STATE AND LOCAL TAX ISSUES FOR NONPROFITS AND CHARITABLE ORGANIZATIONS

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I. **Differences Between Nonprofit and For-profit Entities for State and Local Tax Purposes** - In addition to exemption from federal income taxes, qualifying nonprofit organizations may enjoy exemption from the broader range of taxes at the state and local level. The requirements for exemption from business activity taxes, sales and use taxes and property taxes differ from state to state. It is not generally safe to assume that a nonprofit organization is exempt from all types of taxation in every state solely as a result of having been recognized as exempt by the Internal Revenue Service for federal income tax purposes. In addition, organizations exempt under other provisions of the Internal Revenue Code, such as 501(c)(4) civic leagues, may qualify as exempt from federal income taxes but not under state law (ie, Michigan).

A. **Characteristics of a Nonprofit Organization -** Although state laws vary widely, the general rationale behind exemption for nonprofit organizations is that these organizations exist to provide public benefit in the form of charitable, educational, healthcare or similar activities and to relieve the burdens of government. Unlike commercial entities, these organizations are routinely restricted from being privately owned. Also unlike a privately owned entity, the net earnings of a nonprofit organization may not benefit private interests but must be devoted to public purposes. Although individuals certainly may benefit from the largesse of a nonprofit organization, charitable beneficiaries may not ordinarily be insiders with respect to the organization and the organization and an organization must be able to show that it provides sufficient public benefit. Private benefit is discouraged and must be minimal or incidental.

1. **Sources of Income and Community Benefit** - Many nonprofit organizations receive their income as a result of donations or membership fees and not as payment for goods and services. Organizations such as hospitals and healthcare providers as well as higher educational institutions, when organized as nonprofits, may receive a substantial part of their income from program services but, although they are allowed to charge for their services, they are not allowed to restrict their program services to those who can pay but must typically establish that they serve indigent individuals as well (a community benefit standard). As a result of a number of recent cases in which nonprofit healthcare organizations have had their exemptions challenged on the basis of the community benefit standard, both the federal government and the states are increasingly seeking to quantify the degree to which nonprofit organizations provide indigent care in order to establish guidelines for nonprofits and to justify exemption from tax.

B. **Nonprofit Organizations with Commercial Characteristics -** Organizations that serve public purposes that may be characterized as economic development (such as business incubators) are more vulnerable to denial of exemptions than organizations that serve traditionally underserved populations such as the poor, the disadvantaged, the disabled and the elderly.

C. **Organization under State Law –** Organization under state nonprofit corporation laws does not, by itself, guarantee recognition as exempt. For federal tax purposes, a public charity seeking IRS recognition as an exempt organization under 501(c)(3) must file a Form 1023 with the IRS. The approval process for new exempt organizations has been streamlined to comport with the new Form 990 and its extensive disclosure requirements. TD 9423. The IRS has abandoned the advance ruling process and now will make a definitive ruling that an organization is a public charity based on a new application for exempt status. The IRS has shifted from monitoring public support through the advance ruling process to monitoring public support through disclosures on the organization's Form 990. Another change that has occurred in the last few years is that, previously, a single member LLC, treated as a disregarded entity, could enjoy the exempt status of a nonprofit corporate parent but could not apply for its own determination of exemption. Now the instructions to Form 1023 make clear that an LLC may file a Form 1023. Not all states have laws that allow organization as a nonprofit entity other than as a corporation.

1. **State Regulation of Charitable Solicitations and Fundraising –** Every state and the District of Columbia have laws regulating nonprofit organizations. Many states have laws that require licensing or registration of organizations engaged in charitable solicitation. Most of these state laws would seem to apply to internet solicitation through maintaining a website on which donors can contribute. Of the states that do require registration before charitable solicitation, many (but not all) expressly exempt organizations that have indicia of reliability such as educational institutions and religious organizations or exempt organizations whose solicitations do not result in contributions over a de minimus level. As a result of a project of the National Association of Attorneys General and the National Association of State Charities Officials, a Unified Registration Statement is available at http://www.multistatefiling.org/c_statement.htm.

D. **Income or Business Activity Taxes -**

1. **Federal Exemption Generally Recognized at State Level -** Most states exempt from business activity taxes an organization listed in IRC §401(a) or IRC§ 501 to the extent that the organization is exempt from federal income tax. Many states exempt by specific reference to the Internal Revenue Code and others have constitutional or legislative provisions which exempt nonprofit or charitable organizations (for example, Mississippi, Montana, New Jersey, Rhode Island, Texas and Vermont) without explicit reference to the Internal Revenue Code.

2. **Special Taxes Imposed on Certain Charitable or Public Benefit Providers -** Rhode Island applies a special surcharge on the service revenues of outpatient healthcare facilities including those operated by nonprofit or governmental entities and a special assessment certain

residential facilities providing services to disabled individuals and nursing facilities.

