

ST 08-19

Tax Type: Sales Tax

Issue: Exemption From Tax (Charitable or Other Exempt Types)

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

No: 07 ST 0000

Sales Tax Exemption

v.

**ABC HOSPITAL
LABORATORIES, INC.,
TAXPAYER**

Kenneth J. Galvin

Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Mr. Michael J. Wynne, Reed Smith LLP, on behalf of ABC Hospital Laboratories, Inc.; Mr. John Alshuler, Special Assistant Attorney General, on behalf of The Department of Revenue of the State of Illinois.

SYNOPSIS: ABC Hospital Laboratories, Inc. (hereinafter “ABC”) sought an exemption from the imposition of tax under the Illinois Retailer’s Occupation Tax Act (35 ILCS 120/1 *et seq.*) (“ROTA” or “ROT”) and the Illinois Use Tax Act (35 ILCS 105/1 *et seq.*) (“UTA” or “UT”) as an entity organized and operated exclusively for charitable purposes. 35 ILCS 120/2-5; 105/3-5. The Department of Revenue denied ABC’s request twice, with ABC formally protesting and requesting a hearing following the issuance of the Second Denial of Sales Tax Exemption on December 8, 2006. Dept. Ex. No. 1.

An evidentiary hearing was held in this matter on April 8, 2008 with testimony from XXXX, Vice-President of Finance for Sisters of ABC Health Services, XXXX, Controller for ABC Health System, and XXXX, Chief Executive for ABC Clinical Laboratories and ABC. The sole issue to be determined at the hearing was whether ABC qualified for an exemption identification number as “a corporation, society, association, foundation or institution organized and operated exclusively for charitable ... purposes.” 35 ILCS 120/2-5. Following a careful review of the evidence and testimony presented at the hearing, and ABC’s “Post Hearing Memorandum of Law” (“ABC Memo.”) and the Department’s “Response Brief” (“Dept. Resp.”), I recommend that this matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. ABC requested an exemption identification number (35 ILCS 120/1g) from the Department on the basis that it was exempt from taxes imposed by the ROTA and UTA as an entity organized and operated exclusively for charitable purposes. The Department denied ABC’s second request on December 8, 2006. Tr. pp. 11-12; Dept. Ex. No. 1.
2. ABC was incorporated on July 15, 2005. ABC’s amended Articles Of Incorporation state that ABC is a non-profit, public benefit corporation existing pursuant to the Indiana Nonprofit Corporation Act of 1991. Tr. pp. 60-61; Taxpayer’s Ex. No. 1.
3. ABC operates under a set of Bylaws which state that the corporation “shall be organized and operated as a cooperative hospital service organization within the

meaning of Section 501(e) of the Internal Revenue Code...” Taxpayer’s Ex. No. 2.

4. ABC is organized and operated to provide laboratory services for the benefit of its “Participant” and “Patron” Hospitals. ABC can only provide services to Participants and Patrons. Participants are hospitals as described in Section 501(e)(1)(B) of the Internal Revenue Code. Initial Participants in ABC were Sisters of XYZ Health Services (“XYZ”) and ABC Hospitals (“ABC”). Participants are “members” and have the power, *inter alia*, to approve and admit new Participants, appoint and remove directors, appoint and remove the president, approve the incurrence of debt and the annual capital and operating budgets and adopt strategic plans for ABC. Taxpayer’s Ex. No. 2.
5. Initially, 4 directors of ABC were appointed by XYZ and 4 directors were appointed by ABC. MMM Healthcare (“MMM”) joined ABC as a Participant in December, 2007. There are now 12 directors, 4 appointed from each Participant. Tr. p. 61; Taxpayer’s Ex. No. 2.
6. “Patron Hospitals” are hospitals as described in Section 501(e)(1)(B) of the Internal Revenue Code. No more than one-half of ABC’s business in any fiscal year can be done with Patron Hospitals. A Patron Hospital would typically be a stand-alone or small group of hospitals that does not have an ownership interest in ABC. ABC does not currently have any Patron Hospitals. Tr. pp. 62-63; Taxpayer’s Ex. No. 2.
7. Effective July 15, 2005, ABC is exempt from income tax under Section 501(c)(3) of the Internal Revenue Code. Tr. pp. 63-65; Taxpayer’s Ex. Nos. 3 and 4.

8. XYZ owns 12 hospitals and is exempt from Illinois ROT. Tr. pp. 15-17, 26; Taxpayer's Ex. No. 9.
9. ABC maintains 6 hospital "ministries" throughout Illinois and is exempt from Illinois ROT. Tr. pp. 29-31; Taxpayer's Ex. No. 8.
10. MMM maintains 8 hospitals and is exempt from Illinois ROT. Tr. pp. 65-66; Taxpayer's Ex. No. 10.
11. ABC provides clinical laboratory testing services for 12 XYZ, 6 ABC and 8 MMM hospitals. Tr. pp. 70-71.
12. Approximately 65% of all testing that is ordered by XYZ, ABC and MMM is performed at the on-site hospital laboratories operated by ABC. The staff in the laboratories on site at XYZ and ABC are ABC employees and receive their paychecks from ABC. MMM laboratory staff employees are MMM employees under the management of ABC. Tr. pp. 70-72.
13. ABC is a "virtual" organization, meaning it has no physical facility of its own. The only physical presence that ABC has is the on-site laboratory space inside each of the hospitals. Tr. pp. 74-75.
14. ABC Clinical Laboratories ("ACL") is a for-profit, taxable, limited liability company, which provides laboratory testing services and has its physical facility in Anywhere, Indiana. ACL has not applied for an Illinois sales tax exemption. ACL is owned and controlled by XYZ, ABC and MMM. ACL provides testing for ABC, and for other entities and organizations, which may be for-profit organizations. Tr. pp. 55, 56, 69-70.
15. Laboratory testing at the XYZ, ABC and MMM hospitals that does not need to be done on an immediate time basis or which requires special technician skills is

