

CHARITABLE ORGANIZATION PROPERTY TAX EXEMPTION DEVELOPMENTS IN PENNSYLVANIA AND UTAH

Pennsylvania and Utah have received considerable attention on the issue of charitable organizations property tax exemptions in recent years. The Taxation Committee requested a summary of developments in these states.

BACKGROUND

When property tax exemptions originated, churches conducted most educational and charitable activities. Because these activities were operated by churches and relieved government of the cost of performing some services or obligations, there was little controversy when property tax exemptions were written into states' constitutions and laws. As other organizations began to offer these services, exemptions were extended to these new activities. However, modern operation of charitable organizations has changed so that they sometimes compete with businesses run on a for-profit basis. A 1990 United States Government Accounting Office report prepared for the House Select Committee on Aging noted these changes and contained the observation that nonprofit hospital goals most often relate to increasing the share of patients within market areas, mirroring the goals of investor-owned institutions. Several observers have suggested that granting and retaining charitable exemptions in the modern political environment has more to do with political clout than benefits to the public and government. The changing nature of charitable organization operation is one of the factors that led assessment officials to more closely scrutinize application of exemptions.

Another factor leading to increased scrutiny of claims for exemptions is the great proliferation in tax-exempt real property. In Philadelphia over the period from 1915 to 1966 exempt real property increased from 13.1 to 24.3 percent of the value of all real property. Exempt property in St. Louis grew from 23.8 percent of total property valuation in 1958 to 30 percent in 1969. In Washington, D.C., the value of exempt real property as a percentage of the value of all real property increased from 40 percent in 1959 to 52.3 percent in 1969. Similar increases occurred across the country. Another mitigating factor is the tendency of exempt property to concentrate in large urban areas, reducing the tax base at a time when increased revenue demands were placed on

local governments and additional tax base was being lost through migration to suburbs. With increased incentive to expand the tax base, assessment officials in many states began to scrutinize hospital operations under property tax exemption provisions.

1985 COURT DECISIONS

The Supreme Courts of Pennsylvania and Utah decided cases in 1985 which gained national attention with regard to property exemption application for hospitals. The Utah Supreme Court (*Utah County v. Intermountain Health Care, Inc.*, 709 P.2nd 265 (1985)) concluded that two hospitals whose exempt status had been challenged by local assessors lacked sufficient charitable attributes to qualify for property tax exemption. The Pennsylvania Supreme Court (*Hospital Utilization Project v. Commonwealth*, 487 A.2nd 1306 (1985)) concluded that a jointly owned hospital support facility was not an institution of purely public charity. The Pennsylvania decision involved application of a sales tax exemption, but the same standards apply to property tax exemptions in Pennsylvania so the decision meant the facility lost its exempt property tax status.

The Utah Supreme Court traced the evolution of hospitals' missions from the 19th century to their current status. The Utah Supreme Court adapted a six-factor standard from the Minnesota Supreme Court (*North Star Research Institute v. County of Hennepin*, 236 N.W.2nd (1975)) and laid out the following factors to be weighed in determining whether a particular institution is using its property exclusively for charitable purposes:

1. Whether the stated purpose of the entity is to provide a significant service to others without immediate expectation of material reward;
2. Whether the entity is supported, and to what extent, by donations and gifts;
3. Whether the recipients of the "charity" are required to pay for the assistance received, in whole or in part;
4. Whether the income received from all sources (gifts, donations, and payments from recipients) produces a "profit" to the entity in the sense that the income exceeds operating and long-term maintenance expenses;

5. Whether the beneficiaries of the "charity" are restricted or unrestricted and, if restricted, whether the restriction bears a reasonable relationship to the entity's charitable objectives; and
6. Whether dividends or some other form of financial benefit, or assets upon dissolution, are available to private interests, and whether the entity is organized and operated so that any commercial activities are subordinate or incidental to charitable ones.

