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Tax-Exempt Property and the Cities: Striking a Balance

by Richard D. Pomp*

Wisely or not, all states grant a property tax exemption to certain categories of private, nonprofit institutions. From the perspective of a revenue-starved mayor, tax-exempt property is one further source of erosion of the property tax base. Caught between rapidly increasing costs and already burdensome levels of property taxes, cities have begun to eye covetously the tax-exempt nonprofit institutions as a source of untapped revenue. Connecticut has recently responded to this problem by adopting landmark legislation that provides municipalities with state payments in lieu of the taxes lost due to the presence of certain nonprofit organizations. Reprinted below is the testimony of Professor Pomp before the Connecticut State Finance Committee, in which he proposed this approach, as well as others.

I

It is a pleasure to sit here at the tax-exempt Capitol, having just arrived on tax-exempt I-84, to share with you some thoughts on tax-exempt property. In fact, the more I think about it, the more I realize how little time I actually spend on taxable property. Take this weekend, for example. I spent a fair amount of time at the tax-exempt State Library doing research on tax-exempt property—not so much time, I might add, that I could not exercise at the tax-exempt YMCA, or walk through the city’s tax-exempt parks, or visit a friend at a tax-exempt hospital, or drop in at a tax-exempt museum. Later today, I will return to my tax-exempt office at the University, park in a tax-exempt lot, and eat at a tax-exempt cafeteria. All this good fortune stops when I return to a taxable home at the end of the day. But some taxpayers in New

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York have even managed to solve that problem, at least temporarily. For $20, the Universal Life Church will ordain you as a minister through the mail. You might remember that the Church became famous during the Vietnam War when ordination provided a divinity exemption from the draft. Now that the war is over, the Church has found a new market by ordaining taxpayers who can then claim that they are holding their homes as church property. For a modest $20 investment, you earn the right to argue with the assessor over whether your home is indeed a church.

My weekend activities give only a small hint of the great variety of exemptions. Property tax exemptions are granted for federal, state, and municipal property, private colleges and universities, churches, hospitals, cemeteries, and scientific, literary, historical, and charitable organizations. Exemptions are granted for the Daughters of the American Revolution, the Lions Club, the Boy Scouts, the Hartford Medical Society, various camps, argicultural associations, athletic associations, and so forth. We have a saying in the income tax field that exemptions rarely die—instead they usually multiply, and the same thing appears true in the property tax area. In fact, it could be said that we have cradle-to-grave tax exemptions in Connecticut (as well as in most other states), since we are born in tax-exempt hospitals and are buried in tax-exempt cemeteries.

The largest proportion of tax-exempt property is found in the major cities. In Hartford, the percentage of real property exempted from taxation is twice that in the surrounding suburbs. This result is not surprising, because the cities are, after all, the administrative, cultural, medical, and educational centers for both their surrounding regions as well as the state, but it does underscore the heart of the tax-exempt controversy: properties exempt from taxation provide regional and statewide benefits, yet the costs of such properties are disproportionately borne by the residents and businesses in the cities. Indeed, as my weekend activities illustrate, I, for one, make ample use of tax-exempt institutions in Hartford even though I live outside the city. As economists often remind us, there is no "free lunch," but those of us in the suburbs who enjoy the benefits of these institutions are surely dining at the expense of the city.

Let me be specific about the costs that are imposed on the city by the tax-exempts. When land is removed from the tax base because it is devoted to a tax-exempt activity or purchased by a tax-exempt organization, the city obviously loses the amount of property tax revenue
that it previously collected. But the city’s cost in servicing that property does not necessarily decline. Tax-exempt properties can consume a high level of local services in terms of fire and police protection, maintenance of the roads around the property, traffic control, sewer services, garbage collection, and so forth. As the property tax base shrinks without a concomitant reduction in costs, the city is thrust into an untenable position. In order to make up the lost property tax revenue, either the tax rates on the remaining properties must be increased, or the services must be reduced, or, more commonly, some combination of the two must occur. At the same time, inflation is driving up the cost of maintaining even the existing level of services.