referred to ACL in Anywhere. ABC refers between 20 to 30 percent of its testing to ACL. Tr. pp. 40, 73-74.

16. ABC purchases its supplies and equipment through ACL. Employees of ABC log onto ACL's purchasing system and submit orders. ABC is liable for payment for the supplies, but it receives the price that ACL has negotiated with the vendors. Tr. pp. 76-77.
17. ACL bills Participant Hospitals for services requisitioned from ABC. ABC's Form 1023, "Application for Recognition of Exemption," sent to the Internal Revenue Service states that "[a]ll fee arrangements between ABC and ACL, LLC are set forth in the Master Services Agreement and are at arm's length and for fair value." "Further, there will be an annual review of the fee structure to ensure that such fees remain at fair market value. Please see Exhibit E for a copy of the Master Services Agreement." Exhibit E, the "Master Services Agreement" between ACL and ABC was not offered into evidence. Tr. pp. 78-79, 83-89; Taxpayer's Ex. No. 3.
18. Costs, including overhead, incurred by ACL are allocated to the Participant Hospitals through a measure referred to as "relative value units," which is a weighting system. Each of the Participant Hospitals pays an allocation based on their portion of relative value units or the number of tests ordered at their hospital as a percentage of the number of tests ordered by all other entities using ACL. Tr. pp. 94-96.
19. ABC's audited "Statement of Operations and Changes in Net Assets" for the four month period ended December 31, 2005 shows \$28.3 million in "Revenues" and \$28.3 million in "Operating Expenses" yielding an "Operating

Income (Loss)” of zero. Revenues represent the fees charged and billed to the Participant Hospitals as compensation for the services rendered by ABC. Operating expenses represent ABC’s costs of laboratory operations. These expenses include direct expenses (85%), a per unit charge for tests performed at ACL, LLC (10%), and overhead allocation from ACL, LLC (5%). Tr. pp. 40-42. Taxpayer’s Ex. No. 6.

CONCLUSIONS OF LAW:

An examination of the record establishes that ABC Hospital Laboratories, Inc. has not demonstrated, by the presentation of testimony or through exhibits or argument, evidence sufficient to warrant an exemption from sales tax. Accordingly, under the reasoning given below, the determination by the Department denying ABC a sales tax exemption number should be affirmed. In support thereof, I make the following conclusions.

The Use Tax Act (35 ILCS 105/1 *et seq.*) imposes a tax upon the privilege of using in Illinois tangible personal property purchased at retail from a retailer. 35 ILCS 105/3. Section 3-5 of the Act provides a list of tangible personal property that is exempt from tax, and includes the following: “(4) Personal property purchased by a governmental body, by a corporation, society, association, foundation or institution organized and operated exclusively for charitable, religious or educational purposes...[.] On or after July 1, 1987, however, no entity otherwise eligible for this exemption shall make tax-free purchases unless it has an active exemption identification number issued by the Department.” 35 ILCS 105/3-5(4). Section 2-5(11) of the Retailers’ Occupation

Tax Act (35 ILCS 120/1 *et seq.*) contains a similar provision. (See 35 ILCS 120/2-5(11)).

ABC has requested an exemption identification number pursuant to these provisions, which the Department has twice denied on the basis that ABC did not demonstrate that it operates exclusively for charitable purposes. Dept. Ex. No. 1. The Department's denial of an applicant's claim for an exemption identification number is presumed to be correct, and the applicant has the burden of clearly and conclusively proving its entitlement to the exemption. See Wyndemere Retirement Community v. Department of Revenue, 274 Ill. App. 3d 455 (2nd Dist. 1985). To prove its case, an applicant must present more than just testimony denying the Department's determination. Sprague v. Johnson, 195 Ill. App. 3d 798 (4th Dist. 1990). Rather, the applicant must present sufficient documentary evidence to support its claim. *Id.*

It is well established in Illinois that there is a presumption against exemption and that therefore, "exemptions are to be strictly construed" with any doubts concerning the applicability of the exemptions "resolved in favor of taxation." Van's Material Co. Inc. v. Department of Revenue, 131 Ill. 2d 196 (1989). The applicant bears the burden of proving "by clear and convincing" evidence that the exemption applies. Evangelical Hospitals Corp. v. Department of Revenue, 223 Ill. App. 3d 225 (2nd Dist. 1991).

