
Opinion of the Tax Commissioner

Date Issued: July 21, 2009

Opinion No: 09-0002

Tax: Commercial Activity

Subject: Nonprofit Organization

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This request for an Opinion of the Tax Commissioner was received on March 27, 2009. The request concerns whether XXXX (“Taxpayer”) is a “nonprofit organization” as defined in Ohio Adm. Code 5703-29-10 and therefore not subject to the commercial activity tax (“CAT”) because it is not a “person” for purposes of the tax.

TAXPAYER STATEMENT OF FACTS

Taxpayer is a professional medical association maintaining its principle office at XXXX in Ohio. One of Taxpayer’s stated purposes is “[t]o engage in the practice, and to render professional service[s], of medicine as authorized by Chapter 4731 of the Ohio Revised Code and any related or incidental services.” These services include: providing medical, surgical and other health care and treatment of the sick, disabled, and injured; conducting education activities related to health care and treatment of the sick, disabled and injured; and promoting medical, scientific and clinical research related to the health care and treatment of the sick, disabled, and injured.

Taxpayer’s Articles of Incorporation further specify that the entity is “[t]o be operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code of 1986 (“Code”).” In addition, Article 10¹ provides:

Notwithstanding anything to the contrary, the corporation may not engage in any activity which is not permitted to be engaged in by an organization exempt from federal income tax under section 501(c)(3) of the Code. Furthermore, upon the dissolution of the Corporation, any assets remaining shall be conveyed to one or more organizations as shall be selected by the board of directors; provided, however, that any such organization shall be exempt from federal income taxation under section 501(c)(3) of the Code.

¹ Of Taxpayer’s original articles. Taxpayer filed amended articles as discussed *infra*.

Taxpayer is exempt from federal income taxes pursuant to IRC 501(c)(3).

Taxpayer is part of XXXX Health Systems (“System”). System is an Ohio nonprofit corporation that is exempt from federal income taxes. In addition to its charitable purposes, System is organized “to provide health care services and to own, lease, and operate or provide health care facilities for the promotion of health in the area served” by it. As a member of System, Taxpayer is bound by the charitable policies and mission of System. As a result, every patient is seen and treated without regard to the patient’s ability to pay.

For Ohio purposes, Taxpayer is organized as an Ohio professional medical association under R.C. Chapter 1785. At the time of its formation, organization as a professional medical association under R.C. Chapter 1785 was the only option that allowed Taxpayer (and System) to carry out its purposes in compliance with Ohio’s corporate practice of medicine doctrine. System and the XXXX Hospital (“Hospital”) could not employ physicians directly.

Taxpayer has one shareholder. That shareholder is a doctor employed at Hospital and is party to a perpetual Share Control Agreement in place between the shareholder, Taxpayer, and System. There are restrictions against transferring the stock of Taxpayer; System has a right of first refusal as to the sale of the stock; and the shareholder must tender the stock to System in the event he is no longer employed at Hospital.

In addition, the Agreement also provides for various tax exemption restrictions in Section 11. This section insures that Taxpayer will be operated exclusively for charitable purposes, and that none of its net earnings, if any, will inure to the benefit of any private person, except the Taxpayer may pay reasonable compensation for services rendered. Physicians employed by Taxpayer are paid a salary based on market rates and quality bonuses.

QUESTION PRESENTED BY TAXPAYER

Whether Taxpayer is exempt from the CAT because, as a nonprofit organization, it is not a “person” for purposes of the tax?

ANALYSIS

Pursuant to R.C. 5751.02(A), the CAT is a tax levied on all persons with certain taxable gross receipts for the privilege of doing business in this state. The term “doing business” is defined in R.C. 5751.02(A) as “engaging in any activity, whether legal or illegal, that is conducted for, or results in, gain, profit, or income, at any time during the calendar year.” For CAT purposes, a “person” is broadly defined in R.C. 5751.01(A) to include individuals, associations, and other types of entities, but specifically excludes “nonprofit organizations”. The term “nonprofit organizations” is not defined under either Ohio or federal law. Under the general law provision, Ohio uses the term “nonprofit *corporations*” and federal law uses the term “*charitable organizations*”. Therefore, for CAT purposes, neither term fits exactly within the term “nonprofit organizations”. For that reason, the Department promulgated Ohio Adm. Code

5703-29-10, which defines “nonprofit organizations” for purposes of the CAT.

Ohio Adm. Code 5703-29-10 states that, solely for CAT purposes, an entity that meets both prongs of a two-prong test is considered a “nonprofit organization”. A nonprofit organization is excluded from the definition of a “person” and is therefore not subject to the CAT.

First Prong: Organized Other Than for Pecuniary Gain or Profit

The first prong of the nonprofit organization test is two-fold: (1) the entity must not be organized for the pecuniary gain or profit of its members, directors, officers, or other private persons; and (2) no part of the entity’s net earnings may be distributable to the entity’s members, directors, officers, or other private persons, unless otherwise permitted by law.

