

THE PROPERTY TAX EXEMPTION FOR NONPROFITS AND REVENUE IMPLICATIONS FOR CITIES

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The nonprofit sector accounts for roughly one-tenth of the U.S. economy, whether measured by employment or by total spending (Walker 2005), and has grown faster than the rest of the economy in recent decades. For example, while real GDP grew by 38 percent from 1995 to 2010, real total revenues reported by charitable nonprofits registered with the IRS grew by 65 percent.²

Municipalities that host charitable nonprofits benefit in many ways from their presence: they are often major employers that also provide important services for local residents and attract visitors to the community. But the nonprofit sector can also impose fiscal hardships on cities. Properties owned by charitable nonprofits and used for a tax-exempt purpose are exempt from property taxes under state law in all 50 states even though municipalities still need to pay to provide these nonprofits with public services like police and fire protection and street maintenance (Gallagher 2002, 3).³ For cities heavily reliant on the property tax, the exemption of nonprofits from property taxation means that homeowners and businesses must bear a greater share of the property tax burden. Sherlock and Gravelle (2009) estimated that in fiscal year 2009, property tax revenues forgone due to the charitable exemption were between \$17 and \$32 billion nationally, or roughly 4 to 8 percent of total property taxes.⁴

Many cities whose economies used to be dominated by manufacturing have seen relatively mobile for-profit businesses leave their cities, while colleges, universities, and medical centers that are tied to their location due to fixed capital investments and other factors remain in place (Penn Institute for Urban Research 2009, 148). For example, the 2010 Commission to Study Tax-Exempt Institutions in Providence, Rhode Island, found that tax-exempt institutions had been expanding in that city over the last decade, particularly in education, healthcare, and social services, while the manufacturing and financial services sectors were shrinking.⁵ While not all education and healthcare businesses are nonprofits, examining the shift in the employment base from manufacturing to this sector can illustrate how a city's industrial mix is changing and becoming more reliant on nonprofits. Nationally, the share of workers employed in manufacturing fell from 16.2 percent to 8.9 percent between 1990 and 2010 while the share working in education and health services grew from 10.0 percent to 15.1 percent. Table 1 shows these employment changes for the 25 largest metropolitan areas in the United States, with metropolitan areas ordered from highest percentage employment in education and medical services to lowest.

¹ Based on a paper prepared for the Fiscal Future of the Local Public Sector conference June 2–3, 2011, at the George Washington Institute of Public Policy and sponsored by the Brookings Institution, the George Washington Institute of Public Policy, the Lincoln Institute of Land Policy, the National League of Cities, and the Urban Institute. The authors are grateful to Bethany Paquin for her able research assistance and to discussants and other conference participants for their helpful comments.

² Data for nonprofits are from the National Center for Charitable Statistics for August 1995 and August 2010, which includes public charities and private foundations. Real charitable nonprofit revenues grew from \$825 billion to \$1.36 trillion over that period. Nominal values were adjusted using the CPI for all urban consumers and real values are expressed in 2010 dollars.

³ For the most part, nonprofits are exempt from sales and income taxes as well, but the state and local revenue forgone from these tax provisions is less than for the nonprofit exemption from property taxes (Kenyon and Langley 2010, 19).

⁴ From the U.S. Census Bureau's FY 2008 Annual Survey of State and Local Government Finances, published 2009.

⁵ "A Call to Build the Capital City Partnership for Economic Growth," a report to the Providence City Council from the Commission to Study Tax Exempt Institutions, November 2010.

Table 1. Employment in Selected Industries for the 25 Largest Metropolitan Areas, 1990–2010.

