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Recent Policy Changes Affecting Property Tax Exemptions

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MEMORANDUM

To: Not-For-Profit Clients Owning Illinois Real Estate

Re: Recent Policy Changes Affecting Property Tax Exemptions

A. Introduction

Many nonprofit organizations have long enjoyed broad entitlement to property tax exemptions under Illinois law, such as for religious programs, educational activities, traditional social services, and other charitable programs. The current trend at the Illinois Department of Revenue (DOR) – the government agency charged with approving and monitoring such exemptions -- is increasing scrutiny of programs that charge fees, programs receiving significant government funding, child care centers, property used for more than one type of exempt use or by more than one user, and other novel or innovative programs. The Illinois Supreme Court recently affirmed this restrictive view in the landmark case of *Provena Covenant Medical Center v. Department of Revenue*, decided on March 18, 2010.

This constrained view appears to be based on a perception of abuse within the nonprofit sector and concern that nonprofits are operating more like commercial ventures, that is, with an impermissible "view to profit." There also appears to be a growing public antipathy toward the concept of tax-exempt property when used in a manner that competes with taxable commercial interests. Accordingly, nonprofit organizations with changing property uses or newly acquired property must be cognizant of these trends. This memorandum provides background information on property tax exemptions, analyzes exemptions in light of recent policy changes and court decisions, and provides specific recommendations to nonprofit organizations.

B. Exemption Qualifications

1. Exclusivity Requirement

To qualify for property tax exemption, Illinois law requires that the property be used "exclusively" for exempt purposes. This term has long been interpreted as "primarily" for exempt purposes. Accordingly, if a nonprofit wants to operate or allow a program that does not qualify for property tax exemption, such activity will be permissible so long as it is only "incidental" or secondary."

If the nonprofit allows non-exempt uses of its property to the extent that one cannot reasonably say it is "exclusively" used for exempt purposes, then the nonprofit may lose its entire property tax exemption. For example, if a nonprofit allows patrons from nearby stores to use its parking lot without any physical restrictions, then the nonprofit may lose its entire exemption for the parking lot. On the other hand, if the nonprofit allows such usage but chains off or otherwise separates certain parking spaces for the patrons' use, then only those rented parking spaces may be subject to property tax and the rest of the parking lot should remain exempt. Likewise, if a nonprofit regularly allows others to use its facilities for private events, then the nonprofit's exemption for the entire facility may be at risk.

2. Prohibited "View to Profit"

A key consideration in exemption analysis is whether an organization is operating with a "view to profit," which is incompatible with property tax exemption principles. Accordingly, to the extent a nonprofit operates like a commercial venture -- charging fees, rejecting those who cannot afford the fees, using collection agencies, and competing with the commercial sector in offering similar services – it risks losing its property tax exemption. While a nonprofit may not intend any prohibited "view to profit" by its activities, it nevertheless may face significant legal expenses to challenge and disprove the DOR's contrary perception. Consequently, novel fund-raising ideas and new social service programs may seem appealing, and they may well be worthwhile methods to advance the organization's goals, but their impact on the organization's property tax exemption deserves careful prior evaluation.

In the recently decided *Provena* case, the hospital had significant problems under this factor that serve as a clear warning of what **not** to do with nonprofit financial practices. Among other things, the hospital initially charged all users the same high established rates, used collection agencies, made a profit from later discounted rates, did not advertise charity care, and relied almost exclusively on fees from patients, private insurance, and public insurance (i.e., Medicare and Medicaid) for its revenues instead of charitable contributions. In short, as the Illinois Supreme Court determined, the hospital acted like a for-profit commercial venture and therefore was ultimately denied the privilege of property tax exemption.

C. Exemption Categories

The Illinois Property Tax Code provides for several statutory categories of exemption. The three most relevant to this memorandum are religious, educational, and charitable.

1. Religious Exemption

Churches generally qualify for religious exemption based on their worship and related religious activities. In addition, church-operated elementary and secondary schools may qualify under either the religious or educational exemption depending on how they are organized and

operated. (Churches also may qualify under the charitable exemption for certain programs that are primarily aimed at serving social needs, particularly if the programs operate within a separately incorporated organization.)

