

exempts

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Real Property Tax Exemptions At Risk

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REAL PROPERTY

A history of local problems and responses have drawn the criteria away from the federal income tax norm.

TAX EXEMPTIONS AT RISK

Oh No, They Can't Take That Away From Me!

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Nonprofit organizations must tread carefully through a landmine of taxing statutes. Although it is generally correct to state, as many assume, that securing a tax-exempt determination of Section 501(c)(3) status immunizes a nonprofit from most federal and state impositions, an important exception is often overlooked. Exemption from state and local property taxation is a substantially separate regime. Exemption requirements are different, frequently more stringent, and often depend on unfamiliar, cramped constructions of familiar terms (e.g., “educational” and “charitable”). Even when such property exemptions are obtained, they are transitory to a degree unparalleled in the income tax world.

State property tax law

State governments, as well as the governments of their various subdivisions, are under increasing financial pressure. Federal revenue sharing dollars are decreasing at the same time that state and local budgets (largely composed of fixed costs that rise with the Consumer Price Index or even more rapidly rising indices) are ineluctably growing. States and localities must therefore turn to their own tax bases to close budget gaps. But with increases in tax rates a largely forbidden topic—for those who wish to seek re-election with any chance of success—state and local legislatures are examining their tax bases to see whether they can capture taxes from residents or entities that now enjoy immunity. There is less political resistance to

pursuing a relatively weak constituency, the non-profit sector, than to increasing the marginal rates payable by individuals and for-profit business organizations or subjecting newly established profitable activities or actors to taxation.

An interesting example of this trend is the long-standing but now accelerating effort of the City of New Haven to impose taxes on Yale University, which in broad terms is exempt from property taxation as a matter of Connecticut state law. Decades ago, Yale agreed to enter into a PILOT program¹ with New Haven with respect to portions of its real estate portfolio, but the pressure to revoke existing exemptions or limit new exemptions has increased of late.²

A related phenomenon has been the reaction in both the press and in the U. S. Senate to the well-publicized growth of the endowments of major charities—particularly universities, including Yale and Harvard—at a time when government agencies feel budgetary pressure.³ The outpouring of criticism is now occurring at what appears to be the tail end of an unprecedented period of growth in the value of equities. Well-managed university endowments have grown in recent years by as much as 20% per year. Not surprisingly, no similar criticism of the size of university endowments was voiced in earlier eras, when universities and large charities recorded modest, if any, growth in their investments.⁴

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**EXEMPTION
FROM STATE
AND LOCAL
PROPERTY
TAXATION IS A
SUBSTANTIALLY
SEPARATE
REGIME.**

A number of universities have recently announced changes in their “spending rates” in response to the criticism that they are “hoarding” great wealth without adequate justification.⁵ Increases in spending rates are far less painful than the potential loss of tax exemptions. Moreover, spending rates are a subject that may be revisited from time to time by the charity’s board; what rises in one era may decline in another. Finally, of course, charities are essentially in the business of spending or giving away money. A “spending rate” is merely a measure of the rate of distribution. It is radically different from an involuntary tax payment to a state or municipality. Nonetheless, the public outcry over the increased size of certain charitable endowments, along with the purportedly meager expenditure of charitable dollars by those institutions that have enjoyed an unprecedented growth in their endowments, is reflective of a broad-based willingness to look hard at charities as potential sources of funds to underwrite governmental functions that have been squeezed financially.

Although “town-gown” tensions over property tax are widespread,⁶ it should not be supposed that the universities represent the only battleground, nor should it be assumed that PILOTs and media attention are the only weapons of attack. All manner of nonprofits have been targeted for loss of tax immunity,

with the trend growing in recent years, and a wide range of methods have been employed by governments in attempts to squeeze revenue from nonprofits. State and local governments throughout the country have tried to revoke or limit property tax exemptions.⁷ A decade ago, for example, after lengthy debate over property tax exemptions, Colorado voters were presented with Amendment 11. Had it not been defeated, Amendment 11 would have eliminated the property tax exemption for most religious, charitable, and cultural organizations.⁸

Another popular method of bringing property owned by nonprofits into the fisc has been to significantly narrow the statutory definitions of what qualifies as charitable and educational. Late last year, for example, in the context of reviewing a nonprofit social welfare agency, the highest court in Minnesota decided that the sole criterion of eligibility for property tax exemption is whether the entity provides goods or services without fee or at substantially reduced rates as a substantial part of its operations.⁹ In reaching that result, the Minnesota court overturned substantial state law precedent that eligibility for real property tax exemption turns on a multi-part test in which the absence of profitability of the entity’s activities was but one factor. If followed in other states, the Minnesota test would effec-

¹ “Payments in lieu of taxes” are conventionally referred to as PILOT programs or agreements. PILOT programs have been part of state and local government revenue-raising arsenals throughout much of the past century. For example, Harvard University has been making payments to Cambridge under a PILOT program since 1928. See, e.g., Brody, “Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption,” 23 Iowa J. Corp. L. 585, 602-03 (Summer, 1998); Nusbaum, “Exemption from State and Local Property Taxes,” 18 Exempts 271, 275 (May/June 2007).