An increase in property tax rates, coupled with a decline in the real level of services, only encourages individuals and businesses to leave the city and landlords to abandon marginal buildings. As businesses and jobs leave the city, as buildings are abandoned, and as the more affluent residents migrate to the suburbs, the property tax base is further eroded. And, because the state has allowed local governments to raise revenue only through the property tax, the further erosion of this base touches off yet another cycle of higher mill rates or reduced services.

This cycle has another and perhaps even more serious dimension. Since the more affluent and mobile individuals have migrated to the suburbs, the city is left with a disproportionate share of the state’s poor and elderly. The costs of tax-exempts are therefore borne by those least able to pay, and the already regressive nature of the state and local tax system is aggravated. Churches, universities, and hospitals are desirable, but so also are police, fire, housing, and welfare services. Tax-exempt property thus raises a fundamental question of taxpayer equity: Is it fair to impose all of the burden of a state-mandated exemption on the residents and businesses of the city, when the benefits and services generated by these properties, including jobs provided for commuters, accrue as well to those living outside the city? In other words, why should the city get indigestion because of my “free lunch”?

Some numbers may illustrate the problem. In Hartford, for example, the taxable grand list declined between 1975 and 1976, but the value of tax-exempt property actually increased. The tax revenue lost between 1971 and 1976 because of private tax-exempts has been estimated at $124,000,000. This is $124,000,000 that the city had to make up by increasing property tax rates or curtailing services.

But isn’t the city better off for having these tax-exempts? After all,
don't they create jobs and generate business? Sophisticated cost-benefit studies have been conducted to measure the economic impact of the exempt institutions. In terms of their net economic impact, these institutions are indistinguishable from institutions and businesses that pay the property tax and that also generate jobs and other benefits for the city.

If the state were starting anew and writing on a clean slate, would the existing property tax exemptions be enacted in exactly their present form? Obviously not, but no doubt the problems referred to above were unimaginable in 1822 when the first Connecticut statute that specifically exempted properties used for religious, charitable, educational, and public purposes was adopted. In 1822, the city was unchallenged as the center of the region's population, income, industry, and commerce. Property tax rates were low, and the amount of revenue lost because of tax-exempt property was probably insignificant. I suspect that the amount of tax-exempt property was not large in absolute terms either. Before the existence of the automobile, the city's continued growth and development was unquestioned. It was probably inconceivable that these exemptions would ever strain the city's finances. The state should not be locked in by history, however; the financial crisis and decay of the cities makes it an appropriate time to reconsider the whole issue of tax-exempt property.

II

The subject of tax-exempt property can be broken down into three parts: (1) whether the existing exemptions ought to be continued and, if so, for which activities; (2) which level of government ought to bear the costs of the exemption; and (3) what are the alternative ways of subsidizing the activities of organizations which the state wishes to encourage.

When I use the word "subsidize," I know that some will object and argue that certain organizations are not properly taxable because they are nonprofit. Before the mid-1800s, this position could be argued with some force in Connecticut because our property tax was part of a group of taxes on productivity; in other words, the property tax could then be viewed as somewhat similar to an income tax. But that is certainly not what the property tax has become. No one today seriously argues that the property tax is a disguised income tax, and there are no qualms about levying the tax on commercial enterprises that are run-
ning at a loss. Once the decision has been made to tax real property, the concept of horizontal equity or fairness dictates that all forms of real property should be taxed at the same rate. At a minimum, the burden of proof should switch to those who argue that particular classes of real property are not properly taxable. All this is really beside the point, however, and the Subcommittee should not get bogged down in semantics and blinded by smoke screens. For, however it is phrased, the fundamental issue is to determine the contribution that would be appropriate for these properties to make toward the costs of local government and how best to accommodate and balance the interests of the cities or other jurisdictions that contain a disproportionate percentage of tax-exempt properties.

The first question, whether the existing exemptions ought to be continued and, if so, for which activities, is obviously a controversial one. It does, however, have a noncontroversial aspect. Even if the state is content to continue the existing statutory exemptions, a number of ambiguities in the law could be eliminated through better drafting. These problem areas are well identified in the legal literature, and a systematic distillation of situations encountered by Connecticut assessors would also help focus on the troublesome issues. I would think that many of the problems could be corrected administratively, through the promulgation of regulations, similar to the regulations that are issued under the state corporate income tax.

