable nonprofits that suffer a comparative disadvantage in capital markets."). Atkinson has sought to justify the tax exemption as an appropriate reward for altruistic impulses. He argues that, when an potentially profitable organization is established on a nonprofit basis, it embodies altruism, see Atkinson, supra note 59, at 553, and that the governments should encourage such altruism by exempting the entity from taxation, see id. at 629. Atkinson's theory would lead to an extremely broad exemption, and, although the author acknowledges this, see Rob Atkinson, Theories of Federal Income Tax Exemption For Charities 37, 41 (1991) (unpublished manuscript on file at the Harvard Law School Library), he does not attempt to justify the associated expense, see Atkinson, supra note 59, at 628.
83 See Hall & Colombo, supra note 1, at 388-89.
84 See id. at 388.
85 See id. at 390 & n.300.
substantial level of donative support from the public." They propose a "donative theory," whereby the exemption would be limited to those nonprofits that attract substantial donative support.

The authors argue that tax exemption is an appropriate response to a problem they identify as a "twin failure." The first is a market failure resulting from the free rider problem inherent in the provision of public goods. Private markets are unlikely to produce an optimal supply of public goods because no one has the incentive to pay for his or her fair share of the benefit.

The second failure is government's failure to provide an adequate supply of certain public goods due to the vagaries of majoritarian voting. Government can supply public goods through its coercive taxing power. However, certain voting blocs lack the voting strength to force the government to meet their public good needs, thus limiting the ability of government to meet the needs of all of its citizens. The authors argue that private donations to nonprofit organizations demonstrate the existence of both a demand for such organizations' services as well as an undersupply of those services by the government. A government subsidy in this context is warranted because voluntary donations will never meet the real public demand, due to the free rider problem. The authors recommend (for hospitals, at least) a threshold level of 30% funding through donations to qualify for tax exemption. Under Hall's and Colombo's theory many important currently-exempt organizations would not merit exemption. For example, the authors argue that nonprofit hospitals do not merit tax exemption.

The donative theory is promising. One strength is that the theory seeks to explain all forms of tax exemption, including both the income tax and the property tax. It recognizes the teachings of tax expenditure analysis by focusing on the public spending aspects of the tax exemption. Moreover, it treats the level of public donations as an approximate measure of public support for the activity.

However, one problem with the theory lies in its inherent arbitrariness in setting the threshold level of donations necessary to qualify for tax-exempt status. In addition, under Hall's and Colombo's theory only those individuals with money are allowed to "vote" through their

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86 Id. at 390.
87 See id. at 316.
88 Public goods are characterized by durability and indivisibility — once produced, it is impossible to prevent others from benefiting from the good. Classic examples include national defense and pollution control.
89 See id. at 391–93.
90 See id. at 394.
91 See id. at 409.
92 See id. at 411.
donations. Furthermore, intensity of support is not necessarily commensurate with amount of donation. The number of different donors may be a better indication of public support than the percentage of revenues from donations. Thus, the donative theory urges reliance upon an imprecise measure of the level of public support.

D. Refinement: Lessons from Local Governments

The above-mentioned approaches for determining which institutions merit tax exemption are unsatisfactory. What is needed is a determination that rests upon the level of public support for the category of activity in which the particular organization engages. If the public supports a given category of activity, the inquiry should then turn to whether a particular institution meets an objective standard to fall within a supported category. If one accepts the premise that public spending should reflect the public will, then local governments' decisions concerning property tax exemption should be a good indicator of the level of public support that a particular activity enjoys.

In many instances, local governments have forcefully acted to reject the charitable characterization of certain traditionally exempt activities. Some municipalities have successfully negotiated agreements with prominent nonprofit landowners for voluntary payments in lieu of taxes.93 In the absence of such agreements, some municipalities have unilaterally revoked the exemption of formerly untaxed property.94 This activism has generally been rejected by state courts, but in recent years a few municipalities have won court approval for reinstating the taxable status of previously exempt organizations.95 Most of the activity has been related to hospitals, but municipalities have also targeted other institutions that have lacked a charitable purpose. For example, the Oregon Supreme Court upheld the state revenue department's decision to deny the property tax exemption of two fitness centers operated by the YMCA.96 If municipalities do not find charity in the operation of these institutions, it may be because charity is absent.97