² Interestingly, PILOT program funds do not always flow from private to public. In 1978, for instance, Connecticut instituted a PILOT program under which local governments would receive payments from the state government for private colleges and hospitals within their borders. See Nusbaum, *supra* note 1, at 277; Carbone and Brody, “PILOTs: Hartford and Connecticut” in *Property-Tax Exemption for Charities: Mapping the Battlefield* (The Urban Institute Press 2002) (hereafter “*Battlefield*”).

³ See, e.g., “Well-Funded Schools vs. High College Costs: Advocates for Affordable Education Look Forward to the Debate Sparked by Growth in Endowments,” Balt. Sun, 1/28/08, page 1A, available at 2008 WLNR 1608008; Schworm, “Harvard’s Endowment Surpasses \$34 Billion: Stock Market Fuels Investment Gains for Elite Colleges and Universities,” Boston Globe, 1/24/08, page 3B, available at 2008 WLNR 1344095; “Snapshots of Endowment Spending,” Inside Higher Ed., 3/7/08, available at <http://www.insidehighered.com/news/2008/03/07/endow>; “Endowment Debate Seeps into the States,” Inside Higher Ed, 5/1/08, available at <http://www.insidehighered.com/news/2008/05/01/mass>. See also “Enjoy the

Reunion: Skip the Check,” N.Y. Times, 5/25/08, available at 2008 WLNR 9877729; [U.S. Sen. Charles] Grassley, “Wealthy Colleges Must Make Themselves More Affordable,” Chron. Higher Ed., 5/30/08, at “[Point of View].”

⁴ Indeed, to the contrary, for decades the criticism was that such nonprofits were too staid in their investment philosophies. What has changed in the last 20 years is beyond the scope of this article, but the substitution of the principle of “total return” for the ancient talisman of “prudent investments,” which was interpreted to mean that investment managers should minimize risk above all other goals, provides an important part of the explanation.

⁵ See Brown and Schworm, *supra* note 3.

⁶ See, Note, “Alternatives to the University Property Tax Exemption,” 83 Yale L.J. 181 (1971).

⁷ See Anderson et al., “The Status of Nonprofit Property Tax Exemption in the State of North Carolina: Final Report to the North Carolina Center for Nonprofits,” May 2003, available at <http://www.pubpol.duke.edu/research/students/spring2003-01.pdf> (describing revenue-raising strategies considered or adopted in Colorado, Pennsylvania, and Fairfax County, Virginia). See also Nusbaum, *supra* note 1 at 273-75 (describing revenue-raising approaches in Utah, Texas, and California).

⁸ See, e.g., “Amendment 11’s Effects Debated; Plan Involves Taxing Nonprofit Organizations,” Boulder Daily News, 10/29/96, page 1A, available at 1996 WLNR 579479; “Amendment to Tax Colorado Nonprofits Loses Big,” Denver Post, 11/6/96, available at 1996 WLNR 485293.

⁹ Under *The Rainbow Child Care Ctr., Inc. v. County of Goodhue*, 741 N.W. 2d 880 (Minn. 2007).

tively eviscerate the property tax exemption for most nonprofits.¹⁰

Offsetting the Minnesota precedent are the two recent cases of *Town of Peterborough v. The MacDowell Colony, Inc.*, 943 A.2d 768 (N.H. 2008), which upheld the tax exemption of an art colony, applying a traditional four-part test,¹¹ and *Adult Home at Erie Station, Inc. v. Assessor/Regional Economic Community Action Program, Inc. v. Assessor*, 886 N.E.2d 137 (N.Y. 2008), which upheld the tax exemptions of two social service providers in upstate New York, invoking long-standing definitions of “poverty” and “charitable” activities. The New Hampshire and New York courts clearly are bucking a national trend in the property tax arena.

New York State

The phenomenon of states and localities seeking to extract tax revenue from nonprofits is national in scope. As an illustration, the discussion below focuses on the special case of New York State. Events in New York a generation ago presaged what would happen elsewhere around the country and the debates in which many states and localities are currently embroiled. Moreover, the ways in which New York—the state and the city—addressed and later resolved tax policy issues illuminate the tensions between the not-for-profit and governmental spheres. Additional value derives from the example of New York because the jurisprudence of property tax exemption is more fully developed there than in many other states.

New York real property tax law. Some properties (mostly religious) are exempt from

property tax under the New York State Constitution.¹² There is no analog in the federal income tax area; the granting or denial of exemptions under Section 501(c)(3) is not in general compelled or constrained by the U.S. Constitution.¹³ Some properties in New York State are mandatorily exempt, by statute, and the assessor is without discretion to deny them exemption based on their status.¹⁴ Other categories of property enjoy only permissive exemption by statute. Their fate is in the hands of the local assessing authority.¹⁵ Here, too, there would not appear to be a clear federal analogy.

