



STATE BOARD OF EQUALIZATION

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April 3, 2015

Ms.
 Principal Appraiser
 County Assessor's Office

**Re: Welfare Exemption – The Art Association
 Assignment No.: 14-285**

Dear Ms. :

This is in response to your request for our assistance in interpreting the proper application of the welfare exemption to property owned and operated by the Art Association (AA), a nonprofit organization. As discussed below, whether the property is disqualified from receiving the welfare exemption will depend on whether the County Assessor's office (Assessor) finds that the property is being used primarily in furtherance of AA's exempt purposes, or primarily for commercial purposes.

Background

The AA is a 60 year old institution devoted to "sustaining County's cultural character and artistic resources by developing visual artists in all stages of their careers."¹ Its services include "bi-monthly demonstrations and workshops allowing artists to learn from each other," field trips and artist talks for adult education programs and school and youth groups, and arts-and-crafts days for children.² The AA also hosts annual competitions for members and artists, an annual "ArtWalk" with downtown merchants, and on the First Friday of every month, the AA joins other galleries/studios to put on special events or receptions.³

The AA utilizes four exhibition spaces, and your letter states that corresponding uses of various areas of the property are as follows:

- *Main gallery:* artwork and other handcrafted items are displayed for sale 5-6 days per week. The proceeds are used to support the organization's educational activities. The space is also used for occasional art-related demonstrations and workshops.
- *Bathroom:* used to support all other areas.
- *Office:* used for administration of the gallery and the entire organization.

¹ See Attachment A to Assessor's July 11, 2014 letter to the State Board of Equalization.

² *Ibid.*

³ See Attachment B to the Assessor's July 11, 2014 letter to the State Board of Equalization.

- *Basement*: used for the AA's storage including files, archives, and gallery displays.
- *File room*: used for storage of files related to the gallery and entire organization.
- *Kitchen*: used to store supplies for the gallery and the organization as a whole, provide an area for volunteers to store and prepare food and drink when they are working, and support food and drink preparation for free public receptions for the gallery exhibits.⁴

The AA states that its artist members have over 20 group exhibition and 18 solo show opportunities annually, as well as 2-3 other competitive shows that are open to the public. "The result is the display of between 1700-2000 art objects annually for the community to participate in and enjoy, with the assurance that professional artist-jurors are maintaining quality standards. Approximately 6,000 patrons visit the downtown Gallery every year, with another 7,000 tourists and locals visiting the Village Gallery. Countless patients, visitors, and hospital employees enjoy the Community Memorial exhibits."⁵

Members of the organization are charged a small fee to display artwork or other artisan pieces for sale in the gallery and are generally expected to volunteer three hours every month in exchange for being an exhibiting member. The Art Association charges a commission of 40 percent on the sale of artwork and the remainder goes directly to the artist.⁶ The AA states that it raises funds through fundraisers and members donating work, and that it relies "heavily on income from dues, entry fees, rent from the tenant café, sale and rental of artwork."⁷

You ask whether the use of the property for the sale of artwork on an ongoing, regular and frequent basis disqualifies the property from receiving the welfare exemption; and if the gallery areas are so disqualified, you ask whether any of the other areas listed qualify for an exemption.

Law and Analysis

Article XIII of the California Constitution authorizes the Legislature to exempt from property taxation in whole or in part "[p]roperty 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." (Cal. Const., art. XIII, § 4(b).) The constitutional authority for the welfare exemption is implemented by Revenue and Taxation Code⁸ section 214, which provides in relevant part that: "property used exclusively for . . . charitable purposes owned and operated by community chests, funds, foundations, limited liability companies, or corporations organized and operated for . . . charitable purposes is exempt from taxation" if all other requirements set forth in section 214 are met.

⁴ See Assessor's July 11, 2014 letter to the State Board of Equalization.

⁵ See Attachment A to Assessor's July 11, 2014 letter to the State Board of Equalization.

⁶ See Attachment C to Assessor's July 11, 2014 letter to the State Board of Equalization.

⁷ See Attachment B to Assessor's July 11, 2014 letter to the State Board of Equalization.

⁸ All further statutory references are to the California Revenue and Taxation Code, unless otherwise specified.

The Revenue and Taxation Code does not specifically define the term *used exclusively*; however, the courts have done so in a series of decisions. The State Supreme Court, following a rule of strict, but reasonable construction, has construed "exclusively used" in section 214, subdivision (a), to include any use of the property which is "incidental to and reasonably necessary for the accomplishment of the exempt purpose." (*Cedars of Lebanon v. County of Los Angeles* (1950) 35 Cal.2d 729, 736.) Thus, if the property is used primarily for exempt purposes, the term "exclusively" does not preclude activity "which while not charitable in the traditional sense, is merely incidental to the charitable purpose and not in competition with commercial enterprise." (See *Greek Theatre Assn. v. County of Los Angeles* (1978) 76 Cal.App.3d 768, 776, holding that a bar within a theater for the convenience of theatergoers "is used exclusively for a purpose incidental to the charitable function." (*Id.* at p. 780.))

