

# The Charitable Property Tax-Exemption Debate

*The financial crisis has affected public-sector and nonprofit relations in one city, which has taken an age-old debate nationwide.*

by Kevin Kearns, Jonathan Livingston, and Christine Waller

**F**OR LOCAL GOVERNMENTS ACROSS THE COUNTRY, real estate property taxes are an important source of revenue. Charitable organizations that do not pay property taxes create special budgetary challenges for municipalities with large land-owning nonprofits, such as universities and hospitals. Recently, Pittsburgh, Pennsylvania, has become the epicenter of heated debate on how local government should face this challenge amid serious fiscal distress.

Southwestern Pennsylvania's large nonprofit sector is concentrated especially within the boundaries of the city of Pittsburgh. Estimates suggest that 35 percent to 40 percent of Pittsburgh's property is not taxable. Although the land is owned mostly by federal, state, and local governments, nonprofits

also own a significant portion of this nontaxable property. Thus, as local taxing jurisdictions have challenged charitable property tax exemptions on legal grounds, imposed municipal service fees, or asked nonprofit institutions to voluntarily contribute to public coffers through payments in lieu of taxes (PILOTs), tensions have mounted.

During the summer and fall of 2009, the debate gained significant momentum, as city and county officials floated—and now have tabled—various increasingly harsh proposals, including levying additional taxes on nonprofit payrolls, fees on hospital patients, service fees on dormitory rooms, a service fee on nonprofit property calculated by square footage, and, finally, a “fair share” tax on students.

Conflict over property tax exemptions is nothing new in Pennsylvania. Prior to 1997, the property tax exemption for Pennsylvania nonprofits was governed by a Pennsylvania Supreme Court case interpreting the state constitution's exemption from property taxes for “organizations of purely public charity.” *Hospital Utilization Project v. Commonwealth* established a five-part definition of a purely public charity that was so stringent that many nonprofits worried

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**KEVIN KEARNS** is a professor of public and nonprofit management in the Graduate School of Public and International Affairs at the University of Pittsburgh and is the director of the Johnson Institute for Responsible Leadership. **JONATHAN LIVINGSTON** is a doctoral student in the Graduate School of Public and International Affairs at the University of Pittsburgh. **CHRISTINE WALLER** is a master's student in the Graduate School of Public and International Affairs at the University of Pittsburgh.

that if required to do so in court, they could not meet the test. Emboldened by the case law, local governments in Pittsburgh and Philadelphia extracted significant concessions from large nonprofit institutions, especially hospitals and universities, often via contentious negotiations and thinly veiled threats.

Act 55 of 1997 softened the definition of a purely public charity and explicitly exempted nonprofit hospitals and universities. With the passage of Act 55, local taxing jurisdictions in Pennsylvania were forced to be less confrontational. In Pittsburgh, this took the form of a roundtable of nonprofit and government leaders, which negotiated a lump-sum payment from the nonprofits to the city of Pittsburgh. But contributions from the roundtable of nonprofits never met the expectations of city officials, resulting in a series of claims and counter-claims about broken promises. But since the economic collapse of 2008, as all parties began to feel the effects of the crisis, rancor increased. Nonprofits claimed that they could no longer afford the level of voluntary payments they had made in the past, while the city claimed that it needed even more contributions to meet its obligations.

In 2007 the major health-care system in the region broke ranks with the roundtable and established its own corporate social-responsibility initiative: a fund to provide partial college scholarships to any student who graduated from the troubled Pittsburgh public-school district. Meanwhile, the same health-care system incurred public criticism for appearing to operate as an aggressively competitive business rather than a charitable organization and for closing a hospital that serves a poor community.

### **An Arcane Revenue Structure**

Amid the increasingly dysfunctional discourse, the Johnson Institute for Responsible Leadership, a program of the Graduate School of Public and International Affairs at the University of Pittsburgh, convened a forum of local and national experts on November 6, 2009.

The panel experts forged a balanced dialogue on a divisive issue, exploring the historical context that frames the current debate in

Pittsburgh and around the country. Along with issues of accountability and ethics for nonprofit institutions and municipal governments, legal precedents were discussed. Those at the forum agreed that a structured and civil dialogue would align different sectors in creating a solution that must be reached at the state level.

