

October 2017

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George S. Forde, Jr.

Christopher E. Cummings

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### Recommended Citation

George S. Forde, Jr. and Christopher E. Cummings (1996) "Payments in Lieu of Taxes: The Philadelphia Experience," *The Catholic Lawyer*. Vol. 37 : No. 2 , Article 4.

Available at: <https://scholarship.law.stjohns.edu/tcl/vol37/iss2/4>

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# PAYMENTS IN LIEU OF TAXES: THE PHILADELPHIA EXPERIENCE

GEORGE S. FORDE, JR.\* & CHRISTOPHER E. CUMMINGS\*\*

De Toqueville once recognized and commented on how Americans unite in nonprofit organizations and accomplish charitable goals from the grass roots level.<sup>1</sup> Historically, these organizations have benefited from tax exemptions granted to charitable institutions.<sup>2</sup> Eventually, however, these exemptions

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\* George S. Forde, Jr., is a partner in the Philadelphia law firm of Stradley, Ronan, Stevens and Young. His practice specialties include representation of religious, educational, social services and other non-profit organizations, probate and estate, and real estate and construction law. Mr. Forde, since 1959, and the firm, since 1944, represent the Archdiocese of Philadelphia. Mr. Forde received his undergraduate degree from St. Joseph's University and his law degree from Villanova University. He is a fellow of the American College of Trusts and Estates Counsel, and a member of the Philadelphia Bar Association, the Pennsylvania Bar Institute, the St. Thomas More Society, and the National Association of College and University Attorneys. Mr. Forde is admitted to practice before the Supreme Court of Pennsylvania, the U.S. District Court for the Eastern District of Pennsylvania, the U.S. Court of Appeals for the Third Circuit, and the U.S. Supreme Court. He is also a member of the Friendly Sons of St. Patrick.

\*\* Christopher E. Cummings is a senior associate in the real estate and banking department of the Philadelphia law firm of Stradley, Ronan, Stevens and Young. Mr. Cummings received his undergraduate degree from LaSalle University and his law degree from Temple University. Mr. Cummings served as a commissioned officer (special operations) in the United States Navy from 1981 to 1986. He is a member of the American Bar Association and the Philadelphia Bar Association. Mr. Cummings is admitted to the bar in Pennsylvania and New Jersey, and to practice before the U.S. District Court for the Eastern District of Pennsylvania.

<sup>1</sup> ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* (1945).

<sup>2</sup> See Rebecca S. Rudnick, *State and Local Taxes on Nonprofit Organizations*, 22 CAP. U. L. REV. 321, 323-29 (1993) (surveying effects of government's exemption of charities and stating that exemptions give nonprofit organizations competitive ad-

and the nonprofit organizations, including the church and other charitable associations, came to be regarded as an impediment to taxation and as a nineteenth century "deal" between the associations and the state.<sup>3</sup> Recently, there has been an increasing trend among state and local governments to attempt to tax or impose other imposts on tax-exempt organizations.<sup>4</sup> This has been practiced most aggressively in Pennsylvania through Philadelphia's Payments In Lieu Of Taxes Program, commonly referred to as PILOTs.

This article's main purpose is to discuss the implications and strategies of the PILOTs program in Philadelphia and to demonstrate that the program is an aggressive attempt to extract money from "innocent" charities in the context of the Pennsylvania experience, which, we think, is similar to most states. It will discuss the process of gaining tax-exemption status in Pennsylvania and the criteria for demonstrating an institution's classification as a "purely public charity," a key concept in this state. In addition, the article will examine different methods utilized by other states. Finally, the article will explore the reasons for this recent wave and suggest actions to shift the tide and protect tax-exempt status.

## I. THE PROCESS OF SECURING A TAX-EXEMPT STATUS

Tax-exempt status in Pennsylvania, requires a bureaucratic process. It also requires that the property be both "owned" and "used" by the charity for a charitable purpose in the case of ex-

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vantage). See generally JOHN D. COLOMBO & MARK A. HALL, *THE CHARITABLE EXEMPTION* 3-13 (1995) (exploring history of charitable exemption); BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 6-8 (6th ed. 1992) (examining history of federal tax-exemptions for charitable organizations); N. Keith Emge, Jr., Comment, *Nonprofit Hospitals and the State Tax Exemption: An Analysis of the Issue Since Utah County v. Intermountain Health Cove, Inc.*, 9 VA. TAX REV. 599, 600-10 (1990) (examining history of federal tax exemption of nonprofit hospitals).

<sup>3</sup> See HOPKINS, *supra* note 2, at 40 ("Tax exemption and tax deductibility shrink the tax base, forcing the remaining taxpayers to bear an increasing tax burden ... Aside from the drain on government revenues, tax exemption is frequently attacked as being a 'loophole.'").