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93 See, e.g., Bill Premo, Tax Exempt Land Hurts City, CAMBRIDGE TAB, Dec. 17, 1991, at 14 ("In 1991, Harvard and MIT, two of the biggest landowners in the city, paid the city a combined gift of $1.9 million."); R.E. Stouffer, 3 Tax-Exempts Pay City Fee, N.Y. TIMES, Aug. 21, 1988, § 10, at 17 (reporting that a partnership of nonprofit hospitals and the University of Pittsburgh will pay the city of Pittsburgh more than $11 million over the next 10 years).
94 See sources cited infra note 132.
95 See infra pp. 1631–32.
96 See YMCA v. Department of Revenue, 784 P.2d. 1086, 1087–88 (Or. 1989).
97 See, e.g., Burlington, Vt., Divided by Mayor's Tax Mission, N.Y. TIMES, Oct. 18, 1987, at 56 (quoting then-Mayor Bernard Sanders as saying that "[t]he bottom line is that any institution should be eligible for tax exemption if the people of a community want it to be").
Examples of efforts to limit the scope of the tax exemption abound. In addition to the debate in the academic literature, there have been judicial challenges to IRS rulings, congressional initiatives to limit the scope of exemption, and local government activity. Yet only at the local level has there been significant progress in putting these arguments into practice by revoking the exemption of organizations that do not sufficiently contribute to the community. The same arguments that result in inaction on the federal and state levels and in the courts are leading to policy changes in localities.

1. Why Local Government Can Better Determine What is Charitable. — Many organizations qualify for exemptions as charitable organizations under both section 501(c)(3) of the Code and relevant state provisions. However, there is no clear understanding of the meaning of the term "charitable." In the case of tax exemption, the activity at the local level sheds valuable light on the question of what is a charitable activity. This Part argues that when concerted local opposition exists to subsidizing an organization through tax exemption, such opposition probably reflects the public’s perception that the organization is not fulfilling its charitable purpose. It further argues that Congress and the courts should take such judgments into account in determining whether a nonprofit qualifies as a charitable organization.

Both the costs of exemption and the benefits derived from the subsidized activity are clearest at the local level. Moreover, it is at the local level that the voice of the people can be most clearly heard. The myriad of essential services that must be funded through local taxation include schools, public works, and police and fire protection. However, the effect of nonprofits’ tax exempt-status dramatically reduces the taxable property base, and, the greater the proportion of property that is exempt from taxation, the greater the tax burden on each individual property owner.

98 See infra p. 1630.
99 See infra p. 1631.
100 See supra p. 1625.
101 Although in 1986 Congress withdrew the tax exemption for commercial-type insurance programs such as Blue Cross/Blue Shield, see I.R.C. § 501(m) (1988); Hall & Colombo, supra note 1, at 401, this amendment, like the enactment of the unrelated business income tax merely demonstrates that organized business interests can galvanize Congress to modify the tax laws to limit what businesses perceive as unfair competition by nonprofits. Cf. Henry B. Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 VA. L. REV. 605, 605–06 (1989) (describing the business community’s advocacy for the unrelated business income tax).
By contrast, at the national level, it is difficult to quantify the costs of income tax exemption. Because there are no standardized accounting practices for nonprofit organizations, it is unclear how much surplus income exists that might be taxed.\(^{103}\) In addition, there are no figures in the tax expenditure budget concerning the cost of the charitable exemption.\(^{104}\) Most importantly, the costs of the exemption are so diffuse that no particular taxpayer is likely to feel unduly burdened by the exemption, even when many undeserving institutions receive tax exemptions.

Just as the costs of exemption are more immediate at the local level, local governments are best able to monitor exempt organizations to ensure that they provide a public benefit. Feedback from community residents as to the benefits the public actually receives enhances this monitoring ability. In the context of hospitals, for example, local officials are more likely than federal officials to be aware of a nonprofit hospital's refusal to treat Medicaid or uninsured patients.

