Case Study

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The Property Tax Exemption in Pennsylvania: The Saga Continues

Abstract: This case study briefly traces the evolution and current status of Pennsylvania's property tax exemption debate. Over the past 30 years court cases and legislative initiatives in Pennsylvania have resulted in dramatic swings of power back and forth between nonprofits and their host taxing jurisdictions, generating confusion and growing acrimony among key stakeholders. As of this writing, a proposed Constitutional Amendment is working its way through the Pennsylvania General Assembly. The amendment seeks to give the legislature, not the courts, exclusive jurisdiction to define what constitutes a purely public charity. The case study concludes with some thoughts on overarching principles that should be considered in the debate.

Keywords: property tax, exemption, charity, Pennsylvania

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Introduction

Many states and localities are debating whether or how land-owning nonprofits, which are typically exempt from certain state and local taxes, should contribute financially support their host jurisdictions. Over the past few years significant policy proposals regarding taxes, fees, Payments in Lieu of Taxes (PILOTs) or other revenue measures have taken place in Louisiana, Massachusetts, Missouri, Montana, Illinois, Nebraska, and other states (National Council of Nonprofits 2015).

This case study briefly traces the evolution and current status of Pennsylvania's property tax exemption debate. Over the past 30 years court cases and legislative initiatives in Pennsylvania have resulted in dramatic swings of power back and forth between nonprofits and their host taxing jurisdictions, generating confusion and growing acrimony among key stakeholders.

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Historical context

Like many other states, the Pennsylvania Constitution allows for property tax exemptions to “purely public charities” but fails to define the term. Thus, there have been many instances of litigation between nonprofits and their host taxing jurisdictions over what exactly constitutes a purely public charity. Historically, the lower courts have taken a rigid stance while the Supreme Court has gravitated toward a slightly more permissive interpretation (Brody 2010).

Administrative agencies, like Pennsylvania’s Department of Revenue, have tried to provide guidance on this issue with rules and regulations that specifically list various types of charitable organizations. In litigation, however, the courts have consistently asserted that the verbatim language in the Constitution (“purely public charity”) has precedence over administrative regulations and legislative statutes.

In *Hospital Utilization Project v. Commonwealth of Pennsylvania* (1985) (*HUP*) the Pennsylvania Supreme Court ruled that an organization qualifies as a purely public charity only if it meets *all* of the following five standards:

1. Advances a charitable purpose by making gifts of services or property for general public use to benefit an indefinite number of persons from an educational, religious, moral, physical or social standpoint;
2. Donates or renders gratuitously a substantial portion of its services to the subjects of the charity or to persons or entities that are directly providing the service on its behalf;
3. Benefits a substantial and indefinite class of persons who are legitimate subjects of charity. The public must be the beneficiary of the gift conferred by the organization;
4. Relieves the government of some of its burden; *and*,
5. Operates entirely free from private profit motive. Surplus funds must be reinvested to aid legitimate subjects of charity.

These standards have since become known as the “*HUP* test,” and for the past 30 years they have been at the heart of Pennsylvania’s increasingly acrimonious debate on the issue of charitable tax exemptions.

1985–1997: Aggressive confrontation from taxing jurisdictions

The *HUP* test gave tax collectors across Pennsylvania the legal clout they needed to compel nonprofits to prove that they were “purely public charities.” *HUP* placed the burden of proof on the nonprofits, not the taxing jurisdictions, and meeting all five *HUP* standards proved exceedingly difficult. The largest and most visible nonprofits, and those that rely heavily on earned income, were particularly challenged by the *HUP* test. With their backs against the wall, many nonprofits decided to play it safe by negotiating PILOTs with their local taxing jurisdictions.

A few jurisdictions were quite aggressive in these negotiations, sometimes employing headline-grabbing stunts in addition to the threat of litigation. For example, the City of Pittsburgh sent its finance director out to photograph luxury automobiles in the employee parking lot of a large hospital, thus implying that the hospital was lavishing high salaries upon its employees and not operating in the spirit of a charitable organization. The same finance director claimed that the football stadium of the University of Pittsburgh should be taxed because it did not serve a charitable purpose.