The Utah Supreme Court emphasized that each case must be decided on its own facts, the six factors are not all of equal significance, and an institution need not qualify under all six factors to be eligible for exemption.

The Utah Supreme Court observed that the distinction between nonprofit and for-profit hospitals is virtually irrelevant for purposes of discovering the element of charity in their operations. The court examined descriptions of operation nonprofit hospitals in available literature under two models, the physicians' cooperative model and the polycorporate enterprise model. The physicians' cooperative model is characterized by control and operation of a hospital primarily for the benefit of the participating physicians. In this model physician income maximizing as a primary goal is described as being hidden behind a nonprofit facade of the hospital. The polycorporate enterprise model was described as being the characteristic of an increasing number of nonprofit hospital chains, where power is largely in the hands of administrators, not physicians. The court described complexities and interrelationships of various corporations all engaged in operation of a single hospital facility or chain of facilities that have "increasingly destroyed the charitable pretensions of nonprofit organizations. . . ."

The Pennsylvania case did not involve a hospital. The Hospital Utilization Project was established by an association of hospitals to prepare a statistical abstract of patient information for all of the hospitals in the area. The court had little difficulty in finding the project not to be charitable in nature. The court went on to establish criteria to determine that an entity is a purely public charity if it:

1. Advances a charitable purpose;
2. Donates or renders gratuitously a substantial portion of its services;
3. Benefits a substantial and indefinite class of persons who are legitimate subjects of charity;

4. Relieves the government of some of its burden; and
5. Operates entirely free from private profit motive.

DEVELOPMENTS IN UTAH

After the *Intermountain Health Care* decision, the Utah hospital industry prevailed upon the legislature to propose a constitutional amendment specifically granting property tax exemption for nonprofit hospitals and nursing homes. Despite an extensive campaign by nonprofits, the measure was defeated in 1986.

A 1986 decision of the Supreme Court of Utah (*Yorgason v. County Board of Equalization*, 714 P.2d 653) supplemented the guidelines from the *Intermountain Health Care* decision. The Utah Tax Commission found that the guidelines after the court decisions did not produce objective standards to apply to particular fact situations. The Tax Commission conferred with county assessors, other county representatives, representatives of nonprofit hospitals and nursing homes, and representatives of for-profit hospitals and conducted a series of public hearings. The Tax Commission adopted standards for determining applicability of property tax exemptions for hospitals and nursing homes. The six standards adopted are as follows:

1. The institution must be organized on a nonprofit basis and the property in question must be dedicated to its charitable purpose.
2. The institution must demonstrate that net earnings and donations do not inure to the benefit of any private shareholder or individual.
3. The institution must provide open access to medical services regardless of race, religion, gender, or ability to pay and must provide evidence of its efforts to inform the public of its open access policy and of the availability of services for the indigent.
4. The institution must maintain a "charity plan" and must have a governing board consisting of a broad-based membership, operate in an open atmosphere, and meet at least annually to address the needs of the community.
5. The institution must enumerate and total various ways in which it provides unreimbursed service to the community according to specified measurement criteria. The value of unreimbursed care to indigent patients must be measured by the hospital's normal billing rate, reduced

by the average of reductions provided to all patients who are not covered by government entitlement programs, plus expenses directly associated with special indigent clinics. The total of unreimbursed service must exceed for each year what would otherwise be the institution's property tax liability for the year.

6. Satellite facilities of an institution are entitled to an exemption if it is shown that these facilities enhance the institution's charitable mission.

The standards adopted by the Tax Commission were reviewed and upheld by the Utah Supreme Court in *Howell v. City Board of Cache County*, 881 P.2d 880 (1994).

DEVELOPMENTS IN PENNSYLVANIA

Pennsylvania has experienced 12 years of litigation in the wake of the *Hospital Utilization Project* decision. Assessment officials and representatives of charitable organizations have been involved in frequent disputes over application of the five-point standards announced by the Pennsylvania Supreme Court in the *Hospital Utilization Project* decision.