The latter category is most vulnerable to the whims of government and the vagaries of politics and economic cycles.

The threat of New York City’s bankruptcy.

The near financial collapse of New York City in 1975-76 shaped the thinking of judges and legislators on property tax issues for a generation, much more so than has generally been acknowledged. Of course, New York’s precarious financial condition did not present itself with unanticipated suddenness in the mid-1970s, and efforts to shore up its finances began well before the city was on verge of filing for protection under the federal bankruptcy laws.¹⁶

An influential state legislative report published in 1970, widely known as the Becker Report, contained alarming forecasts of fiscal doom, and placed the blame for the state’s and the city’s revenue shortfalls squarely on the shoulders of the nonprofits.¹⁷ In 1971 the Legislature amended the Real Property Tax Law (RPTL) to strip many categories of nonprofits of their status as automatically exempt, and to permit localities to make individualized judg-



ANOTHER WAY TO BRING NONPROFITS’ PROPERTY INTO THE FISC IS TO NARROW THE STATUTORY DEFINITIONS.

¹⁰ The Minnesota House and Senate omnibus tax bills contain a one-year moratorium on the ability of assessors to change practices in light of the decision. Local leaders have been pushing for the moratorium in order to encourage nonprofits, assessors, and the Department of Revenue to reach an agreement on the definition of public charity, noting that stability is needed in this area. Shaw, “Minnesota Lawmakers Debating Tax Status of Nonprofits,” *St. Paul Legal Ledger*, 5/5/08, available at 2008 WLNR 8492621. See also “Tax Exemptions of Charities Face New Challenges,” *N.Y. Times*, 5/26/08, page A1, available at 2008 WLNR 9917171.

¹¹ “Whether (1) the institution or organization was established and is administered for a charitable purpose; (2) an obligation exists to perform the organization’s stated purpose to the public rather than simply to members of the organization; (3) the land, in addition to being owned by the organization, is owned by it and used directly for the stated charitable purposes; and (4) any of the organization’s income or profits [for exempt purposes].” *Town of Peterborough v. The MacDowell Colony, Inc.*, 943 A.2d 768 at 771 (N.H. 2008).

¹² Property “used exclusively for religious, educational or charitable purposes, as defined by law,” are exempt under the State Constitution. Art. XVI, § 1.


¹³ Obviously, the Establishment Clause of the First Amendment would prevent the IRS from favoring one religion over another, or all religions over none.

¹⁴ Property used for “hospital, cemetery and moral or mental improvement of men, women or children” enjoy mandatory exemption under New York’s Real Property Tax Law. RPTL § 420-a. In addition, certain specific properties were made exempt by special Act, such as Lincoln Center for the Performing Arts. RPTL § 427.

¹⁵ Properties *may* enjoy exemption pursuant to RPTL § 420-a if their purposes are “bible, tract, benevolent, missionary, infirmary, public playground, scientific, literary, bar association, medical society, library, patriotic, historical and [for the protection of children and animals].”

¹⁶ See “Big Rescues Can Work: Just Ask New York,” *N.Y. Times*, 5/11/08, available at 2008 WLNR 8863233.

¹⁷ “Final Report of the Joint Legislative Committee to Study and Investigate Real Property Tax Exemptions,” *N.Y. Leg. Doc. No. 15 (1970)* (the “Becker Report”).



**NEW YORK
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ments as to whether the nonprofits qualified for a discretionary tax exemption. Two well-established property-owning nonprofits in New York City—the Explorers Club and the Bar Association of the City of New York, both occupying prime midtown locations—lost their exemptions shortly thereafter.

The cases went to the state's highest court, the Court of Appeals, where the denials of exemptions were upheld.¹⁸ Both nonprofits argued that their exemptions were justified because their activities were, by their very nature, charitable or educational. Adopting a seemingly narrow interpretation of both terms, the Court of Appeals held that they were neither charitable nor educational. The Explorers Club was seen by the court as advancing scientific inquiry and exploration, but its educational goals were described as merely incidental. The Bar Association, notwithstanding its holding of public meetings and the publication of reports for the benefit of the bar and the judiciary, was held to be mainly a trade association. Tellingly, the court cited the Becker Report with approval, impliedly endorsing the view that there was a dangerous trend of accelerating exemptions and thus an impairment of the City's tax base. It ascribed to the State Legislature the purpose of "stem[ming] the erosion of the municipal tax bases by permitting local governments to terminate exemptions for nonprofit organizations other than those conducted exclusively for religious, educational, charitable, hospital or cemetery purposes."¹⁹