In contrast, purposes and activities that are "largely commercial in character" and classifiable as business ventures are not charitable, and therefore not exempt. (Assessors' Handbook Section 267, *Welfare, Church, and Religious Exemptions* (AH 267) (October 2004), at p. 53-55; see also *YMCA v. County of Los Angeles* (1950) 35 Cal.2d 760, 775, finding the YMCA's restaurant, tailor and barber shop to be "largely commercial in character and properly classifiable as business ventures.") The welfare exemption was never intended to provide exempt organizations which use their property for commercial purposes with an unfair competitive advantage over for-profit business entities engaged in similar activities. However, a charitable organization does not lose its exemption merely because it engages in competition with businesses that are subject to taxation. (AH 267, *supra*, at p. 54.) Nor does an organization's "nonprofit" status mean that the organization cannot earn a profit, or an excess of revenues over expenses, in order to maintain its exempt status. (*Id.* at p. 48; *YMCA v. County of Los Angeles* (1950) 35 Cal.2d 760, 771.) As stated on page 53 of AH 267:

The question as to whether and to what extent an organization may earn a profit will depend on the facts and circumstances of the particular case. An organization's use of its property for profit-making activities are scrutinized to determine if they were primarily carried on to advance its exempt purpose, or whether the organization was engaged in an unrelated business activity that was conducted in a manner similar to a commercial enterprise.

The court in *Santa Catalina Island Conservancy v. County of Los Angeles* (1981) 126 Cal.App.3d 221 described the issue as follows:

The threshold question is not what revenues are derived from an activity, but the *purpose* for which it is conducted. Accordingly, "any property which is used exclusively for any facility which is incidental to and reasonably necessary for the accomplishment of [the charitable] purpose []; or, in other words, for any facility which is reasonably necessary for the fulfillment of a generally recognized function of a complete modern [operation]" comes within the welfare exemption. (*Cedars of Lebanon Hosp. v. County of L.A.* (1950) 35 Cal.2d 729, 736.) [¶] . . . [¶]

It is only when an activity which is not reasonably *necessary* to the charitable purpose is placed in commercial competition with public businesses that it is deemed not charitably incidental. (*Y.M.C.A. v. County of L.A.*, *supra*, 35 Cal.2d 760, 772-776.) [¶] . . . [¶]

Once the threshold determination is made that the purpose for which the activity is undertaken is proper, the generation of revenue is irrelevant where the receipts are not income from property *held by the charitable organization* solely for investment or commercial (i.e., intentionally profit-making) purposes. (*Id.*, at p. 559 [*San Francisco Boys' Club, Inc. v. County of Mendocino* (1967) 254 Cal.App.2d 548, 559]; see also *Christ the Good Shepherd Lutheran Church v. Mathiesen* (1978) 81 Cal.App.3d 355, 363 [146 Cal.Rptr. 321].)

(*Santa Catalina Island Conservancy v. County of Los Angeles* (1981) 126 Cal. App. 3d 221, 243-244, original italics.)

Thus, an organization's use of its property for profit-making activities is to be scrutinized to determine if the activities are incidental to its exempt purpose, or whether the organization has engaged in an unrelated business activity that is conducted in a manner similar to a commercial enterprise. (Backup Letter to Property Tax Annotation⁹ (Annotation) 880.0099 (December 1, 2006), p. 3.) If the revenue-generating activity is found to be incidental to and reasonably necessary for its exempt purpose, then the fact that the activity generates revenue or is commercial in nature and competitive with business enterprises will not disqualify the property used for such activity from receiving the tax exemption.

According to AH 267, the following factors should be considered in determining whether an activity is commercial in nature:

- The presence of substantial profits
- Consistent profit margins over a period of years
- If prices charged for goods sold or services provided are in line with commercial enterprise
- If activity is in direct competition with commercial enterprise
- Advertising of goods or services in a commercial manner
- Whether employees' compensation is reasonable for the market
- The existence of future plans for growth with the purpose of increasing profits
- Whether the source of the profits is unrelated to the organization's primary, exempt purpose and activity

(AH 267, *supra*, at p.55.)

