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Discussion Draft Prepared for the Greater Hartford Chamber of Commerce's Task Force on Tax Exempt Property

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Service Charges on Tax-Exempt Institutions

The 1972 Governor's Commission on Tax Reform (the Baker Commission), as well as other commentators, has recommended that the tax-exempt institutions be charged a fee for their consumption of municipal services. This proposal attempts to strike a balance between the interests of the municipalities and the interests of the tax-exempt institutions. On the one hand, the proposal recognizes that the tax-exempts are consumers of locally provided, property-related services, and thus ought to compensate the municipalities for the costs of providing those services. On the other hand, by not subjecting the tax-exempt institutions to the regular property tax, the proposal recognizes the special status of these organizations.

A fee levied for the consumption of public services is known as a user, or service, charge. User or service charges are hardly novel. A municipality that bills property owners for their use of water already imposes a service charge, and one that tax-exempt institutions currently pay. Advocates of the service charge approach recommend that it be extended to all property-related services, such as fire and police protection, refuse collection, sewer services, street services, and the like.

Many economists are in favor of service charges for the same reasons that they favor the use of prices in the private market: the minimization of waste by consumers and the efficient allocation of resources. The provision of public services differs from the provision of private services in one important respect, however. As a practical matter, it is difficult to measure the consumption of certain public services, such as fire or police protection, traffic control, or road maintenance. Although the supplying of water and the collection of refuse may lend themselves easily to user charges, no administratively feasible method exists for measuring the consumption of most other publicly provided services. A user charge based on each tax-exempt's actual consumption of public services is therefore likely to be impractical.

An alternative approach is to approximate a user charge by levying on tax-exempts that percentage of the mill rate which is attributable to property-related services. For example, if property-related services constitute one third of all local governmental expenditures, then a tax-exempt institution would pay a user charge equal to one third of the normal mill rate times its assessed value. Using a percentage of the mill rate as a proxy for a user charge is obviously a hybrid approach. Because no relationship exists between a tax-exempt's consumption of services and the user charge, this approach will be viewed by some less as a service charge and more as a thinly disguised property tax.

Whether viewed as a service charge or as a disguised property tax, this hybrid approach may offset one of the inadvertent consequences of the existing system.
of tax exemptions for nonprofit organizations. Because these organizations do not currently pay the property tax, economists argue that they are thereby encouraged to overinvest in land and improvements and to hold land idle for longer periods of time than would otherwise be true. These effects, if true, are hard to justify in land-starved urban areas. Moreover, in times of un-
employment any policy that encourages investment in land instead of in labor is questionable. If a service charge reduces these effects, it will be serving a positive goal.

In order to levy a service charge on the assessed value of a tax-exempt's land and improvements, accurate data on fair market value is required. Connecticut, unlike most other states, requires municipalities to assess their tax-exempt property periodically, but these assessments are presumed by most persons to be less accurate than assessments of taxable properties. This presumption is entirely reasonable: because exempt properties are not taxed, accuracy in their assessment is not crucial, and little effort is therefore spent in valuing them. Yet, even if considerable time and effort were devoted to the assessment process, valuation problems would still exist since many exempt structures are unique or are rarely sold.

At the heart of the valuation problem is whether the traditional techniques for determining fair market value work satisfactorily when applied to tax-
exempt property. In general, three traditional approaches are used in deter-
mining the value of property: the market, the income, and the cost approaches. Under the market approach, the value of a property is determined by examining the sales prices of similar properties that have been sold recently in the same geographical area. This method is typically used in the valuation of residential property, because a sufficient number of similar properties are available for comparison. Tax-exempts are not often sold, however, and the market approach is therefore unlikely to prove satisfactory in many cases. Moreover, the uniqueness of many tax-exempts makes the comparison of sales data, even if available, of little value.

Under the income approach, the appraiser estimates the annual income derived from the operation of a building, obtains net income by subtracting operating costs, and capitalizes net income to arrive at fair market value. The income approach would be satisfactory for valuing an apartment building owned by a hospital and rented to its staff, or for valuing university-owned dormitories or faculty housing. Most tax-exempt property does not produce income, how-
ever, and the income approach would not be generally applicable.