After dodging the bankruptcy bullet in 1976, New York City found itself in a kind of receivership, answerable to newly created state agencies such as the Municipal Assistance Corporation, which urged the city to adopt new, more stringent budgetary measures.²⁰ In 1980, then-Mayor Edward Koch asked for a review

of the tax-exempt status of nonprofits in the city. The city finance commissioner thereupon promulgated a change of policy under which cultural nonprofits would be denied exemption from local property tax. For purposes of this discussion, "culturals" refers to museums, concert halls, theaters, and other public fora where the plastic and performing arts may be viewed or staged. Even within the relatively small world of nonprofits, culturals tend to be particularly vulnerable to political attacks for two reasons.²¹ Their exhibitions are sometimes provocative and defiant of societal norms, and the constituents who support them generally are less numerous than those other institutions.

Several organizations filed test suits in response to this change. The city's policy was overturned by the Court of Appeals in a watershed decision, *Symphony Space, Inc. v. Tishelman*, 453 N.E.2d 1094 (N.Y. 1983). *Symphony Space* was a corporation formed under the state's not-for-profit corporation law to engage in various musical, theatrical, artistic, and academic activities. It owned Manhattan real estate in an area then considered to be in "transition." *Symphony Space* applied for a real estate tax exemption under what is now RPTL §420-a on the grounds that its purposes were exclusively charitable, educational, and in support of the moral and mental improvement of men, women, and children. The court emphasized the fact that *Symphony Space* is a "haven for theater and dance groups that otherwise would have no place to perform" and that it charged small or no fees for the use of its space. The court took an expansive view of the statutory term "educational" and specifically ruled that the performing arts could well be educational and "absolutely exempt" under §420-a. Additional considerations in the court's view were that *Symphony Space* did not make a "profit" when it charged admission or other fees, and that it was not in competition with for-profit theaters. The Court of Appeals held that this

¹⁸ *Association of the Bar of the City of New York v. Lewisohn*, 313 N.E.2d 30 (N.Y. 1974).

¹⁹ *Id.* at 36. Just two years later, the term "religious" was given a narrow reading in another decision by the same court, *Swedenborg Found., Inc. v. Lewisohn*, 351 N.E.2d 702 (N.Y. 1976), where a society dedicated to disseminating the teachings of a 19th century Swedish religious thinker was found to be neither religious nor educational. According to the Court of Appeals, the foundation failed to qualify because it did not advance a recognized religion, and it was not chartered by the Board of Regents or recognized as an educational institution by the Board of Education.

²⁰ See note 18, *supra*.

²¹ Among the more prominent of these controversies is the Robert Mapplethorpe exhibit funded by the National Endowment for the Arts, which sparked uproar and resulted in

calls to abolish the NEA or severely restrict its funding. See "House Overwhelmingly Approves NEA Reauthorization," *Wash. Times*, 10/12/90, page A5, available at 1990 WLNR 117932. Another notable example is the fury of then-Mayor of New York Rudolph Giuliani over exhibits at the Brooklyn Museum of Art (BMA). In 1999, Mayor Giuliani attempted to shut down the exhibition "Sensation: Young British Artists from the Saatchi Collection" at BMA by threatening to withhold funding if the show was not cancelled. See "Shock Grows in Brooklyn," *Newsweek*, 10/11/99, available at 1999 WLNR 5026962. Mayor Giuliani reiterated those threats less than two years later when BMA exhibited "Yo Mama's Last Supper." See "Amid Strong Debate, Mild Curiosity at the Exhibition," *N.Y. Times*, 2/17/01, page B3, available at 2001 WLNR 2897960. These controversies admittedly did not arise from or lead to the revocation of property tax exemptions.

FRACTIONAL ASSESSMENTS

New York City's financial crisis was not the only factor profoundly complicating New York State's finances in the mid-1970s. In *Hellerstein v. Town of Islip*, 332 N.E.2d 279 (N.Y. 1975), the Court of Appeals invalidated a practice dating back 200 years in New York State whereby cities, towns, and villages assessed properties at a fraction of their "true" or market value. This practice had been literally proscribed by statute; but that provision of the statute had been dead letter for generations.

Not surprisingly, it took the state many years to rewrite the RPTL so as to accommodate *Hellerstein* and yet permit localities the flexibility they believed they needed to avoid instituting assessments that would be materially larger than those in effect through 1975. To appreciate the problem, take the simplified example of a township that had been assessing properties at one-third of their "true" value, *Hellerstein* seemed to dictate that the next assessment roll would triple the assessments of property owners within the township. Although the harshness of that result could have been mitigated by shaving the tax rate by two-thirds, most local legislators were concerned about the political impact of such a radical increase in assessments.

community-based theater was entitled to a full exemption.

