The California Property Tax Welfare Exemption in Comparison to IRC § 501(c)(3)
A Long and Rocky Way for Nonprofits to Qualify for Property Tax Benefits

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I. Introduction

The nonprofit sector enjoys benefits in almost all areas of US tax law and on all governmental levels. Property tax exemption is a major preferential treatment that a nonprofit organization can qualify for on both the state and local level. Since most nonprofit organizations do not earn significant profits nor receive big amounts of charitable contributions, exemption from property taxes, especially real property taxes, often provides their most significant financial benefit.[1]

One of the most prominent and rapidly growing exemptions under California property tax law is the *welfare exemption*. At first glance, the term "welfare" might mislead one to assume that the exemption is applicable to all charities[2] also exempt from Federal income tax by IRC § 501(c)(3). This, however, is not the case. A charity is not entitled to California welfare exemption merely because it is granted tax-exempt status under Federal tax law. Many differences exist between the two provisions and for the welfare exemption to apply many more requirements must be satisfied than for IRC § 501(c)(3) purposes. One reason for the difference is that the rules deal with very different tax systems. Another reason is the budget constraints of local municipalities which are heavily dependent on property tax revenue. In an effort to alleviate budget crises the legislature has narrowed the amount of exemption given by enacting increasingly more requirements to be satisfied for nonprofits to qualify for such benefits.

In Part , the following article begins with a general introduction of the welfare exemption provision and identifies the rationale behind it. Part then illustrates some of the important distinctions between the welfare exemption and IRC § 501(c)(3) and describes the additional requirements nonprofit organizations must comply with to qualify for California welfare exemption. Part finally turns to alternative "voluntary" payments by nonprofit organizations which are supposed to compensate localities for revenue losses caused by those exempt entities.

II. Background and Rationale for the Welfare Exemption

A. Scope of the Welfare Exemption

With a constitutional amendment in 1944, California´s voters adopted Section 4(b) of article XIII of the California Constitution (Cal. Const.). With the adoption of this section, popularly known as the *welfare exemption*, California became the last of 48 states in the US to provide such a property tax exemption.[3] Today, the welfare exemption removes almost $56 billion in value from the assessment rolls.[4] The amount of the value exempted has been increasing extensively over the past years. For the tax year 2000/01, for example, the amount had only been some $44 billion.[5]

B. The California Constitution and the Revenue and Taxation Code

1. Permissive Nature under the California Constitution

The welfare exemption is not part of the catalogue of *mandatory* exemptions found throughout Cal. Const. Art. XIII, § 3. Rather, the welfare exemption is merely *permissive* in character and authorizes the legislature to exempt from property taxation,

> "property used exclusively for religious, hospital or charitable purposes and owned or held in trust by corporations or other entities (1) that are organized and operating for those purposes, (2) that are nonprofit, and (3) no part of whose net earnings inures to the benefit of any private shareholder or individual".

2. § 214 – The Major Provision under the California Revenue and Taxation Code

With respect to the wide and unspecified authorization given by the Constitution, it is not astonishing that the California legislature has imposed numerous conditions and complex qualifications on nonprofits seeking welfare exemption. Under state law, the provisions governing the welfare exemption can be found in more than 20 sections of the Revenue and Taxation Code (Rev. & Tax. Code), the primary one of which is Rev. & Tax. Code § 214.[6]

The language of Rev. & Tax. Code § 214(a) partly reminds of IRC § 501(c)(3). In extracts, Rev. & Tax. Code § 214(a) reads as follows:

> "Property used exclusively for religious, hospital, scientific, or charitable purposes owned and operated by community chests, funds, foundations or corporations organized and operated for religious, hospital, scientific, or charitable purposes is exempt from taxation … if:
>
> 1 The owner is not organized or operated for profit. … .
> 2 No part of the net earnings of the owner inures to the benefit of any private shareholder or individual.
> 3 The property is used for the actual operation of the exempt activity and does not exceed an amount of property reasonably necessary to the accomplishment of the exempt purpose.
> 4 The property is not used or operated by the owner or by any other person so as to benefit any officer, trustee, director, shareholder, member, employee contributor, or bondholder of the owner or operator, or any other person, through the distribution of profits, payment of excessive charges or compensations, or the more advantageous pursuit of their business or profession.
> 5 The property is not used by the owner or members thereof for fraternal or lodge purposes, or for social club purposes except where that use is clearly incidental to a primary religious, hospital, scientific, or charitable purpose.
> 6 The property is irrevocably dedicated to religious, charitable, scientific, or hospital purposes and upon the liquidation, dissolution, or abandonment of the owner will not inure to the benefit of any private person except a fund, foundation, or corporation organized and operated for religious, hospital, scientific, or charitable purposes.
> 7 The property, if used exclusively for scientific purposes, is used by a foundation or institution that, in addition to complying with the foregoing requirements for the exemption of charitable organizations in general, has been chartered by the Congress of the United States (except that this requirement shall not apply when the scientific purposes are medical research), and whose objects are the encouragement or conduct of scientific investigation, research, and discovery for the benefit of the community at large.