Under the cost approach, an estimate is first made of the current costs of reproducing the structure being valued. This estimate is then adjusted for depreciation and obsolescence. Although the application of the cost approach to commercial and industrial property is well-developed, little experience exists in applying the method to unique structures, such as the Capitol or churches. The cost approach could, conceivably, be modified for use even with these types of structures.

The application of any one of these three valuation techniques to tax-exempt property is not likely to be completely satisfactory, though some situations
will be amenable to standard techniques. For example, if a tax-exempt institution buys property that was previously taxable, an assessment for the purchased property will have already been established. In addition, any recent construction by a tax-exempt can be satisfactorily valued under the cost approach. Also, situations in which the tax-exempt structure is similar in function and design to a taxable structure, such as an office building that serves as the headquarters of a tax-exempt institution, should not pose a severe valuation problem. Finally, it should be realized that taxable properties can also present problems of "uniqueness" which assessors have had to cope with for a long time. Nonetheless, an area requiring further research is whether the valuation of tax-exempt properties is a manageable problem.7

C

What effect will a service charge have on the operations of a tax-exempt institution? An institution's response in the face of the increased cost may be to (1) lower the price, quality, or quantity of the goods and services that it purchases; (2) raise the price that it charges for its services; (3) increase its efforts to solicit funds; (4) draw upon any liquid assets, such as an endowment; (5) alter the amount of property it owns; or (6) reduce or eliminate its operations.8

Not all of these alternatives may be available to every institution. Because of the heterogeneity of tax-exempts as a group, predicting how these institutions will respond to a service charge is not possible. The magnitude of the service charge, the cost and revenue structure of the institution, its ability to pass the charge forward or backward, and its ability to offset the charge by soliciting more donations are among the factors that influence an institution's response.9 It should not be assumed, however, that any increase in the price of an institution's services or that any curtailment in its services will necessarily be undesirable. For example, if the service charge causes a hospital to increase the rents paid by doctors for the use of hospital-supplied housing or offices, the actual result may be a progressive redistribution of a municipality's tax burden. At a minimum, however, a service charge will inevitably produce a financial strain for certain institutions. The service charge approach therefore presents the problem of identifying those institutions which merit special relief from the increased cost.

One way of responding to this problem is through the use of a "circuit breaker." In its simplest form, a circuit breaker would provide that the user charge could never exceed a certain percentage of the institution's net income, defined as gross receipts (including contributions and other voluntary payments), less operating expenses. A circuit breaker developed for small institutions relying primarily on volunteer help and contributions might be inappropriate, however, for a large institution with an endowment fund, such as a hospital or a university. Different circuit breakers may have to be developed to take into account the net worth of different institutions, the source of their funds, the identity of their beneficiaries, and so forth.

Service Charges—Summary of Issues

I. How many services can be adequately "priced" under a pure user charge approach? Probably, no feasible way exists to "price" most property-
related services.

II. In order to avoid the problem of pricing each property-related service, an alternative approach is to calculate the percentage of the municipal budget which is attributed to such a service. This percentage of the mill rate can then be applied to the assessed value of each tax-exempt institution.

A. Advantages

1. Generates revenue for the municipality.
2. Offsets the present bias for tax-exempts to overinvest in land and to hold land idle.

B. Problem Areas

1. Requires the valuation of each tax-exempt institution. Is this feasible?
   a. Assessments for tax-exempts already exist, but are they satisfactory?
   b. Land, recent improvements, and previously taxed property acquired by a tax-exempt may not pose significant valuation problems; but churches, historic buildings, and other "unique" structures may require that difficult, subjective judgments be made.

2. What effect will the user charge have on the operations of the tax-exempt institutions?

3. Is there any feasible way of identifying those institutions which do not have the ability to pay the service charge? Is the use of a circuit breaker or similar approach feasible?