Taxpayer is organized “other than for pecuniary gain or profit.” Taxpayer’s original Articles of Professional Incorporation, filed December 30, 1994, provided that the entity was “organized and shall operate exclusively for charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code of 1986 (“Code”).” On August 30, 1996, Taxpayer filed Amended and Restated Articles of Professional Incorporation which instead provide in pertinent part:

ARTICLE 3. PURPOSE. The purpose for which the Corporation is formed shall be:

* * *

To be operated exclusive for charitable purposes within the meaning of section 503(c)(3) of the Internal Revenue Code of 1986 (“Code”), including for the purpose of furthering the charitable purposes of XXXX Health Systems (“Systems”), an organization exempt from federal income taxation under section 501(c)(3) of the Code.

* * *

ARTICLE 9. RESTRICTION ON TRANSFER OF SHARES. No holder or beneficial owner of any share of the Corporation’s capital stock may sell or otherwise transfer any such share or any beneficial interest therein to any person other than an individual who is duly licensed or otherwise legally authorized to render the professional services of medicine. No person other than an individual duly licensed or otherwise authorized to render such professional services of medicine shall be registered or otherwise recognized by the Corporation as a record holder of any share of the Corporation’s capital stock. No person who owns any share of the corporation’s capital stock may receive any economic benefit upon the transfer of such shares to any other person.

ARTICLE 10. CHARITABLE RESTRICTIONS. Notwithstanding anything to the contrary in these Articles of Incorporation:

- a. The Corporation may not engage in any activity which is not permitted to be engaged in by an organization exempt from federal income tax under section 501(c)(3) of the Code.
- b. No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to, its directors, officers or other private persons, except that the Corporation shall be authorized to pay reasonable compensation for services rendered and to make payments in furtherance of the purposes of the Corporation.

* * *

Furthermore, upon the dissolution of the Corporation, any assets remaining shall be conveyed to one or more organizations as provided in the Code of Regulations; provided, however, that any such organization shall be exempt from federal income taxation under section 501(c)(3) of the Code.

Additionally, Taxpayer received a determination letter from the IRS that states that Taxpayer is exempt under section 501(a) of the Code as a charitable organization under section 501(c)(3) of the Code. (I.R.S. Determination dated, XXXX). Taxpayer says that its stated purposes have not changed since receipt of such determination.

Taxpayer does not distribute its net earnings to its members, directors, officers, or other private persons, unless permitted by law. Taxpayer does distribute its net earnings to a nonprofit organization. Currently, Taxpayer has one shareholder. This shareholder, however, is a party to a Share Control Agreement between Taxpayer, System, and shareholder. The Share Control Agreement provides that “no part of the net earnings of the Corporation shall inure to the benefit of any private individual or entity.” (Section 11 of Share Control Agreement dated January 26, 1995). By virtue of the agreement, System is the owner of the beneficial economic interest of Taxpayer. (Share Control Agreement dated XXXX). System is organized under R.C. Chapter 1702, which is specifically enumerated in Ohio Adm. Code 5703-29-10(C) as an entity that meets the definition of nonprofit organizations for purposes of CAT.

Finally, the shareholder does not receive distributions of capital or net earnings. He and the other physicians employed by Taxpayer receive only reasonable compensation for medical services provided. Therefore, looking at the facts Taxpayer presents, it appears that Taxpayer meets the first prong of the test.

Second Prong: Operating Consistent with Organization

The second prong of the nonprofit test is that the entity is operating consistent with its organization. Taxpayer states that it continues to operate in a manner consistent with its Articles of Incorporation. Additionally, Taxpayer states that its purposes and operations have not changes since its inception as a medical professional association that is exempt from federal taxation under section 501(c)(3) of the Code.

The rule also includes an illustrative list of chapters within Title 17 of the Revised Code for those entities organized under the laws of Ohio, including entities organized pursuant to similar nonprofit provisions of other jurisdictions. Those chapters address specific entities meeting the definition of nonprofit organizations for CAT purposes; however such list is not exhaustive. At the time of Taxpayer's organization, Ohio law limited Taxpayer's options to incorporation under R.C. Chapter 1785. Taxpayer notes that current law would allow Taxpayer to convert to a nonprofit single member limited liability company organized under R.C. 1705.02; however Taxpayer stresses that the conversion would be extremely burdensome to Taxpayer.

Since Taxpayer is a not-for-profit professional medical association organized under R.C. Chapter 1785 originally to comply with Ohio's corporate practice of medicine doctrine, Taxpayer does not distribute its net earnings to its members, directors, officer, or other private persons, unless permitted by law, and Taxpayer appears to be operating consistent with its organization, Taxpayer meets the definition of a nonprofit organization and is therefore excluded from the definition of a "person" for purposes of the CAT.

ANSWER

According to the facts presented, Taxpayer meets the definition of a "nonprofit organization" for purposes of the CAT and therefore is not included in the definition of a "person" and is not subject to the CAT.

CLOSING

This Opinion applies only to Taxpayer. It may not be transferred or assigned. In addition, the tax consequences stated in this Opinion are subject to change for any of the reasons provided in R.C. 5703.53(C). It is the duty of Taxpayer to be aware of such changes pursuant to R.C. 5703.53(E).

Richard A. Levin
Tax Commissioner