<sup>4</sup> Rudnick, *supra* note 2, at 338-50. In Massachusetts in 1993, Boston representatives submitted a bill providing for the assessment of a fee on tax-exempt property to fund "local public safety." *Id.* at 345 n.117. The Wisconsin legislature passed a user fee, moneys paid for specific services benefiting the tax payer, on exempt property, but the governor vetoed the bill. *Id.* at 346. Meanwhile, a program of payments-in-lieu-of-taxes has become popular and "continues to carry momentum in various states and localities." *Id.* at 343.

emptions based on status as a "purely public charity." If an entity builds or acquires real property to be used for a charitable use, the entity must file with the Board of Revision of Taxes (in Philadelphia) or the Board of Assessment Appeals (for most counties outside of Philadelphia). The entity must file and claim an exemption by the first Monday in September or October, depending on that particular county's rules, preceding the year for which exemption is claimed and establish both the value and the exempt or nonexempt status of the property. While some counties require a hearing, others have a board that reviews the application and notifies the institution if a hearing is necessary. Generally, by December or by the early months of the following year, the entity will be informed of whether or not it will be exempt. The orders granting tax-exempt status typically read that the entity is exempt for the subsequent year and each year thereafter, provided that it continues to use the property for the purposes stated in the application. If an entity changes the use of the property, even to another charitable use, that entity is required to notify the appropriate board. Moreover, the entity is subject to challenge by any of the taxing authorities any year after the exemption is granted.

In Pennsylvania, the Board of Revision of Taxes and Board of Assessment are comprised of individuals who do not possess legal training, and the hearings are often conducted without a solicitor or attorney in attendance. Many board members are drawn from the ranks of the real estate industry, and possess knowledge related to the construction, maintenance, or valuation of real property. In any case, the members are of the same milieu as the supervisors, the school board, and the township managers who are seeking to collect taxes. Thus, the members have an interest in ruling against the approval of exemption applications. While the board members may be familiar with assessment procedures, the appraisal of real estate, or real estate in general, they are not law trained, and thus, are not familiar with the constitutional provisions and statutes pertaining to property tax exemptions. This imposes on institutions the task of making technical legal arguments to non-lawyers.

## II. METHODS OF EXEMPTION: CATEGORIZATION OF INSTITUTIONS AND CRITERIA FOR EXEMPTION

### A. *Source of Authority to Grant Exemptions*

Jurisdictions differ in the manner in which they exempt institutions from taxes. In some states, self-executing constitutional provisions provide the exemptions.<sup>5</sup> In other states, organizations are exempt from tax by statute.<sup>6</sup> States also differ in the methods used in drafting the statute or constitution. One method is to draft the statute or constitution in the positive providing that everything be taxed unless it is specifically exempt.<sup>7</sup> Another method is to draft the statute or constitution in the negative, mandating exemption unless specifically taxed. In addition, a constitutional provision may be self-executing or merely enable a statute (as in Pennsylvania).

It is important to recognize whether the applicable statute or constitutional provision is positive or negative, because such a determination has ramifications for tax-exemption challenges. In Pennsylvania, for example, the statute is positive: there are no exemptions except as provided by the constitution and legislature.<sup>8</sup> This affects, among other things, the burden of proof,

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<sup>5</sup> See, e.g., VA. CONST. art. X, § 6 (1995) (“[A]ll property, real and personal, not held for private or corporate profit and used exclusively for religious worship, for schools and colleges, for purposes purely charitable ... may be exempt from taxation .... All laws exempting from taxation property other than property enumerated in the article, shall be void.”).

<sup>6</sup> See N.Y. TAX LAW § 1230 (McKinney 1987) (“Any tax imposed under the authority of sections twelve hundred one through twelve hundred five shall not be imposed on ... (d) Any corporation, or association ... organized and operated exclusively for religious, charitable or educational purposes ....”); MISS. CODE ANN. § 27-31-1 (1972 & Supp. 1995) (providing exemptions for cemeteries, property belonging to religious or charitable organizations which is used for hospital purposes, nursing homes, and “any charitable society.”).

<sup>7</sup> See WYO. STAT. § 39-1-102 (1994) (“All property within Wyoming is subject to taxation as provided by this act except as prohibited by the United States or Wyoming Constitutions or expressly exempted by W.S. 39-1-201”); MONT. CODE ANN. § 15-6-101(1) (1995) (“All property in this state is subject to taxation, except as provided otherwise”); MICH. COMP. LAWS ANN. § 211.1 (West 1986 & Supp. 1996) (“That all property, real and personal, within the jurisdiction of this state, not expressly exempted, shall be subject to taxation”); ARIZ. REV. STAT. ANN. CONST. art. IX, § 2(6) (West 1984 & Supp. 1995) (“All property in the state not exempt under the laws of the United States or under this Constitution or exempt by law under the provisions of this section shall be subject to taxation ....”).

<sup>8</sup> PA. STAT. ANN. tit. 72 § 5020-201 (1995 & Supp. 1996) (“The following subjects and property shall ... [be] subject to taxation ... (a) All real estate, to wit: Houses ...

which is critical in exemption challenges. Institutions must prove their entitlement to exemption under the constitution and the statute. Because the taxing authorities do not have the burden of proof, it is a “no lose” situation for them and a considerable burden to typically cash starved charities every time there is a challenge. Charitable organizations in Pennsylvania must continually reaffirm, establish, and prove that they are entitled to an exemption.

*B. Categorizing and Exempting Entities: Difficulties and Discrepancies*

In analyzing a charity’s entitlement to tax-exempt status in Pennsylvania and the recent Philadelphia PILOTs program, it is important to understand the state’s statutory framework for tax-exemption. Pennsylvania’s state constitution authorizes the legislature to exempt institutions of purely public charity from local taxation.<sup>9</sup> The legislature exercised this authority by categorizing and exempting numerous classes of institutions, such as colleges and hospitals, as “institutions of purely public charity.”<sup>10</sup> While there are other potential tax-exempt institutions, such as “actual places of regularly stated worship” or VFW posts, institutions that are not so specifically provided for are categorized and exempted as “purely public charities.” This is the most ambiguous tax-exempt category and those entities claiming under it are subject to challenge on the basis that they are not or may no longer be considered purely “public charities.”