C. Rationale for the Property Tax Welfare Exemption

There are essentially three major approaches to justifying property tax exemptions for nonprofits. The prevailing opinion views tax exemption as a *subsidy* granted by the government to the nonprofit sector in order to support and encourage the public benefits and services provided by nonprofits.[7] This approach is consistent with the argument which is regularly brought up to justify the Federal income tax exemption for charities under IRC § 501(c)(3) and the charitable contribution deduction according to IRC § 170. Proponents of this view insist that subsidizing the nonprofit sector is necessary because its property is used both to provide services that the government would otherwise have to provide and to accomplish desired social objectives benefiting the public in large.[8]

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1 JAMES J. FISHMAN & STEPHEN SCHWARZ, TAXATION OF NONPROFIT ORGANIZATIONS 87 (2003).

2 The term *charity* or *charitable organization* in its broader sense commonly refers to all organizations described in IRC § 501(c)(3).

3 *See* State Board of Equalization, *Assessors´ Handbook Section 267, Welfare, Church, and Religious Exemption* (2004) 1, at http://www.boe.ca.gov/proptaxes/pdf/ah267.pdf [last access 02/10/2005]

4 The number relates to the tax year 2003-04, *see* State Board of Equalization, 2002-03 Annual Report, Statistical Appendix Tables, Table 8, at http://www.boe.ca.gov/annual/table8_03.pdf [last access 02/10/2005].

5 *see* State Board of Equalization, 1999-00 Annual Report, Statistical Appendix Tables, Table 8, at http://www.boe.ca.gov/annual/table-8.pdf [last access 02/10/2005].

6 California State Board of Equalization, *supra* note 3, at 1.

7 FISHMAN & SCHWARZ, *supra* note 1, at 87-88.

8 KENNETH A. EHRMAN & SEAN FLAVIN, TAXING CALIFORNIA PROPERTY § 6.5 (3rd ed. Supp. 2004).

Another approach defends property tax exemption for nonprofits with a narrowed *tax base*, arguing that nonprofit organizations for different reasons would not fall into that "right" tax base.[9]
This approach suggests (1) that nonprofits should be granted a property tax exemption because these institutions are not substantially consuming governmental benefits;[10] (2) that the property tax serves as a complement to correct deficiencies in the Federal income tax which fails to tax the imputed rental value of owner-occupied housing, and no such correction is needed for nonprofits because they generally do not owe any Federal income tax;[11] (3) that property taxes are a tool of land use planning, forcing owners to convert their property toward market preferred uses because the tax is measured by the property´s fair market value in its best use rather than its actual use – a regulatory policy that is inappropriate when applied to nonprofit landowners using their property for social purposes which generally do not reflect a fair market price;[12] (4) that the property tax as a wealth tax is based on redistributional principles not applicable to nonprofits;[13] and finally (5) that the property tax as a vestige of history is lacking in normative principles at all, thus simply treating nonprofits as nontaxable because of historical custom.[14]

Determining the right justification is difficult. It became even more complex in 1998 with the addition of a third theory. According to Professor Evelyn Brody, the true rationale underlying the exemption of nonprofits from taxation is found in American history.[15] Her *sovereignty theory* looks at the nonprofit sector – especially the charitable one – as a co-sovereign to the government which had never been taxed because it had existed long before governmental structures developed. The charitable sector, so to say, was the first to assume power. When government finally entered the arena, it was not authorized to tax nonprofits. Rather, it was forced to leave the nonprofit sector untouched. To look at tax-exemptions as a subsidy, therefore appears to obvert the historical facts. In the light of such an intense look at the US-history, the weakness of the tax-based theory is revealed. Apart from the problem that nonprofits owning property by definition have property in their base,[16] the tax base theory is much too formal and technical approach to be able to explain a phenomenon like the nonprofit sector that has developed over a period of centuries.

Especially with respect to property tax, Brody´s historical approach is sensible. Property tax exemption for religious, educational, and charitable institutions "has existed from 'time out of mind'".[17] Charity property, especially that of churches, has always gone untaxed.[18] That is not on account of governmental subsidies or narrow tax-base definitions, but instead reflects the power of the parallel sovereign, the church, out of which most of today´s charities emerged.

9 Thomas C. Heller, *Is the Charitable Exemption from Property Taxation an Easy Case? General Concerns About Legal Economics and Jurisprudence*, in ESSAYS ON THE LAW AND ECONOMICS OF LOCAL GOVERNMENT 183, 212-225 (D. Rubinfeld ed., 1979). *See also* the overview in FISHMAN & SCHWARZ, *supra* note 1, at 88.

10 Heller, *supra* note 9, at 214-216. *But see* Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 598-599 (1998) who properly points out that business owners do not benefit from local expenditures either (e.g., those for schools), and that certain services – such as police, fire, and trash collection – directly benefit all property owners including nonprofit organizations.