The Commonwealth Court of Pennsylvania has issued a series of decisions on property tax exemptions for public charities which have "denied exemption to virtually every charity that came before it." ("When Local Governments Come Calling: The Movement to Tax Charities," Gallagher, *State Tax Notes*, October 13, 1997). Among institutions denied exemptions are hospitals, nursing homes, private schools, a religious publishing company, a residential program for troubled youth, and a Head Start program. In an effort to end the cycle of litigation and uncertainty, Pennsylvania charities have sought a legislative solution that would provide clear, objective standards for determining what is an institution of purely public charity.

Pennsylvania 1997 House Bill No. 55 has been passed and was signed by the Governor on November 26, 1997. A summary of the five criteria established by the bill to qualify as an institution as a purely public charity is as follows:

1. The institution must advance a charitable purpose. This criterion is satisfied if the institution is organized and operated primarily to fulfill any of these purposes:
 - a. Relief of poverty.
 - b. Advancement and provision of education, including postsecondary education.
 - c. Advancement of religion.

- d. Prevention and treatment of disease or injury, including mental retardation and mental disorders.
 - e. Government or municipal purposes.
 - f. Accomplishment of a purpose recognized as important and beneficial to the public and which advances social, moral, or physical objectives.
2. The institution must operate entirely free from private profit motive. Without regard to whether the institution's revenues exceed expenses, this criterion is satisfied if:
 - a. Neither the institution's net earnings nor donations inures to the benefit of private shareholders or other individuals, as the private inurement standard is interpreted under Section 501(c)(3) of the Internal Revenue Code.
 - b. The institution applies or reserves all revenue, including contributions, in excess of expenses in furtherance of its charitable purpose or to funding of other institutions that advance a charitable purpose and have no private profit motive.
 - c. Compensation, including benefits, of any director, officer, or employee is not based primarily on the financial performance of the institution.
 - d. The governing body of the institution has adopted as part of its governing legal documents a provision that expressly prohibits use of any surplus funds for private inurement to any person in the event of a sale or dissolution of the institution.
 3. The institution must provide a community service by donating or rendering gratuitously a substantial portion of its services. This criterion is satisfied if the institution benefits the community by meeting any one of these standards:
 - a. Goods or services are provided to all who seek them without regard to their ability to pay if all of the following apply:
 - (1) The institution has written policy to this effect.
 - (2) The institution has published this policy in a reasonable manner.
 - (3) The institution provides uncompensated goods or services at least equal to 75 percent of the institution's net operating

- income but not less than three percent of the institution's total operating expenses.
- b. Goods or services are provided for fees that are based upon the recipient's ability to pay for them if all of the following apply:
 - (1) The institution can demonstrate that it has implemented a written policy and a written schedule of fees based on individual or family income and consistently applies a formula to all individuals requesting consideration of reduced fees, in part based on individual or family income.
 - (2) At least 20 percent of the individuals receiving goods or services from the institution pay no fee or a fee that is lower than the cost of the goods or services provided by the institution.
 - (3) At least 10 percent of the individuals receiving goods or services from the institution receive a reduction in fees of at least 10 percent of the costs of the goods or services provided to them.
 - (4) No individual receiving goods or services from the institution pays a fee that is equal to or greater than the cost of the goods or services provided to them or the goods or services provided to individuals who pay no fee or a reduced fee are comparable in quality and quantity to the goods or services provided to individuals who pay a fee equal to or greater than the cost of the goods or services provided to them.
 - c. Wholly gratuitous goods or services are provided to at least five percent of those receiving similar goods or services from the institution.
 - d. Financial assistance or uncompensated goods or services are provided to at least 20 percent of those receiving similar goods or services from the institution if at least 10 percent of the individuals receiving goods or services from the institution either paid no fees or fees which were 90 percent or less of the cost of the goods or services provided to them, after consideration of any financial assistance provided by the institution.
 - e. Uncompensated goods or services are provided which, in the aggregate, are equal to at least five percent of the institution's costs of providing goods or services.
 - f. Goods or services at no fee or reduced fees are provided to government agencies or goods or services are provided to individuals eligible for government programs if any one of the following applies:
 - (1) The institution receives 75 percent or more of its gross operating revenue from grants or fee-for-service payments by government agencies and the fee-for-service payments from government agencies does not exceed 95 percent of the institution's costs of providing goods or services to the individuals for whom the service payments are made.
 - (2) The institution provides goods or services to individuals with mental retardation, to individuals who need mental health services, to members of an individual's family or guardian in support of such goods or services, or to individuals who are dependent, neglected, or delinquent children, as long as the institution performs duties that would otherwise be the responsibility of government and the institution is restricted in its ability to retain revenue over expenses or voluntary contributions.
 - g. Providing fundraising on behalf of, or grants to, an institution of purely public charity, an entity similarly recognized by another state or foreign jurisdiction, a qualifying religious organization, or a government agency and actual contribution of a substantial portion of the funds raised to the institution.
4. The institution must benefit a substantial and indefinite class of persons who are legitimate subjects of charity.