Adding to the ambiguity is the variety in application of the law in subordinate taxing jurisdictions (counties, school districts, and local municipalities). Rectories, for example, do not really fall into any tax-exempt category, and thus, in some parts of Pennsylvania, they are taxed. Some jurisdictions exempt parsonages or rectories without even requiring an application or request. Although there are no grounds for an exemption of the place where clergy live, if a rectory has a daily mass chapel or offices for the parish on the premises, a partial exemption may be available. An argument concerning value may ensue in such

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and all other real estate not exempt by law from taxation.”).

<sup>9</sup> PA. CONS. STAT. ANN. Art. IIX, § 2(a)(v) (“The General Assembly may by law exempt from taxation ... institutions of purely public charity, but in the case of any real property tax exemptions only that portion of real property of such institution which is actually and regularly used for the purposes of the institutions.”).

<sup>10</sup> General County Assessment Law, PA. STAT. ANN. tit. 72, § 5020-204(a)(3).

a case, questioning the value of property attached to a church and the number of willing buyers that exist, regardless of construction costs. Thus, because such an institution is not easily pigeon-holed, an assessment of its tax-exempt status may become complicated.

Indeed, there are other seeming discrepancies in the tax-exemption area because certain organizations that appear to be charities are not exempt. For example, rectories are generally taxed, but convents are normally exempt if associated with a school in which the residents are teachers, administrators, etc. Faculty houses and schools are considered purely public charities and are exempt. The actual sanctuary and the peripheral walkways of a church are exempt, but the parking lot is taxed. This scenario was illustrated, in another state, by *Diffenderfer v. Central Baptist Church of Miami*.<sup>11</sup> In *Diffenderfer*, a newly enacted Florida statute allowed exemption of property as long as the property was used "predominantly" for religious purposes. Central Baptist Church's tax-exempt status was challenged, but only to the extent it applied to the church's parking lot. The Supreme Court found that, under Florida law, the church's parking lot could not be exempt, but the status of other sections of the property were not affected. This illustrates why many churches, in Pennsylvania at least, no longer have parking lots. Instead, churches use [school] playgrounds with dotted lines that may, from time to time, be used for parking.

### *C. Pennsylvania's Constitutional and Statutory Requirements*

In Pennsylvania, for an institution to establish that it is a purely public charity, and thus exempt from taxes, the institution must satisfy certain constitutional criteria—that it is a "purely public charity" within the meaning of the state constitution.<sup>12</sup> Additionally, the entity must satisfy certain criteria set forth in the General County Assessment Law, including that it "actually and regularly [uses the real property] for the purposes of the institution." Similarly, statutory criteria has developed, further burdening the organization.<sup>13</sup> The statutory requirements also include proving that the institution was founded, en-

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<sup>11</sup> 404 U.S. 412 (1972).

<sup>12</sup> PA. CONST., art. IIX, § 2(a)(v).

<sup>13</sup> General County Assessment Law, PA. STAT. ANN. tit. 72, § 5020-204(b).

dowed, and maintained by public charity, and that the entire revenue derived must be used by the charity in furtherance of its charitable mission.<sup>14</sup> In recent tax-exemption cases, institutions have had increasing difficulty satisfying the constitutional criteria.

A factor contributing to this complication is the manner of use of the organization's property. Because of downsizing, institutions often own more property than they actually utilize, and they lease out some space rather than occupy the entire property themselves. A seminary, built a hundred years ago, needed to accommodate hundreds of students. Today, however, needs have changed and all buildings are not being used to their capacity. As a result, an entire building or a significant part of the campus may be deemed taxable.

The courts' interpretation of these criteria, especially the constitutional criteria, are also a subject of great concern to charitable institutions. The genesis of the present restrictive judicial interpretation on what satisfies the constitutional criteria is most often attributed to the 1985 decision by the Pennsylvania Supreme Court in *Hospital Utilization Project v. Commonwealth*,<sup>15</sup> commonly referred to as the *HUP* case. There, the state supreme court attempted to consolidate one hundred years of tax-exemption law and articulated five criteria that must be met to demonstrate that an institution is a "purely public charity" under the constitution. These criteria include: (i) the institution must benefit a substantial and indefinite class of persons who are legitimately in need of charity; (ii) the institution must donate or gratuitously render a substantial portion of its services; (iii) the institution must relieve the government of some of its burdens; (iv) the institution must operate entirely free from profit motive; and (v) the institution must advance a charitable purpose.<sup>16</sup>

*HUP* did not present any novel ideas. These standards have been previously articulated. Nonetheless, as restated, they were viewed by taxing authorities searching for revenue as providing opportunity and ammunition for challenging the tax-exempt status of charitable organizations, particularly those with large land holdings. The *HUP* decision has merely strengthened the

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<sup>14</sup> *Id.* at § 5020-204(a)(3).

<sup>15</sup> 487 A.2d 1306 (Pa. 1985).

<sup>16</sup> *Id.* at 1317.



willingness of the taxing authorities to challenge requests for exemptions.