11 Heller, *supra* note 9, at 216-217. The theory is questionable since property taxation had been in existence much longer than the income taxation which came into play – at least on the federal level – not until 1909 as part of the Payne-Aldrich Tariff Act. It seems more accurate, therefore, to say that for ability-to-pay reasons the introduction of the income tax was an attempt to correct the failures of the property tax system rather than vice versa. At least, it seems more safe to say that both tax systems simply stand side-by-side: they are aiming at different tax subjects, and are generating revenues for two different governmental levels.

12 Heller, *supra* note 9, at 217-219. That argument is not convincing, however, at least with respect to some "commercial" nonprofits which are engaged in ventures similar to those of for-profit companies (e.g., hotel, and health and fitness facilities of nonprofits like the YMCA).

13 Heller, *supra* note 9, at 219-223. A wealth tax argument is weak, however, with respect to wealthy nonprofits which can be found, for example, in the area of higher education.

14 Heller, *supra* note 9, at 223-224. That approach strongly reminds of the sovereignty theory taking nonprofits out of the tax base for historical reasons. For Professor Evelyn Brody´s sovereignty approach *see* Brody, *supra* note 10, at 587-596.

15 Brody, *supra* note 10, at 585.

16 Brody, *supra* note 10, at 598.

III. Requirements and Differences to IRC § 501(c)(3)

Even though there are some similarities and intersections between Rev. & Tax. Code § 214(a) and IRC § 501(c)(3), many differences exist.

A. Exempt Purposes

1. Charitable and Hospital Purposes

Under the welfare exemption, like under Federal law, the term *charitable purposes* is broadly construed and goes far beyond the mere relief of poverty.[19] It includes a wide range of activities. Among many others,[20] it includes educational,[21] and environmental protection purposes as well as certain kinds of housing for elderly[22]. It also encompasses the promotion of health in the case that that purpose does not yet qualify for *hospital purposes* separately mentioned in Rev. & Tax. Code § 214(a). For a purpose to be classified as charitable, it must "benefit the community as a whole or an unascertainable and indefinite portion thereof"[23]. Hence, it must satisfy both the *charitable class test* and *the community benefit test* which are also known in the Federal income tax exemption field.[24]

Special attention should be given to the State Board of Equalization´s policy that an organization´s receipt of donations from the general public shall be an important criteria for demonstrating its charitable purpose.[25] In contrast, a comparable suggestion under which charitable contributions indicate the pursuing of a charitable purpose has not been made with respect to an exemption under IRC § 501(c)(3).

A subtle but important distinction between IRC § 501(c)(3) and Rev. & Tax. Code § 214(a) is that the latter appears to being construed more literally, thus giving each of the specifically enumerated exempt purposes its own meaning. Under California law, therefore, *personal*[26] property used for, for example, scientific purposes must not also be used for charitable purposes.[27] The term charitable in IRC § 501(c)(3), on the other hand, has long been construed as overarching all other exempt purposes. So, "an organization seeking tax exemption under IRC § 501(c)(3) must show that it is charitable, irrespective of the particular nature of its activities (e.g., religious, educational, or scientific)."[28]

2. Religious Purposes

The term *religious purpose* that is of importance for two other statutory exemptions besides the welfare exemption,[29] has been expansively defined and covers all forms of belief, regardless of whether it is theistic

17 Brody, *supra* note 10, at 597, with reference to L. Richard Gabler & John F. Shannon, *The Exemption of Religious, Educational, and Charitable Institutions from Property Tax Exemption*, in IV RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2025, 2535-2536 (1977).

18 Brody, *supra* note 10, at 597.

19 *See* the instructive overview in California State Board of Equalization, *supra* note 3, at 2-7.

20 For what might all be eligible as a charitable purpose in terms of IRC § 501(c)(3) *see* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 135-192 (8th ed. Supp. 2004). As the term *charitable* uniformly goes back to the English common law of charitable trusts, reference to interpretations of the term *charitable* under Federal income tax law can be helpful in construing the term for California property tax law purposes.

21 Rev. & Tax. Code § 214(j). *See also* California State Board of Equalization, *supra* note 3, at 36.

22 Rev. & Tax. Code § 214(f).

23 *Stockton Civic Theatre v. Board of Supervisors* 66 Cal.2d 13, 22 (1967).

24 HOPKINS, *supra* note 20, at 126-130.

25 California State Board of Equalization, *supra* note 3, at 5.

26 For *real* property *see infra* on page 10.

27 California State Board of Equalization, *supra* note 3, at 11 and 23. On the other side, the Board demands that *personal* property satisfy the requirements in paragraphs (3) through (5) of Rev. & Tax. Code § 214(a) which – at least in part – are generally of importance for construing the term *charitable*.