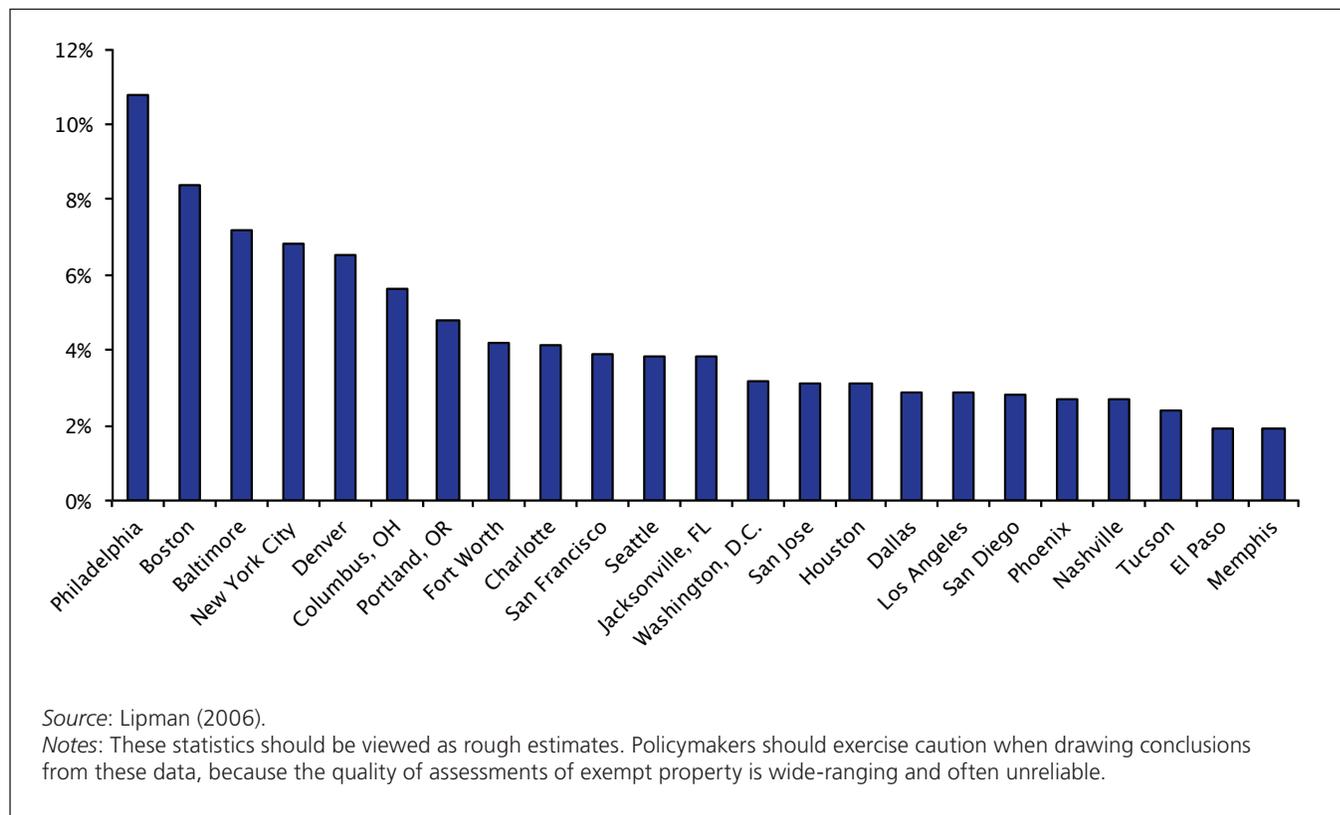
Metropolitan Area	Educational and Medical Services		Manufacturing	
	Percent of Total Nonfarm Employment (2010)	Percentage Point Change (1990–2010)	Percent of Total Nonfarm Employment (2010)	Percentage Point Change (1990–2010)
Pittsburgh	21.0	5.6	7.8	-4.8
Philadelphia	20.7	6.5	6.9	-7.0
Boston	20.5	5.0	8.0	-7.9
Baltimore	18.7	6.1	4.9	-6.3
New York	18.4	6.3	4.4	-6.5
St. Louis	17.3	8.5	8.2	-8.9
Detroit	16.5	6.5	10.8	-7.8
Tampa	15.9	3.2	5.2	-4.4
Minneapolis	15.8	5.7	10.2	-5.3
Miami	15.4	4.4	3.4	-6.1
National	15.1	5.0	8.9	-7.3
Chicago	15.0	5.3	9.5	-7.7
Cincinnati	15.0	3.6	10.5	-7.5
Portland	14.4	4.3	11.1	-6.0
Phoenix	14.1	5.2	6.5	-6.9
San Francisco	13.2	3.5	6.2	-3.2
Los Angeles	12.8	3.9	10.5	-9.2
Seattle	12.7	3.9	10.2	-6.9
Dallas	12.4	3.9	8.7	-8.4
Sacramento	12.3	3.6	4.1	-2.3
Houston	12.2	3.0	8.6	-2.8
Atlanta	12.2	4.6	6.3	-5.3
Washington, D.C.	12.1	3.4	1.8	-1.5
San Diego	12.1	3.4	7.6	-5.2
Riverside (CA)	12.0	2.3	7.6	-3.4
Denver	12.0	3.6	5.1	-4.8