The difficulty in satisfying the *HUP* requirement that a purely public charity benefit a substantial and indefinite class of persons worthy of charity was illustrated by the appellate court in *Appeal of Washington v. Board of Assessment Appeals of Washington County*.<sup>17</sup> The lower court held that a college is not charitable, despite the applicable statute saying, in so many words, that colleges and universities are charitable.<sup>18</sup> To obtain a declaration that college students are charitable, Washington-Jefferson College had to appeal to a higher court. After the time and money for an appeal was expended, the college finally prevailed.<sup>19</sup>

Another *HUP* requirement is that institutions must prove that they donate a substantial portion of their services. This is often a difficult hurdle for an institution, particularly when many of their services are partly or fully reimbursed from Medicare, private insurance, or other third parties. Another judicially imposed burden for the charitable organization is the requirement that the institution "relieve the government of some of its burdens." This is related to and raises the same problem as the question of how much the institution itself is donating as opposed to being reimbursed from the government. Further, a charitable organization has to establish that it operates entirely free of a profit motive. Most properly established and managed non-profits will meet this test. In investigating the extent of an entity's profit motive, the taxing authorities and courts look for large salaries, fringe benefits, and for-profit parents, affiliates, or subsidiaries.

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<sup>17</sup> 666 A.2d 352 (Pa. Commw. Ct. 1995).

<sup>18</sup> Section 5020-204(a)(3) specifically provides that colleges may be exempt if certain criteria are satisfied. PA. STAT. ANN., title 72, § 5020-204(a)(3). After listing the organizations that are exempt and the criteria, the statute states that "any charitable organization providing residential housing services ... shall remain a 'purely public charity' if the certain requirement is satisfied. *Id.* This reveals that the legislature intended to name the listed organizations, including colleges, as a "purely public charity."

<sup>19</sup> The Court determined that Washington-Jefferson College was "founded and is maintained by private or public charity and is, therefore, entitled to an exemption from real estate taxation." 666 A.2d at 364-65.

### III. THE RISING TIDE AGAINST CHARITABLE INSTITUTIONS

With *HUP* and a resurgence of rugged individualism that coincided with a shrinking tax base, federal cutbacks, etc., public charities and their tax exemptions became "fair game." In western Pennsylvania, Erie revoked all exemptions and charities were required to prove their tax-exempt status. The idea spread over the state and reached us in the Philadelphia area in 1993-1994. Meanwhile, back in Pittsburgh, the University of Pittsburgh and its affiliate, Allegheny Hospital, and Duquesne University, which had a facility that was sometimes rented out to the public, were targeted. Allegheny Hospital, we understand, agreed to a substantial payment in lieu of taxes. Duquesne University agreed to pay taxes for business use of its auditorium, based on how many days a year they used their premises for their own activities and how many days the premises were hired out.

In the three or four years prior to the adoption of this new strategy in Philadelphia, the Board of Revision asked organizations like nursing homes and colleges to answer a questionnaire about their operations and finances and to submit copies of their Form 990.<sup>20</sup> The Board did not press for answers from church-related institutions, but did aggressively pursue colleges, universities, and hospitals. They later were also asked to complete more comprehensive additional questionnaires, which the Board examined for evidence of ineligibility for tax-exempt status. Given the implied threat of revocation of the exemption, this irregular discovery in advance of any litigation was offensive to some.

Several reasons influenced the Board's change in policy. On the judicial front, the *HUP* decision was followed by other appellate court cases unfavorable to charities.<sup>21</sup> The tide continued to

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<sup>20</sup> 10 PA. CONS. STAT. ANN. § 162.5(a) (1996) requires a charitable organization to register with the Department of State of Commonwealth. Part of the registration process requires the submission of "a copy of the last filed Internal Revenue Service Form 990 and Schedule A for every charitable organization and parent organization." The Internal Revenue Service requires non-profit organization to file a Form 990 annually. The form is an informational return that reveals revenue, income, assets, and compensation for top executives. See I.R.C. § 6033 (a)(1).

<sup>21</sup> See *Appeal of Lutheran Home at Topton v. Board of Assessment*, 515 A.2d 59, 68 (Pa. Commw. Ct. 1986) (denying tax-exempt status to home for elderly); *Scripture Union v. Dietch*, 531 A.2d 64, 67 (Pa. Commw. Ct. 1987) (holding that nonprofit corporation did not qualify as "purely public charity" even if it qualified as charita-

move against charitable institutions. On the political front, the legislators were faced with a loss in the tax base,<sup>22</sup> an aging population,<sup>23</sup> a manufacturing state that was losing jobs,<sup>24</sup> and declining revenues in general.<sup>25</sup> This climate favored tax cuts or at least an abstention from raising taxes. There never is a positive climate for raising taxes and the legislators looked for ways to reduce taxes and to gather revenue in the most politically acceptable manner. Charities became viewed as the easiest and most politically justifiable targets for "reform." Politicians began holding hearings to investigate the practices of non-profit organizations, and their findings prompted a week long expose in the *Philadelphia Inquirer*. The series of articles outlined a wide range of problems in nonprofit organizations.<sup>26</sup>

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ble organization under Internal Revenue Service definition); Wyoming Valley Montessori Ass'n, Inc. v. Board of Assessment Appeals of Luzerne County, 532 A.2d 931, 935 (Pa. Commw. Ct. 1987) (denying tax-exempt status to school); see, e.g., Bio-sciences Info. Serv. v. Commonwealth, 551 A.2d 672, 676 (Pa. Commw. Ct. 1988) (denying tax-exempt status to company that provided free access to its compilation of biological sciences literature), *aff'd*, 569 A.2d 927 (1990) (per curiam).

