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Nonprofits' Tax-Exemption Battle Moves to the Courts.

Legislative attempts to tax nonprofits have fallen short. But recent legal challenges could present a financial problem for nonprofits and a financial boost for governments.

Faced with tight budgets and in search of new sources of revenue, municipalities increasingly have been eyeing the tax-exempt status of nonprofits. Legislators say that universities' record-high endowments and the corporate-like structure of nonprofit hospitals is making it harder and harder to swallow giving these institutions a tax break.

While many of the legislative attempts to start taxing nonprofits have failed, recent legal challenges have proved more promising. If the trend continues, it could present a financial problem for nonprofits and a financial boost for governments. So far, the focus of both legislation and legal action has been on hospitals and higher education institutions, but some worry they could spill over to smaller nonprofits and charities.

The dollars at stake are significant. According to a 2009 study by the Congressional Research Service, property tax exemption is worth $17 to $32 billion nationwide.

Also driving these challenges is the issue of tax fairness. Many nonprofits fork over an annual PILOT, or Payment In Lieu of Taxes, to help offset the governments' loss of revenue. But residents in the vicinity of hospitals or universities often feel that they still end up paying higher taxes to compensate for the revenue lost to nonprofits' exemptions.

But when lawmakers try to address these issues, their efforts often fall short. For instance, a bill in Connecticut proposed taxing earnings on university endowments valued above $10 billion. The law would have only applied to Yale University, but it died last month. Last year, Maine Gov. Paul LePage tried to strip nonprofits of their exemption as part of his overall tax reform package. It was rejected.

When towns and residents resort to lawsuits, however, they appear to be finding more success.

In New Jersey, the town of Morristown sued Memorial Hospital in a case that opened the door for other challenges. After the hospital agreed to pay more than $15 million in back taxes as well as future property taxes, more than a dozen New Jersey hospitals became embroiled in similar litigation.

Even more worrisome for nonprofits is a case in Princeton, N.J. Residents argue that the university there acts like a for-profit institution and that their property taxes are higher because Princeton doesn't pay any. In an unusual ruling, the judge determined that Princeton University must prove its tax-exempt status again. The case is expected to go to trial in the fall.

The Princeton case differs from previous legal challenges in one important way: It was brought by residents. The fee for filing a property tax challenge is typically very low — less than $100. If the residents of Princeton win, it could lead to copycat challenges aimed at nonprofits that have a

controversial mission, said Linda Czipo, executive director of the New Jersey Center for Nonprofits. She warns that places like abortion clinics or alcohol and drug rehab centers would be particularly vulnerable.

David L. Thompson, vice president of public policy for the National Council of Nonprofits, argues the real issue is one of public finance and not tax fairness. Many governments' long-term liabilities — health care and pensions — are growing faster than their annual revenue streams. Because of that, said Thompson, it's tempting for politicians and policymakers in times of tight revenue to view nonprofits — however inaccurately — as freeloaders.

For instance, last year he testified before the Pennsylvania General Assembly, which has dealt with chronic budget deficits in recent years. Thompson spoke after the state auditor who testified that taxing the state's tax-exempt properties would net about $1.5 billion in new revenue — but, Thompson immediately clarified, government buildings account for most of that figure.

"They always talk about that dollar figure then say that's why we need to tax nonprofits," said Thompson. "But it's a bait-and-switch argument. And they don't even mention the tax breaks that developers get in incentives. Nonprofits are typically only somewhere between 4 and 8 percent."

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