The Court of Appeals' decision in *Symphony Space* came down just a few months after the ruling by the Appellate Division (the intermediate appellate court in New York State) in the closely watched case of *Asia Society v. Tax Commission*, 459 N.Y.S.2d 620 (N.Y. App. Div. 1983). That court upheld the denial of the tax exemption sought by the Society in connection with its newly completed museum and headquarters at 70th Street and Park Avenue—perhaps one of the most valuable parcels of real estate in New York City. The court found that *Asia Society* was organized as a not-for-profit with the express purpose of bringing together the peoples of Asia and the U.S. and, to that end, to foster cultural exchanges. While grudgingly

acknowledging that such activities may be "publicly beneficial and arguably educational in a broad sense," the court concluded that they "do not constitute an educational use for tax exemption purposes under [the Act]."²²

In June 1983, after the decision in *Asia Society* but before *Symphony Space* was decided, Mayor Koch convened a public hearing to consider the competing public policy and fiscal issues raised by this controversy.²³ The hearing was chaired by Frederick A. O. Schwarz, Jr., then the City Corporation Counsel. Notably, Mr. Schwarz had been counsel for the City in the *Asia Society* and *Symphony Space* litigation. He had also chaired a City task force that issued a "Report ... on the Exemption of Non-Profit Organizations From Real Property Tax" in October 1982. The "Core Recommendation" of the report was that the City re-adopt its traditional, expansive interpretations of "charitable" and "educational."

At the end of the hearing, spurred by Mr. Schwarz, a special body appointed by the mayor concluded that the city's policy was unwise and unwarranted. Moreover, notwithstanding (1) the financial pressures to which the city was still subject and (2) the general rule of statutory construction that exemptions from taxation are to be narrowly construed,²⁴ the city adopted new policies that favored exemption for members of the non-profit sector, including cultural.²⁵ These altered policy prescriptions continue to represent official city policy a generation later.²⁶

The impact of the turmoil. The policy shift in the early 1980s, whereby cultural

²² *Asia Society v. Tax Commission*, 459 N.Y.S.2d 620 at 622. (N.Y. App. Div. 1983). The author submitted an *amicus* brief on behalf of the American Association of Museums in support of the position of the *Asia Society* in the Appellate Division.

²³ See "An Ex-Koch Aide Urges Taxing Exempt Groups," N.Y. Times, 6/18/83, available at 1983 WLNR 503218.

²⁴ See *Canton Human Svcs. Initiatives, Inc. v. Town of Canton*, 780 N.Y.S.2d 714 (N.Y. Sup. Ct. 2004); *Symphony Space, Inc. v. Tishelman*, 453 N.E.2d 1094 at 1096 (N.Y. 1983).

²⁵ The city dealt with the problem raised by the *Hellerstein* case (see the sidebar, above) by introducing the concept of "transitional" assessments. Simply put, these assessments deferred the full impact of increases in "actual" assessments for a period of five years. RPTL§ 1805.

²⁶ New York State lawmakers continue to quietly grumble over property tax exemptions, threatening to limit the terms "charitable, educational, religious, hospital or moral or mental improvement of men, women and children," "organized exclusively," and "used exclusively." See Bjorklund, Fishman, and Kurtz, *New York Nonprofit Law and Practice: with Tax Analysis* (Publisher, 2007) (hereafter "Bjorklund"), ¶ 14.03[4][a], fn. 52.

THE QUESTION IS NOT OF INTEREST ONLY TO NARROW SPECIALISTS IN AN OBSCURE CORNER OF TAX LAW.

were denied property tax exemption, came as a jolt to the nonprofit community. Many had assumed that if an entity qualified for federal income tax exemption under Section 501(c)(3), it would perforce be exempt from local and state property tax as well. This was and remains a mistaken assumption, in New York State and throughout the country.²⁷

Though “charities,” in the federal income tax sense, generally should enjoy exemption from state and local taxation, there is not a complete identity between the set of entities enjoying exemption from income taxation under Section 501(c)(3) and those entities owning or net leasing properties exempt under §420-a of New York’s RPTL (the most capacious category of property tax exemption in New York State).²⁸ Stated more abstractly, the fact that an entity qualifies for federal income tax exemption generally is neither a necessary nor a sufficient condition for the entity’s real estate to be granted exemption under the property tax law of New York State or its localities.

To qualify for a federal income tax exemption under Section 501(c)(3), an organization must meet certain general standards. Specifically, it must be organized and operated exclusively for one or more exempt purposes, it must actually pursue those purposes, it must not use its resources to benefit any private shareholder or individual, and it must comply with limits on lobbying activities and a prohibition on political activities. Permissible exempt purposes under Section 501(c)(3) include religious, charitable, scientific, literary, and educational purposes, testing for public safety, and the prevention of cruelty to children or animals.²⁹

For federal income tax exemption purposes, the terms “charitable” and “educational” encompass a range of activities, the breadth of which exceeds traditional understandings of the words.