“Legitimate subjects of charity” is defined as individuals unable to provide themselves with what the institution provides for them. The bill specifically disqualifies any organization not recognized as exempt under Section 501(c)(3) of the Internal Revenue Code and any institution otherwise qualified under Section 501(c)(3) of the Internal Revenue Code that is:

- a. An association of employees.
 - b. A labor organization.
 - c. An agricultural or horticultural organization.
 - d. A business league, chamber of commerce, real estate board, board of trade, or professional sports league.
 - e. A club organized for pleasure or recreation.
 - f. A fraternal beneficiary society, order, or association.
5. The institution must relieve the government of some of its burden. This criterion is satisfied if the institution meets any one of these criteria:
- a. Provides a service to the public that the government would otherwise be obliged to fund.
 - b. Provides services in furtherance of its charitable purpose which are either the responsibility of the government or have historically been assumed or offered or funded by the government.
 - c. Receives on a regular basis payments for services rendered under a government program if the payments are less than the full costs incurred by the institution, under generally accepted accounting principles.
 - d. Provides services to the public which directly or indirectly reduce dependence on government programs or relieve or lessen the burden of government.
 - e. Advances or promotes religion and the institution is owned and operated

by a corporation or other entity as a religious ministry.

- f. Has a voluntary agreement with a political subdivision to make voluntary payments to defray some of the cost of local government services.

The bill contains numerous definitions. The bill allows affiliated corporations to be considered as a single institution under certain conditions. The bill makes clear that political subdivisions retain the responsibility to determine whether a parcel of property or a portion of property is being used for charitable purposes. The bill provides a rebuttable presumption of exemption for institutions previously determined to be exempt but, for institutions having annual program service revenue of \$10 million or more, the presumption applies only if the institution has a voluntary agreement with a political subdivision. The bill allows an institution making voluntary contributions to a political subdivision to credit those contributions as financial assistance or provision of uncompensated goods or services under the community service requirement of the criteria to qualify as an institution of public charity.

The bill states that it is the policy of the State of Pennsylvania that institutions of purely public charity may not use their tax-exempt status to compete unfairly with small business. The bill does provide limited information on what constitutes unfair competition. The bill prohibits an institution of public charity from funding, capitalizing, guaranteeing indebtedness for, leasing obligations of, or subsidizing a commercial business unrelated to the institution’s charitable purpose. Exceptions are provided for a commercial business intended only for use of employees, staff, alumni, facility, members, students, clients, volunteers, patients, or residents or if the commercial business results in incidental or periodic sales rather than permanent and ongoing sales.

The bill requires an institution of purely public charity to file an annual report with the Bureau of Charitable Organizations of the Department of State of Pennsylvania. The report must include a copy of the return filed annually with the Internal Revenue Service and other information.