1997–2012: Power shifts to the nonprofits

Alarmed by these confrontational tactics, and under growing pressure from the healthcare and higher education lobbies, the Pennsylvania General Assembly passed the Institutions of Purely Public Charity Act (1997) (Act 55). Act 55 mirrors the five standards established by *HUP*, but it is less restrictive in its definition of a charitable organization. For example, in Act 55 the criterion of “advancing a charitable purpose” (the first of the five *HUP* criteria) is broadly written to include *any one or combination* of the following:

1. Relief of poverty;
2. Advancement and provision of education;
3. Advancement of religion;
4. Prevention and treatment of disease or injury, including mental retardation and mental disorders;
5. Government or municipal purposes; or
6. Accomplishment of a purpose which is recognized as important and beneficial to the public and which advances social, moral or physical objectives.

With the passage of Act 55, the pendulum of power swung decisively back to the nonprofit property owners. Just as the taxing jurisdictions flexed their muscles after *HUP*, so too did the nonprofits after Act 55. Many nonprofits allowed their PILOTs to expire or unilaterally decreed far more favorable terms. In Pittsburgh a group of large nonprofits formed a powerful coalition that established the Public Investment Fund, a pool of money to be managed by the coalition as a kind of *collective* PILOT. The rules for managing the Public Interest Fund were extremely favorable to the coalition members. For example, the meetings of the coalition were closed to the public and each member's contributions were made anonymously, thus protecting the coalition as a whole and each of its members from the glare of public scrutiny. The members of the coalition even negotiated the terms under which the Fund could be spent.

With the onset of the recession of 2008, the voluntary contributions to the Public Investment Fund shrunk dramatically. It was at this point that the dialogue between the City of Pittsburgh and the nonprofits became increasingly adversarial. Luke Ravenstahl, then Mayor of Pittsburgh, proposed a so-called "Fair Share Tax" on college tuition to be paid by the students, not by the colleges. Similarly, he proposed a usage tax on hospital rooms to be paid by patients, not the hospitals.

By all standards of fair taxation, Ravenstahl's proposals were outlandish. Even he knew that they would never materialize. Ravenstahl's aim, however, was to focus public attention on the City's fiscal plight and to drive a wedge between the large nonprofit institutions and their core constituencies. In the end, the coalition behind the Public Investment Fund pledged to do a bit more to assist Pittsburgh with its financial woes, but the pledge carried no binding commitment. Pittsburgh and other taxing jurisdictions continued to chafe under Act 55.

2012 – Present: Another power shift back to taxing jurisdictions

In 2012, there was yet another unexpected twist in this saga that shifted power back to the taxing jurisdictions. In *Mezivteh Eitz Chaim of Bobov, Inc. v. Pike County Board of Assessment Appeals* (2012) (*Mezivteh*) the Pennsylvania Supreme Court upheld the Commonwealth Court finding that a faith-based summer camp did not meet the standards of a "purely public charity." Specifically, the Supreme Court agreed with the lower court ruling that the camp did not "relieve the government of some of its burden," which is the fourth *HUP* criterion. More importantly, the Supreme Court affirmed the lower court's decision to apply the

HUP test instead of Act 55's more liberal criteria. The Supreme Court's ruling in *Mezivteht* runs counter to principles it articulated in an earlier case which "suggest that in a conflict between Act 55 and *HUP*... the Supreme Court seems to believe that the legislation should be given greater weight" (Brody 2010, 628).

In the *Mezivteht* judgment, the Supreme Court navigated an intricate, and somewhat circular, path between several legal principles. In *Mezivteht* the Court (1) asserted that its decision in *HUP* set the Constitutional minimum standard for a purely public charity; (2) further asserted that no legislative statute could lessen the Constitutional minimum standard established in *HUP*; (3) found that Act 55 did, in fact, lessen the minimum standard; but, (4) nonetheless asserted that Act 55 could still be helpful after an organization demonstrates that it meets the *HUP* standards (Huber and James 2013, 40). The Court's logic leaves one to wonder how the relatively permissive Act 55 could be useful as a check on the more restrictive *HUP* test. Also, it is noteworthy that the Court used the term "minimum standard" when many observers viewed the *HUP* criteria as too high for nonprofits to meet.