Property tax exemption is available to churches in a variety of other circumstances, including property development, recreational use, and parsonages. For property development, it is critical that sufficient documentation is available (e.g., permits, plans, photos) to show that such development is actively being carried out at all times. Churches' recreational activities may qualify for religious exemption, but they must be conducted regularly and be directly related to religious purposes (e.g., church-wide picnics, evangelism, prayer walks, youth ministry activities, etc.). Parsonage tax exemptions are available so long as the property is occupied by a pastor who performs "religious-related activities" as a condition of employment. Church-owned real estate may also be exempt if used for church parking or storage of church-related property.

2. Educational Qualifications

By statutory definition, a school that owns and uses property exclusively for "educational" purposes qualifies for exemption. This is a fairly straightforward category, and schools routinely can obtain exemption simply by showing their status as a school, their ownership of the subject property, and their exclusive use of all the property for educational purposes. The term "school" narrowly connotes a program with regular faculty, curriculum, student body and classrooms. Self--improvement courses, adult education schools and programs that focus on a specific skill set often do not qualify as "educational" for purposes of property tax exemption.

3. A Note on Child Care Centers and Preschools

Neither the religious nor the educational exemption category includes child care centers or preschools. The law defines "educational" as encompassing only education that relieves a government burden (e.g., grammar school). Thus far, Illinois courts have rejected arguments that child care centers and preschools, despite their educational components and recognized societal value, relieve any government burden. Although Illinois religious organizations with such programs – particularly preschools -- have historically qualified for exemption, the DOR has become much more hostile to applications involving preschools and child care, especially when fees are charged.

Alternatively, one could argue that child care centers and preschools run by religious organizations qualify under Illinois' religious property tax exemption statute, but unfortunately the DOR has disagreed. Most recently, in an appeal involving a new church-run child care center and preschool, the DOR approved the hearing officer's finding that the church's program was not "primarily" for religious purposes and therefore was not a qualified religious use. The hearing officer rejected such religious qualification despite extensive evidence showing that the program was an integral part of the church's outreach ministry and had a strong religious focus in caring for the children.

4. Charitable Exemptions

While many nonprofits operate preschools, day care centers, and other social service programs out of religious convictions, the DOR does not grant religious or educational exemptions for them. Accordingly, organizations seeking exemption for these activities most likely will need to base their exemption applications on the charitable exemption category.

a. Six-Factor Test for Charitable Exemption

In 1968, the Illinois Supreme Court established a six-factor test for charitable property tax exemptions, to be applied based on the particular facts and circumstances of each case. See Methodist Old Peoples Home v. Korzen, 39 Ill. 2d 149, 157, 233 N.E.2d 537, 541-42 (1968). Specifically, an applicant must show the following:

(1) the benefits derived are for an indefinite number of persons;

(2) the organization has no capital, capital stock or shareholders, and earns no profits or dividends;

(3) the organization derives its funds mainly from public and private charity and holds them in trust for the objects;

(4) the organization dispenses charity to all who need and apply for it;

(5) the organization 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; and

(6) the organization actually and exclusively uses the property for charitable purposes.

In applying these factors on a case by case basis, hearing officers and courts have discretion regarding the weight to accord each factor. No one factor is determinative. Furthermore, under Illinois constitutional and statutory tax principles, these factors are to be construed strictly against the applicant taxpayer.

Many nonprofit organizations presume that their programs qualify for charitable tax exemption simply because of the organization's tax-exempt status. But that, alone, is insufficient. Both the organization and its actual property use must satisfy the above six-factor test. Most notably, the applicant organization must show that its program is not operated with a "view to profit," that no obstacles exist to the applicant's participants, and that the property is actually used for charitable purposes. With careful planning and evaluation, organizations can determine whether and how they can meet these factors to best plan for successful exemption applications.

b. "Charity" Defined

i. History and Current Trends

The aim of the above six-factor test is to determine whether, in fact, an organization and its property use are "charitable." More than one hundred years ago, the Illinois Supreme Court defined the term "charity" as follows:

> A charity, in a legal sense, may be more fully defined as a gift, to be applied consistently with existing laws, *for the benefit of an indefinite number of persons,* either by bringing their hearts under the influence of education or religion, by relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves for life, or by erecting or maintaining public buildings or works, or *otherwise lessening the burdens of government.*

Crerar v. Williams, 145 Ill. 625, 34 N.E.2d 467 (1893) (quoting *Jackson v. Phillips*, 96 Mass. 539, 556 (1867)).