Source: Bureau of Labor Statistics, Employment, Hours, and Earnings from the Current Employment Statistics Survey (Washington, D.C.: U.S. Department of Labor, 2011).
 Note: The cities listed are the primary cities of the Metropolitan Statistical Areas (MSAs) or New England City and Town Areas (NECTAs) defined by the U.S. Office of Management and Budget (OMB).

The impact of the charitable property tax exemption on municipal revenues varies widely across municipalities; it has a significant impact on some cities' abilities to raise sufficient revenue, while most municipalities are largely unaffected because they have small nonprofit sectors (see figure 1). In Boston, a city with a large nonprofit sector, nonprofit educational and medical institutions alone own tax-exempt properties that would have generated, if they were

taxable, \$390 million in property taxes in fiscal year 2011, which is equal to 25.5 percent of the city's total property tax levy and 16.7 percent of its total budget.⁶ In general, nonprofit property is highly concentrated in a small number of municipalities, especially central cities and college towns. These are the municipalities most likely to pursue policies to offset the impact of the charitable property tax exemption on municipal revenues.

Figure 1. Estimated Value of Exempt Property Owned by Nonprofits as a Percent of Total Property Value (2006)



⁶ Figure 1 shows that the value of exempt property owned by nonprofits accounts for only 8.4 percent of total property value. There are two reasons for this apparent contradiction. First, data in Figure 1 are very rough and were collected by analyzing property assessment rolls in 2006 before the Boston Assessing Department conducted a thorough assessment of exempt properties in 2009. Second, the commercial tax rate in Boston is 2.4 times the residential rate and the city has a very generous homestead exemption.

Policy Responses

A wide range of policy responses have attempted to partially offset the impact of the charitable property tax exemption on municipal revenues.⁷ These policies can be divided into three broad categories: fees and charges imposed on nonprofits, voluntary contributions and in-kind services, and changes in state law.

Fees and Charges

User Fees. Nonprofits are not exempt from paying user fees for services like garbage collection, water, and sewer. Thus, when municipalities reduce the proportion of their budgets financed by property taxes and increase the proportion paid through user fees, they increase the financial contributions of nonprofits. For example, Houston voted in November 2010 to adopt a drainage fee to raise revenue to improve roads and storm-water systems, making the explicit decision not to exempt churches, schools, and charities.⁸ Unlike some of the policy responses below that are applied only to tax-exempt property owners, user fees are applied equally to tax-exempt and taxable properties.

User fees were reported as the most common type of payment made by nonprofits to state and local governments in a recent survey of four types of nonprofits—child and family services, elderly housing and services, community and economic development, and arts and culture. User fees were paid by 41.6 percent of responding organizations, with a 2009 median payment of \$3,064 and an average payment of \$121,277 (due to much higher payments

made by large organizations). User fees were most commonly paid by nonprofits in the West (49 percent of respondents) and the Northeast (48 percent), and by nonprofit museums (53 percent). In addition, 17.6 percent of respondents paid field-specific taxes like bed taxes and ticket taxes (Salamon, Geller, and Sokolowski 2011).

Special Assessments. Special assessments are used to pay for improvements that benefit specific properties within a municipality. For example, a special assessment might be used to pay for sewer hookups for some part of a municipality. As with user fees, nonprofits are typically not exempt from such payments.