Thus, with the *Mezivteht* ruling, the Supreme Court drew a line in the sand – if the General Assembly wished to assert its jurisdiction in defining what constitutes a charitable organization, then it must secure passage of a Constitutional Amendment explicitly granting it such authority.

The current quandary for nonprofits

Accepting the Court's challenge, the General Assembly is now debating a Constitutional Amendment in the form of Senate Bill 4 (2015) (SB 4). The proposed amendment is straightforward, stating simply that "The General Assembly may... by law establish uniform standards and qualifications which shall be the criteria to determine qualification as institutions of purely public charity...".

In the last legislative session, SB 4 passed in the House (118-82-3) and in the Senate (30-20), largely along party lines with Republicans favoring and Democrats opposed. The curious partisan split seems to be attributable to concern of Democrats about the fiscal plight of large urban areas. The proposed amendment must pass again in the current session before being placed on the voter's ballot. The bill is moving so quickly that it could be on the ballot as early as November 2015.

SB 4 is opposed by several municipal leagues and many local government officials, including Pittsburgh's current mayor who is engaged in negotiations with the City's largest nonprofits for long-term PILOTs. SB 4 could undercut his leverage in those negotiations. Other opponents are alarmed by the speed with

which SB 4 is moving through the legislative process and have called for a fact-finding commission to slow its progress (Potter 2015).

SB 4 has the support of a variety of nonprofit groups including a state-wide hospital association, the Pennsylvania Association of Nonprofit Organizations, some YMCA chapters, the United Way, and groups representing colleges and religious organizations. Not all nonprofits, however, support the legislation. The Greater Pittsburgh Nonprofit Partnership, a coalition of nearly 400 organizations, has decided to take no position on SB 4. There is concern among some nonprofits that the Constitutional Amendment would open the door to legislative micromanagement of nonprofits, including intervention on sensitive issues such as salary limits. Opponents also fear that giving the legislature, not the courts, jurisdiction to define a purely public charity will politicize the process; evidently they would rather cast their lot with the courts, not the legislature.

Issues

This case study concludes with brief commentary on a few salient issues illustrated by the Pennsylvania context:

1. Which branch of government – the judiciary, the legislature, or the executive – is best equipped to establish uniform standards?

The nonprofit sector is a menagerie of organizations with vastly different missions, business models, and resources. Moreover, all three sectors – business, government, and nonprofit – are constantly changing and adapting to their environments, spawning entrepreneurial practices and evolving new forms of hybrid organizations that are blurring the boundaries between the sectors and challenging old assumptions about what it means to be a “charity.”

Pennsylvania’s proposed Constitutional Amendment would grant the General Assembly authority to establish *uniform* standards for defining a public charity. In a dynamic nonprofit sector, can a charity be defined in a uniform and lasting way (Grimm 1999)? Which branch of government is best equipped to respond to changing circumstances and new societal needs?

The judiciary is, on the one hand, bound by legal precedent and the accumulated body of case law, which restricts its flexibility. Yet “the courts recognize that the concept of charity evolves over time to take into account... varying conditions... and needs of different communities” (Brody 2010, 635). Moreover, at least in theory, the courts are free of political influence and provide all litigants, whether strong or weak, equal treatment under the law.

The legislative branch may be more proactive than the judiciary, but it is also more vulnerable to political influence and manipulation. Powerful lobbyists representing the healthcare and higher education sectors were behind the passage of Act 55 and now are key supporters of SB 4. Both pieces of legislation mention specific classes of tax exempt organizations including hospitals and private universities effectively exempting specific nonprofit organizations rather than groups of entities as is recommended by various policy advocates (Bureau of Governmental Research 2001, 17). Virginia's law seems to be an extreme example of institutional influence, specifically naming more than 800 organizations as tax exempt (Gallagher 2002, 11).

The executive branch might provide the best balance of responsiveness and political neutrality, yet it too is laden with bureaucratic sluggishness and lack of coordination between agencies on the matter of tax exemptions (Brody 2010, 632–3).