State Payments to Municipalities

A

Connecticut currently has a PILOT program (payment in lieu of taxes) under which the state makes payments to municipalities to partially offset the taxes they lose through the presence of state-owned property. The PILOT program recognizes the unfairness of forcing certain municipalities to subsidize state government. This program could be extended to include private, tax-exempt institutions and thereby relieve the burden on those municipalities which subsidize another state objective--the encouragement of nonprofit activities. A PILOT program that covered these institutions would recognize that their benefits are regional and statewide and that their costs should not be borne primarily by their host jurisdictions. Compared with a service charge, a PILOT program has the advantage of not infringing upon the operations of the tax-exempt institutions; for this reason, it is a politically attractive approach.
A PILOT program that reimbursed municipalities for the property tax lost because of the presence of private, nonprofit organizations would raise all of the valuation difficulties previously discussed, but with one additional and significant difference. In the case of a user charge, the tax-exempts and the municipalities stand in adversary positions vis-a-vis the assessed value of the property. A check is thus provided on the valuation process. But, under a PILOT program, the municipality has everything to gain by overvaluing the property, since the higher the value of the tax-exempt property, the more the municipality would receive from the state. Given that normal assessment techniques may not be suitable for the valuation of tax-exempt property, the state would find it difficult to police the figures supplied by the municipalities.11 A PILOT program thus places the state in the position of making payments on the basis of controversial assessments that can be easily manipulated by the municipalities.

One way of mitigating this problem is to eliminate the hard-to-value properties from the PILOT program. For example, payments could be made on the basis of the fair market value of only the land owned by the tax-exempts, on the theory (which may not prove to be true in all cases) that the land is easier and less controversial to value than a tax-exempt's improvements. In addition, payments could be made for taxable property that had been recently acquired by a tax-exempt, because an accurate valuation of such property would already exist. Similarly, PILOT payments could be made for any recent improvements, since the cost of such improvements would be an accurate measure of their fair market value. Finally, PILOT payments could be based on the existing assessments of tax-exempt property,12 which the municipalities are required to make under state law. Unless all future payments were based on existing assessments (which could be adjusted for inflation), however, the valuation problem would still arise at some point in the future.13

The valuation problem could be avoided by adopting a relatively simple and objective formula as the basis for PILOT payments—a formula based on square footage. The square footage formula would express the relationship between the cost of municipal services and the square feet of land and improvements in the municipality. By dividing the property tax revenue by the square feet of land and improvements, a mill rate per square foot could be derived. This figure would then be multiplied by the amount of square feet that any tax-exempt property occupies in order to obtain the PILOT payment. Admittedly, such a formula is arbitrary to the extent that municipal costs are not directly related to square footage. Although this criticism may prevent the formula from serving as the basis of a service charge, which would be paid by the institution itself, the formula is certainly workable as the foundation for a PILOT program. In reality, the formula may not be any more arbitrary as a basis for PILOT payments than are subjective and elusive valuations of tax-exempt property.14

The final question concerns the distribution of PILOT funds. Under either a square footage formula or an assessed valuation approach, aid can be channeled only to those jurisdictions which have a disproportionate amount of tax-exempt property. One alternative is to make payments only to municipalities whose
tax-exempt property (whether measured by square footage or market value) exceeds the statewide average. The PILOT payment could then be a function of the difference between the statewide average and the municipality's figure. Another alternative would be to make payments only to municipalities whose tax-exempt property exceeds a certain percentage of their taxable grand list. Numerous variations of these alternatives are possible, of course.

Drawing a distinction among jurisdictions on the basis of their amount of tax-exempt property would separate suburban and rural areas from urban areas. This distinction can be defended by focusing on the types of tax-exempt institutions likely to be found in these different areas. In suburban and rural areas, the tax-exempt institutions typically serve a local constituency; institutions located in the city, however, more commonly serve a regional and, in some cases, a statewide constituency. State PILOT payments to jurisdictions having a greater than average amount of tax-exempt property would reflect the spillover in benefits. The cost of the PILOT program would therefore be shared, to some degree, by those who enjoy the services of the institutions.

State Payments to Municipalities--Summary of Issues

I. Advantages
   A. Does not interfere with the operations of the tax-exempts.
   B. Distributes the costs of the exemption among residents of the state.