28 HOPKINS, *supra* note 20, at 111. *See also Bob Jones University v. United States*, 639 F.2d 147 (4th Cir. 1980).

29 *See* Cal. Const. Art. XIII, § 3(f), and Rev. & Tax. Code §§ 206, 206.1 *(church exemption)* which exempt property used for religious worship including necessary parking areas. *See also* Cal. Const. Art. XIII, § 4(b), and Rev. & Tax. Code § 207 *(religious exemption)* which has simplified the claims process since 1982 because it allows to file an exemption for the organization´s entire property, i.e., also for, for example, property used for school, preschool, and kindergarten services which do not fall under the church exemption. However, not all religious purposes are covered by the religious exemption. For hospitals, and TV- and radio stations, for example, the *welfare exemption* remains applicable, Rev. & Tax. Code § 214(a) and (d).

or nontheistic.[30] Under California law, the term is construed slightly differently than its counterpart for Federal income tax purposes for which the US Supreme Court seems to place emphasis on belief in a Supreme Being.[31] In practice, however, generally no problems will arise as the IRS has advised its revenue agents to interpret religion broadly, encompassing even those sects that do not believe in a Supreme Being.[32]

3. Scientific Purposes

Rev. & Tax. Code § 214(7) imposes specific requirements for property used for *scientific purposes*. Among others, the respective organization must be chartered by Congress – a requirement unknown in the field of charitable organizations under IRC § 501(c)(3). The additional requirement in Rev. & Tax. Code § 214(7) that the scientific purpose benefit the community at large is similar to the *community benefit test* generally used for determining a purpose as being charitable.

It is important to note that the State Board of Equalization requires that to attain an exemption of *real* property for scientific purposes the organization must use the property for religious, hospital, or charitable purposes in addition to meeting the requirements in Rev. & Tax. Code § 214(7). The Board argues that the California Constitution does not authorize the legislature to exempt real property for mere scientific reasons – a purpose indeed not explicitly mentioned in the Constitution.[33]

B. Organizational Requirements

1. Owner and Operator Test

A wide difference between both provisions exists with respect to their addressees. While IRC § 501(c)(3) establishes requirements that must be met by the organization alone which aims at qualifying for income tax exemption, Rev. & Tax. Code § 214(a) demands that both owner[34] *and* operator of the property satisfy all statutory requirements. So, if property is owned by one organization and used by another organization, each must meet the requirements established by Rev. & Tax. Code § 214(a) and file a claim for exemption.[35]

2. Organizational and Operational Test

Like IRC § 501(c)(3), the welfare exemption requires that the organization be organized and operated for exempt purposes. However, while under IRC § 501(c)(3) the organization must be organized and operated *exclusively* for those purposes, such a requirement is missing in the welfare exemption field. Nontheless, the State Board of Equalization assumes that it is not necessary that the organization be organized and operated wholly for exempt purposes. Only the *primary purpose* must be an exempt one.[36] The welfare exemption thus fits IRC § 501(c)(3), the wording of which has also long been interpreted as including a *primary purpose test*.[37]

3. Not-for-Profit and Private Inurement Doctrine

According to Rev. & Tax. Code § 214(a)(1), the organization must not be organized or operated for profit.[38] Incorporated entities therefore are eligible for the welfare exemption if they are incorporated under the California Nonprofit Corporation Law or corresponding laws of other jurisdictions. For unincorporated entities a look at the organization´s formative documents is necessary. To be classified as nonprofit rather than for-profit, in essence an organization must meet the *private inurement test*, and *nondistribution constraint test*, respectively.[39]

The Federal tax law does not explicitly refer to the term nonprofit[40] which is commonly used under state law. However, IRC § 501(c)(3) contains the *private inurement* doctrine which can also be found in Rev. & Tax. Code § 214(a)(2). So, in practice only nonprofit organizations can qualify for exempt status under IRC § 501(c)(3) as well as the welfare exemption.

It is clear that the term not-for-profit in Rev. & Tax. Code § 214(a)(1) does not preclude the organization from generating any profits.[41] However, compared to IRC § 501(c)(3), the welfare exemption is much more strict as to the allowable amount of profits that may be made. That is because Rev. & Tax. Code § 214(a)(3) states that the property must be used in the actual operation of the exempt activity and must not exceed an amount reasonably necessary for the exempt purposes. These requirements will generally not be satisfied if property is regularly used for making substantial profits.[42]

4. Income Tax Exemption

One of the basic requirements for the welfare exemption is the organization´s exempt status for income tax purposes either under IRC § 501(c)(3) or Rev. & Tax. Code § 23701d. Rev. & Tax. Code § 214.8(a).[43] That does not mean that the exemption from income taxation would be sufficient for welfare exemption purposes. Rather, the income tax exemption is a mere additional requirement necessary for nonprofits seeking exemption under the welfare exemption.

5. Irrevocable Dedication and Dissolution Clause

Under California law, an explicit statement is required that the property be irrevocably dedicated to the exempt purposes specified in Rev. & Tax. Code § 214(a) and that upon dissolution of the owner the assets will go to another organization organized and operated for such exempt purposes. Rev. & Tax. Code §§ 214(a)(6), 214.01(a).[44] Such statement must be found in the articles of incorporation, and the bylaws, articles of association, constitution, or regulations thereof, respectively. Hence, even though the IRS may accept the language in the articles for exemption from Federal income tax purposes, California property tax exemption may be denied.

