



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	4/28/04	Bill No:	AB 3074
Tax:	Property	Author:	Assembly Revenue and Taxation Committee
Board Position:		Related Bills:	

BILL SUMMARY

This bill would grant the welfare exemption to properties on a retroactive basis for the period between the submission of an application for a building permit and the commencement of actual physical construction.

Current Law

Under existing law, vacant or unused property of a nonprofit organization that is held for a future use is not qualified for exemption from property tax, even if the intended use will be for exempt purposes and activities. However, the California Constitution has been amended to specifically provide that three exemptions can be granted to "**buildings under construction**," land required for their convenient use, and equipment in them if the intended use would qualify the property for the exemption. Those exemptions are:

- **College Exemption.** Buildings, land, equipment, and securities used exclusively for educational purposes by a **nonprofit institution of higher education**. *Section 3(e) of Article XIII (Under construction provisions added by Proposition 14, November 2, 1954)*
- **Church Exemption.** Buildings, land on which they are situated, and equipment used exclusively for **religious worship**. *Section 3(f) of Article XIII (Under construction provisions added by Proposition 9, November 2, 1954)*
- **Welfare Exemption.** 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. *Section 4(b) of Article XIII (Under construction provisions added by Proposition 15, November 2, 1954)*

Currently, these provisions are found in Section 5 of Article XIII of the California Constitution. With respect to the welfare exemption, the provisions of Section 5 are statutorily embodied and expanded upon in Revenue and Taxation Code Sections 214.1 and 214.2. Section 214.1 provides that the welfare exemption is available to **facilities in the course of construction**, together with the land on which the facilities are located as may be required for their convenient use and occupation.

Section 214.2 specifies that "facilities in the course of construction" require activity connected with the construction or rehabilitation of a new or existing building or improvement that **results in physical changes visible to any person inspecting the site** where the building or improvement is located. (A court has held that the phrase, "in the course of construction," as used in Section 214.1, includes the digging of trenches for the foundation of a building prior to the lien date.¹) As long as construction has commenced, the property will be considered "under construction" unless the construction is abandoned. However, if there is a delay in construction due to reasonable causes and circumstances beyond the property owner's control and that occurs notwithstanding the exercise of ordinary care and the absence of willful neglect, then the construction will not be considered "abandoned."

Section 214.2 further provides that "facilities in the course of construction" will include the demolition or razing of a building with the intent to replace the building with a facility to be used exclusively for religious, hospital or charitable purposes.

Proposed Law

This bill would amend Section 214.2 of the Revenue and Taxation Code to provide that the phrase "course of construction" includes prospective construction or rehabilitation of a new or existing building or improvement as evidenced by application for a building permit to the local planning or building department or improvement is to be used exclusively for religious, hospital, or charitable purposes. However, the exempt status will only be granted and applied **retroactively** to the date of permit application, after it is verified that actual construction has commenced.

Any tax, penalty, or interest levied on the exempt portion of the assessment is to be refunded or cancelled as specified in Section 271 and 272 for property that was acquired or did not exist on the lien date. Any refund or cancellation is limited to the last four years

In General

Welfare Exemption. Under Section 4(b) of Article XIII of the California Constitution, the Legislature has the authority to exempt property (1) used exclusively for religious, hospital, or charitable purposes, and (2) owned or held in trust by nonprofit organizations operating for those purposes. This exemption from property taxation, popularly known as the *welfare exemption*, was first adopted by voters as a Constitutional Amendment on November 7, 1944. With this amendment, California became the last of 48 states in the country to provide such an exemption from property taxes. The ballot language in favor of the amendment stated:

These nonprofit organizations assist the people by providing important health, citizenship and welfare services. They are financed in whole or in part by your contributions either directly or through a Community Chest. It is good public policy to encourage such private agencies by exemption rather than to continue to penalize and discourage them by heavy taxation.

¹ *National Charity League v. County of Los Angeles* (1958) 164 Cal.App.2d 241.

When the Legislature enacted Section 214 of the Revenue and Taxation Code to implement the Constitutional provision in 1945, a fourth purpose, *scientific*, was added to the three mentioned in the Constitution. Section 214 parallels and expands upon the Constitutional provision by exempting property used exclusively for the stated purposes (religious, hospital, scientific, or charitable), owned by qualifying nonprofit organizations if certain requirements are met. An organization's *primary* purpose must be either religious, hospital, scientific, or charitable. Whether its operations are for one of these purposes is determined by its activities. A qualifying organization's property may be exempted fully or partially from property taxes, depending on how much of the property is used for qualifying purposes and activities. Section 214 is the primary welfare exemption statute in a statutory scheme that consists of more than 20 additional provisions. Over the years, the scope of the welfare exemption has been expanded by both legislation and numerous judicial decisions.