II. Problem Areas
   A. Requires the valuation of the tax-exempts. Is this feasible? Valuation of the institutions raises the same issues as a user charge, with one additional and significant problem. Under a PILOT program, the tax-exempts have no incentive to contest their assessments. Therefore, no check exists on a municipality's incentive to overassess the tax-exempts in order to obtain larger PILOT payments. Can the state police this problem?
      1. Can the valuation morass be avoided by using a square footage formula, or a similar approach?

III. Which Municipalities Will Receive PILOT Payments?
   A. All municipalities?
   B. Only jurisdictions having an amount of tax-exempt property in excess of the statewide average?
   C. Only jurisdictions having an amount of tax-exempt property in excess of a certain percentage of their taxable grand list?

Acreage, Market Value, and Other Limitations on the Exemption

Other means of balancing the interests of the tax-exempts with the interests of the municipalities involve the imposition of various ceiling or similar limitations on the exemption. For example, a time period could be provided beyond which the exemption would be phased out. The exemption might be granted for the first five years in an organization's life and phased out
thereafter. A time limitation would enable new organizations to get started without the burden of the property tax and, at the same time, would recognize the host jurisdiction's interest in not being burdened with a perpetual exemption. If the time period is sufficient, the organization will be able to plan for the eventual phasing out of the exemption. Other approaches would be to limit the number of acres of land which could qualify for the exemption, to place a ceiling on the fair market value of property that can be exempt, or to phase in the exemption whenever taxable property is removed from the grand list by a tax-exempt. As is true with respect to any approach that imposes increased costs on the tax-exempts, relief may have to be provided for those institutions which are unable to bear the additional financial burden imposed by a curtailment of the exemption.

Research is underway to determine the extent to which these limits are used by other states. Preliminary findings indicate that ceilings on acreage and fair market value are used by some states in limited circumstances.

Municipal Permission for Tax-Exempts To Acquire Taxable Property

Another approach would be to require a municipality's permission before any taxable property could be acquired for a tax-exempt purpose. The municipality would thus be given the power to control the erosion of its tax base, a power similar to the power that it now possesses to grant property tax exemptions in order to attract new industrial and commercial property.

Although our research has not yet uncovered any state that has granted this authority to its municipalities, three sets of potential problems can be identified which need further study. First, from the state's perspective, the cities represent the optimum location for many kinds of tax-exempts. The cities are the administrative, cultural, medical, and educational centers for both their surrounding regions and the state. Services offered by nonprofit institutions located in urban areas are accessible to the greatest number of persons. The state's interest in having an optimum distribution of these services thus conflicts with a municipality's interest in restricting the expansion of the tax-exempts. Limiting a municipality's power to deny the expansion of a tax-exempt may therefore be necessary in order to ensure that the state's interests are not significantly undermined. Second, controls may be required so that a tax-exempt does not simply play one jurisdiction off against another in an attempt to nullify each municipality's power. Third, the state would have to provide certain guidelines for the exercise of the municipality's power if it is to guarantee that all organizations are treated fairly and equally.

Review of the Statutory Definition of Tax-Exempt Property

No significant legislative changes have recently been made in the state's definition of those activities which qualify for the tax exemption. The recourse of the towns has been to institute litigation, and the task of refining the definition and of resolving the inevitable ambiguities in the law has therefore fallen onto the courts. The legislature appears indifferent whether the law developed by the courts comports with current views on the policy underlying the granting of the exemption.
Perhaps the source of the state's indifference can be identified. Under the present system, the municipalities—not the state—bear the cost of the exemption; consequently, the state has little direct financial interest in maintaining close vigilance over the development of the law. A PILOT program for tax-exempts would provide an incentive for the state to examine the present range of uses and activities that qualify for the exemption. Whether or not a PILOT program is adopted, however, an evaluation of existing law is appropriate. Research is currently being conducted to determine the scope of existing tax exemptions. This research will also examine the definition of tax-exempt activities which is used for federal income tax purposes to see whether some correlation between the state and the federal definitions is possible.15

The Church/State Issue

In contrast to all the other tax-exempt institutions covered by this discussion draft, churches pose a special set of constitutional problems. The first amendment prohibits laws "respecting an establishment of religion, or prohibiting the free exercise thereof." In a sense, the first amendment acts as a double-edged sword. On the one hand, any state policy that benefits religion is likely to be challenged by opponents as an impermissible establishment of religion. On the other hand, those who support the policy are likely to argue that a failure to provide the benefit places an unconstitutional burden on the free exercise of religion. The "damned-if-you-do, damned-if-you-don't" nature of the dilemma is readily apparent.