The State Board of Equalization gives a sample of what language would satisfy the requirements for organizations incorporated in California as follows:

> „The property of this [legal entity] is irrevocably dedicated to [religious/charitable/scientific/hospital purposes or charitable and educational purposes meeting the requirements for exemption provided by section 214 of the Revenue and Taxation Code] and no part of the net income or assets of this organization shall inure to the benefit of any private persons. Upon the dissolution or winding up of the [legal entity] its assets remaining after payment, or provision for payment, of all debts and liabilities of this [legal entity], shall be distributed to a nonprofit fund, foundation, or corporation which is organized and operated exclusively for [religious/ charitable/scientific/ hospital purposes or charitable and educational purposes

30 *Fellowship of Humanity v. Alameda County,* 153 Cal.App.2d 673, 693 (1957).

31 *United States v. Seeger*, 380 U.S. 163, 165-166 (1965).

32 FISHMAN & SCHWARZ, *supra* note 1, 185.

33 Compare the language in Cal. Const. Art. XIII, § 4(b) which does not contain the term *scientific* with Rev. & Tax. Code § 214(a). Cal. Const. Art XIII, § 2 only applies to *personal* property. The State Board´s argumentation implies the understanding that all exempt purposes enumerated in Rev. & Tax. Code § 214(a) provide a distinct basis for tax exemption. So, as long as property qualifies for exemption for religious, hospital, or scientific (only *personal* property) reasons, the requirements of the term charitable must not be satisfied as well. That approach is different under Federal income tax law, though, *see supra* text accompanying note 28 and 27.

34 The owner includes one who holds a taxable possessory interest in publicly owned real property, California State Board of Equalization, *supra* note 3, at 18.

35 California State Board of Equalization, *supra* note 3, at 14-15 with instructive examples. In the case of an occasional use of property by an operator organization exempt, for example, from Federal income taxes under IRC § 501(c)(3) or (4), a special exception applies, *see* Rev. & Tax. Code § 214(a)(3)(D) and California State Board of Equalization, *supra* note 3, at 29-30.

36 California State Board of Equalization, *supra* note 3, at 13.

37 HOPKINS, *supra* note 20, at 76-82.

38 Cal. Const. Art. XIII, § 4(b), on the other side, speaks of *nonprofit* organizations. As to content, both *nonprofit* and *not-for-profit* are often used synonymously. JODY BLAZEK, TAX PLANNING AND COMPLIANCE FOR TAX-EXEMPT ORGANIZATIONS – RULES, CHECKLISTS, PROCEDURES 11-12 (4th ed. 2004). The term nonprofit appears preferable, though, because *not-for-profit* rather describes an activity which is not engaged with the intent to make profits. The term is improper to describe nonprofit organizations since nonprofits in general are not precluded from generating profits as long as their net-earnings are devoted to their exempt purposes.

39 *Nondistribution constraint* and *private inurement test* are two commonly used labels for one and the same doctrine which forbids any direct or indirect distributions of the net-earnings to the organization´s members or private individuals. All revenues have to be used exclusively for the organization´s exempt purposes. The idea of nondistribution constraint traces back to Henry B. Hansmann, *see* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835, 838.

40 BLAZEK, supra note 38, at 11.

41 *see supra* note 38.

42 The State Board of Equalization is of the opinion that a rent must not exceed operating expenses by more than 10%. State Board of Equalization, Letter to County Assessors 79/30, dated February 9, 1979.

43 Some exceptions apply, though. *See* Rev. & Tax. Code § 214.8(a) and California State Board of Equalization, *supra* note 3, at 18 note 70.

44 An exception to the dissolution clause requirement is found in Rev. & Tax. Code § 214.3.

meeting the requirements for exemption provided by section 214 of the Revenue and Taxation Code] and which has established its tax exempt status under section 501(c)(3) of the Internal Revenue Code."[45]

C. Use of the Property

Unlike IRC § 501(c)(3), Rev. & Tax. Code § 214(a)(3) and (5) establish some requirements with respect to the organization´s use of its property. The mere ownership of property by a nonprofit organizations – even if tax-exempt under IRC § 501(c)(3) – does not satisfy the welfare exemption requirements. The State Board of Equalizations explains that "both ownership and use of the property drive the welfare exemption."[46]

1. Use Exclusively for Exempt Purposes

For being exempt, the property must be used *exclusively* for exempt purposes. Rev. & Tax. Code § 214(a). Additionally, it must be in such use on January 1, the lien date.

