LAO
70 YEARS OF SERVICE

February 3, 2014

Nonprofits and the Property Tax

L E G I S L A T I V E   A N A L Y S T ' S   O F F I C E

Presented to:
Assembly Local Government Committee
Hon. Katcho Achadjian, Chair
Assembly Housing and Community Development Committee
Hon. Ed Chau, Chair
Assembly Revenue and Taxation Committee
Hon. Raul Bocanegra, Chair

Nonprofits and the Property Tax

- ☑ ***Major Revenue Source for Local Governments.*** Property taxes are collected at the county level and distributed to local governments—cities, counties, schools, community colleges, and special districts. Revenue allocated to schools and community colleges generally offsets state spending on education.

- ☑ ***Annual 1 Percent Tax.*** The property tax is levied on the assessed value of real property (land and buildings) as well as personal property (primarily business equipment).

- ☑ ***Most Property Is Subject to the Property Tax.*** All California property is subject to the property tax unless exempted. The State Constitution authorizes the Legislature to exempt certain property, including property owned by charitable nonprofits.

- ☑ ***Nonprofits Exempt From Ad Valorem Property Taxes…*** Universities, hospitals, churches, affordable housing, and other nonprofits are exempt from most taxes on property they own and use for charitable purposes. In particular, they are exempt from taxes based on the property's value, known as ad valorem taxes, including Proposition 13's 1 percent rate and additional rates used to repay locally approved infrastructure bonds. Nonprofits that rent or lease property are not eligible for the exemption, nor are properties owned by nonprofits but held for investment purposes.

- ☑ ***… But Are Not Exempt From Other Taxes and Charges Levied by Local Governments.*** Some local governments levy property taxes and charges in addition to the statewide property tax. These taxes and charges—primarily assessments, parcel taxes, and Mello-Roos taxes—are based on factors other than property value, such as the cost of government services provided to the property or its parcel size. Charitable nonprofits are not exempt from paying these taxes and charges.

70 YEARS OF SERVICE

Why Exempt Nonprofits?

- ☑ ***States Exempt Nonprofits Because They Provide Public Benefits.*** In exchange for providing charitable services, nonprofit property is exempt from property taxes.

- ☑ ***Some Nonprofits Provide More Local Benefits Than Others.*** A nonprofit hospital provides benefits primarily to local residents while an international disaster relief nonprofit provides benefits overseas. Under state law, both are eligible for the same tax exemption.

- ☑ ***Some Nonprofits Benefit From the Exemption More Than Others.*** The exemption tends to benefit nonprofits that have valuable landholdings more than other nonprofits. Smaller nonprofits are more likely to rent or lease property and therefore do not benefit from the exemption. Nationally, two-thirds of all nonprofit organizations rent or lease their property.

- ☑ ***Nonprofits Exempt From Property Taxes in All 50 States.*** All states exempt property owned by nonprofits. Many states, however, set stringent eligibility requirements. One state, for example, requires that a majority of a nonprofit's revenue come from donations (as opposed to foundation grants or user fees), while another state mandates that one-half of a nonprofit's spending benefit in-state residents.

70 YEARS OF SERVICE

California's Nonprofit Property Tax Exemption

- ***State Constitution Allows Legislature to Exempt Nonprofits.*** The California Legislature has authority to exempt charitable organizations from the property tax. California's exemption is known as the *welfare exemption*.

- ***Welfare Exemption Is the Largest Property Tax Exemption.*** Except for government property—which is not subject to taxes—the welfare exemption is the state's largest property tax exemption. Amounting to $122 billion in exempt property value—or about 3 percent of all taxable property value in California—the exemption represents more than $1 billion in foregone local government revenue.

- ***Value of Welfare Exemption Varies by County.*** In most counties, the welfare exemption accounts for between 2 percent and 5 percent of countywide taxable property value. Counties with large nonprofit sectors—hospitals, private universities, and nonprofit headquarters, for example—have higher shares than counties with fewer nonprofits.

- ***Affordable Housing Does Not Appear to Be Large Component.*** Although comprehensive data are unavailable, affordable housing developments likely account for only a small portion of value exempt under the state's welfare exemption.

What Property Is Eligible?

☑ ***Most Nonprofits Must Meet Two Requirements.***

- ***Ownership.*** The property must be owned by a nonprofit organization.
- ***Use.*** The property must be used exclusively for charitable purposes.

☑ ***Housing Developments Must Meet Additional Requirements.***

- ***Rent Limitations.*** Rents must be affordable for low-income households.
- ***Property Tax Savings.*** Developers must certify that property tax savings from the exemption are used to "maintain the affordability of, or reduce rents otherwise necessary for, the units occupied by lower income households."

What Are Payments In-Lieu of Taxes (PILOTs)?

- ☑ ***PILOTs Are Payments Made to Local Governments as a Substitute for Property Taxes.***

- ☑ ***PILOTs Typically Equal Portion of Property Taxes Exempted.*** PILOTs typically equal the portion of property taxes allocated to that local government were it not for the welfare exemption. If, for example, a city would have received 17 percent of the nonprofit's property taxes were it not exempt, a PILOT between the two would equal 17 percent of the nonprofit's tax exemption.

- ☑ ***Do Not Appear Common in California.*** Local governments in some states operate standard PILOT systems, in which all tax-exempt nonprofits that meet certain criteria—based on size, nonprofit type, or revenue composition—make PILOTs. California PILOTs instead appear to be less common and typically negotiated on a case-by-case basis as part of the land use approval process.

LAO
70 YEARS OF SERVICE

Recent Developments

- ☑ ***Recent Events Test Whether PILOTs Are Compatible With Welfare Exemption.*** In 2013, the Ventura County Assessor's Office revoked the welfare exemption for several nonprofit housing developments that make PILOTs. According to the assessor, the exemption is invalid because developers use some of the property tax savings from the exemption to make PILOTs instead of lowering rents or otherwise improving affordability.

- ☑ ***Updated Board of Equalization (BOE) Legal Opinion Finds PILOTs Compatible With Exemption.*** The BOE finds that a housing developer making PILOTs qualifies for the welfare exemption as long as it has a reasonable belief that its PILOT payments will be used to benefit the housing development. An earlier opinion found one PILOT to be unconstitutional and warned that nonprofits making similar PILOTs could lose their welfare exemption.

Key Policy Questions

- ☑ Do PILOTs conflict with the legislative intent of the welfare exemption?
- ☑ Could local governments without land use approval authority—for example, school districts—also impose PILOTs?
- ☑ Could restrictions on PILOTs (1) affect local governments' willingness to approve development of affordable housing projects or (2) lead to local governments levying other charges?
- ☑ Should existing PILOTs be exempt from restrictions?