2. **What level of government – state or local – should make decisions on charitable status?**

Local jurisdictions are creations of the state and, as such, are subject to extensive vertical control. Localities can achieve some autonomy in states that have provisions for local “home rule,” but this modest level of independence typically does not extend to the granting or withholding of tax exemptions. Thus, the property tax exemption constitutes an unfunded mandate imposed by an upper level of government upon its lower jurisdictions.

In theory, a uniform definition of a charitable organization, applied state-wide, treats all of these jurisdictions equally. In practice, however, it is obvious that communities that are home to universities, hospitals, and other large land-owning institutions bear a heavier burden than others. For example, only 7% of Pennsylvania's municipalities host an acute care hospital and a private university (Committee on Legislative Budget and Finance 2009, 17). Thus, from one point of view, these so-called “Eds and Meds” communities are penalized for their *success* in attracting institutions and talented people who are widely deemed to be net contributors to civil society as a whole, not just the local jurisdiction.

There is the separate, but related, issue of government-owned properties that are tax exempt, including properties owned by the state or federal government. Studies show that the vast majority of tax exempt property is not owned by charities, but by government itself (Brody 2007, 269).

Should a certain amount of self-determination be granted to local governments by, for example, allowing them to cap the percentage of tax exempt property at a level that is financially sustainable? Should the state

reimburse localities for all or a portion of their tax exempt properties? Should regional taxing authorities be established to share the burden of tax exempt properties, especially those such as museums and hospitals that are generally deemed to be assets that benefit a region, not just one jurisdiction? Should the state provide some sort of technical assistance, or sanctioned guidelines, that would empower municipalities to negotiate PILOTs in a way that is more transparent and fair to all parties such as the system used by the City of Boston (Kenyon and Langley 2011, 7)?

3. **Should the debate be reframed in terms of root causes?**

In Pennsylvania's debate there is a so-called "elephant in the living room" – a bigger issue that is easier to ignore than to address it straight on. On the government side of the debate, that "elephant" is the property tax itself – an outdated and insufficient source of tax revenue. Several of the communities that are at the center of Pennsylvania's charitable exemption debate have been officially declared "financially distressed," in part because their tax base is no longer sufficient to cover the growing cost of government. Expanding the tax rolls to include charitable property is seen by many as a "quick fix" to financial problems that have been simmering for decades, including legacy debts incurred over generations. For example, unfunded pension liabilities in Pennsylvania municipalities are estimated to be \$6 billion. It is no coincidence that the estimated revenue from Mayor Ravenstahl's desperation tactics, discussed above, was almost exactly equal to the unfunded portion of Pittsburgh's antiquated pension plan.

New and more effective revenue mechanisms, such as regional tax base sharing and higher commuter taxes may be better long-term solutions, but these measures are considered by many to be the third rail of local politics; they are made all the more intractable by Pennsylvania's extraordinarily fragmented and parochial system of local government.

But charitable organizations must contend with their own "elephant" – namely their business practices and revenue streams that are viewed by the general public as a far cry from being "charitable." For example, two nonprofit healthcare systems in Pittsburgh own massive amounts of land. Both organizations are vertically integrated corporate giants wielding vast power over the entire supply chain of health programs and services. For the past few years, these two organizations have been locked in a high-stakes battle in which patients have been reduced to bargaining ploys by each combatant to force concessions and gain a competitive advantage. The acrimony between the two became so dysfunctional that the state attorney general intervened to protect vulnerable populations from being caught in the corporate cross-fire. In the property tax debate, both of these health

systems have boasted of their beneficial impact on the Pittsburgh's economy and their pivotal role in helping the City recover from the death of the steel industry. Their positive economic impact is not in dispute, but their expensive public relations campaigns miss the point – the property tax exemption is a quid pro quo for their *charitable* work, not a reward for their economic impact (Kearns et al. 2009).

While the Pennsylvania case study has some unique characteristics, issues such as those outlined above are playing out in other states and localities as well. As of this writing, pressure is building to slow the progress of SB 4 so that these and other issues may be thoughtfully discussed with greater transparency and public input. If SB 4 passes in the current legislative session and then is placed on the fall ballot, a substantial responsibility will be placed on scholars and practitioners to help the general public navigate through the shrill rhetoric, to focus clearly on the issues and long-term consequences that are at stake.

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