Municipal Service Fees. Some municipalities have imposed mandatory payments on nonprofits that fall between what would traditionally be considered a fee and a tax; they are sometimes referred to as municipal service fees or parcel fees. These fees are sometimes charged solely to tax-exempt nonprofits and sometimes charged to both taxable and tax-exempt organizations. Unlike a user fee, the amount of the payment is not directly related to the amount of a service used by a nonprofit. This is largely because municipal service fees are used to pay for public goods like street maintenance that are normally funded by general taxes. Unlike the property tax, the fee's amount is not necessarily based on a property's assessed value; instead it uses some other basis, such as square footage or street frontage, to calculate payments. This is likely because state laws clearly exempt charitable nonprofits from ad valorem property taxation, but are less clear on fees that use alternative bases for payments.

⁷ Just as the Great Recession had a negative impact on municipal revenues, it has created a fiscal crisis for many nonprofits. A 2009 survey of nonprofits found that 80 percent were experiencing fiscal stress in the wake of the recession (Center for Civil Society Studies 2009). Nonprofits can complain (often rightly) about municipal governments who shift fiscal problems onto nonprofits through increased fees or PILOTs as well as expanded social service needs met by some nonprofits to replace eliminated public services.

⁸ lanthe Jeanne Dugan, "Strapped Cities Hit Nonprofits with Fees," *Wall Street Journal*, December 27, 2010.

Minneapolis provides one example of a municipal service fee. More than \$1.0 million is raised by fees for street maintenance and street light operations that are based on the square footage of tax-exempt property.⁹

Voluntary Contributions and In-Kind Services

Payments in Lieu of Taxes (PILOTs). PILOTs are payments made voluntarily by tax-exempt nonprofits as a substitute for property taxes. These payments typically result from negotiations between local government officials and individual nonprofits, but the exact arrangements vary widely. PILOTs are sometimes formalized as long-term contracts, sometimes as routine annual payments without formal contracts, and sometimes they consist of irregular one-time payments. The payments can go into a municipality's general fund or be directed to

a specific project or program. PILOTs are most frequently made by hospitals, colleges, and universities, but are also made by nonprofit retirement homes, low-income housing facilities, cultural institutions, fitness centers, and churches. Since 2000, they have been used in at least 117 municipalities in at least 18 states (Kenyon and Langley 2010, 2). Table 2 shows PILOT revenues in 10 municipalities. While they rarely account for more than 1 percent of total revenues, the dollar values can be quite large.

PILOTs can provide crucial revenue for certain municipalities and are one way to make nonprofits pay for the public services they consume. However, negotiations can become contentious, and the often ad hoc determination of payment amounts results in widely varying payments among similar nonprofits. Boston provides an example of a collaborative approach where the local government works with nonprofits to reach PILOT agreements that advance both sides' interests.

Table 2. PILOT Contributions to City Revenues, Selected Cities

City	Year	PILOT Revenue (\$)	City Budget (\$ Millions)	Property Tax (\$ Millions)	PILOTs as % City Budget	PILOTs as % Property Tax
Baltimore, MD	FY11	5,400,000	2,936.0	765.7	0.18	0.71
Boston, MA	FY10	17,432,359	2,394.0	1,528.7	0.73	1.14
Bristol, RI	FY09	181,852	43.8	32.5	0.41	0.56
Cambridge, MA	FY08	4,508,000	466.7	238.7	0.97	1.89
Lebanon, NH	FY10	1,280,085	42.3	17.2	3.03	7.43
New Haven, CT	FY10	7,500,000	648.6	206.8	1.16	3.63
Pittsburgh, PA	FY11	2,800,000	507.8	130.6	0.55	2.14
Princeton Borough, NJ	FY10	1,180,496	24.7	10.4	4.78	11.37
Providence, RI	FY10	3,686,701	444.5	284.5	0.83	1.30
Worcester, MA	FY11	590,000	506.1	215.2	0.12	0.27

Source: Authors' research.

⁹ Steve Brandt, "Minneapolis to Boost Utility Fees for Tax-Exempt Properties," *Minneapolis Star Tribune*, September 20, 2009.