Our experience with the income tax indicates quite clearly that only through vigilance can circumvention of the law be prevented. Again, the property tax is no exception. Once an exemption is provided by the law, taxpayers will restructure their transactions to bring themselves within the blessed, exempt category as the following incident illustrates. A number of years ago, a local Hartford church purchased 121 acres of vacant land in New Britain for $23,500. One person was buried there, and the land was exempted as a cemetery. In 1966, when the land had appreciated to $607,000, the body was removed, and the cemetery sold. Experiences of this sort are not unique to Connecticut. We can only speculate on how many examples of abuse never surface, either here in Connecticut or elsewhere.

Resolving the ambiguities in the statute is of course desirable, but what is really necessary is a wholesale evaluation of the scope of existing exemptions. When tax rates were low and when the cities were thriving, we could live with broad, generous, wide-reaching exemptions. We cannot today. If I were to reexamine the statute, I would
grant an exemption only if the activity or service were one which the state would have to perform if a private entity did not, and only if the exemption were required in order to provide the service to all needy members of the public. I realize that many will find my criteria too narrow for their tastes, but as long as the cities are going to finance the cost of the exemption, I think that a narrow test is entirely justified. I would be content with a broader test for the exemption if the cities were to be compensated adequately for their lost revenue. In any event, I think that most persons would agree that the case for an exemption becomes weaker if the activity in question can command sufficient fees to pay for local services, if the activity is one lacking in quasi-public features, and if the activity is directed toward middle- and upper-income individuals. If such activities are exempt, then the state is, in effect, redistributing income away from the poor.

Opinions will obviously differ about where in the spectrum particular activities will fall. A strong candidate for exemption under my criteria would be the Red Cross, the Salvation Army, a hospital that treated the indigent, or a library; a strong candidate for denial of an exemption might be a medical, dental, or bar association. An apartment building owned by a hospital and rented to interns and residents would not, under my criteria, present a very strong case for exemption, though such a building is currently exempt.

III

Assuming that some subsidy is in order, the next question is to decide the level of government which should provide that subsidy. I have already suggested that many exempt properties provide general and diffuse benefits to areas beyond the jurisdiction in which they are located. This is clearly seen for the Capitol and other state-owned buildings, but is also true for many other properties. For example, a recent study found that less than half the patients treated in tax-exempt hospitals in Bridgeport, Hartford, New Haven, and New London actually lived in these cities. The results were even more pronounced for colleges and universities located in these cities. Perhaps in the 1800s, more of an overlap existed between the jurisdiction where the property was located and the jurisdiction where the beneficiaries lived. But the growth of the suburbs and the increased mobility of individuals have now produced a situation in which many of the benefits and services generated by tax-exempts are provided to residents of other jurisdic-
tions. Where is the justice of a state law that forces the city to subsidize those who live in the suburbs? Indeed, this injustice is recognized for state-owned property by the payment-in-lieu-of-taxes (PILOT) program. Under the PILOT program, the state provides municipalities with payments intended to offset the revenue lost because of state-owned property. Although these payments represent only a small percentage of the lost property tax revenue, the state at least recognizes the unfairness of forcing certain municipalities to subsidize state government. Why not recognize the unfairness in forcing certain municipalities to subsidize another state objective—the encouragement of nonprofit activities?

IV

If a subsidy is to be provided to certain organizations, what form should it take? The present treatment, an exemption from property taxes, is probably one of the least rational methods. Consider, for instance, two organizations, X and Y. X is a young organization, and struggling financially, and can afford only to rent office space. Y is well-established and known for its generous salaries and opulent headquarters located on prime real estate. Has the state consciously chosen to ignore X, the struggling organization, but to grant benefits to Y, the less needy organization? Has the state consciously chosen to increase its subsidy in proportion to the amount of land and buildings that an organization owns? In a period of high unemployment, would it not make more sense to dispense a subsidy on the basis of the number of persons employed by a charitable organization, rather than on the basis of real estate owned?