Although it was in a case concerning a property tax exemption, the Illinois courts have used guidelines set forth in Methodist Old Peoples Home v. Korzen, 39 Ill. 2d 149 (1968) in determining whether an entity qualifies as one organized and operated exclusively for charitable purposes. Wyndemere Retirement Community, *supra*. These guidelines are that the organization: 1) has no capital, capital stock or shareholders; 2) earns no profit or dividends, but rather derives its funds mainly from private and public

charity, and holds them in trust for the objects and purposes expressed in the charter; 3) does not provide gain or profit in a private sense to any organization or person connected with it; 4) benefits an indefinite number of persons; and 5) dispenses charity to all who need and apply for it and does not appear to place obstacles of any character in the way of those who need and would avail themselves of the charitable benefits it dispenses. Korzen, *supra*.

The issue before this tribunal is whether ABC qualifies as “an institution of public charity” under the guidelines of Korzen. I am unable to conclude, based on the evidence and testimony presented at the evidentiary hearing, that ABC qualifies as an “institution of public charity.”

ABC operates under a set of Bylaws which state that the corporation “shall be organized and operated as a cooperative hospital service organization within the meaning of Section 501(e) of the Internal Revenue Code...” Taxpayer’s Ex. No. 2. Section 501(e) governs “cooperative hospital service organizations,” and states that such organizations shall be treated as organized and operated exclusively for charitable purposes if the organization performs, on a centralized basis, one or more services, which if performed on its own behalf by a hospital which is an organization described in subsection 501(c)(3) and exempt from taxation, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption. One of the activities mentioned is “laboratory.” 26 U.S.C. § 501(e)(1)(A).

ABC is organized and operated to provide clinical laboratory services for the benefit of its “Participant” and “Patron” Hospitals. ABC can only provide services to Participants and Patrons. Participants are hospitals as described in Section 501(e)(1)(B) of the Internal Revenue Code. 26 U.S.C. § 501(e)(1)(B). Initial Participants in ABC

were Sisters of XYZ Health Services and ABC. Participants are, in effect, “members” and have the power, *inter alia*, to approve and admit new Participants, appoint and remove directors, appoint and remove the president, approve the incurrence of debt and the annual capital and operating budgets and adopt strategic plans for ABC. Taxpayer’s Ex. No. 2.

Initially, 4 directors of ABC were appointed by XYZ and 4 directors were appointed by ABC. MMM joined ABC as a Participant in December, 2007. There are now 12 directors, 4 appointed from each Participant. Tr. p. 61; Taxpayer’s Ex. No. 2. XYZ owns 12 hospitals and is exempt from Illinois ROT. Tr. pp. 15-17, 26; Taxpayer’s Ex. No. 9. ABC maintains 6 hospital “ministries” throughout Illinois and is exempt from Illinois ROT. Tr. pp. 29-31; Taxpayer’s Ex. No. 8. MMM maintains 8 hospitals and is exempt from Illinois ROT. Tr. pp. 65-66; Taxpayer’s Ex. No. 10. ABC provides laboratory testing services for 6 ABC, 12 XYZ and 8 MMM hospitals. Tr. pp. 70-71.

“Patron Hospitals” are hospitals as described in Section 501(e)(1)(B) of the Internal Revenue Code. No more than one-half of ABC’s business in any fiscal year can be done with Patron Hospitals. A Patron Hospital would typically be a stand-alone or small group of hospitals. Patron Hospitals would not have an ownership interest in ABC. ABC does not currently have any Patron Hospitals. Tr. pp. 62-63; Taxpayer’s Ex. No. 2.

THE ORGANIZATION HAS NO CAPITAL, CAPITAL STOCK OR SHAREHOLDERS: ABC was incorporated on July 15, 2005, as a “non-profit, public benefit corporation existing pursuant to the Indiana Nonprofit Corporation Act of 1991.” Tr. pp. 60-61; Taxpayer’s Ex. No. 1. Effective July 15, 2005, ABC is exempt from income tax under Section 501(c)(3) of the Internal Revenue Code. Tr. pp. 63-65;

Taxpayer's Ex. Nos. 3 and 4. ABC's Bylaws contain no provisions related to shareholders or the issuance of capital stock. Taxpayer's Ex. No. 2.

THE ORGANIZATION DERIVES ITS FUNDS FROM PUBLIC AND PRIVATE CHARITY AND THE FUNDS ARE HELD IN TRUST FOR THE OBJECTS AND PURPOSES EXPRESSED IN THE CHARTER: ABC's audited

"Statement of Operations and Changes in Net Assets" for the four month period ended December 31, 2005 shows \$28.3 million in "Revenues" and \$28.3 million in "Operating Expenses" yielding an "Operating Income (Loss)" of zero.¹ ABC receives no funding from public and private charity. ABC's revenues represent the fees charged and billed to the Participant Hospitals as compensation for the laboratory services rendered by ABC. Ms. XXXX was asked if any individuals made contributions to ABC. She responded: "No. Absolutely, not." Tr. p. 94. I am unable to conclude that any of ABC's revenue is derived from public and private charity, one of the guidelines from Korzen for determining whether an organization is an institution of public charity.²

ABC's revenue is derived from clinical laboratory services performed for hospitals, similar to any for-profit laboratory services business. ABC's operating expenses represent ABC's costs of laboratory operations. These expenses include direct expenses,

¹ At the hearing, the Department's Counsel questioned Ms. XXXX as to why the financial statements were for December 31, 2005, "instead of 06 or even 07?" Ms. XXXX responded that she "assumed" that the December 31, 2005 financial statements were attached to the application for exemption. "We certainly do have financial statements for 2006 and 2007." Tr. p. 93. No financial statements for 2006 and 2007 were admitted into evidence. No IRS Form 990, "Return of Organization Exempt from Income Tax," for ABC for any year was admitted into evidence.