Boston's PILOT Task Force

In January 2009, Boston Mayor Thomas Menino created a PILOT Task Force with the objectives of making PILOT contributions more consistent across institutions and increasing revenue from PILOTs. The task force included representatives from universities, hospitals, city government, public sector unions, business, and community groups. Over 14 months, the group met more than 10 times and city staff collected an extensive amount of data on the city's nonprofits to help guide their recommendations. Despite their divergent interests, the group unanimously reached a set of recommendations. The task force agreed that PILOTs should continue to be voluntary; that the goal of obtaining 25 percent of what a nonprofit would pay if it were taxable should apply to the total exempt value owned by each nonprofit and that it should be extended to a broader range of nonprofits, such as cultural institutions and secondary schools; and that community service credits could offset up to 50 percent of the target cash PILOT.¹⁰

Many of the potential flaws of PILOTs can be reduced by adopting a systematic PILOT program that includes the following features, many of which are inspired by Boston's program:

- *Adopt a goal for contributions.* Municipalities can estimate the share of the local budget that funds core public services directly benefitting nonprofits, like police and fire protection and street maintenance. For example, officials could ask for PILOTs equal to 25 percent of the property taxes each nonprofit would owe if they were taxable entities.
- *Choose a basis to calculate suggested PILOTs.* The amount for each nonprofit can be calculated based on the assessed value of exempt property, square footage of property, size of nonprofit budget, or number of hospital or dorm beds.
- *Offset community benefits against suggested cash PILOTs.* For example, if a college provides scholarships to local residents, this can be credited against the cash PILOT.
- *Use multi-year agreements.* This creates a "win-win" situation for both the municipality and nonprofits by providing reliable revenue for the city and avoiding budget surprises for nonprofits.

Despite the formulaic approach, these are not statutory requirements; the framework can help guide negotiations with nonprofits, but PILOTs should remain voluntary.

Services in lieu of taxes (SILOTs). Instead of making cash payments to a municipality, local officials can work out arrangements with nonprofits to provide valuable services for local residents. These in-kind services can be incorporated into a PILOT program as community benefit offsets like in Boston,

¹⁰ From the Boston Mayor's PILOT Task Force's Final Report and Recommendations, December 2010.

or they can be standalone agreements. In addition, nonprofits sometimes form partnerships with their host municipality to foster economic growth, which can increase a city's tax base. For example, Yale University's contributions to the city of New Haven go beyond its \$7.5 million PILOT and include paying a stipend for Yale employees buying homes in the city, redeveloping several blocks of the city's retail center, and funding an organization that taps New Haven's civic resources to tackle its social problems (Kenyon and Langley 2010).

Changes in State Law

State Payments to Municipalities Hosting Tax-Exempt Institutions. The charitable property tax exemption can be thought of as an unfunded state mandate: it is granted at the state level but local governments bear the cost in the form of forgone property tax revenues. In addition, there is frequently a geographic mismatch between the benefits and costs of the charitable property tax exemption. Many nonprofits provide services that benefit people who reside outside the borders of their host municipalities. For example, hospitals normally serve an entire metropolitan area, not a single city; many universities educate students from around the world. Yet the cost of the exemption is borne entirely by the municipality where the nonprofit is located. To promote accountability in governmental decisions on the charitable tax exemption and to better align the benefits and the costs of subsidizing nonprofits via tax exemption, it makes sense for state governments to compensate local governments for the property taxes they forgo due to the presence of tax-exempt nonprofits.