Moreover individual citizens are better able to organize at the local level to voice effective support for—or against—the exemption of a given category of activity. The influence of organized interest groups at the national level tends to drown out the diffuse interests of concerned, but comparatively unorganized, individuals. Abstract arguments for exempting broad categories of institutions based upon intangible benefits, such as the promotion of health or physical fitness, can be persuasive only when they are not properly compared with the concrete costs of exemption. For example, the American Hospital Association has been an influential voice in the defense of the exemption of nonprofit hospitals.\(^{105}\) National interest groups intervene at the local level,\(^{106}\) but individuals and local officials are better able to organize and to neutralize their impact.

2. Weighing the Local Voice. — A difficult issue remaining is what weight the courts should give to the views of local government actors, whose motivation may often be simply to raise more revenues in the face of a shrinking tax base. Courts cannot blindly rubber-stamp local revocations of property tax exemptions. Several dangers of such a course are readily apparent.\(^{107}\) First, the municipality may be prompted to revoke exemption not because there is an absence of

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\(^{103}\) See Hansmann, supra note 1, at 62 & n.30.


\(^{105}\) See Schaffer & Fox, supra note 65, at 223–24, 226 (discussing the AHA's arguments between 1969 and 1990 on behalf of nonprofit hospitals).

\(^{106}\) Two nonprofit hospitals submitted amicus briefs on behalf of the hospital in the Intermountain litigation. See supra p. 1631. A for-profit hospital sought to enter a brief on behalf of the county. See Utah County v. Intermountain Health Care, Inc., 709 P.2d 265, 267 (Utah 1985).

\(^{107}\) See Frug, The City, supra note 102, at 1067 (noting the common fear that local power results in corruption, local selfishness, and local abuse of power).
charity, but because the benefits provided by the organization are not localized. For example, the benefits of a national university are spread broadly, but the full cost of the property tax exemption is borne by the city or town where the university is located. Second, opposition to exempt status could arise from a desire to keep a particular social service out of the community — the “not in my backyard” syndrome. Examples include drug treatment clinics and homeless shelters. Finally, there is the danger that a pernicious local bias may prompt a community to revoke the exemption of a group that promote the public good. A municipality may object to certain political goals or the racial, ethnic, or religious background of a group or its beneficiaries. For example, a gay rights group may be targeted for revocation because a majority of the community objects to the group’s mission.

Because of these dangers, courts must carefully evaluate the arguments of both the locality and those of the entity seeking exemption. The party seeking exemption bears the burden of proving that it meets the criteria set forth in the relevant statutory or constitutional provision. Thus, there should be a rebuttable presumption that all of the income or property of any organization is taxable. When a municipality acts to revoke property tax exemption, this presumption should be strengthened. To rebut this presumption, the organization could demonstrate its charitable nature by showing the monetary value of the charity it contributes in relation to its gross revenues and the value of the exemption. Alternatively, an organization might make the more generalized claim that it confers a “public benefit.” In revoking an organization’s exemption, the municipality has made the judgment that the benefit the organization confers is insufficient to merit exemption. To rebut the municipality’s position, an organization may point to one of the three dangers outlined above. The judge should examine the facts to determine if any of these factors appear to have motivated the municipality’s decision to revoke the exemption. If, in the court’s judgment, none are applicable, the revocation should be upheld. In addition to the courts, Congress and the IRS must also pay close attention to local tax policy initiatives and closely scrutinize the charitable qualities of those institutions that are consistently targeted for taxation at the municipal level.

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108 See Premo, supra note 93, at 14 (noting how the burden of tax exemption for Harvard and MIT falls heavily on the city of Cambridge).
109 See, e.g., Harding Hosp., Inc. v. United States, 505 F.2d 1068, 1071 (6th Cir. 1974) (“An organization which seeks to obtain exempt status . . . bears a heavy burden to prove that it satisfies all the requirements of the exemption statute.”).
111 For suggestions of reasonable requirements for charity care, see sources cited infra note 130.
112 See Barker, supra note 110, at 350 (asserting that the revocation of a state, county or
E. The Example of Nonprofit Hospitals

A vigorous debate on the merits of tax exemption for nonprofit hospitals has raged since the late 1960s. Recently, many commentators have argued against the exemption. Historically, hospitals were perceived as charitable institutions. Although they accepted money from paying patients, they also treated the poor free of charge. With changes in medical technology and the advent of Medicaid and Medicare, however, the charitable role played by hospitals has diminished in importance. Indeed, some have asserted that hospitals should no longer be required to treat the indigent to merit exemption. Conversely, others argue that less reason remains for subsidizing hospitals through exemptions because the government directly subsidizes indigent and elderly hospital care. However, because millions of Americans are uninsured, a need for charitable hospital care persists, and many advocates seek to impose that burden on hospitals that wish to maintain their tax-exempt status.