² ABC's audited "Statement of Operations and Changes in Net Assets" for the four month period ended December 31, 2005 shows "Contributions" of \$8.3 million, consisting of property, plant and equipment, inventory and other current assets contributed by XYZ and ABC. These "contributions" consisted mainly of the equipment that was in each of the XYZ and ABC hospital laboratories that was transferred to ABC when ABC was formed. Tr. pp. 93-94; Taxpayer's Ex. No. 6. The only financial statements admitted for ABC were dated December 31, 2005, and the record does not show that ABC received any "contributions" after that date. The one-time contributions from ABC and XYZ to ABC are insufficient for me to conclude that, on an on-going basis, ABC derives its funding from public and private charity.

a per unit charge for tests performed at ABC Clinical Laboratories (“ACL”), LLC and overhead allocation from ACL, LLC. Tr. pp. 40-42. Taxpayer’s Ex. No. 6.

ABC’s “purpose” as stated in its “Amended and Restated Articles of Incorporation,” is to provide “clinical laboratory services on a cooperative basis to hospitals described in Section 501(e)(1)(B) of the Internal Revenue Code.” Taxpayer’s Ex. No. 1. Providing clinical laboratory services and providing clinical laboratory services on a cooperative basis are not inherently charitable purposes. There are no provisions in ABC’s Articles or Bylaws for the provision of any charitable clinical laboratory services. No document detailing any charitable policy for clinical laboratory services was admitted on behalf of ABC. There was no testimony at the evidentiary hearing regarding any charitable clinical laboratory services performed by ABC. No documentary evidence was offered by ABC showing that any of the clinical laboratory services it performed were performed for charitable patients. There was no testimony as to the dollar value of any charitable clinical laboratory services performed by ABC. ABC’s financial statements, including notes, do not mention any charitable clinical laboratory services rendered by ABC.

When ABC gets a request from a Participant Hospital for laboratory services, ABC does not “have any way of knowing” whether the request for laboratory services is for a “charity care or a paying patient.” According to Ms. XXXXX’s testimony, any charity that is rendered would be rendered by ABC’s Participant Hospitals only. If the Participant Hospitals render charity, there is no adjustment of costs between ABC and the donating hospital. “The hospitals do the billing because ABC, as a 501(e), is only able to bill the member of the hospital and then the hospital bills the insurance companies and/or the patients, and then the charitable care is at that level.” Tr. pp. 96-97.

As Ms. XXXXX's testimony indicates, ABC is attempting to "bootstrap" its way into an exemption from Illinois ROT by arguing that its Participant Hospitals, rather than ABC, provide charitable clinical laboratory services. There are several problems with this argument. First and foremost, there is no documentary evidence or testimony in the record of this case showing that any of the Participant Hospitals now contributes or ever contributed clinical laboratory services to patients. The Participant Hospitals are exempt from Illinois ROT as primarily charitable organizations, but no evidence was provided as to the basis of these exemptions. Taxpayer's Ex. Nos. 8, 9 and 10. I am unable to conclude from the record in this case that the Participant Hospitals contribute charitable clinical laboratory services to patients. Mr. XXXXX testified that prior to the creation of ABC, ABC had a "little bit of a unique set-up with med center labs which handled the labs in Kankakee, Champaign and Danville and that was [a] for-profit corporation" which ABC had an interest in. Tr. pp. 31-32. There is no logical reason for me to conclude from this testimony that Participant Hospital, ABC, which formerly used for-profit laboratories for some testing, now contributes or ever contributed charitable clinical laboratory services to its patients. ABC's attempt to bootstrap its way to an exemption from ROT must fail because it has failed to show any direct link between the clinical laboratory services it performs and the contribution of clinical laboratory services on the part of either ABC or the Participant Hospitals.

Second, there is no statutory exemption in Illinois for cooperative hospital service organizations and there is no statutory exemption in Illinois comparable to Section 501(e) of the Internal Revenue Code. The issue to be tried at the evidentiary hearing was whether ABC was a tax-exempt organization in accordance with Illinois statutes and regulations. If cooperative hospital service organizations are entitled to an

exemption from Illinois ROT, they must prove their right to this exemption under existing Illinois statutes, regulations and case law. ABC has a separate legal identity from the hospitals that formed it and control it. The status of ABC as an exempt organization must be determined independently of its Participant Hospitals. Each individual claim for tax exemption must be determined from the facts presented. People ex rel Goodman v. University of Illinois Foundation, 388 Ill. 363 (1944). I am unable to determine the charitable status of ABC from the “facts” that supported the ROT exemptions for the Participant Hospitals. Moreover, the record of this case does not include the “facts” which supported the ROT exemptions of the Participant Hospitals. The record does not show that the Participant Hospitals now contribute or ever contributed charitable clinical laboratory services to patients.