To point up yet another irrationality, suppose that X is located in a jurisdiction that makes wide use of service charges. Assume that X and Y use the same amount of water, sewer services, refuse services, and so forth. X however, pays for these services in the form of a service charge, whereas Y's jurisdiction finances these services through its property tax. Has the state intentionally decided that Y is to be insulated from costs that X bears? To put it yet another way, if the state were to grant cash subsidies to organizations that are presently exempt, would it purposely adopt a program that gave nothing to organizations so poor that they could not afford to own real estate and, instead, distribute money on the basis of how much real property were owned? That is the effect of the existing law, except that the local jurisdictions grant
the cash subsidies by not collecting the property tax they otherwise would.

Because of these irrationalities, my own preference would be to replace the property tax exemption with an explicit cash subsidy. (The exemption could be continued for religious organizations, since giving them a cash subsidy would presumably be unconstitutional.) If a system of cash grants were adopted, I have no doubt that the state would narrow the existing law in order to channel money only to the neediest of organizations. But if the state would not grant a cash subsidy in the same amount and to the same organizations that are now benefiting from the statutory exemptions, why should the existing system be continued? Is the answer because the local jurisdictions are footing the bill?

V

I have no illusions about a wholesale change in the law, but an understanding of the defects in the existing system is useful in identifying areas in which a better balance can be reached among the interests of the tax-exempts, the cities, and the state. The following options attempt to strike a better balance while staying within the present structure.

Option 1: Require the permission of the local jurisdiction before any taxable property can be bought by a tax-exempt. This approach places the decision-making power at the level of government that bears the cost of the exemption. Option 1 is hardly radical, since it is the very approach used with respect to industrial and commercial property. At present, a jurisdiction has the power to grant a property tax exemption in order to attract industrial and commercial property. Before granting an exemption, a jurisdiction must evaluate whether the benefits of having such property outweigh the loss of tax revenue, and assure itself that the business would not locate within the jurisdiction without the exemption. Option 1 merely extends this approach to property currently exempt under state law.

A municipality would be free to evaluate whether the presence of a particular institution were worth the granting of an exemption. The analogy with commercial property is useful in highlighting another similarity. The state has a valid reason for being interested both in industrial property and in tax-exempts. The state has an interest in encouraging nonprofit activities and also an interest in attracting new
industry to Connecticut; yet no law requires local jurisdictions to grant an exemption to business moving into the state. That decision is properly left to the local jurisdictions. The state is not helpless in attracting industry, because it has a wide variety of incentives and inducements that can be offered as part of a package. These incentives and inducements are paid for by the state, however. Why should not a similar approach be used for hospitals, colleges, museums, and other quasi-public organizations?

Option 1 also allows the local jurisdiction to offset the leverage that a tax-exempt organization has in bidding against other potential purchasers of land. Because a tax-exempt organization does not have to pay one of the carrying costs associated with the ownership of property, a cost that all other purchasers must take into account, it can afford to pay a higher purchase price and thus outbid other potential buyers. In a jurisdiction having high property taxes, typically a city, this leverage is increased. Option 1, however, allows a jurisdiction to offset this advantage. Moreover, Option 1 allows a jurisdiction to exercise rational land-use planning. As an illustration, a city could refuse permission for a tax-exempt to buy property in the heart of the financial or shopping district, but welcome expansion into an area undergoing urban renewal. Furthermore, permission to expand could be conditioned on a host of subsidiary agreements concerning the creation of new jobs, affirmative action programs, or any other priorities of the city.

Option 2: Phase in the exemption whenever taxable property is bought by a tax-exempt. This option cushions a jurisdiction against an abrupt decline in revenue in the year of purchase. [Wesleyan reputedly has an arrangement of this nature with Middletown.] Option 2 is feasible for established organizations and for property being bought by the state. It would be improper to phase in the exemption for property bought by a newly created organization, because it is during the start-up period that the organization is likely to be short of funds and thus most in need.

Option 3: Phase out the exemption after a certain period. A time limitation would enable new organizations to get started without the burden of the property tax but would also recognize the jurisdiction's interest in not being burdened with a perpetual exemption. A specific phase-out date would allow an organization to plan adequately for the eventual imposition of the property tax.
Option 4: Limit the number of acres qualifying for the exemption. Like Option 3, this approach attempts to balance the interests of the tax-exempts against the revenue loss incurred by the jurisdiction. An acreage limitation recognizes that once some reasonable level of property ownership has been exempted, further expansion should not be at the expense of the local government.