Research is needed to evaluate the constitutional issues presented by the following questions:

1. Could the state make PILOT payments to municipalities which are based on either the value or the square footage of church property? Conversely, could church property be excluded from a PILOT program?

2. Could a service charge based on that percentage of the mill rate which represents property-related services be applied to churches? Conversely, could churches be exempted from a service charge that is applied to all other tax-exempts?

3. Could a law under which a municipality's permission were required before a tax-exempt institution could expand its land holdings be applied to churches? Conversely, could churches be exempt from requiring the municipality's permission?

4. Could various limits on the property tax exemption (for example, the first 50 acres of land or the first $100,000 of value) be applied to churches? Conversely, could churches be exempt from such limits if they were applied to all other tax-exempts?

* * *
FOOTNOTES

1See, e.g., Quigley and Schmenner, Property Tax Exemption and Public Policy, 23 Public Policy 259, 278 (1975).


3Even if it were possible to develop a pricing mechanism for a wider range of municipal services, other difficulties remain. Requiring payment for services that are meant to be redistributive in nature (e.g., welfare) is obviously counter-productive. Furthermore, there are many services, such as education, which are purposely made available to all consumers regardless of their ability to pay. Also, the Internal Revenue Code does not allow a deduction for service charges (unless business related) but does allow a deduction for property taxes. The federal income tax thus contains an inducement for municipalities to "bill" for services through the property tax, rather than utilizing service charges.

4If this approach is viewed as a service charge, will an adjustment be made for tax-exempts that have their own private security guards or who pay for the private collection of refuse? If viewed as a property tax, will this approach violate the property tax immunity found in the charter of a number of private colleges and universities (e.g., Yale, Trinity, and Wesleyan)?

Not only is there no precise way to link an institution's consumption of services with the amount called a service charge, but there is the additional problem that so-called property-related services also benefit individuals qua individuals rather than qua property owners. For example, police services protect individuals as well as their real and personal property. No method exists for separating the total amount spent on police protection into these components. Classifying all of the costs for police protection as a property-related service is thus an oversimplification.

5See G. Wassall, Tax-Exempt Property: A Case Study 44 (John C. Lincoln Institute, 1974).


7For example, could the amount of fire insurance coverage carried by the institution provide an acceptable figure for valuation purposes?


9The problem of adjusting to a service charge would be less severe if the charge were phased in over a period of years.
Federal PILOT programs also exist with respect to properties owned by the Housing and Home Finance Agency, the Atomic Energy Commission, the Farmers Home Administration, and some forest lands.

Query whether the amount of fire insurance coverage carried by the institution could provide an acceptable figure that would help reduce disagreement over valuation.

These valuations may already be overinflated, however, by a municipality wishing to dramatize the erosion of its grand list by tax-exempts, or by a municipality having the foresight to anticipate the eventual enactment of a PILOT program.

To the extent the PILOT payments are based on only a small percentage of the value of the municipality's tax-exempt property, or limited in total amount by a low cap, the valuation problem becomes less significant.

The square footage formula can also be refined to adapt to special categories of property. Take the case of undeveloped land. Because undeveloped land arguably consumes fewer municipal services than improved land, it may be viewed as unfair to divide the total property tax levy by a square footage figure that includes raw land. Instead, some percentage of the property tax levy, perhaps measured only by property related services (similar to the service charge approach) can be used. A levy per square foot of undeveloped land could thus be derived which would then be used as the basis of the PILOT payment. This same approach could be extended to other categories of property.

Even if the definitions were to remain unrelated, some coordination between the IRS and the state is still possible. For example, the IRS could notify the state whenever the federal tax-exempt status of a Connecticut organization has been either revoked or denied. It would seem appropriate that a federal denial or revocation of tax-exempt status should trigger a re-examination of the organization's property tax exemption.