Under Reg. 1.501(c)(3)-1(d)(2), “charitable” is defined to include:

Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.³⁰

Similarly broad in scope, Reg. 1.501(c)(3)-1(d)(3) defines educational as relating to the “instruction or training of the individual for the purpose of improving or developing his capabilities” or “the instruction of the public on subjects useful to the individual and beneficial to the community.” In addition to traditional schools, the regulations list museums, zoos, planetariums, symphony orchestras, and other similar organizations as examples of educational organizations and include public discussion groups, forums, panels, and lectures as examples of educational activities.³¹

Exemption from state income tax (or income tax equivalent) tends to follow the federal recognition of exempt status.³² New York Tax Law Article 9-A imposes a general corporation franchise tax on domestic and foreign corporations based on net income. Under 20 NYCRR § 1-3.4(b)(6), a corporation that is exempt from federal income tax under Section 501(a) of the Internal Revenue Code “will be presumed to be exempt from tax under Article 9-A,” and a corporation that is denied exemption from federal income tax will be presumed to be subject to New York franchise tax.³³

New York’s willingness to follow the federal government’s lead on exemption determinations does not extend to exemption

²⁷ See *Battlefield*, *supra* note 2.

²⁸ Article 4 of the RPTL includes a laundry list of specific complete or partial exemptions for subclasses of property including historic property that has been designated as a landmark or contributes to the character of a historic district (RPTL § 444-a), historic barns (RPTL § 483(b)), certified eligible tracts of forest lands (RPTL § 480(9), 480-a), nuclear-powered electric generating facilities (RPTL § 485(1)), and certain stadiums built with state funds (RPTL § 420-a(9)).

²⁹ Reg. 1.501(c)(3)-1(d)(2).

³⁰ See also Rev. Rul. 67-235, 1967-2 CB 79; Hill and Mancino, *Taxation of Exempt Organizations*, (Warren, Gorham & Lamont, 2006) ¶ 3.02 (stating that “[r]evenue rulings and case law address an exhaustive range of activities conducted by organizations that have qualified as charitable”).

³¹ Reg. 1.501(c)(3)-1(d)(3)(ii). See also Colombo, “Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions),” 35 *Ariz. L. Rev.* 841, 847 (1993) (“[t]he educational exemption also has been applied to organizations that provided continuing legal education and other professional skills training, university bookstores, a jazz festival, various counseling services, research organizations, and a number of organizations whose stated purpose was to disseminate information to the public”).

³² See Bjorklund, *supra* note 26 at 14.03[4][a]; see also Colombo, *id.* at 856.

³³ Similarly, New York Tax Law § 1116 generally treats organizations exempt from federal income tax as exempt from payment of State and local sales and use taxes, as well. See Bjorklund, *supra* note 26, at 14.03[3][a].

from real property taxes.³⁴ New York State's RPTL § 420-a provides:

Real property owned by a corporation or association organized or conducted exclusively for religious, charitable, hospital, educational, or moral or mental improvement of men, women or children purposes, or for two or more such purposes, and used exclusively for carrying out thereupon one or more of such purposes either by the owning corporation or association or by another such corporation or association as hereinafter provided shall be exempt from taxation as provided in this section.³⁵

Despite the facial similarities between the text of the Section 501(c)(3) regulations enumerating permissible exempt purposes and the analogous portion of the text of RPTL § 420-a, some of the overlapping terms are subject to additional conditions by state and local taxing authorities for which there is no federal analog. For example, the record owner and every tenant deriving rights from the owner must be a nonprofit, rents must be no more than is necessary to cover costs, and the owner must take formal steps to ensure that only tax-exempt uses are permitted at the property for which an exemption is claimed. RPTL § 420-a(1), (2); § 420-b(1), (2).³⁶ Additionally—and contrary to common belief among nonprofits—when a not-for-profit acquires a property on the tax rolls of an assessing district, and demolishes the existing structure in contemplation of erecting a structure to advance its mission (such as a warehouse adjacent to a museum for the holding of artworks that are not being displayed), the vacant land may well remain taxable until the new structure is completed unless the construction of such structure “is in progress or is in good faith contemplated.”³⁷

It is also worth noting that the agency charged with assessing properties for taxation

for local government in New York State—importantly including the New York City—may impose additional reporting requirements on owners of tax-exempt properties, and that a failure to comply with such requirements may result in the loss of the exemption. Generally speaking, the reports are annual, and they require a showing that the property continues to be used for purposes that qualify as exempt.³⁸

Finally, IRS procedures for determining eligibility for exempt status have nothing remotely analogous to the public hearing conducted in 1983 to consider the wisdom of New York City's tax policies vis-a-vis the culturals. Nor does the IRS delegate to any other federal agency the authority or discretion to grant or deny federal income tax exemptions. Once the determination is made, IRS revocation of Section 501(c)(3) status is a rare event.³⁹

How much is at stake?

Property taxes are not just nuisances. For small- to medium-sized nonprofits, property taxes are highly material.