<sup>22</sup> See William Sutton, Jr., *Coleman: Tax Plan in Trouble - Wants to Drop Key Provision*, PHILA. INQUIRER, May 12, 1984, at B1 (quoting local City government officials stating that "loss of jobs, the shrinking of the tax base, escalating city operational costs and growing city payroll" were responsible for the city's fiscal constraints). *But see* Rich Heidorn, Jr., *Realty Tax Base Expands But School-Levy Hike Still Likely*, PHILA. INQUIRER, December 21, 1985, at B1 (stating that reassessment program contributed to a \$420 million increase in the city's real estate tax base, bringing \$30 million in new tax revenues).

<sup>23</sup> See Robin Palley, *Empty-Bed Syndrome Hospitals Suffer as Shorter Stays Squeeze Revenues*, PHILA. DAILY NEWS, June 10, 1985, at 33 (stating that Philadelphia has third oldest population in nation).

<sup>24</sup> See, e.g., Craig Stock, *Phila. Needs More Start-Up Firms, Temple Study Says*, PHILA. INQUIRER, November 16, 1985, at D11 (stating that Philadelphia area showed trend toward losses of manufacturing jobs). United Press International, *'Pa' Doesn't End with 'Y' '83 Earnings Drop in State While Jumping in U.S.'*, PHILA. DAILY NEWS, October 2, 1984, at 36 (noting that the great drop in earnings in Pennsylvania was largely due to drop in employment manufacturing).

<sup>25</sup> See, e.g., Sutton, Jr., *supra* note 22 (stating that City of Philadelphia faced \$108 million revenue shortfall in its operating budget).

<sup>26</sup> See Gilbert Gaul, *Philadelphia Looks For Ways To Make Up Lost Taxes: The City Re-evaluates Who Isn't Paying and Why*, PHILA. INQUIRER, April 18, 1993, at A11; Gilbert Gaul & Neill Borowski, *The Rise Of Medical Empires In Return For Free Care For The Poor, Hospitals Didn't Have To Pay Taxes. Now There's Less Charity Care. But Hospitals Are Still Exempt*, PHILA. INQUIRER, April 19, 1993, at A1; Gilbert Gaul & Neill Borowski, *A Tax Break Colleges Can Bank On While Colleges Stockpile Millions Every Year From Investments And Research, Tuition Climbs Out of Reach For More And More Americans*, PHILA. INQUIRER, April 20, 1993, at A1; Gilbert Gaul & Neill Borowski, *The IRS, An Enforcer that Can't Keep Up*, PHILA. INQUIRER, April 21, 1993, at A1; Gilbert Gaul & Neill Borowski, *In High Level Jobs At Nonprofits, Charity Really Pays. Wanted: Top Executive To Run Nonprofit Or-*

There were, in fact, many problems. From the tax authorities' point of view, hospitals were particularly notorious abusers of their tax-exempt status.<sup>27</sup> Hospitals were building or buying huge office buildings and arguing that they should enjoy tax-exempt status because the facilities were rented to their doctors. In some communities, hospitals and colleges became owners of the majority of what were once ratable properties, and while they claimed tax exempt status, they did not use their holdings strictly for charitable purposes.

In Philadelphia, exempt properties are an enormous portion of the whole. An article in the *Philadelphia Inquirer* on March 25, 1995, stated that the total assessed value of all properties in Philadelphia totals \$12 billion dollars, \$1.9 billion of which are considered exempt.<sup>28</sup> While these figures may be slightly exaggerated and there has not been—until now—much interest in the accuracy of the taxable value placed on exempt land, many will agree that Philadelphia has a large base of hospitals and universities. However, while the city does have a large amount of exempt property, two-thirds of it belongs to various government entities, rather than to private nonprofit organizations. In any event, a great portion of these land holdings are not worth very much. Many parishes and schools in Pennsylvania are located in areas where, even if they were to close and sell the properties, it would be hard to find buyers.

Another reason for the city's policy shift was the reality that many charities really were dealing in businesses other than the ones historically related to their charitable purpose. The public, or at least the government, began to change its perception of what a charity was and should be. Businesses impacted by the "unfair competition" were especially vocal. The courts even adopted the view that an organization that may have been con-

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organization. Salary: \$350,00 To \$400,000 A Year Plus Bonus. Perks: Luxury Car, Country Club Membership, Interest-Free House Loan. Domestic Help Provided, PHILA. INQUIRER, April 22, 1993, at A1; Gilbert Gaul and Neill Borowski, *For Non-profits Only: A Cheap Pool Of Money*, PHILA. INQUIRER, April 23, 1993, at A1; Gilbert Gaul & Neill Borowski, *Foundations Build A Giant Nest Egg: Foundations Become Tax Exempt Because Of The Grants They Give. Now They Earn Far More Than They Give Away*, PHILA. INQUIRER, April 24, 1993, at A1.

<sup>27</sup> See G.J. Simon, Jr., *Non-Profit Hospital Tax Exemptions: Where Did They Come From and Where Are They Going?*, 31 DUQ. L. REV. 343 (1993).

