

Challenges to Local Property Tax Exemptions

Likely to Increase as State and Local Budgets are Squeezed



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Not-for-profit hospitals were quite literally a front-page story during 2004. This fact likely caused many to instinctively adopt a practice followed by Thomas Jefferson, who reportedly said, “I do not take a single newspaper, nor read one a month, and I feel myself infinitely the happier for it.” Unfortunately, not reading the news didn’t make the very real challenges faced by not-for-profit hospitals and health systems during 2004 disappear, and 2005 isn’t likely to make us any happier.

From the revocation of the local tax exemption of Provena Covenant Medical Center in February, to the filing of class action lawsuits against hundreds of not-for-profit hospitals, to hearings held by the Senate Finance Committee and the House Ways and Means Committee in June, to the announcement in August of an aggressive IRS enforcement initiative targeting executive compensation, a number of developments placed not-for-profit hospitals squarely in the spotlight during 2004, and intensified the operational pressures already felt by many due to the need for additional capital, ever-increasing malpractice premiums, and changing corporate governance standards.

These challenges, among others, are certain to remain in 2005. Worse yet, we expect challenges to valuable local property tax exemptions to become more common in 2005 and beyond as cities are forced to seek new sources of revenue to offset dramatic reductions in support historically received from the federal and state governments. The amounts at issue are not insignificant.

Ironically, we believe these local challenges will be intensified, as the number of uninsured who rely on not-for-profit hospitals for care will significantly increase. The budget proposed by President Bush in early February would, if enacted, reduce federal payments to the states under the Medicaid program by approximately \$60 billion over the next decade. Additional burdens would also be shifted to states and cities. According to the National League of Cities, the proposed budget would eliminate “key city priorities, including Community Development Block Grants, COPS, and Law Enforcement Block Grants...” The League also points to proposed cuts to the much-heralded Homeland Security First Responder Program to illustrate just how dire economic circumstances have become. Others share this pessimistic view. According to the National Conference of State Legislatures, “the administration’s budget proposal would further exacerbate the level of unfunded mandates and shift costs to state

and local government,” and “would merely export the federal deficit to the states.” This begs a question: how will states and cities fund necessary programs in light of these proposed cuts and their existing budget deficits?

Local governments are heavily dependent on property tax revenue. It isn’t difficult to imagine, therefore, that many local governments will seek to enhance revenues by revoking the property tax exemptions of not-for-profit hospitals and health systems—especially as to real property not directly used to accomplish the core, charitable mission of these hospitals and health systems. Short of direct challenges, tax-exempt hospitals should also expect to be asked to make “voluntary” payments in lieu of the taxes (PILOT). New Haven, Connecticut is said to be currently seeking up to \$6 million in voluntary PILOTs from Yale

University and other local not-for-profits. In addition, we are familiar with a recent situation in which a county required a PILOT as a condition to its approval of an acquisition of a for-profit hospital by its own county hospital.

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Statutory interpretation may play a significant role in these efforts, especially given the limited state law guidance. Specifically, under the Internal Revenue Code and related regulations and case law, the “community benefit standard” is applied to determine whether a public charity is operating “exclusively for charitable purposes” as required by Section 501(c)(3). As a general matter, however, an organization’s tax-exempt status will not be questioned if it is operated primarily for charitable purposes. In other words, the community benefit standard does not require a strict reading of the statute (that a charity act *exclusively* for charitable purposes)—some unrelated activities are permissible.

Although state and local governments have generally deferred to the tax-exempt determinations made by the IRS, they are not prohibited (or preempted) from applying a more stringent standard when state and local tax exemptions are considered. Some states and cities have started to strictly apply the statutory language to revoke tax exemptions because an organization is not operated *exclusively* for charitable purposes.

As communities become more desperate for increased or new sources of revenue, state and local governments will be, we believe, uniquely incentivized to adopt or apply more rigorous standards when considering property tax exemptions. For many reasons, we hope this conclusion is proven inaccurate. Based on the fiscal crisis that our federal, state, and local governments face, however, we have our doubts.

The Governance Institute thanks Paul D. Gilbert, a member of Waller Lansden Dortch & Davis, PLLC, for contributing this article. He can be reached at paul.gilbert@wallerlaw.com.