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Tax Exemptions of Charities Face New Challenges

By STEPHANIE STROM

RED WING, Minn. — Authorities from the local tax assessor to members of Congress are increasingly challenging the tax-exempt status of nonprofit institutions — ranging from small group homes to wealthy universities — questioning whether they deserve special treatment.

One issue is the growing confusion over what constitutes a charity at a time when nonprofit groups look more like businesses, charging fees and selling products and services to raise money, and state and local governments are under financial pressure because of lower tax revenues.

And there are others: Does a nonprofit hospital give enough charity care to earn a tax exemption? Is a wealthy university providing enough financial aid?

In a ruling last December that sent tremors through the not-for-profit world, the Minnesota Supreme Court said a small nonprofit day care agency here had to pay property taxes because, in essence, it gave nothing away.

The agency, the Under the Rainbow Child Care Center, charges the same price per child regardless of whether their parents are able to pay the full amount themselves or they receive government support to cover the cost.

“We were shocked,” said Michelle Finholdt, who founded the center in 1994 and scraped together the money to buy a building in 2002. “There are a lot of other organizations in our area that we’re similar to, and they are exempt from property taxes.”

The tax-exempt status of charities costs local governments $8 billion to $13 billion annually, according to various rough estimates.

And local assessors are not the only government officials scratching their heads over which groups deserve privileged tax status. Congress has threatened to impose a requirement that wealthy universities make minimum payouts from their endowments and raised questions about whether nonprofit hospitals are really all that different from their for-profit — and tax-paying — competitors.

And, concerned about the way some churches are spending money, the Senate Finance Committee has asked for detailed financial information from six evangelical ministries asking them to justify their tax exemptions.

Others are questioning whether some tax-exempt nonprofits, primarily universities and hospitals, have accumulated so much wealth that they should no longer be considered charities. In Massachusetts, where Harvard’s endowment has reached $35 billion in assets, legislators are weighing whether to impose a 2.5 percent annual assessment on universities with endowments of more than $1 billion.

The idea behind tax exemptions is that the organizations provide a public service or substantially reduce the burdens of government. Standards from property-tax exemptions are set by the states, while the federal exemption means charities are not taxed on their income.

Almost 88 percent of overall nonprofit revenues in 2005, the most recent year for which figures are available, came from fees for services, sales and sources other than charitable contributions, according to the National Center for Charitable Statistics. Nonprofit health care providers, day care centers and retirement homes, among others, are often difficult to distinguish from their tax-paying competitors.

"We're all seeing the growth of revenue in this area we call earned income," said Audrey R. Alvarado, executive director of the National Council of Nonprofit Associations, adding that the Minnesota court decision "is saying, 'Wait a minute, charities are supposed to give things away for free.' "

"It goes to the core of how nonprofits are classified and defined," she said, "and I think it is an example of the confusion in the public, and even among folks in the sector itself, about what a nonprofit is."

Evelyn Brody, a professor at Chicago-Kent College of Law and an expert on nonprofits and property taxes, said that, in studying the issue in 2002 and revisiting it last year, she had seen an explosion of cases across the country in which charities were challenged to say why they deserve their property tax exemptions.

As universities charge high tuitions, and pay large salaries to administrators, they have become prime targets. For example, New London, Conn., assessed property taxes on a skating rink owned by Connecticut College. Local assessors tried to tax Smith College in Northampton, Mass., arguing that the women's college engaged in sex discrimination and thus was not charitable.

Smaller organizations that provide services like day care or drug treatment are being challenged, too. The Oregon tax court denied property tax exemption to a residential substance-abuse treatment center because it catered to "addicted professionals" and, like Under the Rainbow, did not give away its services.

The Minnesota Department of Revenue and county tax assessors say the uproar over the court ruling here has surprised them.

"From the assessors' standpoint, the Under the Rainbow ruling didn't change anything for us," said Thomas J. May, the tax assessor for Hennepin County and a spokesman for the state's assessors.

In determining which organizations qualify for exemption, assessors in Minnesota rely on the State Constitution, which explicitly exempts things like public burial grounds, seminaries and colleges and universities from taxation, and on six criteria set out in a 1975 State Supreme Court decision.

Mr. May said that the determination process had become increasingly difficult, however, noting that the Mall of America, a major tourist attraction, was seeking tax exemptions as part of its plans to expand, arguing that it aids the state economy by drawing visitors.

"From our perspective in the assessment field, it's harder to define what's a nonprofit these days because there are so many different types, and many of them are doing the same thing for-profit groups that aren't exempt are doing," he said.

Some 95 percent of Under the Rainbow's $550,582 budget in 2006 came from fees for services paid by families or by county and tribal governments. The court concluded that because the center charged all families the same amount, regardless of their ability to pay, and because its rates were not lower than those of its competitors, it was not an institution of "purely public charity" under the law and thus was subject to thousands of dollars in property taxes — $16,000 in 2006 and in 2007.

"The extent to which the recipients of the charity are required to pay for the assistance received tests for a value that is fundamental to the concept of charity — that is, whether the organization gives away anything," Chief Justice Russell A. Anderson wrote in the decision.

Additionally, the court ruled that government payments were not evidence of charity — those payments were not a gift.

These two elements of the ruling have profoundly alarmed nonprofit groups in Minnesota and elsewhere.

"There are between 300 and 500 nonprofit groups in this state that could lose their property tax exemptions under that ruling," said Jon Pratt, executive director of the Minnesota Council of Nonprofits, which represents about 2,000 of the state's roughly 3,400 charities.

RSI Inc. in Duluth is among those at risk, said Jon Nelson, its executive director. The organization was founded 30 years ago by parents of mentally disabled children when the state closed the last of its homes for the disabled.

More than 93 percent of its $11 million budget this year will come from government, and 6 percent will come from clients. "For-profit businesses aren't going to take on these clients, and the state long ago recognized that as a nonprofit, we could provide better care at a lower cost than it could," Mr. Nelson said.

"This court ruling is just ripe with unintended consequences," he said. "The state is cutting off its nose to spite its face." RSI owns real estate valued at $5.5 million and would pay an estimated $110,000 in property taxes if it lost its exemption.

"The nonprofit sector is being pressed to be more business-like and to find new ways to fill the gaps between what government will pay and what services cost, but then assessors want to treat us like businesses, which pay taxes," said Jan Malcolm, chief executive of the Courage Center in Minneapolis and a former state health commissioner.

The Courage Center, which provides services and facilities for physically disabled people, estimates that a change in its tax exemption would cost it $1.7 million — $1.4 million in property taxes and $300,000 in sales taxes, which are linked to payment of property taxes in Minnesota.

That, Ms. Malcolm said, would force the center to cut programs and services.

This month, the Minnesota Legislature passed a tax bill that establishes a one-year ban on reversing property tax exemptions held by existing nonprofits.

The bill requires legislators to set criteria to define what is "purely public charity," a phrase included in many state statutes on charitable property tax exemption, in an era of nonprofit groups that charge for their services and receive only negligible amounts of donations.

“We need to figure out what we mean by ‘purely public charity’ because, frankly, we can’t afford as a state to lose nonprofits providing these kinds of services,” said State Representative Paul Marquart, chairman of the property tax subcommittee. “But it isn’t going to be easy.”