<sup>28</sup> Craig McCoy, *City Gains Revenues From Big Non Profits: About \$8.4 Million Is Expected to Voluntarily Come In From Tax Exempt Entities. Court Cases Have Bolstered The City's Bid*, PHILA. INQUIRER, March 25, 1995, at A1.

sidered charitable yesterday may not be considered charitable today or tomorrow.<sup>29</sup>

Many people are unaware of the subtle and increasingly complex nature of the problems facing today's charities. For example, while many hospitals achieved cost savings and efficiency through centralizing their laundry operations, the centralization resulted in putting many small private laundry operations out of business. Those disgruntled business owners retaliated by complaining to their local politicians, blaming the public charities for forcing legitimate taxpayers out of business. The complaining business owners argued that the charities with which they have to compete resemble private corporations more than public enterprises. They pointed to the large salaries that many of the CEO's of these organizations enjoy as indicative of an entity which is something other than nonprofit.<sup>30</sup>

In Philadelphia, while information regarding nonprofits was being collected, a negative newspaper campaign erupted against charities.<sup>31</sup> The newspapers' negative influence was aggravated by the citizens' collective cry for tax relief. The Board of Revision formed a commission, which included members of the Board and members of the municipal government, but did not include any representatives of the nonprofits or their clientele. It produced a brief, labeled as a report of their study, for the proposition that all exempts should pay for police, fire, and other services rendered by the city and the public school system. The commission began to develop and implement the payments-in-lieu-of taxes and services-in-lieu-of-taxes programs, or PILOT and SILOT programs, through which the municipality requested nonprofit organizations to voluntarily pay a percentage of the amount that would be due under their property's tax assessment and to provide Services In Lieu of Taxes ("SILOTS") as well. The latter was not, however, to be a total substitute for PILOTS and contemplated services in addition to those already rendered to the public. The government expressed that the only other alternative would be to mandate that each institution prove its eligibil-

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<sup>29</sup> See *Pennsylvania State Univ. v. County of Centre*, 615 A.2d 303 (Pa. 1992).

<sup>30</sup> See Gilbert Gaul & Neill Borowski, *In High Level Jobs At Nonprofits, Charity Really Pays. Wanted: Top Executive To Run Nonprofit Organization. Salary \$350,000 To \$400,000 A Year Plus Bonuses. Perks: Luxury Car, Country Club Membership, Interest Free Loan. Domestic Help Provided*, PHILA. INQUIRER, April 22, 1993, at A1.

<sup>31</sup> See *supra* note 26.

ity as a nonprofit organization at a hearing, and that they believed the PILOT program to be a generous alternative.

In reality, requiring a hearing for each charitable organization would not have been logistically feasible in Philadelphia (and probably, was not in Erie either, because we concluded that many small fish were returned to the stream). The large number of property owners who would have needed hearings would have occupied the Board calendar for years and, likely, the courts for beyond that. Realizing this problem, the government stated that the charities should understand that it was less expensive to be wronged by this program, rather than to face the consequences of the government doing it correctly by undertaking a comprehensive examination of each and every existing exemption. The government further stated that charities should also understand that, as "corporate citizens," they should contribute to the community.

After the initial stages of the PILOT and SILOT programs, the government began notifying charitable organizations of "voluntary" contributions "requested" by the City. These notices turned out to be a very deceptive form of communication. The City designed the PILOT form by using a standard City Department of Revenue change of assessment form as the underlying document. This form was designed to notify an owner of a change in a property assessment, as when the value of the property changes by the construction or addition to the property or by a change in market value. The City simply doctored the bottom of the change in assessment form to include PILOT contribution as a line item, without further explanation.

Many organizations tried to figure out the meaning of the PILOT forms on their own, in an effort to eliminate legal fees. The forms closely resembled a bill, and some charities simply paid the suggested PILOT contribution.

It turned out that the Board's plan in sending the PILOT mailings was to generate inquiries from the recipients, and to selectively suggest to some that they might safely ignore the notice and to others that they make an appointment to visit City Hall and find out what the City really wanted from them. The City was eager to meet with any institution which owned any substantial property.

In the past, diocesan and other exempt property in the most blighted parts of the city could have a very high assessment, but

its owner would remain unaffected because of the charity's tax-exempt status. The assessments were generally higher than they would have been if the charities had to pay taxes on them, because the organizations would have had the assessment corrected had they known that these assessment figures would eventually be the source of a substantial tax liability. Consequently, the statistics calculated by the City to estimate the value of exempt property in relation to the value of all other land were inflated by overstated assessments of tax exempt property and so too were the suggestions calculated at a percentage thereof. Nevertheless, the City used these often inflated assessment figures in their computer generated letters which were sent out to the charities.

The City considered the PILOT program a way to settle tax issues concerning nonprofit organizations in a benign fashion. Also in light of the fact that the City's tax records were often inaccurate, it provided a way to resolve things without embarrassing itself. The City government believed this program would bring money in much faster, especially because the City did not have the necessary records or staff to discern which organizations were the real abusers and which were really exempt, even after several years of investigation.

The City of Philadelphia mailed PILOT contribution letters to 582 charitable institutions, and received a 40% response rate. Of the 231 institutions that responded, approximately 50 have either signed agreements or have indicated a willingness to enter into an agreement.<sup>32</sup> The Mayor of Philadelphia exerted pressure on the charities by sending them a letter, which stated that if an institution did not respond to or participate in this voluntary program, the government would have no choice but to seek to revoke that institution's tax-exempt status. At this time, however, such a measure has not yet been sought against any charity.