3. **UBTI –** Income that is substantially related to an organization's exempt function (or "exempt function income") is not taxed at the federal level even if such income is derived from the conduct of a trade or business and even if the conduct of a trade or business is a substantial part of the organization's activities. Most states tax nonprofit organizations on their UBTI or any other income that is not protected under IRC § 401(a) or IRC § 501. Some states (Delaware, Kentucky and New Jersey) do not tax UBTI or do not tax particular types of UBTI (Minnesota does not tax certain advertising revenue of (c)(4) organizations or certain charitable gaming revenues).

    a. **Louisiana –** The Louisiana Department of Revenue is now enforcing the statutory requirement that taxes be collected on unrelated business taxable income for tax periods beginning on and after January 1, 2008. La. Admin. Code §61:I.1140(B); Louisiana Revenue Bulletin 09-009 (Feb. 25, 2009). Prior to these effective dates, the Department did not enforce the statutory requirement and no return was available on which nonprofits could report their Louisiana UBTI. As a result of the change in position, nonprofit organizations must now register with the Department as an income only type filer and must file on Louisiana Corporate Income Tax Return (Form CIFT-620) and attach a special schedule according to instructions for its completion by nonprofit organizations.

4. **Tax Credits for Tax-Exempts** – Although it seems counterintuitive, occasionally nonprofit organizations may benefit from tax incentive legislation. The Louisiana Department of Revenue recently issued PLR 09-010 in which the Department confirmed that a refundable credit may provide an additional, previously overlooked, source of funding for nonprofit organizations developing musical and theatrical production facilities in the State. The PLR confirms that, although the nonprofit organization requesting the ruling has no corporate tax liability, the organization is nonetheless entitled to a refund of 25% of its qualified expenditures in excess of its nonexistent tax liability. The reasoning of the PLR may apply to other refundable corporate income and franchise tax credits for nonprofits engaged in non-entertainment related activities.

E. **Sales and Use Taxes –** All states that impose a sales/use type tax have some exemptions from tax for nonprofit organizations. These exemptions are liberally available in some states and limited in others. Most states that provide exemptions have statutes that exempt specific taxpayers or specific transactions. Typically, even where nonprofits are not exempt from tax on their own purchases, they may be able to engage in limited sales of tangible personal property or admissions to fundraising or cultural events or entertainment without being required to collect tax on these sales. Most states exempt sales of meals to patients and staff of hospitals as well as sales of certain medical supplies and equipment. Although many states have them, exemptions that are available only to churches and religious organizations may be vulnerable to constitutional challenges.

F. **Property Taxes –**

1. **Most States Exempt -** Many states (39) exempt property from ad valorem taxation if it is both owned and operated for charitable purposes. Some states (11) allow exemption where the property is operated for charitable purposes. No states allow exemption solely on the basis of nonprofit ownership. Seventeen states exempt a nonprofit from property taxes when leasing property belonging to a commercial entity.

2. **Exclusivity of Use and Bifurcation of Exemption -** States differ as to whether a property must be used exclusively for exempt purposes in order to enjoy exemption from property taxation. Some states allow it (example, South Dakota) and some don't (example, Louisiana). Thirty one states will separately assess the portion of a nonprofit's property that is used for for-profit purposes (such as when property is leased for related commercial use such as a daycare center in a hospital or physicians' offices).

3. **State and Local Revenue Loss Resulting from Exemptions for Nonprofits –** In these tough economic times, local governments (historically, the primary beneficiaries of property taxation) are increasingly scrutinizing nonprofit organizations and requiring such organizations to justify their entitlement to property tax exemption. In Orleans Parish, Louisiana, a 1996 study by the Bureau of Governmental Research estimated that the primary threat to the property tax base in Orleans Parish was that 65% of the exempt property on the rolls was owned by nonprofit and governmental entities resulting in the annual loss of $93 million in revenue. After factoring in the state homestead exemption, the bulk of the property tax burden was shown to be borne primarily by businesses and renters and small proportion of the remaining homeowners. A 2006 report by Harvey Lipman and published in the Chronicle of Philanthropy estimated that New York loses $605 million and Boston $258 million annually as a result of property tax exemptions afforded exempt entities.

4. **PILOT and SILOT Agreements –** In an effort to recover some of these tax losses, exempt organizations may nonetheless be required to enter into agreements with the local taxing authority to make "payments in lieu of taxes" or PILOTs. In other states, SILOTs or "services in lieu of taxes" are required.

G. **Interstate Issues –**

1. ***Board of Education v. Illinois,*** 203 U.S. 553 (1906) - Upheld a statute limiting a charitable deduction against state inheritance tax on the basis of where the charity was organized. The Court held that the deduction against Illinois inheritance tax for charitable contributions was not available for bequests to a KY charity. This was because the charter of the charity provided that its resources and activities only benefit KY residents and the charity, in fact, did no charitable work in Illinois.