Like in the area of IRC § 501(c)(3) for purposes of the organizational and operational test,[47] the term *exclusively* is not to be literally construed to mean that the property must be used solely for exempt purposes. It is sufficient if the organization´s use of its property is "reasonably necessary for the accomplishment"[48] of the exempt purpose. Nevertheless, the exempt purpose must be the *primary* use made of the property.[49] As long as the use for nonexempt purposes is *incidental and occasional* only, the primary purpose test is met and the property is not disqualified from exemption.[50]

The use of property for fundraising purposes does not qualify for exemption, and neither do unused buildings or unused vacant land.[51] The same is true if the nonprofit organization allows property to be used by other unqualified individuals or organizations for private benefits. In all these cases the property is not primarily used for the organization´s exempt purposes. As far as an otherwise exempt organization engages in activities which produce unrelated business income the welfare exemption will not apply either. Rev. & Tax. Code § 214.05. Income is treated as unrelated business income as defined in the IRC,[52] thereby closely linking the welfare exemption with the exemption from Federal income taxation.

2. Use for Actual Operation of Exempt Activities and Amount of Property Limitation

Rev. & Tax. Code § 214(a)(3) requires the property to be used for the actual operation of the exempt activities. So, the property must both be primarily *used for the exempt purpose*[53] and be *used for the exempt activities* undertaken by the organization. This latter "actual operation" requirement has been liberally construed by the courts[54] similar to the broad interpretation of the exclusively test mentioned earlier.[55] Nontheless, it is an additional test disqualifying property used for nonexempt activities. For example, property that is only incidentally used for nonexempt purposes, may qualify as being exclusively used for the organization´s purposes. However, such property is not eligible for exemption to the extent it is actually used for such non-exempt activities, thus failing the actual operation test.

A liberal interpretation also applies to the requirement that the amount of property be reasonably necessary to the accomplishment of the exempt purpose. As long as the property is used in the actual operation of the organization´s exempt activities, even a significant amount of property will generally be respected by the courts.[56]

3. Private Inurement Principle with Respect to Property

The welfare exemption as well as the Federal income tax exemption for charities have in common the private inurement principle discussed earlier under which no part of the *net earnings* may be distributed to the organization´s members or shareholders.[57] The welfare exemption goes beyond that requirement. Rev. & Tax. Code § 214(a)(4) demands that *the property itself* must not be used or operated for the advantage of a private person. In general, all possible advantages, not only economical or pecuniary ones, disqualify for the exemption. On the other hand, agreements resulting from good faith arm´s length negotiations will usually be upheld.[58]

4. Fraternal, Lodge, and Social Club Exception

If the organization uses its property for fraternal, lodge, or social club purposes, such use must be only incidental to the primary exempt purpose to still qualify for the welfare exemption. Rev. & Tax. Code § 214(5). Under California property tax law as well as Federal income tax law, such groups are usually not organized and operated exclusively for charitable purposes. Therefore, they generally cannot qualify for Rev. & Tax. § 214(a) treatment.[59]

D. Claiming Process

The claiming process under IRC § 501(c)(3) is a single-level recognition process that is generally completed with the IRS´ issuing a favorable determination letter.[60]

Claiming the welfare exemption, on the other hand, is a two-stage procedure.[61] After filing a claim form with the California State Board of Equalization, the Board makes the determination whether an organization qualifies for the welfare exemption by meeting the requirements of Rev. & Tax. Code § 214. Rev. & Tax. Code § 254.6(b). In case of a favorable decision, the Board will issue an *Organizational Clearance Certificate* to the organization. The claimant then has to file an exemption claim form with the county assessor where the property is located. A copy of the Organizational Clearance Certificate must be included. It is the county assessor´s duty to determine whether an organization´s *property meets the use requirements* to qualify for the exemption. Rev. & Tax. Code § 254.5(b).

Both, the IRS´ determination letter and the Organizational Clearance Certificate usually remain valid as long as there are no substantial changes in the facts or the law.[62] The claim for welfare exemption filed with the county assessor, however, is due on an annual basis – generally no later than February 15 of each year. If an organization fails to file the claim in time, the exemption is deemed waived for that year. Rev. & Tax. Code §§ 255(a), 260.

IV. PILOTs, SILOTs and User Fees Imposed on Nonprofits

Even if nonprofits are eligible under the Revenue and Taxation Code to claim the welfare exemption, that is not the end of the story. Frequently, local governments try to get around the legislative command to exempt organizations from property taxes.

45 State Board of Equalitzation, *Property Tax Payment and Relief, Welfare or Veterans´ Organization Exemptions – Frequently Asked Questions,* Question 11, at http://www.boe.ca.gov/proptaxes/faqs/welfarevetsfaqs.htm#11 [last access 02/10/2005].

46 State Board of Equalitzation, *Property Tax Payment and Relief, Welfare or Veterans´ Organization Exemptions – Frequently Asked Questions*, Question 13, at http://www.boe.ca.gov/proptaxes/faqs/welfarevetsfaqs .htm#13 [last access 02/10/2005].

47 *See supra* text accompanying note 37.

48 *Cedars of Lebanon v. County of Los Angeles*, 35 Cal.2d 729, 736 (1950).