The tax treatment of nonprofit hospitals has commanded attention because of the amount of revenue at stake and the dominance of nonprofit hospitals in the nonprofit sector. Furthermore, most nonprofit hospitals operate on a commercial basis, with limited reliance on donations, and often compete with for-profit hospitals located in the same geographic region.

The tax status of nonprofit hospitals impacts dramatically on the nation's health-care policy. Many of those who object to extending the tax exemption do so because of the inhumane treatment nonprofit hospitals give to the poor and the uninsured. These hospitals commonly admit only patients with a demonstrated ability to pay either through insurance, Medicaid, or Medicare. Some hospitals also

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113 See, e.g., Hall & Colombo, supra note 1, at 409-10; Hansmann, supra note 1, at 89.
114 See Hall & Colombo, supra note 1, at 407-08; Claudia Coates, Penny-Pinching Pittsburgh Saves Big in Small Increments, CHI. TRIB. (Zone W.), Sept. 29, 1991, at 9A (paraphrasing a City Finance Director as reasoning that "since the advent of Medicare and Medicaid, many hospitals are reimbursed for work they once performed as charity").

115 The estimated value of exemptions, federal, state, and local, for nonprofit hospitals is $8.5 billion annually. See John Copeland & Gabriel Rudney, Tax Subsidies for Not-For-Profit Hospitals, 46 TAX NOTES 1559, 1565 (1990). The General Accounting Office estimates that the federal government loses $4.5 billion a year as a result of tax exemptions for nonprofit hospitals. See Robert Pear, Tax Exemptions of Nonprofit Hospitals Scrutinized, N.Y. TIMES, Dec. 18, 1990, at Al, B17.

116 Hospitals account for almost one-half of the revenues of all charitable organizations, although they constitute only 1% of such organizations. See Pear, supra note 115, at B17.

117 See Schaffer & Fox, supra note 65, at 218 (arguing that the IRS made health-care policy in promulgating Revenue Ruling 69-545).

118 See Hall & Colombo, supra note 1, at 319 (noting that nonprofit hospitals have "increasingly taken on the appearance of business enterprises by serving mostly paying patients").
engage in patient dumping, in which uninsured emergency patients are transferred to city and county hospitals to avoid the costs of indigent care.\textsuperscript{119}

1. Current Law and Hospital Tax Exemption. — Section 501(c)(3) does not explicitly define health care as an exempt purpose. Therefore, nonprofit hospitals must qualify for federal income tax exemption under the catch-all charitable purpose provision of section 501(c)(3). The IRS has consistently redefined the requirements that hospitals must meet in order to qualify for exemption, allowing for progressively lower levels of charitable service for maintaining tax-exempt status. In 1956, the IRS issued a revenue ruling setting forth the requirements for hospitals to qualify under the charitable definition of section 501(c)(3).\textsuperscript{120} The ruling stated that a hospital “must be operated to the extent of its financial ability for those not able to pay for services rendered.”\textsuperscript{121} In 1969, another ruling changed this standard to a “community benefit standard.”\textsuperscript{122} The new ruling stated that the promotion of health was a purpose “deemed beneficial to the community as a whole” according to the general law of charity.\textsuperscript{123} Under the 1969 ruling, a hospital satisfied the charitable definition if it had an emergency room open to all persons, regardless of their ability to pay, and provided care on an nondiscriminatory basis to paying patients.\textsuperscript{124}

2. The Challenge to Hospital Exemption. — In Eastern Kentucky Welfare Rights Organization v. Simon,\textsuperscript{125} a plaintiff group led by welfare rights organizations challenged the validity of the 1969 ruling, and argued that Congress had intended “charitable” to require the provision of relief for the poor. A federal district court granted summary judgment for the plaintiffs.\textsuperscript{126} In a 2-1 decision, the appellate court reversed and upheld the IRS’s broad interpretation of the term “charitable.”\textsuperscript{127} The Supreme Court vacated the ruling on procedural