2. ***WHYY, Inc., v. Borough of Glassboro*** **–** 393 US 117 (1968) - The Supreme Court held that state of incorporation was not a valid criteria on which to discriminate against an in-state charity and distinguished *BoE v. Illinois* on the ground that the charities in the latter case were not in a position to benefit state residents to the same extent as in-state charities. The taxpayer television station was a PA nonprofit corporation which had registered and qualified to do business in NJ. The taxpayer had a communications tower in NJ and broadcast to NJ residents as part of its activities. The taxpayer was denied a property tax exemption which, as a nonprofit organization, it would have qualified for if it had been a NJ nonprofit and so argued that it was being denied the equal protection of the law solely on the basis of its state of incorporation. The held that classifications based solely on the residence of the owner are not constitutionally permitted. A state may restrict entry of out-of-state corporations but once it has allowed them to enter, they are entitled to equal protection with in-state corporations, that is they are entitled to an equally favorable ad valorem tax base. The taxpayer need only show that it meets the requirements of NJ law.

3. ***Camps Newfound/Owatonna, Inc., v. Town of Harrison, ME*** **–** 520 US 564 (1997) **–** Taxpayer operated Christian Science camps and charged $400 a week. Property tax was applicable to all property in state but exempted nonprofit property operated for the benefit of residents. Nonprofits which operated for the benefit of nonresidents could still qualify if they charged less than $30 a person. The Supreme Court held the statute to be unconstitutional as violating the Commerce Clause because the consumers of the services were out-of-state residents and the campers were transported across state lines. The Court rejected the Town's argument that campers were not articles of commerce and that the services provided were exclusively in Maine. The Court noted that the Commerce Clause protects "commerce" here, even though the services are provided by a nonprofit. The nonprofit is both a consumer of goods and services and a seller of services. Also, nonprofits as a group have an unquestionably large impact on interstate commerce. No categorical exemption of nonprofits from the Commerce Clause. The refusal to grant an exemption is equivalent to an affirmative penalty. The tax falls in a predictably disproportionate manner on out-of-staters. It doesn't matter

that the tax falls on the camp rather than the campers, it impermissibly singles out interstate activity. Further, it doesn't matter that the cost is passed on to campers and there has been no showing that this discouraged attendance or that this camp didn't show that it lost campers to other camps with which it competed. Even if the effect was de minimis, no discrimination is permitted. The Town does not and cannot argue that the tax advances a legitimate local interest which cannot be resolved through nondiscriminatory means. This type of argument invites the strictest scrutiny. Maine certainly had alternatives if their goal was to encourage serving local children at Maine camps. They could have provided direct subsidies to the camps to the extent they serve Maine kids or sent the money directly to the parents of campers. Disparate treatment constitutes discrimination only if the objects of the discrimination are similarly situated, such as in this case. The Court also rejected arguments that the State was a "market participant" and that the exemption was the functional equivalent of a permissible subsidy.

II. Both the IRS and the States Have Increased Scrutiny of Tax-Exempt Organizations

A. **Increased Federal Scrutiny and Compliance Enforcement –** All tax exempt organizations are required to be organized and operated for public (rather than private) benefit in order to maintain tax exemption under section 501(c)(3) of the Internal Revenue Code. Failure to comply could result in revocation of an organization's tax-exempt status or imposition of sanctions with respect to specific transactions. State laws, although not uniform, generally grant tax exemption from income, property and/or sales/use taxes, to those organizations which are organized and operated for public benefit. In general, state "sanctions" for failure to operate for public purposes are more likely to be denial of exemption to the organization with respect to the type of tax at issue.

1. **Compensation Issues -** Unreasonable compensation for officers, directors, trustees or other insiders would constitute unacceptable private benefit under the Internal Revenue Code and related IRS rules and regulations. Excessive payment for goods or services in transactions involving related parties creates the same issues. Therefore, exempt organizations must be able to show that they pay compensation that is reasonable under the circumstances to "disqualified persons" or organization insiders who are persons in a position of substantial influence with respect to the organization. The Internal Revenue Code contains provisions allowing the IRS to impose "intermediate sanctions" or penalty excise taxes under IRC §4958 in situations in which "excess benefit" transactions are found to have occurred. Nevertheless, the IRS regulations also provide safe harbor procedures which an organization can follow to establish a rebuttable presumption that compensation is reasonable. Treas. Reg. §§53.4958-6, et seq.

2. **UBIT Issues –** An organization that (1) regularly carries on a (2) trade or business that is (3) not substantially related to its exempt purposes is taxable on the income from that activity. That is, If the nonexempt activity is substantial in relation to an organization's total activities, the organization may lose its exemption altogether. Although there is no hard and fast ratio for use in determining when UBTI will be considered substantial in relation to an organization's exempt function income, the presence of even one substantial nonexempt purpose is sufficient cause to deny or cause revocation of an organization's exemption. *Better Business Bureau v. United States*, 326 U.S. 279 (1945).