The Participant Hospitals created ABC as a separate corporation, and ABC is either primarily a charitable organization in accordance with Illinois statutes, case law and regulations, or not, in its own right. Counsel for ABC did not cite any case, and my research does not indicate any case, that holds that the Korzen guidelines are not applicable to cooperative hospital service organizations. Counsel for ABC did not cite any case, and my research does not indicate any case, that holds that the charitable characteristics of participating members are controlling in determining the charitable status of a legally separate affiliate. If such a case did exist, I would still recommend that ABC’s exemption request be denied because the record in this case contains no testimony or evidence that the Participant Hospitals currently contribute or ever contributed charitable clinical laboratory services to patients.

In effect, ABC is asking this tribunal to conclude, without any documentary evidence, that the Participant Hospitals make charitable contributions of clinical

laboratory services and that these contributions are sufficient to justify an exemption for their affiliated organization, ABC. This conclusion and the exemption requested are not justified by the record in this case. The record does not show that either ABC or the Participant Hospitals derives their funds from public and private charity or that either ABC or the Participant Hospitals holds any funds in trust for the provision of charitable clinical laboratory services.

THE ORGANIZATION DOES NOT PROVIDE GAIN OR PROFIT IN A PRIVATE SENSE TO ANY PERSON OR ORGANIZATION CONNECTED WITH IT: ABC's "Statement of Operations and Changes in Net Assets," for December 31, 2005, shows "Salaries" of \$10.8 million, "Purchased labor" of \$0.3 million and "Employee benefits" of \$3.1 million. There was no testimony or documentary evidence admitted at the hearing concerning salaries, purchased labor or employee benefits. There was no testimony or documentary evidence admitted at the hearing as to whether ABC pays a bonus to its employees. 86 Ill. Adm. Code § 130.2005, entitled "Persons Engaged in Nonprofit Service Enterprises," states that an organization cannot qualify as being organized and operated exclusively for charitable purposes unless no personal profit inures to anyone as a result of the organization's operations. "The payment of reasonable salaries to necessary employees for services actually rendered does not convert a nonprofit enterprise into a business enterprise." 86 Ill. Adm. Code § 130.2005(h). There was no testimony as to whether ABC's salaries, purchased labor and employee benefits were "reasonable" or how any of these costs compared to those of similar institutions. There is no evidence in the record that the Participant Hospitals pay reasonable salaries and benefits.

Moreover, it is reasonable to conclude from the record in this case that ABC provides gain and profit to the owners of ABC Clinical Laboratories (“ACL”). ACL is a for-profit, taxable, limited liability company, which provides laboratory testing services and has its physical facility in Anywhere, Indiana. ACL is owned and controlled by XYZ, ABC and MMM, who also own and control ABC. ACL provides testing for ABC, as well as for other entities and organizations, which may be for-profit organizations. Tr. pp. 55, 56, 69-70. Testing at XYZ, ABC and MMM hospitals that does not need to be done on an immediate time basis or which requires special technician skills is referred to ACL in Anywhere. Ms. XXXXX testified that ABC refers approximately 25% of its testing to ACL. Tr. pp. 73-74. Mr. XXXXX testified that 20 to 30 percent of ABC’s testing is referred to ACL. Tr. p. 40. There is no testimony in the record that ABC refers testing to any laboratory, other than ACL.

ACL bills Participant Hospitals for laboratory services requisitioned by ABC. According to Ms. XXXXX, ACL charges ABC for the cost of the laboratory test. Tr. pp. 83-84. Note 5, entitled “Related-Party Transactions,” in ABC’s financial statements states that “ABC, Inc. purchases services from ACL, LLC at cost. These services include laboratory and management services.” Taxpayer’s Ex. No. 6. ABC’s Post Hearing Memorandum states that “ABC purchases are made at cost from ACL, and ABC does not mark up its purchases in allocating its purchasing expenses to the Participants.” ABC Memo. p. 12.

The above testimony, the note in the financial statements, and ABC’s Post Hearing Memorandum are in conflict with ABC’s (undated) Form 1023, “Application for Recognition of Exemption,” sent to the Internal Revenue Service. ABC’s Form 1023 states that “[a]ll fee arrangements between ABC and ACL, LLC are set forth in the

Master Services Agreement and are at arm's length and for fair value." "Further, there will be an annual review of the fee structure to ensure that such fees remain at fair market value. Please see Exhibit E for a copy of the Master Services Agreement." Tr. pp. 78-79, 83-89; Taxpayer's Ex. No. 3. ABC's Form 1023 does not state that ABC purchases laboratory services from ACL at cost.