\textsuperscript{120} See Rev. Rul. 56-185, 1956-1 C.B. 202, 203.
\textsuperscript{121} Id.
\textsuperscript{122} Id.
\textsuperscript{124} See id. In 1983, the IRS issued a ruling that further relaxed the charitable standard. It stated that a nonprofit hospital qualifies for tax exemption under § 501(c)(3), even if it has no emergency room, when a state health planning agency has determined that operation of an emergency room would be “unnecessary and duplicative.” See Rev. Rul. 83-157, 1983-2 C.B. 94. The effect was to extend tax exemption to specialty hospitals, such as cancer hospitals. See id. at 95.
\textsuperscript{125} 506 F.2d 1278 (D.C. Cir. 1974), vacated, 426 U.S. 26 (1976).
\textsuperscript{127} See Eastern Kentucky, 506 F.2d at 1287-90. For a critique of the appellate court’s reasoning, see Hall & Colombo, supra note 1, at 322-23.
grounds, holding that the plaintiffs lacked standing to challenge the IRS revenue ruling. 128

Although the legal challenge to the IRS hospital rulings ultimately failed, some members of Congress have recognized the concerns raised by the plaintiffs in *Eastern Kentucky*. They believe that government resources should be devoted only to those activities that offer a clear public benefit. Consequently, these congressmen have sought to place on the hospitals the burden of demonstrating that they provide sufficient public benefits to merit tax exemption. In 1991, two bills were introduced in the Congress that would impose more stringent requirements for nonprofit hospitals seeking tax-exempt status. 129 Both bills would require such hospitals to provide specified amounts of charity care and community benefits in order to receive exemption. 130

States have administered the exemption of hospitals from property taxes in a fashion similar to the federal government's administration of the income tax exemption. Some state statutes specifically exempt nonprofit hospitals, while hospitals in other states must rely on the "charitable" catch-all category of the property tax exemption. 131

Local taxing authorities have become increasingly aggressive in challenging the tax-exempt status of nonprofit hospitals located within their jurisdictions. 132 *Utah County v. Intermountain Health Care, Inc.* 133 was the first case in which a state court upheld a municipality's revocation of the tax exemption of a nonprofit hospital on the grounds that the hospital failed to demonstrate that it was operating for a charitable purpose. 134 Tax authorities in other states have tried to revoke or deny property tax exemptions from hospitals without success. 135 However, the Pennsylvania courts have been more receptive

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130 House Resolution 790, introduced by Rep. Roybal, would require hospitals to provide charity care equal to 50% of the value of the exemption and community benefits equal to 35% of the value of the exemption. See H.R. 790, 102d Cong., 1st Sess. 1–3 (1991). House Resolution 1374 was introduced by Rep. Donnelly, and would require qualifying hospitals to devote 5% of its revenue to supporting charitable services. See H.R. 1374, 102d Cong., 1st Sess. 1–7 (1991).
131 See WELLFORD & GALLAGHER, supra note 51, at 125.
132 See Pear, supra note 115, at B17 ("Local officials have tried to revoke tax exemptions from nonprofit hospitals in at least 12 states."); see also Burlington, Vt., Divided By Mayor's Tax Mission, supra note 97, at 56 ("[The mayor] has launched a campaign to force both [Medical Center Hospital of Vermont] and the [University of Vermont] to make payments to the city in lieu of taxes . . . .").
133 709 P.2d 265 (Utah 1985).
134 See id. at 278–79. Intermountain later entered into an informal agreement with the county to establish what Intermountain would do to maintain its exemption. See Martin Tolchin, Hospitals Use Charity to Fend off Tax Collectors, N.Y. TIMES, May 3, 1988, at C3.
135 In Vermont and Tennessee, efforts to revoke exemption based on the arguments which were successful in *Intermountain* failed. See Medical Ctr. of Vt. v. City of Burlington, 566
to the kinds of arguments put forth by the litigating county in Inter-
mountain. Although an earlier decision that upheld the exempt status
of a nonprofit hospital on the basis of its open door policy remains
good law,136 a later decision was more demanding for a health-related
institution.137 In Erie v. Hamot Medical Center,138 the state court
upheld the revocation of a hospital’s property tax exemption because the
hospital did not prove that it provided sufficient charitable care.139
Similarly, another revocation of a health-related institution’s exempt
status has been upheld.140 In Texas, a more innovative suit is pend-
ing. Instead of revoking the property tax exemption, the attorney
general has sued to force a major hospital to provide more charitable
care to comply with the attorney general’s definition of a nonprofit
hospital.141

Although many have recognized that the government does not get
its money’s worth by exempting nonprofit hospitals from taxation,142
little has changed at the federal level. Only on the local level are
arguments against the broad exemption for nonprofit hospitals leading
to changes in tax policy.