Option 5: Set a dollar limit on the amount of property that can be exempt. A dollar ceiling on the exemption is another means of balancing the interests of the tax-exempts with those of the jurisdiction. Owning property in excess of the ceiling indicates that the organization has a level of wealth or ability to pay which does not justify any further exemption.

Option 6: Impose a user charge. A user charge recognizes that tax-exempts consume local services and should therefore contribute to the costs of local government. The institution of user charges was recommended in 1972 by the Governor's Commission on Tax Reform. Recall from my earlier example that Option 6 exists in jurisdictions that already provide some services on a user charge basis, such as the supplying of water. Applying Option 6 to all tax-exempts, regardless of where they are located, would end the discrimination that currently exists between tax-exempts located in jurisdictions that have user charges and those which are located in jurisdictions that "charge" for similar services through the property tax. More important, a service charge removes an incentive for a tax-exempt to hold vacant or idle land that it no longer needs, a tendency that a land-starved city can ill afford. A user charge will also curtail the incentive for tax-exempts to overinvest in real estate; Option 6 should therefore result in a more efficient allocation of resources.

A user charge need not involve the elaborate metering of various municipal services, though such a procedure might be feasible in certain situations. A simple means of implementing a user charge is to estimate the percentage of the jurisdiction's total budget which is devoted to supplying property-related services, such as fire and police protection, traffic control, and garbage collection, and to apply that percentage of the mill rate to the value of the tax-exempt property. If 35 percent of the budget were estimated as attributable to the provision of these services, and if the mill rate were 60, then the assessed value of the tax-exempts would be subject to a user charge of 21 mills (.35 ×
60). A “circuit breaker” could be used to grant relief to organizations that could not afford the increased cost.

In theory, I find no reason not to apply the full mill rate to tax-exempts, just as we do to commercial and industrial property. Tax-exempts would still be receiving a subsidy under Option 6, measured by the difference between the user charge and the full mill rate (39 mills difference in my example).

Option 7: State payments to jurisdictions containing tax-exempt property. Option 7 recognizes the unfairness in a jurisdiction’s bearing the entire loss in property taxes attributable to the presence of tax-exempt property. Option 7 extends the state’s PILOT (payments-in-lieu-of taxes) program to non-state-owned property, on the theory that the exemption from the property tax implements state objectives and goals. In order to channel state funds where they are needed most, payments should be made only to jurisdictions having more than the statewide average of tax-exempt property. Alternatively, jurisdictions might be reimbursed not for all of their tax-exempt property, but only for the amount in excess of the statewide average.

The above options are not mutually exclusive; various combinations could be adopted to deal with special situations. Nor is there any reason to apply the same approach to all categories of property. For example, Option 4, an acreage limitation, might be more suitable for some types of organizations, such as cemeteries, than for others. Or, a different acreage limitation could be applied to different categories of property. Similar flexibility exists in the other approaches. Payment by the state, Option 7, could be combined easily with any of the other approaches. A different combination of approaches would allow for a different balance in the sharing of the costs of the exemption. The user charge option, for instance, could be adopted in conjunction with a state contribution to the jurisdiction which was equal to a percentage of the difference between the user charge and the full property tax. The percentage contributed by the state could vary from 0 percent, that is, no contribution, to 100 percent. If it were felt that the tax-exempt provided benefits that were spread throughout the entire state, the percentage would be closer to 100 percent; if it were felt that most of the benefits were distributed to residents of the jurisdiction, the percentage could be adjusted accordingly.

A combination of approaches introduces a degree of sophistication and a balancing of the competing interests which is unattainable under
the present system. Indeed, in view of the flexibility that is possible with the various options, the existing statutory scheme of exemptions is a crude and inequitable approach to a difficult problem.

As far as my own preference is concerned, I favor extending the existing PILOT program to include tax-exempt property. This approach would free the institutions and the cities from their present adversary roles. Both parties are currently on a collision course, as revenue-starved mayors covetously eye the institutions as a source of untapped revenue. By placing the issue in its proper statewide context, a PILOT program for tax-exempts would allow the parties to form a new partnership, to work together harmoniously and constructively at solving more pressing social problems. The issue of tax-exempt property has driven a wedge between groups that should be working together, and I urge the Subcommittee to help remove that wedge.

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