ABC's Form 1023 uses the terms "arm's length" and "fair market value." "Arm's length" is defined as "relating to dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power." "Fair market value" is defined as the "price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm's length transaction." Black's Law Dictionary (8th ed. 2004). The terms "arm's length" and "fair market value," as commonly used, and as used in ABC's Form 1023, imply that the seller, ACL, earns a profit on the laboratory services it provides for ABC.

There was considerable testimony at the evidentiary hearing on the difference between cost and fair market value. Mr. XXXXX testified on this issue that "cost is the cost and it may be fair market value..." Tr. p. 55. Ms. XXXXX testified that fair market value is "synonymous" with cost and that ACL is able to provide testing to ABC at cost. Tr. p. 84. She stated further:

As a comparison, we know what the commercial labs are charging [ACL] and we know what commercial labs would be charging some of our customers, and [ACL's] costs are in the same range that they're charging. So I believe very much that that's an indication that it's a fair market value.
Tr. p. 85.

It is reasonable to conclude that if ACL's charges to ABC are similar to what a commercial lab would charge ACL, then ACL is making a profit on the laboratory

services that it performs for ABC. A commercial lab would be making a profit on its charges to ACL. At the risk of sounding simplistic, making a profit is what makes the commercial lab “commercial.” In addition, the above testimony from Ms. XXXXX seems to indicate that ACL is charging ABC a fair price, because the price is in the “same range” as commercial labs are charging. However, “fair” is not synonymous with “cost.” It must be noted that Exhibit E, the “Master Services Agreement” between ACL and ABC mentioned in ABC’s Form 1023, which may have contained more detail on the fee arrangements between ACL and ABC, was not offered into evidence.

It is unclear from the record whether ABC’s decision to use ACL for the processing of 20 to 30 percent of its testing was based on sound economic reasons or because of the symbiotic relationship between the two organizations. If ACL is making a profit on the testing it does for ABC, it is unclear from the record what the owners of ACL do with this profit and whether the profit results in private inurement to ACL’s owners-who, incidentally, are the same as ABC’s. Thus, it is unclear from this record whether the prohibition against private inurement does not present a real issue in this matter.

There is further evidence that there may be inurement to the owners of ACL from its affiliation with ABC. ACL “actually provides the purchasing function...” for ABC. Ms. XXXXX testified that “[S]o someone out here at one of these [ABC hospital laboratories] would say, I need to have reagents for my chemistry analyzer, we have connectivity via computer systems for them to log on to the purchasing system ... under the control of ABC Clinical Laboratories and order those reagents. ABC Clinical Laboratories then cuts the purchase order and does the paying.” “So the purchasing and the payment for the reagents and the supplies and the equipment needed for the ABC

sites, for the hospital locations is actually performed by ABC Clinical Labs.” ABC receives the price that ACL has negotiated with the vendors. Tr. pp. 76-77. “ACL facilitates the activities of ABC by enabling ABC to benefit from volume ordering of supplies and equipment...” ABC Memo. p. 3. Ms. XXXXX was asked what the purpose was “behind your asking for this exemption?” She responded:

It makes the purchasing easier to be able to have an exemption in Illinois as well as in Indiana when we are purchasing supplies from our vendors in order for them to keep [straight] that part of the hospitals do pay taxes and part don't and the complexity of all of our delivery locations, it's just from an operations standpoint much easier to do that.
Tr. pp. 94-95.

There are a myriad of internal control concerns inherent in having a for-profit affiliate make purchases for a not-for-profit affiliate. There was no testimony about these concerns at the hearing and they were not addressed in either ABC's Post Hearing Memorandum or in the Department's Response. I question how ACL keeps “straight” its inventory between an Indiana tax-free purchase of equipment that would be used for processing laboratory tests for a Participant Hospital and a taxable purchase of the same equipment that would be used to purchase laboratory tests for a commercial client. There is a distinct potential for inurement by the owners of ACL if ACL is not paying sales tax on purchases used in performing laboratory tests for its commercial clients. There is no testimony in the record on what internal control procedures have been adopted by ACL and ABC, to ensure that tax free inventory is used only for tax exempt laboratory processing. The lack of testimony on this issue in the record again raises a serious concern as to whether the owners of ACL are privately profiting from the purchasing ACL performs for ABC and this concern must be resolved against ABC's exemption request and in favor of taxation.

Directly related to the issue of ACL profiting from its affiliation with ABC is ABC's argument in its Post Hearing Memorandum that the Participant Hospitals' collaboration through ABC is "reasonably necessary" to the continuing and improved delivery of charitable care. ABC Memo. p. 14. In Memorial Child Care v. Department of Revenue, 238 Ill. App. 3d 985 (4th Dist. 1992), the court found that a child care facility, operated for the employees of Memorial Medical Center, was "reasonably necessary" to the efficient administration of the hospital. The court noted that property may qualify for a charitable exemption if the use of the property is exclusively charitable or "reasonably necessary" for accomplishment of the goals of the charitable organization. *Id.* at 989. The court found that the availability of secure, flexible child care is "more than a mere convenience," but a necessity that directly affects an employee's willingness and ability to provide much needed services to the hospital and the community. *Id.* at 993.