Owned and Operated Requirement. Section 214 requires that, to be eligible for the welfare exemption, both the owner and the user of a property must meet specific requirements. The first step in determining welfare exemption eligibility is to determine if the organization itself qualifies. In brief, an organization must meet the following requirements:

- It must be organized and operated for exempt purposes;
- It must not be organized or operated for profit;
- The owner organization must have an IRC §501(c)(3) or Revenue and Taxation Code 23701d letter of exemption;
- The user organization may also qualify with an IRC §501(c)(4) or Revenue and Taxation Code §23701f or §23701w letter;
- The organization's earnings must not benefit any private shareholder or individual;
- Articles of Incorporation must contain an acceptable statement of irrevocable dedication of the property to exempt purposes;
- Articles must contain an acceptable Dissolution Clause; and
- The property owner must be the owner of record on the lien date.

When the owners and operators of a property are different nonprofit entities, the property is not eligible for exemption unless both the owner and operator meet the specific requirements of Section 214. An operator is a user of the property on a regular basis, with or without a lease agreement. Typically, the owner and operator are one and the same and the filing of one claim for exemption will suffice. However, it is not necessary that the owner and the operator of the property be the same legal entity. If property is owned by one exempt organization and operated by another exempt organization, each must qualify and file a claim for exemption. If the operator is not an exempt organization meeting all the requirements of Section 214, the welfare exemption is not available on the property.

Specific Requirements for Use of Property. The Constitution and statutes impose a number of requirements that must be met before property can become eligible for exemption. Nonprofit organizations claiming exemption for their properties must satisfy various organizational requirements and must also meet additional requirements concerning uses of their property. With respect to the use of the property:

- The property must be used exclusively for exempt purposes.
- The property must be used for the actual operation of an exempt activity.²
- The property is not to be used to benefit any person through distribution of profits, compensation or the more advantageous pursuit of his or her business or profession.

Background

Related Legislation. AB 783 (Maddox and Mountjoy) of the 2003 Legislative Session would have provided that the phrase "course of construction" includes the period subsequent to an owner filing a completed application for a building permit with an appropriate local agency for purposes of qualifying for the property tax welfare exemption.

AB 2662 (Bogh) of the 2002 Legislative Session would have amended Section 214.1 to specify that property already in the course of construction will not be considered "abandoned," and therefore no longer eligible for exemption, if due to financing delays or delays in governmental approval. These provisions were removed from this bill by the May 17, 2002 amendments.

Assembly Bill 1559 (Wiggins; Stats. 1999; Ch. 927) added Section 214.15 to the Revenue and Taxation Code to provide a limited extension of the welfare exemption to vacant land. In this case the charitable purpose of the organization is acquiring and holding real property for the future construction/rehabilitation of single or multifamily residences for sale at cost to low-income families. Section 214.15 provides:

(a) Property is within the exemption provided by Sections 4 and 5 of Article XIII of the California Constitution if that property is owned and operated by a nonprofit corporation, otherwise qualifying for exemption under Section 214, that is organized and operated for the specific and primary purpose of building and rehabilitating single or multifamily residences for sale at cost to low-income families, with financing in the form of a zero interest rate loan and without regard to religion, race, national origin, or the sex of the head of household.

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(2) With regard to paragraph (1), the Legislature finds and declares all of the following:

(A) The **exempt activities** of a nonprofit corporation as described in subdivision (a) **qualitatively differ** from the exempt activities of other nonprofit entities that provide housing in that the exempt purpose of a nonprofit corporation as described in subdivision (a) is **not to own and operate** a housing project on an ongoing basis, but is instead to make housing, and the land reasonably necessary for the use of that housing, available **for prompt sale** to low-income residents.

² The exemption is limited to the amount of property reasonably necessary for the accomplishment of the exempt purpose. Portions of the property in excess of that reasonably necessary for the purposes of the organization do not meet the requirements for property tax exemption and are subject to taxation.

(B) **In light of this distinction, the holding of real property** by a nonprofit corporation as described in subdivision (a), for the future construction on that property of a single or multifamily residence as described in that same subdivision, **is central to that corporation's exempt purposes and activities.**

(C) In light of the factors set forth in subparagraphs (A) and (B), **the holding of real property** by a nonprofit corporation described in subdivision (a), for the future construction on that property of a single or multifamily residence as described in that same subdivision, **constitutes the exclusive use of that property** for a charitable purpose within the meaning of subdivision (b) of Section 4 of Article XIII of the California Constitution.

COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by the California Assessors' Association. According to the sponsor under existing law in order to qualify for an exemption, an organization has 90 days from the date of purchase to begin demolition or construction on property designated for exempt use. This bill attempts to recognize that 90 days is no longer sufficient time for a nonprofit organization to acquire the vast array of permits and approvals required by local jurisdictions. The Constitution makes clear that it is in the public interest to provide property tax exemption to organizations that provide charitable services on exempt use property. Exemption from property taxes is not currently available during the entitlement process period. This bill is intended to remedy that situation without loss of revenue from organizations that do not actually construct an exempt use property.
2. **Generally, property is not eligible to receive the welfare exemption unless it is used by a nonprofit entity for exempt purposes and activities.** Historically, vacant, unused property held for future construction does not qualify for the welfare exemption since it is not being "used" for an exempt purpose and activity. Thus, unimproved land or vacant buildings or homes owned by the entity, are not qualified for the welfare exemption because the property is not being "used" for an exempt purpose and activity. The "use" requirement is usually a non-issue, since most exempt organizations that acquire property, generally start using it immediately. Therefore, the property of an otherwise qualified organization, is *not* exempt from property taxes between the period of time the property is initially acquired and the point in time where "onsite physical activity" commences. This bill would expand the welfare exemption to vacant, unused property that is held for future qualifying use. Currently, this property is not eligible for the welfare exemption.
3. **The Constitution does permit the welfare exemption to commence as soon as a building is "under construction."** A relatively minor preparatory activity that results in physical changes visible to any person inspecting the site, such as grading vacant land or tearing down a building, can be undertaken for the purpose of complying with the requirement that the property be in the course of construction for purposes of qualifying for the property tax exemption.
4. **Certain vacant property is eligible for the welfare exemption.** Specifically, Section 214.15 provides that vacant land acquired or donated to organizations, like Habitat for Humanity, for the future construction of a single or multifamily residence that will be sold at cost with zero interest loans constitutes the exclusive use of that property for a charitable purpose within the meaning of the California Constitution. However, in this situation the charitable activity of the organization is the acquisition

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

of vacant land to construct homes that will subsequently become subject to property taxation upon acquisition by low-income families. In contrast, most entities eligible for the welfare exemption are long-term owners of properties and the exemption from property taxation for their properties will likely apply indefinitely.

5. **This bill does not apply to property that qualifies for exemption under the college exemption or the church exemption.** It is possible that future legislation will be sought to similarly extend these provisions to those types of properties.

COST ESTIMATE

The Board would incur insignificant costs (less than \$10,000) in informing and advising county assessors, the public, and staff of the change in law.

REVENUE ESTIMATE

Under this bill, “facilities in the course of construction” will include prospective construction or rehabilitation of a new or existing building or improvement for which the intended use is exclusively for religious, hospital, or charitable purposes, and for which an application for a building permit for the building or improvement has been submitted to a local planning or building department.

Any tax, penalty, or interest assessed upon an exempt portion of a building as or improvement as described above may not be refunded or cancelled until the assessor confirms the actually commencement of definite onsite construction activities, pursuant to Section 214.2 (b) of the Revenue and Taxation Code.

The revenue effect is difficult to pinpoint due to the lack of predictability of the factors involved, specifically, forecasting which properties would be eligible for this treatment, the value of the properties, and the length of time between the date of the permit application and the start of onsite construction. This bill applies only to permits secured after January 1, 2005. As such, we cannot determine the value of property that would qualify for this exemption. However, we believe that the value would be significant.

For example, for the analysis of a similar proposal, two counties provided us with information on the total assessed value of several major properties that had been acquired by nonprofit organizations as either bare land or existing facilities that require modification. The assessed value of these properties ranged from \$1.2 million to \$33 million. If onsite construction were started on one of these properties, then, under this bill, the property would be eligible for the welfare exemption retroactively to the date of the permit application.

Assuming on average it takes six months after the date of the permit application to begin onsite construction, the annual reduction in assessed value per property can be estimated as follows:

$$\$1.2 \text{ million to } \$33 \text{ million} \times \frac{1}{2} = \$0.6 \text{ million to } \$16.5 \text{ million}$$

Then assuming that there were fewer than ten properties that would be affected each year, the maximum total annual reduction in assessed value is then:

$$[\$0.6 \text{ million to } \$16.5 \text{ million}] \times 10 = \$6 \text{ million to } \$165 \text{ million}$$

Revenue Summary

Based on the example above, if the assessor verifies the actual commencement of definite onsite construction activities and the property meets the criteria for “facilities in the course of construction” this bill would reduce property tax revenues from the basic 1 percent property tax rate by, at most, \$60,000 to \$1.65 million—[\$6 million to \$165 million] x 1%—annually.

Qualifying Remarks

This estimate assumes that there are no more than ten properties that would be affected each year. We also assume that the data from two counties for the analysis of an earlier bill can be used to represent such properties statewide and in the future.

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