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STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date:	**04/08/13**	Bill No:	**Assembly Bill 975**
Tax Program:	**Property**	Author:	**Wieckowski and Bonta**
Sponsor:	**California Nurses Association**	Code Sections:	**RTC 218**
Related Bills:		Effective Date:	**01/01/14**

This analysis addresses provisions that impact property tax administration.

BILL SUMMARY

Requires not-for-profit hospitals with "surplus revenues" to rebut a presumption that they operate for profit and, as a result, are ineligible for the property tax welfare exemption.

ANALYSIS

CURRENT LAW

Revenue and Taxation Code (RTC) Section 214 exempts property used exclusively for religious, hospital, charitable, or scientific purposes, when owned and operated by nonprofit organizations structured and operated for these purposes. This property tax exemption is known as the welfare exemption.

Profit Margin Safe Harbor. A key welfare exemption requirement is that the owner is not organized or operated for profit. An organization that claims it is exempt from property taxation has the burden of demonstrating its exempt status.

The law ensures that an organization that owns and operates a hospital or a multispecialty clinic will not be deemed to be "for profit" if, during the immediately preceding fiscal year, operating revenues, as defined, do not exceed operating expenses, as defined, by 10%. When revenues are at or below this threshold, property tax administrators are barred from finding that the organization is operating for profit. This provides organizations with a safe harbor up to the threshold.

Surplus Revenue. When revenues exceed the 10% threshold, the excess is called "surplus revenue." However, earning surplus revenue is not a bright-line test for exemption disqualification.

An organization may earn surplus revenue and still qualify for the exemption based on how the surplus revenue is spent. Allowable uses include: (1) debt retirement, (2) plant or facility expansion, and (3) operating contingency reserves. The allowable uses are specified in uncodified legislative intent provisions enacted in 1953, as well as in a 1992 appellate court decision interpreting this language. Both are discussed in the **Background** section.

The welfare exemption does not require nonprofit organizations that operate hospitals or multispecialty clinics to provide any community benefits or charity care.

PROPOSED LAW

Community Benefit and Charity Care Reporting. This bill, in part, declares that "hospitals and multispecialty clinics . . . receive favorable tax treatment by the

government and, in exchange, assume a social obligation to provide charity care and other community benefits in the public interest."

It states the Legislature's intent in adding Chapter 2.6 "Community Benefits" (commencing with Health and Safety Code 127470) to provide uniform standards for reporting the amount of charity care and community benefits provided to ensure that private nonprofit hospitals and multispecialty clinics . . . actually meet the social obligations for which they receive favorable tax treatment."

This bill requires the Office of Statewide Health Planning and Development to annually calculate the total value of community benefits provided by private nonprofit hospitals and nonprofit multispecialty clinics.

"For Profit" Rebuttable Presumption. Currently, RTC §214(a)(1) sets forth the "safe harbor" profit margin provision as a conditional statement in the negative. It provides that if operating revenues do not exceed 10% of operating expenses, the hospital shall **not** be deemed to be organized or operated for profit. This bill adds a second paragraph to RTC §214(a) to rephrase the safe harbor provision in the inverse and replace the term "deemed" with the phrase "rebuttably presumed." That is, in the case of hospitals, the organization shall be rebuttably presumed to be organized or operated for profit if, during the immediately preceding fiscal year, operating revenues, as defined, exceed operating expenses by an amount equivalent to 10% of those operating expenses, as defined.

Thus, organizations retain the safe harbor provision for surplus revenues of 10% or less, but, once surplus revenues exceed 10%, the hospital must rebut the "for profit" presumption.

Section 7 of this bill provides that these changes do not constitute a change in law, but are declaratory of existing law.

IN GENERAL

Welfare Exemption. Section 1(a) of Article XIII of the California Constitution provides that all property is taxable unless otherwise provided by the constitution or the laws of the United States. Under Section 4(b) of Article XIII, the Legislature is authorized to exempt from taxation, in whole or in part:

> 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 operated 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.

