



South Dakota Legislative Research Council

Issue Memorandum 97-09

PROPERTY TAX EXEMPTIONS FOR 501(c)(3)'S (CHARITABLE & BENEVOLENT ORGANIZATIONS)

Introduction

Like many taxation issues, providing property tax exemptions to charitable and benevolent organizations is not new. The 1965 LRC Executive Board appointed a committee to study all property exempt from taxation in South Dakota. There was also a 1985 Interim Taxation Committee which studied property tax exemptions. The 1985 committee as part of its work plan studied tax exempt property with special emphasis on establishing definitions for tax exempt property to provide guidance to local governments. The 1986 Legislature adopted HB 1017, which further defined criteria for charitable and benevolent organizations to satisfy when seeking tax exempt status for property.

The basis for property tax exemptions is provided in the South Dakota Constitution for public property as well as for religious, educational, charitable, and benevolent organizations.

"Article XI, § 2. . . . the Legislature is empowered to divide all property including moneys and credits as well as physical property into classes and to determine what class or classes of property shall be subject to taxation and what property, if any, shall not be subject to taxation. . . ."

"Article XI, § 5. The property of the United States and of the state, county and municipal corporations, both real and personal, shall be exempt from taxation, provided, however, that all state owned lands acquired under the provisions of the rural credit act may be taxed by the local taxing districts for county, township and school purposes, and all state owned lands, known as public shooting areas, acquired under the provisions of § 25.0106 SDC 1939 and acts amendatory thereto, may be taxed by the local taxing districts for county, township and school purposes in such manner as the Legislature may provide."

"Article XI, § 6. The Legislature shall, by general law, exempt from taxation, property used exclusively for agricultural and horticultural societies, for school, religious, cemetery and charitable purposes, property acquired and used exclusively for public highway purposes, and personal property to any amount not exceeding in value two hundred dollars for each individual liable to taxation."

The provisions of Article XI, § 6 are the foundation for exempting certain property and the Legislature has established thresholds and criteria for property used for charitable purposes to qualify for a property tax exemption. Charitable organizations must be open to the public and any exclusion of certain population segments must be due

to some reasonable classification. One of the thresholds used is that a charitable organization must have received a § 501(c)(3) designation from the Internal Revenue Service as prescribed by SDCL 10-4-9.1. This section also requires charitable organizations to meet the following four-part test:

1. Devotes its resources to the relief of the poor, distressed, or underprivileged.
2. Receives a majority of its revenue from donations, public funds, membership fees, or program fees generated solely to cover operating expenses.
3. Lessens a governmental burden by providing its services to people who would otherwise use governmental services.
4. Offers its services to people regardless of their ability to pay for such services.

Property owned by a benevolent organization and used exclusively for a benevolent purpose is also exempt from taxation pursuant to SDCL 10-4-9.2. A benevolent organization may be any lodge, patriotic organization, memorial association, educational association, cemetery association, or similar association. A benevolent organization must be nonprofit and recognized as an exempt organization under sections 501(c)(3), 501(c)(7), 501(c)(8), 501(c)(10), or 501(c)(19) of the Internal Revenue Code. A benevolent organization also includes a congressionally chartered veterans organization which is nonprofit and recognized as an exempt organization under § 501(c)(4) of the Internal Revenue Code. A benevolent purpose means an activity that serves the

poor, distressed, or underprivileged, promotes the physical or mental welfare of youths or disadvantaged individuals, or relieves a government burden.

The tax exemption provided to charitable and benevolent organizations affects the potential capacity for local governments to generate revenue from property taxation, while these organizations receive public services similar to what is provided to taxable property. The amount of state resources needed to fully fund the state-aid-to-education formula is also affected by the amount of tax-exempt property. However, the logic for providing a tax exemption is that the cost is partially or fully offset by lessening the burden of government.