I am unable to conclude that the Participant Hospitals' collaboration through ABC is "reasonable necessary" to the continuing and improved delivery of charitable clinical laboratory services. ABC Memo. p. 14. As discussed previously, no evidence was presented by ABC as to any clinical laboratory services contributed by ABC or by the Participant Hospitals. I cannot conclude with any certainty that charitable care by ABC or its Participant Hospitals is "continuing" or "improved" since there was no testimony or evidence presented as to what clinical laboratory services were contributed before or after the incorporation of ABC. It should be noted again that Ms. XXXXX testified that the purpose of ABC applying for this exemption is to make "purchasing easier." Tr. p. 94. She did not testify that the exemption is necessary for the "continuing" or "improved" delivery of clinical laboratory services. It is unclear from the record how making

“purchasing easier” allows ABC and/or the Participant Hospitals to continue or improve contributions of clinical laboratory services.

Moreover, I am unable to conclude from the record in this case that a cooperative hospital service organization performing clinical laboratory services is “reasonably necessary” for the accomplishment of the Participant Hospitals’ goals. ABC Memo. p. 7. Frankly, the record of this case contains no evidence as to what the Participant Hospitals’ goals are in terms of contributions of clinical laboratory services. Mr. XXXXX’s testimony that ABC previously used for-profit laboratories for some of its testing leads me to conclude that the form of the corporation that performs the laboratory testing has no relation to the accomplishment of the Participant Hospitals’ goals for charitable laboratory services. Tr. pp. 31-32.

If I were able to conclude that access to a clinical laboratory is “reasonably necessary” for the accomplishment of the Participant Hospitals’ charitable goals, I would not be able to conclude, for the reasons discussed above, that funneling 20 to 30 percent of ABC’s clinical laboratory services and the ordering of supplies through ACL, a for-profit affiliated testing service, is the best way to accomplish the Participant Hospitals’ goals. In this regard, I note that ABC’s Post Hearing Memorandum recognized that Illinois courts have not previously addressed the charitable status of an Internal Revenue Code 501(e) cooperative service organization. The Post Hearing Memorandum then cites three cases where various courts have concluded that cooperative laboratory or laundry services should be exempt from state sales or property taxes.³

³ Department of Revenue v. Central Medical Laboratory, Inc., 555 S.W. 2d 632 (Ky. 1977), United Hospital Services, Inc. v. U.S., 384 F. Supp. 776 (S. Dist. Ind. 1974), and Shared Hospital Services Corporation v. Ferguson, 673 S.W. 2d 135 (Tenn. 1984).

In none of these cases are any of the services performed by the cooperative service organization funneled through a for-profit affiliated company. In none of these cases is there any indication that the cooperative service organization is providing gain or profit in a private sense to the owners of the for-profit affiliated company. Based on the record in this case, it is not unreasonable for me to conclude that the funneling of 20 to 30 percent of ABC's clinical laboratory testing through ACL provides gain and profit in a private sense to the owners of ACL, which is proscribed by Korzen and inconsistent with the operations of a "charitable" organization. I have no doubt that the affiliation between ABC and ACL is "convenient." However, the record in this case does not allow me to conclude that this corporate structure is "reasonable necessary" for the accomplishment of the vague, undetermined, undocumented, charitable goals of the Participant Hospitals.

THE ORGANIZATION BENEFITS AN INDEFINITE NUMBER OF PERSONS: According to ABC's Post Hearing Memorandum, each Participant Hospital "works through ABC to improve the quality of charitable care dispensed, and to reduce the cost of medical care generally available through their respective hospital systems, thus, ABC is exclusively used for charitable purposes of its Participants and its services are dispensed for the benefit of an indefinite number of persons." ABC Memo. p. 7.

The record in this case is devoid of any evidence that clinical laboratory services are dispensed by either ABC or the Participant Hospitals to an indefinite number of persons. In fact, the record in this case is devoid of any evidence that clinical laboratory services are dispensed by either ABC or the Participant Hospitals to even one person. Ms. XXXXX testified that ABC does not "have any way of knowing" whether a request for laboratory services is for a "charity care or a paying patient." According to Ms.

XXXXX's testimony, any charity that is rendered would be rendered by ABC's Participant Hospitals only. Tr. pp. 96-97.

The only documentary evidence admitted at the hearing with regard to the Participant Hospitals is the certificates exempting them from ROT as charitable organizations. I cannot conclude from the ROT exemption certificates that the Participant Hospitals dispense clinical laboratory services to an indefinite number of persons. The written charity care policies of the Participant Hospitals were not admitted into evidence. There was no testimony or documentary evidence as to how many patients requested charitable clinical laboratory services from the Participant Hospitals and how many patients were given these services without charge. There was no testimony as to the dollar amount of clinical laboratory services, if any, contributed by each of the Participant Hospitals. Mr. XXXXX testified that ACL does not provide any charitable clinical laboratory testing. Tr. p. 38. So the "indefinite number of persons" that ABC argues are benefited by the Participant Hospitals' charity definitely excludes the patients in the 20 to 30 percent of ABC's testing that is referred to ACL.