49 *Peninsula Covenant Church v. County of San Mateo*, 94 Cal.App.3d 382, 396 (1979).

50 *Fellowship of Humanity v. County of Alameda*, 153 Cal.App.2d 673, 699 (1957) discussing the church exemption.

51 An exception applies as to vacant land under specific conditions, *see* Rev. & Tax. Code § 214.15. Moreover, Cal. Const. Art. XIII, § 5 and Rev. & Tax. Code §§ 214.1 and 214.2 extend the welfare exemption to property under construction or demolition.

52 IRC §§ 512, 513.

53 Rev. & Tax. Code § 214(a), *see* discussion *supra* on page 15.

54 *See* the examples in California State Board of Equalization, *supra* note 3, at 29.

55 *See supra* text accompanying note 48.

56 *San Francisco Boys´ Club, Inc. v. Mendocino County*, 254 Cal.App.2d 548 (1967). Keep in mind, however, that generating too much profit might be an indication that either the property is not used for the actual operation of the exempt activities or that too much property is held not reasonably necessary to the accomplishment of the exempt purposes. *See supra* note 42 and the accompanying text. The language "and does not exceed an amount of property reasonably necessary to the accomplishment of the exempt purpose" in Rev. & Tax. Code § 214(a)(3) was inserted in the Code not until 1968, i.e., after the decision in *San Francisco Boys´ Club*.

57 *See supra* on page 12.

58 *Scripps Clinic and Research Foundation v. County of San Diego*, 53 Cal.App.4th 402, 415 (1997).

59 California State Board of Equalization, *supra* note 3, at 6.

60 Organizations seeking recognition of exemption as an IRC § 501(c)(3) organization are required to file a proper application with – in general – the IRS in Cincinnati, Ohio. HOPKINS, *supra* note 20, at 620-621 and 631-635. The IRS has issued a revised application form 1023 which must be used after April 2005. The form, proper instructions, and frequently asked questions and answers are available online at http://www.irs.gov/charities/charitable/article/0,,id= 130145,00.html [last access 02/12/2005].

61 *See* California State Board of Equalization, *supra* note 3, at 85-113. For the claiming process prior to January 1, 2004, *see* California State Board of Equalization, *supra* note 3, at 86.

62 HOPKINS, *supra* note 20, at 621 and 628; California State Board of Equalization, *supra* note 3, at 87.

From a local fiscal point of view such behavior is understandable. Local governments have found themselves in difficult situations, when in times of increasing local fiscal crises, they must realize that a good portion of their tax revenues is exempted from taxation. Some of the most important and influential nonprofits in California owning remarkable amounts of property take advantage of the welfare exemption even though – on the other side – they benefit from local services provided by the municipalities to a similar extent as do all other property taxpayers.
In an attempt to seek new sources of revenues, to protect their tax base, and to collect a fair share for governmental services, localities throughout the U.S. keep on imposing "voluntary" *payments in lieu of taxes* (PILOTs), *in-kind services in lieu of taxes* (SILOTs), and *user fees* on nonprofits. Similar efforts are unknown in the Federal income tax exemption area where Congress easily has the power to narrow the exemption provisions of the IRC if that might be necessary for fiscal purposes.[63] The localities do not have that power. On the one side, they have to bear the revenue losses, on the other side, they are unable to change the statutory exemptions granted by state law.

The question for nonprofits of whether to enter into a PILOT or similar agreement depends on the organization´s individual situation. Making such payments results in increasing costs and may require a reduction or even complete closure of the organization´s services. Moreover, there is a risk that the nonprofit sector will lose its independence, and sovereign status, respectively. On the other hand, organizations defending their privileged status take the serious risk of negative publicity, of time-consuming and expensive legal conflicts, and the danger of straining their relationship with the government as a predominant funder of nonprofits.[64] Moreover, the municipality´s sanctions could include the denial of zoning relief or building permits desired by the nonprofit organization or even the threat to seek political or judicial revocation of the organization´s exempt status. So, in practice, it is typically in everyone's interest to compromise on a "voluntary" payment. In general, it is less than the full taxes that would be paid if the property were fully taxable.[65]
In California, however, the situation is slightly different. Imposing user fees on nonprofits appears to remain the only major revenue source available for the local governments. For PILOT agreements between local governments and nonprofits no constitutional or statutory authority exists, thus making them illegal.[66] Since PILOTs are nothing else than substitutes for property tax payments, they in fact result in a waiver of the welfare exemption pursuant to Cal. Const. Article XIII, § 6.[67] The same arguments are true for SILOT agreements. Hence, under California law, nonprofits should never accept PILOT or SILOT requests if they do not want to run the risk to lose their exemption. On the other side, it is hardly possible to avoid user fees. Stanford University, for example, has entered into an agreement with the city of Palo Alto to pay about $5.2 million, and $586,000 a year, respectively for fire and police services.[68]

V. Conclusion

This paper has just highlighted several important requirements of the California property tax welfare exemption as well as pointed out some distinctions to its counterpart in the Federal income tax field. Disclosure of all details scattered in the Revenue and Taxation Code would have been beyond the scope of this article.
It has been the author´s intention to show that for nonprofits to qualify for the welfare exemption, many requirements must be met which go much further than those necessary for the Federal income tax exemption under IRC § 501(c)(3). Further, even if an organization should succeed with respect to the welfare exemption, it still is in danger of governmental requests for user fee agreements or other similar contributions in lieu of property taxes. To be eligible for an all-embracing relief from property taxes and in lieu payments, nonprofits thus face a long and rocky way.