Assume, for example, that a coalition of nonprofits owns a five-story office building (“the Property”) situated in a relatively inexpensive area of Manhattan. Assume further that the Property comprises 50,000 square feet. Each year, the city's Department of Finance is required to separately assess each of the more than 900,000 tax lots on the assessment roll. In order to assess the Property, the Department of Finance will first inspect it—either actually or virtually—and will then perform a number of complex calculations whereby its adjusted net rental income is capitalized to achieve a hypothetical market value.⁴⁰ That figure is then multiplied

³⁴ This diversion from federal income tax treatment is not unique to New York. See Colombo, *supra* note 31 at 856 (“[p]roperty tax exemptions ... usually do not directly key off federal exemption, but rather are covered by independent state statutes or constitutional provisions”).

³⁵ Compare the expansive reading of “charitable” in older cases, e.g., *Matter of Rockefeller*, 165 N.Y.S. 154” 157-58 (N.Y. App. Div. 1917) (citing *Ould v. Washington Hospital*, 95 U.S. 303, 311 (1877)) and *Tilden v. Green*, 28 N.E. 880, 882 (N.Y. 1891) for the proposition that “[a] charitable use ... may be applied to almost anything that tends to promote the well-doing or well-being of social man”) with the narrower construction of such term given in *Association of the Bar of the City of New York*, 313 N.E.2d 30 at 34-37, and the intermediate test announced in *Symphony Space*, 453 N.E.2d 1094 at 1095-97.

³⁶ RPTL § 420-a(1), (2); § 420-b(1), (2).

³⁷ RPTL § 420-a(3)(a).

³⁸ RPTL § 420-a(11); see also New York State Office of Real Property Services, *Assessors' Manual, Exemption Admin-*

istration, Part II, available at <http://www.orps.state.ny.us/assessor/manuals/vol4/part2/section4.05/sec420-a.htm>.

³⁹ By contrast, it is not at all uncommon for property tax exemptions to be revoked, in whole or in part, by state or local officials based on changing uses of the property or (more ominously) changing interpretations of the statutory terms by the assessors and the administrative agencies charged with reviewing such assessments. See *The City of New York Dep't of Fin., Tentative Assessment Roll Fiscal Year 2009*, available at http://www.nyc.gov/html/dof/html/pdf/08pdf/tent_asses_s_roll_08_09v5.pdf (stating that charitable property tax exemptions for about 5,000 tax lots were revoked in fiscal year 2009).

⁴⁰ The actual rents are compared to market rents compiled by the Department of Finance and, if the actual rents are significantly below market, will be adjusted upwards. From the rental income will be subtracted operating expenses (not including real estate taxes), also adjusted for reasonableness.

A VERY TALL EXEMPTION

No analysis of this area can escape the unpredictable variable of local discretion, rooted in history and politics, that could factor in to the benefit or detriment of a nonprofit. For Cooper Union, a nonprofit educational institution in Manhattan, almost no rule of property taxation applies. Cooper Union, however, owns a valuable piece of mid-Manhattan land on which the Chrysler Building stands.

The Chrysler Building is owned by a for-profit real estate company, and space in the building is sublet to for-profit tenants. Cooper Union receives a substantial amount of ground rent from this property, at which it conducts no educational activities. Nevertheless, Cooper Union has enjoyed an exemption from property taxes with respect to the Chrysler Building site for more than a century. Various efforts to revoke the exemption have been made, unsuccessfully, over the decades. (See Cohn, *Cooper Union and the Chrysler Building* (1996), available at <http://wernercohn.com/Chrysler.html>.)

To be fair, various nonprofits have been beneficiaries of special legislation exempting their properties from taxation—notably the Explorers Club and the Bar Association of the City of New York—but these exemptions were extinguished in the early 1970s. How Cooper Union managed to retain its immunity is beyond the scope of this article, but the story serves as an example of discretionary elements beyond the control or prediction of a nonprofit attempting to secure a property tax exemption or challenge a revocation.

by 45%—the “equalization rate” that has been in effect in New York City since 1983—to reach what is called an “actual” assessed valuation.⁴¹ The assessed value per square foot is then compared to assessed values of comparable buildings to assure that the assessment is within an established range.⁴² The assessed value—technically the lesser of the “actual assessed valuation” and the “transitional assessed valuation”—is then multiplied by the applicable tax rate, which is reset each year by the New York City Council.

The resulting property tax on the Property might have ranged in the last 20 years from \$2.50 to \$6.00 per square foot. At the high end of this scale, the nonprofits comprising the tenants in the building would have had to bear a total of \$300,000 in property taxes absent an exemption. For many nonprofits, their pro rata share of that tax burden would spell the difference between economic survival and closing up shop. Put concretely, a nonprofit occupying 10,000 square feet, probably a modestly sized organization, would have a property tax burden of \$60,000. For a nonprofit with an executive director, an associate director, and a bookkeeper, the imposition of a \$60,000 tax burden might mean having to cut paid staff by a third.