There was considerable testimony at the hearing as to the cost savings generated by ABC. No documentary evidence was presented that this cost savings was passed on by either ABC or the Participant Hospitals in the form of increased charitable clinical laboratory services. The record contains no evidence as to the dollar amount of clinical laboratory services, if any, donated by the Participant Hospitals before or after the incorporation of ABC. No documentary evidence was presented that the cost savings generated by the incorporation of ABC allowed ABC or the Participant Hospitals to provide clinical laboratory services to more patients. The record contains no evidence as to the number of patients, if any, provided clinical laboratory services before or after the

incorporation of ABC. No financial statements were offered into evidence for the Participant Hospitals for periods before or after the incorporation of ABC. There was considerable testimony at the hearing that the cost savings generated from the incorporation of ABC provided the Participant Hospitals with a decrease in laboratory expenses, but there is no evidence in the record that the decrease in laboratory expenses had any effect on the dispensation of charitable clinical laboratory services.

The issue of cost savings generated by the centralization of services was addressed in Association of American Medical Colleges v. Lorenz, 17 Ill. 2d 125 (1969). In American Medical Colleges, a not-for-profit corporation, whose members included American medical colleges, challenged the Department's denial of an educational property tax exemption. The Department argued that the property was not used for school purposes because it was not devoted to class work and that the functions that the applicant performed for its member institutions were primarily administrative and statistical having only an incidental relationship to teaching.

The Court rejected the Department's arguments finding that the functions to which the plaintiff's property is devoted "are identical to those which would afford exemption if conducted separately by its member institutions." "Where the functions themselves qualify for exemption, it does not matter that they are performed by a separate organization rather than by the respective member institutions." "It is not the policy of the law to penalize efficiency or to favor duplication of effort." *Id.* at 129.

In American Medical Colleges, the applicant performed an educational function for its member institutions and this function was exempt under 35 ILCS 200/15-35. ABC performs a clinical laboratory testing function for its member institutions. There is nothing inherently charitable about clinical laboratory testing. There is no exemption for

clinical laboratory testing in the Illinois Property Tax Code. Performing clinical laboratory testing is not a “function” that, without more, would afford exemption if performed by the Participant Hospitals. The merger of exempt educational functions in one institution was not a valid reason for the denial of an educational exemption in American Medical Colleges. The record in the instant case does not show the merger of charitable functions in an affiliated institution. It shows the merger of clinical laboratory functions in an affiliated institution, and this function is not individually exempt under the Property Tax Code.

THE ORGANIZATION DISPENSES CHARITY TO ALL WHO NEED AND APPLY FOR IT AND DOES NOT APPEAR TO PLACE OBSTACLES OF ANY CHARACTER IN THE WAY OF THOSE WHO NEED AND WOULD AVAIL THEMSELVES OF THE CHARITABLE BENEFITS IT DISPENSES: The record in this case is devoid of any evidence that ABC or the Participant Hospitals dispense clinical laboratory services to all who need and apply for them or that ABC or the Participant Hospitals do not place obstacles in the way of those who need and would avail themselves of charitable clinical laboratory services. ABC conducts the testing and other services that its Participant Hospitals require, without regard to whether the hospital orders the testing and services for a charitable care patient or a paying patient. ABC Memo. p. 11. As far as the record of this case shows, all testing and services requested by the Participant Hospitals could have been for paying patients. Mr. XXXXX testified that ACL does not provide any charitable clinical laboratory testing. Tr. p. 38. This clearly is an obstacle in the way of any patient needing charitable assistance whose tests are in the 20 to 30 percent of ABC’s testing referred to ACL.

The Participant Hospitals are exempt from Illinois ROT as exclusively charitable organizations, but no evidence was provided as to the basis of these exemptions. Taxpayer's Ex. Nos. 8, 9 and 10. ABC is asking this tribunal to conclude, without any documentary evidence, that the Participant Hospitals provide clinical laboratory services to all who need and apply for them and do not place obstacles in the way of those needing clinical laboratory services and, further, that these conclusions justify an exemption for their affiliated organization, ABC. The conclusion and the exemption requested for ABC are not justified by the record in this case.

In exemption cases, the applicant bears the burden of proving "by clear and convincing" evidence that the exemption applies. Evangelical Hospitals Corp. v. Department of Revenue, 223 Ill. App. 3d 225, 231 (2d Dist.1991). The Department's second denial of ABC's request for an ROT exemption is presumed to be correct, and ABC had the burden of clearly and conclusively proving that it is entitled to the exemption. Wyndemere Retirement Community v. Department of Revenue, 274 Ill. App. 3d 455 (2nd Dist. 1995). To prove its case, a taxpayer must present more than its testimony denying the Department's determination. The taxpayer must present sufficient documentary evidence to support its exemption. Sprague v. Johnson, 195 Ill. App. 3d 798 (4th Dist. 1990). At the least, the absence of documentary evidence in this case, on the issue of the charitable clinical laboratory services performed by either ABC or the Participant Hospitals, if any, forces me to conclude that ABC has not proven, by clear and convincing evidence, that they are entitled to an ROT exemption. For the above stated reasons, I recommend that the Department's second denial of ABC's request for a sales tax identification number be affirmed

ENTER:

Kenneth J. Galvin

September 9, 2008