3. Applying the Proposed Analysis to the Case of Hospitals. —
Typically, in deciding cases on tax exemption for hospitals, state
judges rely on precedent and traditional categories of tax-exempt ac-
tivity.143 They reason that, because operating a hospital is a charitable
activity, all nonprofit hospitals are per se exempt. Most state courts,
however, have not recognized that changes have occurred in the our
health care delivery and payment systems that render inaccurate and
obsolete the traditional designation of hospitals as per se charitable.144
Even those courts that have recognized changes in the health care
system have broadened the category of charitable institutions to in-
clude hospitals, rather than concluding that many nonprofit hospitals
no longer operate as charitable institutions.145 Many local tax au-

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A.2d. 1352, 1354–55 (Vt. 1989); Downtown Hosp. Ass’n v. State Bd. of Equalization, 760


139 See id. at *9–*11.


141 See Gary Taylor, Hospital Sued in Novel Law Suit: Charity Begins in Court?, NAT’L

142 See, e.g., Copeland & Rudney, supra note 115, at 1576 (arguing that the exemption of
nonprofit hospitals should be reconsidered by Congress because the current subsidy is inequitable
and inefficient).

143 See, e.g., Downtown Hosp. Ass’n v. State Bd. of Equalization, 760 S.W.2d 954, 956

144 See supra p. 1629.

145 See Medical Ctr. of Vt. v. City of Burlington, 566 A.2d 1352, 1355 (Vt. 1989) (noting
sociological changes but expanding the conception of charitable). The IRS also has redefined
authorities, by contrast, have recognized the changes in the health care industry and have determined that hospitals not actually providing charitable care do not relieve a government burden, and thus are not charitable.\textsuperscript{146}

If a municipality revokes the property tax exemption for a non-profit hospital within its jurisdiction, and if the hospital sues in state court to have its exempt status restored, a proper analysis would proceed as follows. The hospital should have the burden of proving that it is a charitable institution. It could meet this burden through a variety of means. First, the hospital could demonstrate that the monetary value of the services it provides to the community without compensation exceeds a threshold level.\textsuperscript{147} The congressional proposals referred to above offer guidance in defining a reasonable level of charitable care sufficient to justify exemption.\textsuperscript{148} Second, the hospital can claim that through its services it confers a public benefit.\textsuperscript{149} This claim should be treated as suspect, however, because many studies have shown that there is little difference in quality and cost between nonprofit and for-profit hospitals.\textsuperscript{150} Furthermore, the municipality may have concluded that the public benefit conferred is insufficient to merit exemption. Because these community benefits are intangible, and cannot be quantified, the municipality's judgment should trump the hospital's. The hospital should be taxed unless it can demonstrate that it provides benefits that are distributed beyond the confines of the taxing district, that its charitable activities impose social costs to which the community particularly objects, or that it serves a disfavored or underrepresented class. In the case of hospitals, none of these three saving factors commonly apply.

\textbf{F. Conclusion}

The tax exemption for nonprofits raises profound questions of public policy. Because exemption is the equivalent of a subsidy, it is vital to determine to which endeavors limited government resources should be allocated. Abstract theories that attempt to distinguish those organizations that deserve subsidy are bound to prove unsatisfactory. Focusing on change at the local level should lead to a better

\textsuperscript{146} See Coates, \textit{supra} note 114, at 9A.

\textsuperscript{147} A mere showing of an "open door" policy without actual provision of free care should not suffice to meet the hospital's burden.

\textsuperscript{148} See \textit{supra} note 130.

\textsuperscript{149} See Hall, \textit{supra} note 145, at 25-26.

\textsuperscript{150} See \textit{id.} at 32 (noting several studies showing little difference in performance between for-profit and nonprofit hospitals).