B. **New and Enhanced Sources of Publicly Available Information about Nonprofits –** Tax-exempt organizations are required to make public their application for exemption and their annual tax returns, including amended returns, and any schedules and attachments, under IRC §6104(d). The organization may make this information available strictly on request or by publishing it on a website. The tax returns of many nonprofit organizations are available on www.guidestar.org. The new Form 990, as discussed below, requires an organization to report information much more extensively than in the past. In addition, as a result of the 2006 Pension Protection Act, Forms 990T (disclosing UBTI) are now required to be made public. In addition, FIN 48 has created new disclosure requirements for tax-exempt organizations.

1. **New Form 990 Disclosures –** For most organizations, use of the new Form 990 is required for tax years beginning in 2008. The new form requires a taxpayer to outline in exhaustive detail various aspects of its organization and operation. The IRS has presented the new form as designed to increase transparency and assist in monitoring compliance (for the benefit of the IRS, donors to the organization and for the public, in general). The form also has the potential to educate organizations on the requirements for maintaining tax-exempt status.

a. **Changes to Information that Must be Disclosed Annually –** The new Form 990 changes the threshold amounts for reporting compensation which must now be reported on a calendar year basis. It also requires greater disclosure of disposition of assets and has added key employees to the list of persons who must be reported.

b. **Donor Information Not Required –** Although an organization is required to make its returns, including schedules and attachments, available to the public, exempt organizations other than private foundations are not required to disclose the names and addresses of contributors. Since this information is reported on Schedule B to the Form 990, it is important to make sure that the organization's staff knows that this information is to be redacted before the returns are provided to anyone requesting them.

c. **Schedule H for Hospitals** - The IRS has indicated that the new Schedule H will allow for a more accurate analysis of quantitative and qualitative community benefit information. The IRS will use this information to determine the correct set of expenditures that hospitals should report. The IRS will also be attempting to determine the extent to which bad debt, Medicare shortfalls, and community building should be considered when determining whether the organization has satisfied the community benefit standard.

2. **Form 990T Now Disclosable –** An exempt organization that receives gross income of $1,000 or more from all of its unrelated trades or businesses must report that income (all of its UBTI) and related expenses on one Form 990-T under IRC §512(b)(12). Until the Pension Protection Act of 2006, exempt organizations were not required to make their 990-T's available for public inspection. Charitable organizations, but not other types of exempt organizations, are now required to make their 990-T's available to the public. IRC §6104(d)(1)(A)(ii).

3. **FIN 48 –** Nonprofit organizations may be required to have audited financial statements in a number of situations including where the organization has issued tax-exempt bonds or if it receives federal funds or in those states in which organizations are required to register before making solicitations and must file audited financial statements as part of the registration process. In 2006, FASB released Interpretation No. 48 ("Accounting for Uncertainty in Income Taxes") or "FIN 48." This interpretation advanced the "More-Likely-Than-Not" recognition standard for identifying and reporting uncertain tax positions. Effective for tax years beginning after December 15, 2007, FIN 48 applies to nonprofit organizations. Any activity which would impact an organization's tax-exempt status would be significant for FIN 48 purposes including transactions that could be characterized as private inurement, payment of unreasonable compensation, lobbying or political expenditures or excessive UBTI.

a. **The Good News -** Fortunately, FIN 48 applies only to income tax liability and not property tax and sales tax exemptions or even employment taxes. (But note that FASB No. 5, Accounting for Contingencies, might apply.) It also would not seem to apply to intermediate sanctions which are excise taxes and not imposed on the organization.

i. **The Not-So-Good News -** While the prospect of intermediate sanctions does raise the possibility of private inurement issues, the IRS has indicated that it will pursue intermediate sanctions rather than revocation of exempt status as a general rule. Nevertheless, until the issue of whether the IRS will pursue private inurement theories with respect to excess benefit transactions is resolved, the issue may be sufficiently relevant to require disclosure.

b. **Schedule D, Part X of the New Form 990 –** The new Form 990 requires an organization to "Provide the text of the footnote to the organization's financial statements that reports the organization's liability for uncertain tax positions under FIN 48." Issues arise as to whether this constitutes a subject matter waiver for attorney-client privilege or if it impacts work product privilege. It will be important to watch the *Textron* decision in the First Circuit, which recently vacated its earlier decision dealing with the extent to which work product is protected in situations like this. State taxing authorities may be willing to pursue workpapers even where IRS has exercised restraint. In any event, since the Form 990 becomes a publicly available document, the disclosure of the tax risk, as required by FIN 48, becomes available to all.