As an example, in the *YMCA* case mentioned above, the court held that portions of *YMCA* property used for a restaurant, a barbershop, a valet shop, and a gym store were not exempt because they were available to the public, charged standard prices, in competition with like enterprises in the community, were largely commercial in character, and were classifiable as business ventures. (*YMCA, supra*, at p. 774-775.) On the other hand, the dormitories operated by the *YMCA*, for which moderate fees were charged, were held to have a close interrelation with the *YMCA*'s charitable purpose, and no profit motive, which distinguished the operation from a commercial hotel enterprise. (*Id.* at p. 769-770.) In another case involving a *YMCA* facility, the court rejected the argument that the *YMCA* was not operated for a charitable purpose

⁹ Property tax annotations are summaries of the conclusions reached in selected legal rulings of State Board of Equalization counsel published in the State Board of Equalization's Property Tax Law Guide. (See Cal. Code Regs., tit. 18, § 5700 for more information regarding annotations.)

even though its health club facility was engaged in competition with other health club businesses. The court held that it was immaterial that some YMCA facilities competed with private health clubs; the activity challenged as competing with the health club business was found to be within the YMCA's charitable purpose to provide athletic and recreational facilities and programs. (*Clubs of Cal. for Fair Competition v. Kroger* (1992) 7 Cal.App.4th 709, 720-721.) The distinction between these two cases is that one involved the use of property for businesses unrelated to its charitable purposes, while in the other, the activity challenged as being in competition with other health club businesses was within the YMCA's charitable purpose to provide athletic and recreational facilities and programs. (AH 267, *supra*, at p. 54-55; see also *YMCA v. County of Los Angeles, supra*, at p. 771.)

Thus, the issue of whether a revenue generating activity is a disqualifying commercial activity, as opposed to an activity that is incidental to and reasonably necessary for its exempt purpose, must be decided on a case by case basis, taking into account all the facts of the situation. (*Ibid.*) Procedurally, once an organization obtains an organizational clearance certificate from the State Board of Equalization pursuant to section 254.6, section 254.5 provides that:

(b)(1) The assessor shall review all claims for the welfare exemption to ascertain whether the property on which the exemption is claimed meets the requirements of Section 214. . . . In this connection, the assessor shall consider, among other matters, whether: [¶] . . . [¶]

(B) The property on which the exemption is claimed is used for the actual operation of an exempt activity

(2) The assessor may institute an audit or verification of the operations of the owner or operator of the applicant's property to ascertain whether both the owner and operator meet the requirements of Section 214.

(c)(1) The assessor may deny a claim for the welfare exemption on a property, notwithstanding that the claimant has been granted an organizational clearance certificate by the board.

(Rev. & Tax. Code, § 254.5, subd. (b), (c).) Thus, the Assessor is to grant or deny the welfare exemption based on the actual usage of the property.

In this case, if the Assessor determines that AA's sale of artwork on an ongoing, regular basis is primarily functioning to promote its charitable mission of "sustaining County's cultural character and artistic resources by developing visual artists in all stages of their careers," and is simply a revenue-generating activity that is incidental to and reasonably necessary for such exempt purposes, then the property will be eligible for the welfare exemption. However, if the Assessor determines that AA's ongoing sales function primarily as a commercial enterprise although they also happen to help sustain County's artistic resources, then the property will not be exempt under the welfare exemption.

To provide some guidance, we offer a number of factors an Assessor may consider to determine whether the activities are in competition with commercial enterprises. Of course, this is not an exhaustive list but is merely representative of the types of factors an Assessor should

consider. Such factors include whether there are future plans for growth in sales for the purpose of increasing profits, whether the prices/fees are fixed with the intention of yielding a surplus over and above operating expenses, whether expenses, including salaries, are not excessive, and the reasonableness of AA's financial reserves. The Assessor may also note the extent to which AA solicits and receives charitable donations as well as volunteer work, especially in comparison to the amount of fees it earns and the number of paid staff members. Additionally, the Assessor may consider whether advertising is performed in a commercial manner, such as whether it focuses on purchasing art or on educating the general public. Another factor to consider is the extent and degree of below cost services provided, including the educational programs, competitions, and special events, as well as consideration of the amount of time the art is available for sale, as opposed to being simply viewed. Furthermore, the Assessor may consider whether the artwork on display is selected based on its ability to be sold, or on its educational value, such as its representation of modern or historical trends.

Finally, if the Assessor determines that the gallery is disqualified from exemption due to the sale of artwork, none of the other areas in your inquiry qualify for exemption, because those areas would not be exclusively used for exempt purposes and their only purpose would be to support non-exempt areas. (See Back-up Letter to Annotation 880.0099, *supra*, at p. 5.)

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present laws and the facts set forth here, and are not binding on any person or public entity.

Sincerely,

/s/ Sonya S. Yim

Sonya S. Yim
Tax Counsel III (Specialist)

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cc: Mr. Dean Kinnee MIC:64
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