Consistent with recent scrutiny of hospitals and other large nonprofit entities, the DOR has recently been defining the term "charity" more narrowly, thereby raising significant policy concerns as to what really constitutes "charity." The DOR has also been suspicious of potential charitable abuses and more critical of many charitable operations, particularly those with some apparent commercial viability. The Illinois Supreme Court's recent *Provena* decision exemplifies this narrow definition of "charity."

ii. Lessons from *Provena*

First, agreeing with the basic definition enunciated in *Crerar*, some of the justices in *Provena* went even further and required "relief of government burdens" for charitable tax exemption:

> While Illinois law has never required that there be a direct, dollar-for-dollar correlation between the value of the tax exemption and the value of the goods or services provided by the charity, it is a *sine qua non* of charitable status that those seeking a charitable exemption be able to demonstrate that their activities will help alleviate some financial burden incurred by the affected taxing bodies in performing their governmental functions.

Slip op. at 20. A dissenting justice clarified, however, that under Illinois law relief of government burden is an underlying policy rationale for tax exemption, not a condition of charitable status. *Id.* at 36. This apparent disagreement should not be ignored: to the extent possible, all organizations seeking charitable exemption should seek to demonstrate how they relieve government burdens – and more specifically the better – in providing their services on the subject properties.

Second, the *Provena* court rejected the argument that providing health services through Medicaid and Medicare is not "charity" and instead determined that such services are offered solely in exchange for compensation received, even though the payments received do not cover the full costs of care. *Id.* at 21-22, 25. This ruling serves as a clear warning for organizations that rely substantially on government contractual funding for their programs: property tax exemption will now be more difficult to obtain. To the extent possible, such organizations should seek to increase both their gifts, grants, and other contributions as sources of funding and their provision of free and/or substantially discounted services.

Third, and on a related matter, some of the justices in *Provena* concluded that charitable use did not exist because only a *de minimus* amount of free or deeply discounted medical services were provided. *Id.* at 21. The dissenting justices strongly disagree with this quantitative approach: "By imposing a quantum of care requirement and monetary threshold, the plurality is injecting itself into matters best left to the legislature." *Id*. at 33. In other words, the question arises of "how much free care is enough?" The *Provena* court left this question unanswered, but at least a plurality of justices (3 out of 7, with 2 justices not participating in the decision) found it very relevant to the determination of charitable property tax exemption.

Some aspects of the *Provena* decision are arguably confined to the realm of hospitals and other health care providers. But the question -- "What is charity?" -- is clearly affected by this landmark decision, and nonprofits organizations can be expected to justify their requests for charitable tax exemption within these newly constrained parameters.

c. Guidelines for Satisfying the Six-Factor Charitable Exemption Test

As demonstrated from the above information, no charitable exemption should be sought without careful planning and, as necessary and appropriate, revision of corporate documents and organizational policies. Failure to take these measures may be fatal to an exemption application, resulting in unanticipated property tax liability and costly legal expenses to challenge the DOR on appeal. To satisfy the six-factor test for charitable exemptions, and to avoid unnecessary complexity, delay, and even exemption denial, nonprofit organizations should comply with the following recommendations.

1. The organization should have a well-written mission plan that articulates the religious and/or charitable goals to be implemented through any property acquisition and consequent program development (e.g., to spread religious beliefs, to provide outreach opportunities, to serve as worship facilities, and to encourage congregational growth).

2. If the organization has a religious purpose, its programs should have strong and clearly evident religious aspects.

3. If fees are charged, the organization's bylaws should explicitly state that no one will be denied services for financial inability to pay fees. This and the following

recommendations regarding fees address the above factors requiring that charity is dispensed to all without obstacles.

4. The organization should also have a well-publicized, Board-approved financial assistance policy that (a) sets forth eligibility criteria, and (b) explicitly states that no one will be denied services for financial inability to pay fees.

5. The organization should structure any program fees to not be "commercial" in nature (e.g., below market rates, no late fees, no collection activities). The more a program looks like it is operated "with a view to profit," the more likely it is that exemption will be denied or lost.

6. To the extent possible and practicable, the organization's programming should not rely primarily on fee revenue. Ideally, the program should have extensive charitable funding through organizational contributions, individual contributions, foundation grants, and other donations. This will help satisfy the requirement for charitable exemption that its activities are funded "mainly" by charitable contributions. With respect to organizations receiving significant direct government program funding, the DOR's current view – as upheld by a plurality of Illinois Supreme Court justices in the *Provena* decision – is that such funding does not constitute the requisite "charitable contributions" but rather is more in the nature of a "business contract" devoid of any charitable nature.