4. **Disclosure by the IRS to State Tax Agencies –** The 2006 Pension Protection Act authorized the IRS to disclose to State taxing agencies certain proposed actions with respect to nonprofit organizations including when the IRS issues a notice of proposed deficiency with respect to certain taxes, a notice of proposed refusal to recognize exemption, a notice of proposed revocation of exemption and the names and identifying information of taxpayers who have applied for exemption as well as returns and return information for organizations to which any of the foregoing apply. IRC §6104(c)(2)(B).

III. **Areas in which State and Local Governments Have Begun to Question the Availability of Exemption for Nonprofit Organizations -** Although availability of any exemption might be in jeopardy, there appears to have been an increase in activity on the part of local governments questioning property tax exemptions afforded to nonprofit organizations. Organizations that, on the surface, appear to be competing with for-profit entities are particularly suspect. As a result, hospitals organized as nonprofits, affordable housing charities and (not surprisingly) business incubators have found themselves having to defend their right to exemption, particularly in the property tax area. As a related matter, nonprofit organizations including universities may receive assets by gift or bequest that are valuable but not directly related to their exempt function. Assessors have been challenging the ability of nonprofits to hold these assets for investment purposes as not sufficiently related to the organization's exempt mission.

A. **Healthcare Organizations –** Promotion of health is a recognized charitable purpose but is not by itself enough. *IHC Health Plans*.

1. **Nonprofit Hospitals** - The availability of exemption to nonprofit hospitals is based on the hospital's satisfaction of a facts and circumstances "community benefit" test. Under IRS Rev. Rul. 69-545 and subsequent rulings as fleshed out in the relevant jurisprudence, the IRS may look to the following factors when determining whether a nonprofit hospital meets the community benefit test:

    i. presence of a full-time emergency room open to all regardless of ability to pay;

    ii. providing hospital care for patients including those whose care is paid for by Medicare and Medicaid;

    iii. operating surplus devoted to exempt purposes such as improvements to the facilities, improving patient care, training and research;

    iv. providing educational programs to the public;

    v. actual adherence to an adequate conflict of interest policy;

    vi. having an open (privileges available to all qualified) medical staff consistent with the size and nature of the facility; and,

    vii. a majority independent board of directors including community members.

b. **IRS Hospitals Study –** The IRS recently released the results of a study it conducted of more than 500 nonprofit hospitals. The 191 page study, released February 12, 2009, focused on the community benefit and executive compensation practices of nonprofit hospitals. The IRS conducted this study by surveying hospitals on many issues now required to be disclosed on the new Form 990 and Schedule H (patient mix, emergency room information, board governance practices and policies, privileges of medical staff, the extent to which care is provided to the indigent, programs for the community, and other issues). The IRS found that there is a wide disparity in the amount of charity care and uncompensated care provided for by hospitals. Rural hospitals had the lowest rate of community-benefit expenditures as a percentage of revenues while the opposite was true for large urban hospitals. The study also found that most hospitals surveyed complied with the procedures for establishing a rebuttable presumption of reasonableness with respect to compensation including the use of comparable salary surveys and independence of the decision-makers.

c. **The State of California Conducted its Own Study -** The Board of Equalization of the State of California recently approved new reporting requirements for non-profit hospitals that will require them to provide data on charity care on a cost basis on the basis of a study conducted by the California State Auditor that did not find significant differences between the uncompensated-care costs for care provided by nonprofit and that provided by for-profit hospitals.

2. **State Scrutiny Has Been Steadily Increasing –**

a. **Legislation –** Utah, Pennsylvania, Texas, California and New York have all passed legislation aimed at quantifying and requiring community benefit or requiring planning and reporting of benefit to the community. Utah passed legislation that requires that hospitals make an annual gift to the community in excess of property tax exemption benefits. Massachusetts provisions are voluntary.

b. **Jurisprudence –**

i. ***HCPI Indiana, LLC v. Hamilton County Property Tax Assessment Board of Appeals***, No. 49T10-0604-TA-36, 2007 WL 1559294 (Ind. Tax Ct. May 31, 2007) (unpublished table decision) – The organization's property, the Methodist Medical Plaza of Carmel and a parking lot, was denied property tax exemption because the owner was unable to show that the property "was used more than 50% of the time (ie, predominantly) to educate medical students or to provide charitable health care." HCPI argued that the property was owned and used for charitable or educational purposes with respect to the 59% of the property that was leased to Clarian Health Partners, Inc., a nonprofit corporation, at below market rates. Clarian used the property to provide surgical and medical care, including free or reduced medical care to indigent patients and for providing medical students with a "experiential educational setting."