The Legislature enacted RTC Section 214 to impose numerous qualifying conditions on qualifying for the exemption.

Hospital Purposes. Hospital, as it is used in the welfare exemption, has been defined by the California Supreme Court as follows:

> A hospital is primarily a service organization. It serves three groups: the patients, its doctors, and the public. It furnishes a place where the patient, whether poor or rich, can be treated under ideal conditions. It makes available room, special diet, X-ray, laboratory, surgery, and a multitude of other services and equipment now available through the advances of medical science. Essential to the administration of these techniques is the corps of highly trained nurses and

> student nurses who are on duty twenty-four hours per day. In the large hospitals there are the interns and residents whose presence makes it possible for the hospital to do a better job. In addition, the hospital . . . must have administration to see that its services function properly and are coordinated, and that patients are received and cared for regardless of the hour or the patient's condition. Nothing can be left to chance because a slip may mean a life or many lives. These facilities also stand ready to serve the community in times of epidemic or disaster.[1]

Property may also be considered exclusively used for hospital purposes if it is owned and operated by a qualifying nonprofit organization and if it is exclusively used to provide support services for the hospital. Some examples of support services to hospitals include purchasing, food service, laundry, collections, or waste disposal.

Outpatient Clinics. RTC Section 214.9 defines "hospital" to include outpatient clinics of two types: a clinic that provides psychiatric services for emotionally disturbed children or a nonprofit multispecialty clinic as described in Health and Safety Code Section 1206(l) as:

- a clinic operated by a nonprofit corporation exempt from income taxation under 501(c)(3) of the Internal Revenue Code,
- that conducts medical research and health education and provides health care to its patients,
- through a group of 40 or more physicians and surgeons,
- who are independent contractors,
- representing not less than 10 board-certified specialties, and
- not less than two-thirds of whom practice on a full-time basis at the clinic.

Welfare Exemption Administration

The BOE and county assessors co-administer the welfare exemption. The BOE must determine whether the *organization* itself is eligible for the exemption. The county assessor must determine whether the *property* of a qualifying organization qualifies for exemption based on the property's use. Welfare exemption claims are filed annually with the county assessor.

As part of the BOE's role, staff review organizational clearance certificate claims to determine if the organization is organized and operated exclusively for one or more qualifying purposes and otherwise meets the requirements of Section 214. If the BOE determines an organization qualifies, it issues an *Organizational Clearance Certificate for Welfare or Veterans' Organization Exemption* (OCC), which remains valid until the BOE determines that the organization no longer meets the requirements. A BOE-issued OCC demonstrates that the organization meets the qualifications for exemption. A county assessor may not grant a welfare exemption on an organization's property unless the organization holds a valid BOE-issued OCC.

Organizational Requirements. Generally, an organization must meet the following organizational requirements:

- Organized and operated for exempt purposes (religious, hospital, scientific, or charitable) in accordance with section 214(a).

[1] *Cedars of Lebanon v. County of Los Angeles* (1950) 35 Cal.2d 729, pp.735-736.

- Not organized or operated for profit in accordance with RTC §214(a)(1).
- Have a valid tax exempt status letter from the Internal Revenue Service (IRC 501(c)(3)) or Franchise Tax Board (RTC § 23701(c)) in accordance with RTC §214.8.
- Net earnings must not benefit any private shareholder or individual (RTC §214(a)(2)).
- Formative document must contain acceptable irrevocable dedication and dissolution clauses as provided by RTC §§ 214(a)(6), 214.01, and Property Tax Rule 143. Property is to be irrevocably dedicated to one or more of the exempt purposes of RTC §214; and upon dissolution property is to be distributed to an organization exclusively organized and operated for such purposes.