Theoretical justifications for exemption

There have been many theoretical statements of why the nonprofit sector deserves to be spared the burden of property taxation.⁴³ Arguing for their exemption is the fact that:

- Nonprofits perform quasi-governmental functions (such as operating private schools and hospitals).
- They perform services that would not otherwise be available to the community.
- They confer economic benefits on society by attracting tourists and customers (to nonprofit theaters and concert halls, for example).
- They provide employment by doing so.

But there are also powerful arguments against exemption. The basic argument is that a tax exemption is a hidden subsidy to nonprofits that has not been expressly voted on and approved by citizens whose taxes are incrementally increased because of the exemptions enjoyed by the nonprofits. Further, it is

⁴¹ See the sidebar on the Hellerstein case on page 13. That decision was followed by RPTL § 305, which permitted fractional assessments. See also The City of New York Dep’t of Fin., *Annual Report: The New York City Property Tax FY 2007*, available at http://www.nyc.gov/html/dof/html/pdf/07pdf/nyc_property_tax_fy07.pdf.

⁴² Comparability controls for the location, age, size, and physical condition of the building.

⁴³ See, e.g., Swords, *Charitable Real Property Tax Exemptions in New York State* (Columbia Univ. Press, 1981).

contended that the amount of the state or local subsidy is not related to the financial need of the nonprofit but turns on the accident of real estate values. It is also sometimes contended that nonprofits unfairly compete with small businesses, the unfairness springing from the fact that the for-profit business must pay property (and other) taxes from which the nonprofits are spared.⁴⁴

It is not the task of this article to weigh the competing fiscal and political arguments concerning whether nonprofit tax exemptions are justified. It is sufficient to alert the reader to the fact that this is not a subject of interest only to narrow specialists in an obscure corner of tax law. The stakes are high, and both the proponents and opponents of exemption are vocal. Indeed, these issues are roiling the entire country. New York State went through a period of rapid changes in the law shaping nonprofit property tax exemption in the '70s and '80s, but has settled into a fairly predictable regime ever since. The remainder of the country is now plunging into (or is already in the midst of) that same turmoil.⁴⁵ It may therefore be in the interest of other states and localities to learn from the lessons of New York and curtail the controversy by performing a cost-benefit analysis of property tax exemptions before they erase the exemptions in the name of some abstract principle of tax equity and/or in the hope of closing a governmental budget gap.

Conclusion

State and local property taxes are often among the greatest economic burdens a nonprofit may have to face. At the same time, many municipalities are heavily dependent on the collection of property taxes to support their governmental functions.

Attorneys counseling nonprofits on federal income taxes should not assume that their client's eligibility to receive tax-deductible contributions and exemption from paying federal or state income tax is a guarantor of exemption from state and local taxes levied against the real property owned by those clients. As discussed above, there are countless

snare for the uninitiated. The cautious attorney should:

- Check whether the assessing authority with jurisdiction over the client's property has promulgated any reporting requirements and, if so, be sure that the client submits timely responses.
- If the client has leased all or any part of the space in the subject property to a nonprofit third party, ensure that the lessee in turn either does not sublet or assign the space or, if it does, that such subletting and/or assignment is also to a qualifying nonprofit. (To shortcut the problem, insert in the first lease a prohibition against leasing or assignments without the client's consent.)
- If the client is receiving rent or a license or user fees for the use of the subject property, make sure that the client can document that the revenues received are no greater than the operating costs.
- If the client intends to use the property for one or more purposes that differ from those announced when the exemption was first granted, review the new purposes to ensure that they satisfy state and local law requirements. Consider having the client adopt resolutions formally committing itself to these new activities and no others.
- If the client enjoys only a partial exemption from property taxation, be prepared to demonstrate the pro rata economic value of the exempt and non-exempt space, as well as the actual dimensions of the two areas. This may make it possible to obtain a higher exemption allocation.
- If the client is contemplating transferring the property to a nonprofit, check the state and local laws applicable to title transfers. There may be an unanticipated hiatus during which the property will be restored to the tax rolls. If so, consider structuring the transaction as a lease or assignment to avoid the loss of exemption, even for a period that may be only several months in duration.
- If a client cultural organization is planning on mounting a show that is likely to shock segments of the community, put together a legal team and litigation budget before local officials begin to thunder about revoking its exemption. ■

⁴⁴ See, e.g., Brody, *supra* note 1 at 600-01; Rose-Ackerman, "Unfair Competition and Corporate Income Taxation," 34 Stan. L. Rev. 1017 (May 1982); Rudnick, "State and Local Taxes on Nonprofit Organizations," 22 Cap. U.L. Rev. 321, 361-62 (Spring 1993).

⁴⁵ See Strom, *supra* note 10.