ii. ***Methodist Hospitals, Inc. v. Lake County Property Tax Assessment Board of Appeals***, 862 N.E.2d 335 (Ind. Tax. Ct.), *review denied*, 869 N.E.2d 456 (Ind. 2007) – Methodist Hospitals, a 501(c)(3) organization, appealed the denial of a charitable purposes exemption for two medical offices it owned and operated. Methodist also owned and operated two acute care hospitals. Methodist employees provided staffing and administrative services for all of the properties and, including billing and collections. The medical offices provided medical services to the general public and, although patients could be admitted to the acute care hospitals as needed, they would not ordinarily be sent from the hospitals to the medical service offices. The court denied the exemption on the ground that mere ownership of the medical offices by the exempt hospital was not enough. The court held that Hospitals was unable to show that the medical offices were "substantially related to or supportive of" the inpatient facilities as required by the relevant statutes. The court stated that it "will not [be] presume[d] that a substantial relationship or supportive network arises merely because two entities are engaged in the same type of business activity."

iii. ***McLaren Regional Medical Center v. City of Owosso***, 275 Mich.App. 401, 738 N.W.2d 777 (Mich. App., 2007) - Michigan Supreme Court overturned denial of property tax exemption holding that the exemption is based on analysis of the organization's charitable purpose and not on the basis of a threshold level of charity. Consolidated with *Wexford Medical Group v. City of Cadillac,* 713 N.W.2d 734, 474 Mich. 192 (MI 2006).

iv. ***Hotel Dieu v. Williams***, 410 So. 2d 1111 (La. 1982), was a case in which the Louisiana Supreme Court determined that a parking garage and medical office building, which contained a restaurant, were sufficiently related to the exempt purpose of a hospital operated by a nonprofit so as to be entitled to exemption under the State Constitution.

v. ***Provena Covenant Medical Center v. Department of Revenue of State***, App. 4 Dist. 2008, 323 Ill. Dec. 685, 384 Ill.App.3d 734, 894 N.E.2d 452, *appeal allowed,* 326 Ill.Dec. 879, 229 Ill.2d 694, 900 N.E.2d 1126 – The organization had great difficulty establishing that its primary purpose is charitable care in light of the fact that only .7% of its total revenue is devoted to charitable activities. The assessor argued that the operation of the property was commercial or businesslike and more characteristic of a business activity than a facility devoted to religious purposes.

B. **Affordable Housing and Elderly Residential and Assisted Living Charities –**

1. **Residential Charities for the Elderly** - Local governments have been increasingly challenging property tax exemptions and even sales tax exemptions for charities that provide housing for the elderly.

   a. ***New Orleans Towers Affordable Housing Corp., Inc. v. Kahn***, 744 So 2d 50 (La. Ct. App. 4th Cir. 1998), *aff'd on rehearing,* ___ So. 2d ___ (Jan. 29, 1999) - A federally tax-exempt nonprofit corporation was held to be entitled to the exemption over the City's objection that the property was making money and was competing with for-profit businesses for tenants and rents. The court cited IRS Rev. Rul. 67-138, 1967-1 CB 129, in support of its holding that providing adequate or affordable housing to low-income families was an acceptable charitable purpose. The court rejected the City's argument that the operation was a commercial enterprise operating "under the cloak of a nonprofit organization." The court held that the nonprofit corporation's receipt of federal rent subsidies and other funding was related to its charitable purpose of providing a home for persons who met low-income requirements. The court held that, as long as the corporation continued to operate consistent with its charitable purpose, then it was not operating as a commercial entity and it was entitled to the exemption.

   b. ***Pratt-Stanton Manor Corp. v. Parish of Orleans***, 821 So. 2d 748 (La. Ct. App. 4th Cir. 2002). An Orleans Parish assessor challenged the exempt status of another nonprofit-owned and operated complex. In the *Pratt-Stanton* case, all of the tenants were elderly and although they paid rents and could purchase additional services for a fee, their rents were subsidized by donations and an endowment. Other than being elderly, the tenants were not otherwise disadvantaged and appeared to be paying rents which were more than nominal. The court once again held that the property was exempt from taxation because it was organized and operated for charitable purposes and, although irrelevant, the court noted that the property was not making a profit.

   c. ***St. Joseph's Living Center, Inc. V. Town Of Windham***, 290 Conn 695, 966 A2d 188 (CT 2009) **–** The local assessor denied property tax exemption to a skilled nursing facility owned by a diocese of the Catholic church and developed with a for-profit partner who was bought out on the ground that the organization was not a public charity (it was covered by the blanket exemption granted the Catholic church but had not sought exemption on its own) and was not organized or operated exclusively for charitable purposes. The court found that the organizational documents reflected organization for a sufficient charitable purpose (the provision of healthcare to the elderly), that the organization, although profitable, was not impermissibly self-supporting and that the organization was providing a public benefit as a result of primarily treating patients covered by Medicare and Medicaid. Nevertheless, the organization was not allowed the exemption because the court found that its long-term chronic care services (a charitable purpose for which it was organized) were offered in a portion of the facility that was not physically separate from, and exclusively dedicated to, its short-term rehabilitative care operation (a charitable purpose not stated in its organizational documents). The court could not bifurcate the exemption between charitable and noncharitable uses of the subject property but suggested that the organization could modify its organizational documents so as to include the short-term rehabilitative use and thus be entitled to the exemption.