Although the City stated that its efforts to create revenue would be aimed mostly to post-secondary educational and health-care facilities and would not be directed toward religious or cultural properties, the city has not kept its promise. For example, the City did scrutinize cultural organizations such as the Philadelphia Art Museum. At least one private, Catholic elementary and a church-related high school were also contacted to

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<sup>32</sup> See McCoy, *supra* note 28.

“contribute.” This school has not been asked to pay anything yet, but they have been asked to produce financial records. So far, most diocesan organizations have not been asked to participate in the program, but there are no assurances that future administrations will not try that too.

In Philadelphia, there are many institutions of higher education ranging from the very small to the very large. The City is home to the University of Pennsylvania, which receives more interest on its endowment on a given day than many of the entire annual operating budgets of other small colleges.<sup>33</sup> Yet, the City government has proclaimed that it wants to treat all these different institutions as if they were the same and has refused to negotiate for different terms with any. Few have signed formal agreements but some are making some formal payment to the City.

#### IV. THE PILOT PROGRAM IN PRACTICE

Charities have found that when they contact the City to discuss their PILOT situation, they have been misinformed. The City tells them that all the other organizations are paying their PILOT contributions, while in reality sixty percent of the organizations have not yet participated in the program, and many claim that they are not going to participate. It will be necessary for the charitable institutions to stick together in the struggle with the City, although this may be difficult because the great differences which exist among these institutions make each situation unique.

The difficulty of ascertaining whether an organization classifies as a “purely charitable” entity under existing law is the problem at the core of the dissent among the institutions on whether to participate in the program. One of the main reasons why charities cannot predict whether they will classify as a charitable institution is that many organizations own properties that may not be viewed as charitable operations. A classic example is a college book store.<sup>34</sup> The University of Pennsylvania operates a hotel and owns other revenue generating properties,

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<sup>33</sup> The university of Pennsylvania is Philadelphia’s largest private employer, with a budget of \$1.6 billion. See McCoy, *supra* note 28.

<sup>34</sup> See *Appeal of Washington v. Board of Assessment*, 666 A.2d 352 (Pa. Commw. Ct. 1995) (holding college exempt even though bookstore, cafeteria, dormitories and residential center operate with yearly surplus).



such as a campus shopping center. If the organization can qualify as a charity under existing case law, it should ignore the PILOT notice, because it has the right to tax exemption; however, if the organization cannot qualify, it is in the organization's best interest to pay the PILOT contribution and keep its tax-exempt status.<sup>35</sup> Of course, some are concerned that the cost of litigation to prove their right to exemption will exceed the PILOT sum requested. City officials have been quoted as suggesting the cost is to be passed *via* tuition to out-of-town [non-voter] students, so, why not? To smaller colleges, this has a very negative effect on the ability to compete for students.

The Rendell Administration initially projected that the program would raise approximately \$23 million dollars in revenue. This estimate was later decreased to \$10-12 million. Even the lower estimate is too generous because the actual amount of revenues raised borders on \$8 million dollars. When compared with the City's budget of one billion dollars per year, \$8 million seems to be a trivial amount. Though small, this extra revenue will enable the City to balance its budget. In fact, the extra revenue may be the difference between a balanced budget and budget deficit. Although last year the City budget was the first balanced budget in many years, the budget only balanced by approximately \$100,000. With revenues of a billion dollars, \$100,000 does not provide much leeway.

In the meantime, nonprofit institutions are also having problems balancing *their* budgets; however, they do not have the ability to tax or terrorize in order to raise funds. Thus, although this program is focused on real estate taxes, the underlying concept transcends the boundaries of real estate. For example, in Wisconsin, religious organizations are exempt from paying taxes, but not from paying fees. In *St. Bridget's Catholic Church v. City of River Falls*,<sup>36</sup> the City set up a fire protection fee. St. Bridget's Church claimed that such a fee was unconstitutional and accused the City of trying to tax them. The Church lost, because the water charge was deemed a fee and not a tax. Back in Philadelphia, despite prior opinions from the City Solicitor that it did not apply to dormitories, the City also suddenly started to insist on a rooming house license fee from colleges and universi-

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<sup>35</sup> See McCoy, *supra* note 28.

<sup>36</sup> 513 N.W.2d 673 (Wis. App. 1994).

ties which had resident students. The City offered as its rationale that a fee is necessary to "regulate" dormitories, not just to raise revenues.

Before sending the notices, the City called the colleges, universities, and nursing homes to learn the number of rooms there without saying why it wanted to know or misrepresenting it as a routine inquiry. Then the City back-dated the invoices to 1970 (when some, but certainly not all, had first been given notice of a change in the City's interpretation of the ordinance) and billed almost a million dollars for this "retroactive license fee." They added interest and penalties, but said that if each paid the tax, the City would not charge any interest. More importantly, if each entity paid the tax by March 31st, the City even offered to waive the penalty fee.

Assuming that any such fee was even due, by demanding fees retroactively, the City had deprived the institutions involved from collecting money from the students who actually occupied the facilities during all the years for which the City demanded fees. Consequently, institutions have to raise the money on their own. The result could be devastating or impossible for many of them.

With respect to charities, the program is no longer called PILOTs and SILOTs. Now, the City calls it the "Voluntary Contribution Program," to keep it "charitable."

The law, with respect to charities, respects the intent of the donor. A donor presumably wants any contributions to be used for the charitable purposes for which an entity is formed, and that entity cannot use the money for any other purpose, regardless of how worthy the cause might be.