26 U.S.C. 501(c)(3) Status

The 1986 Legislature sought to provide a more definitive definition for tax-exempt property for use by the local directors of equalization. Part of the solution was to require certain nonprofits to have a § 501(c)(3) designation under the Internal Revenue Code. The number of organizations that have a § 501(c)(3) designation has grown immensely over the years. Although this requirement is reasonable, it is not a significant limiting factor for obtaining a property exemption. There are many organizations that may have a § 501(c)(3) designation and are not classified as charitable or benevolent organizations.

There are approximately 5,200 nonprofits registered by the Secretary of State which include § 501(c)(3) organizations and other § 501(c) organizations. Many of these nonprofits do not own property. In 1997, there were 316 charitable parcels, 927 benevolent parcels, and 393 other parcels of

property that were exempt from property taxation. The other parcels include organizations which have a § 501(c)(3) exemption but do not fit into one of the other categories. Examples include volunteer fire departments, rodeo and roping clubs, nonprofit water supply companies, homeowner associations, hunting and shooting clubs, telecommunications cooperatives, improvement districts, garden clubs, and community playhouses.

The following definition for § 501(c)(3) is quoted from the Internal Revenue Code:

§ 501(c)(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Interpretation of Tax Exemptions

The Supreme Court has been involved in several cases concerning the constitutional language and statutes relating to property tax exemptions. The court has found that ownership of property alone is not a sufficient test to determine a tax exemption

and has ruled in several cases that the property must be used for school, religious, cemetery, and charitable purposes as well as owned by a tax-exempt organization. There have also been rulings that the use of rent and profit from property for charitable or benevolent purposes makes property exempt from taxation. The court, when ruling on cases concerning ambiguous statutes granting tax exemptions, is to strictly and narrowly construe the application of the statute in favor of the taxing power. The court has said that the determination of the exemption hinges upon two primary considerations:

1. The character, structure, and function of the organization.
2. Whether the property is devoted to the legitimate use or primary purpose of the organization.

The Attorney General has also been asked to provide opinions relating to ownership and use of tax-exempt property and other related issues. For instance, an Attorney General Report 1949-50, p. 328, concerning school districts stated that property owned by a school district and provided to teachers or other school district employees may be exempt from property taxation. However, property leased to the general public is taxable. Housing for teachers was considered a school purpose.

Procedures & Guidance

In 1967 the Legislature enacted SB 238 to amend chapter 10-4 establishing procedures and some guidance for determining property tax exemptions. Local assessors and the county board of commissioners review the requests for exemption status and are obligated to periodically review the status

once the exemption is provided.

Charitable and benevolent organizations are exempt from taxation by virtue of their charitable or benevolent character and recognition as such by the federal government through a § 501(c) designation and meeting certain criteria enacted by the Legislature. South Dakota law directs counties to look at the use of property as well as ownership in determining tax exempt status. SDCL 10-4-15 requires any entity claiming a property tax exemption status pursuant to SDCL 10-4-9 to 10-4-14, inclusive, to apply to the county director of equalization before November 1. The director of equalization then examines and reviews the property and recommends a status to the county board of commissioners pursuant to SDCL 10-4-16. Each charitable and benevolent organization must file an annual statement before November 1 each year certifying that the use of the property has not changed pursuant to SDCL 10-4-9 to 10-4-14, inclusive.

Each charitable organization must submit a long form every five years and the short form in other years pursuant to SDCL 10-4-19 certifying that the use of the property has not changed. If property is found exempt, the property exemption is not later subject to appeal unless ownership or use changes or the organization fails to file an annual statement. Failure to file this statement causes the director of equalization to review the status of the property, and director may make a recommendation to the county board of equalization to change the status of the property. Every five-year period pursuant to SDCL 10-4-21, the director must review the status of all tax-exempt property and file a report with the county board of equalization. A copy of the long form required by statute

is attached to this issue memorandum.

If the property is used exclusively for religious purposes or if it is a cemetery, it is not necessary to file the annual statement. However, if the property is sold or its use changes, then the owner must reapply for a tax exemption.