d. ***Brothers of Holy Cross, Inc. v. St. Joseph County Property Tax Assessment Board of Appeals***, 878 N.E.2d 548 (Ind. Tax Ct. 2007) - The Brothers of Holy Cross, Inc., were allowed only a 17% charitable purposes property tax exemption with respect to a retirement community that the religious organization owned and operated. The exemption was granted only with respect to the property's administrative center and the land itself on the ground that the property was not predominantly used for a charitable purpose.

e. ***Catholic Health Initiatives Colorado v. City of Pueblo, Dept. of Finance***, --- P.3d ----, 2009 WL 806827 (Colo.) – An organization exempt under 501(c)(3) and that was affiliated with the Catholic church, provided housing for the elderly. Although the organization was motivated by religious belief, the sales tax exemption was available to "charitable organizations" which were those certified as not-for-profit under the Internal Revenue Code and which were religious or charitable organization, and which "exclusively, and in a manner consistent with existing laws and for the benefit of an indefinite number of persons, freely and voluntarily ministers to the physical, mental or spiritual needs of persons, and which thereby lessens the burdens of government." The organization did not qualify for exemption because its ministry to the physical, mental, and spiritual needs of the residents was not exclusively free and voluntary, and so did not lessen the burden of government. Further, the organization's pricing and fee structure made the nature of the services provided transactional, rather than charitable. Finally, the organization provided "retirement lifestyle" housing to some elderly persons who were financially independent.

2. **Affordable Housing Charities –** In Louisiana and elsewhere, affordable housing projects and particularly mixed-income developments (that include units rented to tenants who do not strictly qualify as low income under federal guidelines) have been having their exemption for property taxes challenged.

   a. ***Whitten Foundation v. Granger***, 950 So.2d 720 (La. App. 1st Cir. 2006), *writ denied*, 948 So.2d 1080 (La. 2007) **–** The East Baton Rouge Parish assessor has been challenging tax exemption for all affordable housing charities in that parish. In *Whitten*, the assessor challenged the exemption for a nonprofit that operated an affordable housing facility resulted in an unnecessarily broadly worded opinion suggesting that, if rents were calculated based on commercially available rates, no exemption would be available. The opinion stated:

> There is no evidence in the record before us that the low-income tenants received any type of reduction [in rent] or benefits from [the nonprofit's] operation of the apartment complexes as a commercial operation. In fact, the joint stipulation indicates the low-income tenants are paying the same or comparable rates as any other commercially operated apartment complex in the Baton Rouge area. There is no question that Whitten qualifies as a non-profit corporation for the purposes of Section 501 of the Internal Revenue Code. However, Art. VII, § 21(B) of the Louisiana Constitution does not deal with income taxes. It addresses Louisiana ad valorem property taxes, which are separate and distinct from the Internal Revenue Code or the Louisiana Income Tax Laws. In addition to requiring that a corporation be organized as a non-profit corporation, Art. VII, § 21(B) of the Louisiana Constitution also requires that the corporation owner must operate exclusively for charitable purposes and that the property cannot be used for any commercial purpose unrelated to the exempt purposes of the corporation. Id. at 727.

      i. Although the First Circuit took the position that unless reduced rents were offered to low-income tenants the affordable housing complex could not qualify as exempt, reduced rents are not a requirement of the Louisiana Constitution.

3. **Carlton Cove Retirement Facilities –** An Alabama appellate court upheld the denial of property tax exemption to a public charity qualified under 501(c)(3) that provided senior living facilities because it held that the use of the property was not strictly charitable. Assistance to the "financially well-off" elderly was not considered sufficiently charitable under the circumstances.

4. **Tax-exempt Bonds Used in Developing Affordable Housing –** Tax-exempt bonds are valid debt obligations of state, local, or Indian tribal governments and the interest paid on these bonds is exempt as a matter of federal government policy not of right. *South Carolina v. Baker*, 485 US 505 (1988). Interest on these bonds will remain exempt for the life of the bonds if all applicable federal tax laws are satisfied. The Internal Revenue Code imposes various requirements on the issuers of these bonds as well as various restrictions including restrictions against issuing bonds for the purpose of earning arbitrage profits or for the benefit of private persons. Information filing requirements apply. Tax-exempt bonds are frequently used in deals to develop affordable housing. As is the situation with a nonprofit's determination of tax-exemption under the Internal Revenue Code, the fact that a project has been financed with tax-exempt bonds (and that there are numerous restrictions on the use of the property under trust indentures and covenants as to land use filed in the public records), this fact alone does not guarantee tax-exempt status.