7. In charging fees, the organization should allow for fee waivers and reductions that are actively used, documented, and publicized (e.g., through parent handbooks, informational brochures, posted notices, and website information).

8. Additionally, it is essential that financial assistance applications be readily available and used.

9. Fee waivers and reductions should be based on evaluation of the participants' ability to pay, not just on their income or on the cost of services provided.

10. The organization should establish a charitable fund for fee waivers and reductions, and document its funding and use.

11. The organization should document and keep track of all fee waiver/reduction applicants, the amounts given, and the amounts waived.

12. Ideally, before applying for any charitable property tax exemption, the organization should have some fee waivers and reductions already granted, to establish a track record of charitable services.

13. To the extent possible, the organization should articulate how its programs and use

of the subject property relieve burdens of government (e.g., through social services that reduce homelessness and violence, through enrichment activities that alleviate juvenile delinquency, or through programs that enable adults to find gainful employment).

D. Space-Sharing Arrangements and Property Tax Exemption

As an exercise of good stewardship, to promote mutual ministry goals, or for other reasons, a nonprofit owner may allow another organization or group to use its facility as a regular guest. Such use should not, however, be allowed to jeopardize the property's tax-exempt status or to pose any undue risk to the owner. Accordingly, and to avoid any appearance of a "view to profit", the owner should have a written space-sharing agreement (*not* a commercial lease) that specifies the amount of financial contribution (not rent) to be paid to help cover property-related costs. These costs may include mortgage service, utilities, ordinary wear and tear, landscaping, cleaning, security, and depreciation. In addition, the agreement should address the times of usage, rules governing such use, insurance requirements and indemnification, and termination of use. To help support the exemption qualification, the space-sharing agreement should also articulate the parties' mutual religious, educational, and/or charitable goals for space usage. The owner should carefully investigate potential guests to ensure that their activities qualify for property tax exemption, including review of their corporate documents, policies regarding fees, and their activities.

E. Exemption Application Process

Property tax exemptions may be obtained through an administrative filing process. Having legal counsel prepare, submit, and follow through on applications is generally recommended. New owners of previously exempt property must apply in their own right for property exemption. The county Boards of Review may well issue tax bills to unsuspecting new nonprofit owners who are unaware of their obligation to file new applications. Although refunds are available for up to three years' back taxes, the property tax bills will have to be paid while such exemption applications are pending.

Exemption applications should contain the following materials. First, all corporate documents must be in proper order. The applicant's articles of incorporation and bylaws must set forth qualified tax-exempt purposes and specify that no stock ownership exists. In addition, the bylaws may need to include fee waiver language if a charitable exemption is involved. Organizations other than religious worship organizations generally must submit an IRS §501(c)(3) determination letter. The applicant organization should also have a sales tax exemption letter, which is also very helpful because the DOR approves both sales and property tax exemptions. A supporting affidavit should be submitted as well, describing the organization, its activities, and the property use. If the applicant allows other persons or organizations to regularly use the property, then additional similar documentation should be submitted showing that these other parties' property uses are consistent with property tax exemption.

Exemption applications are submitted to local County Boards of Review, and they are then reviewed by both the local Boards and the DOR. If the application provides sufficient information

to demonstrate qualification for exemption, it should be approved. If the initial application is denied, however, then the applicant organization must proceed to an administrative appeal, involving settlement negotiations and an evidentiary hearing if no settlement can be reached, and subsequent potential court appeals.

After exemption is successfully obtained, all nonprofit organizations except religious worship organizations must file annual certifications with the County Assessor's office in order to maintain their property tax exemptions. Our office is aware that some County Assessor offices routinely send annual certification forms to all exempt owners including religious worship owners. However, religious owners are required to file these forms only in the event of significant property use changes.

F. Conclusion

The legal landscape for property tax exemptions has changed significantly in recent years, resulting most notably in more restrictive administrative and judicial interpretations of previously unquestioned charitable and religious exemptions. Accordingly, nonprofit organizations – particularly those with fee-based programs – should proceed carefully, plan wisely, and evaluate the above considerations in light of their overall mission, the law, and other practical considerations.

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