The list of tax exempt property must be published annually by the director of equalization pursuant to SDCL 10-4-15.1. The publication must include the legal owner, utilization, and a description of the property. The director must also maintain a permanent record of tax-exempt property and report the properties to the secretary of revenue.

Issue Facing Other States

South Dakota is not alone in facing the issue of providing property tax exemptions and the financial impact this has on local governments. This issue is illustrated by the states of Florida and Rhode Island, which have seen the value of nonprofit property triple over the last ten years. All fifty states have either constitutional or statutory provisions exempting charitable and benevolent organizations from taxation. All the states require that property be used for exempt purposes and that benefits not be restricted to members of a particular group unless membership in the group is involuntary. States do differ about how to define exempt purposes.

An article in the October 1995 issue of "Governing" outlined several examples on how local governments have pursued payments-in-lieu-of-taxes from nonprofits. The article reported that some large metropolitan cities were approaching this

issue with certain nonprofit charitable organizations by using tougher criteria passed by the state legislature and the city's willingness to go to court contesting whether the nonprofit met those legislative tests. The city of Philadelphia has successfully used this strategy with nonprofits, which own about 25 percent of the total assessable tax base, to obtain payments-in-lieu-of-taxes.

Lightening the Burden

Although many charitable and benevolent organizations do not pay property taxes for the services provided by local government, it is generally accepted that these organizations lighten the financial burden of local governments because of the services they provide that otherwise may have to be provided by government. Nonprofits are also considered an element of economic and community development through the jobs and other economic activity created by nonprofits. Another factor for granting a tax exemption is that nonprofits do not generate net income and may possess little capacity to pay taxes. And, finally, most nonprofits are considered a benefit to society and, for this reason alone, should be provided tax-exempt status.

If local governments are allowed to levy a tax or additional fees on charitable and benevolent organizations, it may inhibit the organization's ability to invest any capital into new services or upgrading facilities. If this assumption is valid, there could be long-term consequences with this policy in that it may hinder the future ability of nonprofits to deliver services, adapt to changing needs, and invest in capital improvements.

Only taxable property is assessed in South Dakota, therefore, it is difficult to estimate

the value of the tax-exempt property and what it may represent in lost revenue. Several attempts have been made in the past to determine the value of the tax-exempt property through surveys, but this data was determined to be suspect. It is recognized that some nonprofits do have substantial investment in real property.

Conclusion

Property tax exemptions provided for certain properties is not a new issue, nor is it an issue that will most likely fade away. Although the amount and value of property owned by governmental entities is quite substantial, the exemption provided to public property is absolute pursuant to Article XI, § 5. The provision of providing charitable and benevolent organizations is also found in the Constitution. The Legislature, however, does have the prerogative on controlling or limiting some of these exemptions by developing more definitive criteria. The state has delegated much of its authority to local governments to make the judgment on whether certain properties qualify for this exemption. Different interpretations and enforcement of these exemptions are possible from county to county.

The primary purpose of a tax exemption is to encourage the development and delivery of a service that relieves a government burden. Tax-exempt property for the most part does not, to any extent, compete with other taxable property. However, some may question whether certain tax-exempt property does compete with taxable property, and others may question whether certain services relieve a government burden, provide an essential or beneficial service to the community, or benefit a reasonable group of persons to warrant a tax exemption.

One suggestion during the 1965 taxation study was that South Dakota employ or hire a commercial appraisal firm to review exempt property in South Dakota. Another suggestion was that the Legislature delegate the responsibility for determining the tax status of property to the Department of Revenue. Other suggestions included that an application be submitted and approved, that more definitive criteria be provided, and that property be reassessed every five to ten years. The last three suggestions have been

enacted by the Legislature since 1965.

Any change in the tax relief programs designed for charitable and benevolent organizations may have long-range impacts and implications for the people and communities served by such organizations. The balance of providing an incentive to create and operate a beneficial organization must be weighed against the tax burden placed on the other taxpayers.

This issue memorandum was written by Fred Baatz, Senior Research Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.