Panel expert Woods Bowman identified one of the major difficulties in addressing the issue: we are “trying to solve twentieth-century problems with a nineteenth-century revenue structure,” Bowman noted.

Echoing Bowman’s sentiment, Sabina Deitrick stressed that the “bell towers of the universities have replaced the smoke stacks of the cities as the driving forces in Pittsburgh’s economy.” She emphasized that outmoded municipal tax structures simply do not work today.

Offering possible solutions, James Turner referenced the state of Connecticut as a potential model. In 2008, Connecticut reimbursed local governments with \$120 million to account for tax-exempt value not paid by nonprofits. But getting Pennsylvania to consider such measures will require considerable reformation of existing state procedures.

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Historically, diverse groups of institutions have worked toward structured solutions to these kinds of problems. When local groups come together and put pressure on the state, the state government will respond, Turner noted.

### **Community Implications**

Despite an unambiguous Pennsylvania law about the rights and privileges of nonprofit property owners, local taxing jurisdictions continue to press for concessions and threaten to circumvent existing law. Minnesota went through a similar battle in 2008, ultimately requiring the legislature to adopt a new definition of “organizations of purely public charity,” with the final support of nonprofits, local assessors, and the state’s Department of Revenue. While still unfolding, the Pittsburgh example offers important lessons for other communities that have struggled to reconcile

# Charity Begins at Home

By Woods Bowman

Should nonprofit organizations pay their fair share to support local government services and school districts? This is a loaded question, but this is precisely how local public officials seeking to extract money from nonprofits by special taxes or “voluntary” payment frame the property tax-exemption issue.

Lost in the debate are a few key facts. Most exempt property is government owned. Oops, let’s revise that statement: most nonprofit exempt property is owned by churches. Oops, again: these churches are seemingly untouchable. Beyond these institutions, universities, hospitals, and cultural institutions own the most property, but the most recent adverse court ruling on the tax exemption issue was against a Minnesota day-care center. It is entirely conceivable that property taxes would eat up more of a day-care center’s budget than they would the budgets of big institutions.

In most states, tax law invokes the concept of charity as the basis for deserving exemption, and courts have created convoluted and inconsistent multipart tests to define it. Whether intentional or not, these jerry-rigged definitions punt the problem back to tax administrators.

Both sides accept an implicit—and false—assumption of the debate: that the problem is fundamentally economic. The underlying assumption is that governments and school districts lose revenue or taxpayers are disadvantaged. But neither is exactly true, and revenue loss is not a foregone conclusion. The misperception that tax-exempt property creates revenue loss is based on erroneous reasoning by analogy. People are familiar with sales taxes and income taxes and they have seen exemptions to these taxes reduce revenue, so they assume property taxes work the same way. But the property tax is different from every other tax. It is designed to collect whatever is needed to balance government budgets, which means that the rate is reset every year. The problem is a political one: that is, how high should the tax rate be?

When property is removed from the tax rolls and put to charitable use, taxpayers get hit with a double whammy. First: they pay more in property taxes. Governments might keep rates constant by cutting spending, but we know that won’t happen. Second, the market value of their property falls. When a person buys a home, he acquires a permanent tax liability, so he must take property taxes into account deciding on a location. Higher taxes mean less demand, which means lower home values.

Undeniably, there is a real problem, but it is a political, not an economic, one. Local public officials do not want to raise taxes, and taxpayers would welcome any rate relief they might get from taxing a few nonprofits. Facts about the economic contributions of nonprofits to the community are irrelevant. Worse, in the hands of a skillful opponent, such facts can be inaccurately portrayed. Consider this proposal based on economic contribution: “If your nonprofit generates so much economic activity, you can afford to pay taxes.” Or this: “Business generates more economic activity than do nonprofits; should that entitle them to exemption too?”

Nonprofits must think politically but not in a partisan way. They must become more self-aware. If their communities do not see nonprofits as relevant to them, if they do not value the nonprofits in their backyard, then nonprofits can expect repeated assaults on their tax privileges. Public service is the essence of “nonprofitness,” and nonprofits should explicitly include the public in their communities among the larger public they serve. Why expect neighbors to be impressed by good work toward others if they do not see good work directed at them? As the saying goes, charity begins at home.