The popularity of PILOT programs has resulted in hardships being imposed on private individuals too. For example, a client running a HUD § 202 housing program in a suburb of Philadelphia,<sup>37</sup> was forced to make a contribution to the township for municipal services. When the client sought reimbursement for the payment as an expense, the Department of Housing refused and the rents of the individual residents had to be raised to make budget. The federal government did not perceive the PILOT as a legitimate expense. The problem, at least, has been

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<sup>37</sup> These programs originated under § 202 of the Housing Act of 1959, 12 U.S.C.A. § 1701q.

addressed. There was an amendment to the tax assessment law which specifically exempted HUD § 202 housing.

#### V. STRATEGIES FOR CHARITABLE ORGANIZATIONS

Belatedly, an organization of independent colleges and universities in Pennsylvania has decided to educate the community on the contributions that they have made and make to the community. The organizations will also try their political strength. Nonprofits have been targeted, among other reasons, because they are perceived as politically weak and disorganized, not just because the government sees nonprofit organizations as potential sources of revenue. These entities must proceed in a way that demonstrates their leverage. A perception that the Archdiocese was going to get involved in the resistance to PILOTS and SILOTS may have prompted the City to ease up on Catholic high schools and elementary schools. Several years ago, when this was happening in the western part of the state and there were bills in the legislature designed to protect exempt status, Cardinal Bevilacqua issued a public statement favoring exemptions and the PCC published pamphlets in favor of the legislation. That legislation did not pass. It was intended to define "purely public charity" in a way that would be a little more orderly than the *HUP* guidelines, but amendments to the bill that would have required payments from charities made it unacceptable to all concerned. Then when the PILOTS program broke out in Philadelphia, the Cardinal, as part of his regular statement to the laity, included a moderate paragraph which acknowledged the needs of the City and emphasized that the City must also understand the contribution that the Church makes to the community.

As far as Catholic institutions are concerned, most problems in Philadelphia arise in connection with nursing homes, which are diocesan institutions, and colleges, which are not. Four Catholic colleges within the city limits are all in varying states of negotiation with the city. Two have made a "contribution," while another is going to look for a creative response, and the other has not decided what to do yet. The latter do not have the money, but one says it will make a contribution in what will be called the "Mayor's scholarship," given to a qualifying child from the public school system. Using this method, the college is able to adhere to Philadelphia's demands, and remain obedient to

Pennsylvania law since its resources will not be diverted from education purpose.

Institutions that deviate from their mission seem to be the ones that get in trouble and cause trouble for others. A classic example may be an institution in Erie that probably over-expanded.<sup>38</sup> Hamot Medical Center, a small, older hospital, expanded to other operations and began to focus much of its attention on owning and operating a yacht club instead. *Hamot* has been held up as a case of bad facts making bad law. Although *Hamot* was unique and there probably is not another institution in Pennsylvania quite like Hamot, every institution must abide by the decision.

Charitable organizations must not seek to operate "like a business," because they may be treated like one as a result. Businesses strive to budget to achieve surpluses or profits. Thus, the focus of charitable organizations should be just the opposite. Ideally, the charity should focus on a projected need rather than on a projected availability of finances and then should seek to satisfy that need by budgeting only for the services and facilities that are required to fulfill its mission. Although a charitable institution is not required to go broke, it should not have as its object the generation of unnecessary surpluses or divert assets outside its charitable purchases. "Surpluses" often disappear when charities establish sinking funds for their deferred maintenance.

These numbers are more of a responsibility for accountants than for lawyers. Since tax reviewers will ask for audited financial statements, the organizations will need to have extensive financial information available. It is up to the organization and their accountants to be certain that their financial information is presented coherently. Clarity of financial statements is crucial and cannot be neglected, because the data, as presented, bears directly on a charity's chances of being accorded tax-exempt status.

While every charitable organization should have a "charitable mission statement," the term "business plan" is probably not appropriate. It is terms like "business" or "profit" that may be used against the organization. Instead organizations should use and think in terms of mission fulfillment and

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<sup>38</sup> *Hamot Medical Center v. Murray*, 658 A. 2d 796 (Pa. 1993).

“service delivery.” When requests for Form 990 and questionnaires were sent out to the various entities in the dioceses, we tried to emphasize how important it is that administrators use caution in replying to these requests for information. Thus, coordination within the organization and with other exempt organizations is extremely important. It would be especially embarrassing if a diocesan entity gave inconsistent responses or compromised the position of other diocesan entities by an inappropriate response. Likewise, the significance of public relations cannot be over-emphasized. Residents of communities must be informed of the invaluable services that are being performed by nonprofit organizations. For example, the Archdiocese of Philadelphia is the largest social service provider in southeastern Pennsylvania and its schools educate a large portion of the children, Catholic and non-Catholic, in that area.

#### CONCLUSION

The perception must be created and maintained in the community that these institutions are viable and worthy, that they affect each community member personally. In addition, the members of the community should strive to expedite the missions which these charitable organizations have undertaken. Each individual should assist the dioceses and any other religious or nonprofit clients to the fullest capacity. The public relations strategy is necessary to counterbalance similar efforts by the government to depict nonprofits as consumers rather than providers of public service, because the government has public relations wheels in motion always and at taxpayers' expense. The *Philadelphia Inquirer* series illustrated that the papers were willing to listen to the government's side of the issue and to project the vagaries of a few upon the many. Charitable institutions need to get their message out as well.