63 Under the sovereignty perspective discussed *supra* text accompanying and following note 15, the question would arise, however, to what extent the Congress´ narrowing the exemptions for nonprofits would be tolerable. The subsidy as well as the base-defining theory could easily explain such congressional action.
64 National Council of Nonprofit Associations, Facing Challenges to Property Tax Exemptions Tool Kit 12 (Summer 2003), at http://www.ctnonprofits.org/Content/NonProfitResources/FlexibleContent/Property_tax_tool_kit.pdf [last access 02/10/2005] with even more arguments pro and contra PILOTs.
65 Edward A. Zelinsky, *The Once and Future Property Tax: A Dialogue With my Younger Self*, 23 CARDOZO L. Rev. 2199, 2216.
66 State Board of Equalization, Property Tax Annotation 880.0155 (2003), at http://www.boe.ca.gov/proptaxes/pdf/ 880_0155.pdf [last access 02/10/2005]. The Board´s Annotation also lists examples where the law explicitly allows payments in lieu of property taxes, *see id.* note 2. *See also* EHRMAN & FLAVIN, *supra* note 8, at § 10.1-10.10.
67 State Board of Equalization, supra note 66.
68 The numbers relate to the year 2001/02. Since then, they have probably grown by 3 to 4 percent a year. *See* Policy Matters Ohio, Memorandum by Zach Schiller, Research Director, 2 and 6 (December 2004), at http://www.policymattersohio.org/pdf/HospitalPILOTs_2004_12.pdf [last access 02/10/2005].

Neuere Entscheidungen zur Schiedsgerichtsbarkeit in der U.S.-amerikanischen Rechtsprechung (Frühjahr 2005)

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Die U.S.-bundesgerichtliche Rechtsprechung bietet mehr als genug Material, um im Anschluss an den Rechtsprechungsbericht im DAJV-Newsletter 4/2004[1] auch im ersten Newsletter des Jahres 2005 über aktuelle U.S.-amerikanische Entscheidungen zu berichten. Wir besprechen dieses Mal eine Auswahl von Entscheidungen des 2. Bezirks (*Circuit*), der die Staaten New York, Vermont und Connecticut umfasst, und des 8. Bezirks, zu dem die Staaten North Dakota, South Dakota, Minnesota, Nebraska, Iowa, Missouri und Arkansas gehören. An erstinstanzlicher bundesgerichtlicher Rechtsprechung berichten wir über eine aktuelle Entscheidung des Bezirksgerichts des *Eastern District of Pennsylvania*.

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1 *Kochinke/Wilske/Krapfl*, Neuere Entscheidungen zur Schiedsgerichtbarkeit in der U.S.-amerikanischen Rechtsprechung, DAJV-Newsletter 4/2004, 138.

1. *Affidavit* eines Schiedsrichters über den eigenen Denkprozess unverwertbar

In einem Rechtsstreit wegen Anwaltshaftung entschied das Bundesberufungsgericht des 2. Bezirks in *Rubens v. Mason, Mason, Ketterman & Cawood* am 26. Oktober 2004, dass einer eidesstattlichen schriftlichen Zeugenaussage (*affidavit*) eines Schiedsrichters kein Beweiswert zuzumessen sei, weil die Gefahr der Voreingenommenheit des Schiedsrichters zu groß sei.[2]

Die Klägerin *Rubens* warf ihrem Anwalt *Mason* vor, er habe sie in einem Schiedsverfahren wegen Arzthaftung nicht ordnungsgemäß vertreten. Sie trug verschiedene vom Anwalt nicht verfolgte Argumentationslinien vor, die nach ihrer Auffassung ihrer Schiedsklage zum Erfolg verholfen hätten. Zu seiner Verteidigung legte der Beklagte *Mason* einen *affidavit*

2 *Rubens v. Mason, Mason, Ketterman & Cawood,* Docket No. 03-9184 (2nd Cir., 26 October 2004), http://caselaw.lp.findlaw.com/data2/circs/2nd/039184p.pdf.
3 *Rubens v. Mason,* No. 01civ5004, 2003 WL 22234704, at 5 (S.D.N.Y. 30 September 2003) (*"Even assuming that MKM was negligent in its representation of Rubens, in light of [...] affidavit, no reasonable jury could conclude that Rubens would have prevailed at arbitration."*).