C. **Property Owned by Economic Development Entities –** Localities may be authorized to create economic development boards which hold title to property for the purpose of economic development. Developers invest their own money or locate investors and lease the property under a lease to own agreement and develop the property. Sometimes the projects are funded through the use of tax increment financing. Nonprofits may or may not be involved. Exemption in this situation is available on the basis of the ownership of the property by a quasi-governmental entity. This is a situation in which PILOT agreements are frequently used in this situation to create payments in lieu of taxes but which are typically less than the taxes would be if the property were owned directly by the developer. In Louisiana, the relevant statutory provision that authorize a "payments in lieu of [ad valorem] taxes" agreement, is La. Rev. Stat. §51:1160 which provides that, because a municipal and parish industrial development board corporation (an exempt entity created to promote state industry and trade and performing a quasi-governmental function), does not pay tax, it may require the lessee of one of its projects to pay annually a sum equal to, and in lieu of, all ad valorem taxes that would be due if the lessee itself were the owner of project. In order for the property to enjoy exemption as property of an IDB, it must be "properly titled" in the IDB and, if so, may be leased to a "developer or other private user" and still be exempt from ad valorem taxation. See La. Atty Gen. Opin. 06-0047 (Sept. 15, 2006).

D. **Fraternal Organizations** -

1. ***United Ancient Order of Druids-Grove #29 v. Wayne County Property Tax Assessment Board of Appeals***, No. 49T10-0406-TA-25, 2007 WL 1439560 (Ind. Tax Ct. May 17, 2007) (unpublished table decision) - The UAOD, an Indiana not-for-profit corporation, argued that it was entitled to a property tax exemption as a fraternal beneficiary association under I.C. §6-1.1-10-23. The organization argued that its property as used for

charitable fundraising and for providing members with meals and private social events. The exemption was denied on the ground that the organization did not have a representative form of government because neither a supreme governing body nor a board of directors elected the organization's officers, rather the officers were elected by local members, and officer positions were not exclusive to benefit members. The UAOD countered that this argument glorified form over substance and misread legislative intent. The court disagreed, holding that the relevant statute, I.C. § 27-11-2-2(2), was clear and unambiguous and specifically defined a representative form of government as being elected by the supreme governing body or the board of directors.

2. ***Sherwood Forest Country Club v. Litchfield***, 998 So. 2d 56 (La. 2008), *on reh'g in part*, 2008-194 La. 2/13/09, 2009 WL 353296 (La. 2009) – the Louisiana Supreme Court held that a country club was not organized and operated exclusively for fraternal purposes under La. Const., Art. 7, § 21, and so was not entitled to exemption from property taxes exemption as the exemption from ad valorem property taxes provided in La. Const. art. VII, § 21(B)(1)(a)(i) to nonprofit corporations "organized and operated exclusively for religious, dedicated places of burial, charitable, health, welfare, fraternal, or educational purposes" implicitly recognizes the quid pro quo of an exchange of a property tax exemption for the public benefits provided by the listed organizations. The court held that, although the word "fraternal" can be defined broadly, it is only on the theory that fraternal acts alleviate the burdens of government that a tax exemption for fraternal purposes can be justified. In general, no exemption is available for property primarily for social or recreational purposes, even if that property is owned by a fraternal organization. The court distinguished exemption for income tax purposes from exemption for property tax purposes by quoting *McGlotten v. Connally*, 338 F.Supp. 448, 458 (D.D.C.1972):

> "Congress has determined that in a situation where individuals have banded together to provide recreational facilities on a mutual basis, it would be conceptually erroneous to impose a tax on the organization as a separate entity. The funds exempted are received only from the members and any "profit" which results from overcharging for the use of the facilities still belongs to the same members. No income of the sort usually taxed has been generated; the money has simply been shifted from one pocket to another, both within the same pair of pants." [Accordingly,] The rationale for granting an income tax exemption to a club such as Sherwood Forest because the club's revenues from its members have already been taxed does not support the granting of a property tax exemption. The country club members, by the payment of dues to the club, would be enjoying the pool and tennis courts without the burden of paying ad valorem taxes. However, if any member built

a swimming pool or a tennis court at his or her own home, these amenities would be considered in the property tax assessment of the home. Thus, to grant to a private club a property tax exemption on its club house, grounds, swimming pool, tennis courts, and golf course is to allow its members to enjoy tax-free amenities. If the property tax exemption were granted, it could not be said that the club members are merely shifting resources that have already borne their tax burden.

3. ***Metairie Country Club v. Louisiana Tax Commission***, 860 So.2d 165 (La. Ct. App. 5th Cir., 2003), *writ den*. 865 So.2d 728 (La., 2004) – The Louisiana Supreme denied writs in a case involving an assessor's challenge to the property tax exemption of a country club on the grounds of a private inurement argument. The assessor's arguments that the members dues increased when its revenues were down so that when revenues were up and members paid lower dues, the organizations earnings were inuring to the benefit of the private individual members, were rejected. The assessor also argued that on dissolution, the members would have access to the assets of the club.