**Woods Bowman** is a professor of public service management at DePaul University.

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the historic rationale for nonprofit property tax exemptions with today’s fiscal realities. It is clear that all parties have a responsibility to engage in problem-focused discussions of the issue.

To resolve this issue, nonprofits need to assume broader leadership and accountability. The onus of this leadership falls largely on the leaders of acute-care hospital facilities and educational institutions, as they are often the target of public-sector hostilities. These entities need to understand that it is not useful to base their

arguments solely on the fact that they significantly contribute to local economies through employment and derivative investments. In Pittsburgh, nonprofits contribute a staggering \$17 billion annually to the regional economy and, in the wake of the industrial decline, have arguably been the economic salvation of the city. Regardless, for-profit firms also contribute significantly to local economies, and they are taxed. Nonprofits must base their claim for tax exemption on their charitable outcomes, not on their economic impact.

Nonprofit institutions must also refrain from financial doublespeak, which they have done, for example, in claiming to be charitable institutions while simultaneously operating like any for-profit business. Amid the increasingly contentious public debate over tax exemptions, the large university-affiliated health system in Pittsburgh announced plans to close a financially distressed hospital in one of the poorest communities in the region. As public officials claimed that the decision violated the charitable purpose of the health system, tempers flared further. Nonprofits have a fiduciary obligation to make the best use of their limited assets, and sometimes they must make the difficult decision to close facilities.

Nonprofits should also be cognizant that efforts to define the terms of the negotiations may backfire. The initiative of the large health system in Pittsburgh to fund college scholarships for public-school graduates was implicitly cited as a substitute for making a tax payment. In fact, just before the scholarship initiative was launched, the health system asked that any donations to the program be deducted from future tax obligations in the event that its tax-exempt status changed. This last-minute request resulted in significant public criticism of the health system. The scholarship program itself did nothing to assuage the concerns of Pittsburgh officials and, indeed, may have incensed officials further.

Nonprofits must not shoulder the burden of paying for financial mismanagement or legacy obligations. It is no secret that the city of Pittsburgh has tried to minimize its unfunded pension liability by placing the burden on college students, who had no role in creating the problem. Service fees based on square footage of property are nothing but a property tax masked as a fee; service fees based on a percentage of tuition are arbitrary and capricious. Attention must be focused on the nonprofit institutions, not on those who use their services.

Local taxing jurisdictions must also avoid ploys that raise the stakes or shift the discourse from the negotiating table to the tabloids. The ploy of the city of Pittsburgh to place a tuition tax on students is questionable on legal grounds but plays well in a working-class community

with entrenched town-and-gown tensions. Such obvious ploys do little to advance the public interest with civility and instead foster a climate of hostility and rancor.

Local governments have directed their attention toward nonprofit organizations that generate a substantial amount of earned income. “Government sees PILOT programs as a way to tax income instead of properties,” Evelyn Brody asserted at the forum convened by the Johnson Institute. “That’s why the hospitals and universities are attractive and not churches. . . . This is really an extralegal self-help policy.”

Local governments and nonprofits hope that state government will take responsibility for relieving the local government’s fiscal squeeze. Because states grant taxing authority to their localities and also exemptions to nonprofits, they must be part of the solution. This can be done by compensating local governments for lost revenue or by authorizing new sources of revenue for local jurisdictions. As the forum noted, antiquated state revenue structures need to be revised for the new

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economic environment. Like many other cities that are home to large nonprofit institutions, the city of Pittsburgh offers many benefits to the surrounding region. Yet it must fund these assets largely on its own with an antiquated property tax. Commuters from surrounding suburban towns who work in Pittsburgh, for example, pay only \$52 per year to work in the city. A small portion of the region’s sales tax supports some of the city’s nonprofit assets. But more regional support must be given to nonprofit assets that have a regional impact.

Nonprofits, local taxing jurisdictions, and the state government all have a responsibility to resolve this issue, and the resolution hinges on a structured and civil dialogue involving key leaders from all sides.

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