Both Connecticut and Rhode Island take this approach. Connecticut law calls for the state to make grants to local governments that host tax-exempt colleges, universities, and hospitals equal to 77 percent of the property taxes those institutions would pay if they were taxable. In FY2008, the state paid a total of \$122.4 million to 57 municipalities and 7 special districts.¹¹ Rhode Island law calls for grants to municipalities equal to 27 percent of the property taxes forgone on properties owned by a wider range of tax-exempt institutions, and in FY2010 these payments were worth \$27.6 million.¹²

While the basic argument in favor of state payments to municipalities hosting tax-exempt institutions is strong, the downside to this approach is that it can leave municipalities susceptible to cuts in grants when states face fiscal challenges. This has been a problem in Connecticut, where in FY2010 municipalities were reimbursed for only 45 percent of forgone property taxes instead of the 77 percent specified by statute.¹³

Provide a Local Option. An alternative way to address the spatial mismatch between the benefits and costs of the charitable property tax exemption is to transfer authority over the exemption to local governments. Virginia is the one state to have pursued this approach, when in 2002 voters approved a referendum amending the state constitution so property tax exemptions would be granted by local governments instead of the state. Fairfax County soon decided to make all future property purchased by nonprofits taxable, although existing tax-exempt properties were not affected (Shafroth 2005, 811).

Narrow the Scope of the Property Tax Exemption. In most states, the group of nonprofits eligible for a charitable property tax exemption

¹¹ From the "Description for Colleges (private) and General/Free Standing Chronic Disease Hospitals: Payments in Lieu of Taxes." State of Connecticut, Office of Policy and Management, Intergovernmental Policy Division (2008).

¹² State of Rhode Island. 2010. "Fiscal Year 2010 State Aid to Cities and Towns." Available online at <http://www.muni-info.ri.gov/documents/stateaid/State%20Aid%20FY%2010.pdf>.

¹³ Paul Bass, "Candidates Make a PILOT Pledge," *New Haven Independent*, May 5, 2010.

largely overlaps with those designated as 501(c)(3) charitable nonprofits at the federal level, with the further stipulation that property must be both owned by such a nonprofit and used to serve its charitable mission. But state requirements vary and some additional revenue may be gained either by narrowing the permissible exemption or by more strictly enforcing the property tax exemption statutes and case law.

One major outlier is Louisiana, which has an unusually broad charitable exemption that covers fraternal organizations, labor unions, professional associations, and other nonprofits that are typically not exempt from property taxation in other states. Additionally, Louisiana's use requirement is weaker than most states', so individual properties owned by an exempt nonprofit will be tax-exempt even if they are not actually used for an exempt purpose. Because of the broad exemption, tax-exempt properties owned by nonprofits account for roughly 21 percent of total assessed value in New Orleans (Bureau of Governmental Research 2011). For these reasons, the New Orleans Tax Fairness Commission has recommended that the state legislature narrow the types of organizations and property uses eligible for property tax exemptions so that Louisiana law is more consistent with other states.¹⁴

Conclusion

For municipalities with a significant share of total property value owned by tax-exempt nonprofits, and especially those that are also highly reliant on property tax revenues, the charitable property tax exemption can create fiscal challenges. This policy brief discusses a wide range of policy responses that

can partially offset the impact of the exemption on municipal revenues.

In theory, changes in state law that more accurately align the benefits and costs of the property tax exemption are best. However, in most places, major changes in state law are not realistic policy options in the near future; additionally, such changes could leave cities susceptible to cuts in state grants during recessions. User fees and perhaps special assessments have significant revenue potential, promote local autonomy, and are more consistent and predictable than PILOTs. Some municipalities, however, may be reluctant to make fundamental changes to their mix of taxes and fees that will affect all property owners, and they may have concerns about the regressivity of user fees compared to the property tax. Municipal service fees leave taxable properties alone and also promote local autonomy, but the legal questions surrounding these fees mean they may face court challenges. Finally, PILOTs and SILOTs promote local government autonomy and do not have any direct impact on taxable property owners. But relying on voluntary contributions limits the revenue potential of PILOTs and often leads to large horizontal inequities in the amounts of payments among similar nonprofits. Many of the flaws of PILOTs can be addressed by adopting a systematic program, along the lines of Boston's program. Whether a systematic program is adopted or PILOTs are negotiated on a case by case basis, it is important to take a collaborative approach to soliciting such payments. While no policy option is perfect, there is a range of responses that cities can consider to offset the revenue implications of the charitable property tax exemption.

¹⁴ New Orleans Tax Fairness Commission, Resolution on Executive Order 10-07, April 2011.

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