Use Requirements. Generally a qualifying organization's property:

- Must be used exclusively for religious, hospital, scientific, or charitable purposes (RTC §214(a)).
- Must be used for the actual operation of the exempt activity, and does not exceed an amount of property that is reasonably necessary to accomplish the exempt purpose (RTC§ 214(a)(3)).
- Cannot be used or operated to benefit any person through the distribution of profits, payment of excessive charges or compensation, or the more advantageous pursuit of their business or profession (RTC§ 214(a)(4)).
- Cannot be used for fraternal, lodge, or social club purposes except where such use is clearly incidental to a primary religious, hospital, scientific, or charitable purpose (RTC §214(a)(5)).

BACKGROUND

Prior to 1953, the law prohibited the property from being operated for profit and prohibited the owner from being organized and operated for profit. In *Sutter Hospital v. City of Sacramento* (1952) 39 Cal.2d 33, the California Supreme Court held that a nonprofit hospital that intentionally earned an 8% income surplus over expenses used for debt retirement and facility expansion could not qualify for the welfare exemption.[2] In 1953, in response to this case, the Legislature amended the law to provide only that the property must be "used in the actual operation of the exempt activity." At the same time, the law was expanded to authorize a qualified nonprofit hospital to make an annual net profit of 10% of total expenditures including depreciation based on cost of replacement and amortization of, and interest on, indebtedness. In addition, an uncodified Legislative intent section specified that an organization did not make a profit if net revenues after expenses did not inure to any individual benefit, but went instead to provide for expansion, to fund contingencies, or to amortize indebtedness.

The uncodified legislative intent language (Stats. 1953, Ch. 730, §4, pp. 1995-1996) reads as follows:

> Sec. 3 This act is an urgency measure necessary for the immediate preservation of the public peace, health or safety within the meaning of Article

[2] The Supreme Court acknowledged that its holding made it difficult for modern hospitals to operate in a financially sound manner to reduce indebtedness and expand their facilities, but said that matter should be addressed with the Legislature rather than the courts because subdivision (a)(3) compelled the court's holding. (*Sutter Hospital, Supra,* at pp.40-41).

> IV of the Constitution, and shall go into immediate effect. The facts constituting such necessity are: Continuously since the adoption of the "welfare exemption" it has been understood by the administrators of the law, as well as by the public generally, that it was the purpose and the intent of the Legislature in the adoption of subdivision [a](3) of Section 214 of the Revenue and Taxation Code to disqualify for tax exemption any property of a tax exempt organization which was not used for the actual operation of the exempt activity, but that such organization could rightfully use the income from the property devoted to the exempt activity for the purposes of debt retirement, expansion of plant and facilities or reserve for operating contingencies without losing the tax exempt status of its property.
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> Recently, doubt has been cast upon the foregoing interpretation by a decision of the State Supreme Court involving the tax exemption of a hospital. This decision was broad in its application and has caused the postponement or actual abandonment of plans for urgently needed hospital construction and expansion at a time when there are insufficient hospital facilities in this State to properly care for the health needs of its citizens, and virtually no surplus facilities for use in case of serious epidemic or disaster. This Legislature has recognized that in addition to gifts and bequests the traditional method for the financing of the expansion and construction of voluntary religious and community nonprofit hospital facilities is through the use of receipts from the actual operating facilities. In its decision the Supreme Court indicated that this was a matter for legislative clarification. [8 Cal.App.4th 223]
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> It has never been the intention of the Legislature that the property of nonprofit religious, hospital or charitable organizations otherwise qualifying for the welfare exemption should be denied exemption if the income from the actual operation of the property for the exempt activity be devoted to the purposes of debt retirement, expansion of plant and facilities or reserve for operating contingencies, it having been the intent of the Legislature in adopting subsection [a](3) of Section 214 to deny exemption to property not used for exempt purposes even though the income from the property was used to support an exempt activity.
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> Therefore, in order to clarify the legislative intent and to remove any doubt with respect to the status of property actually used for exempt purposes, it is necessary to amend subdivision [a](3) of Section 214 of the Revenue and Taxation Code. It is essential that this be done at the earliest possible moment to avoid further delays in the construction and expansion of needed hospital facilities.

It is noteworthy that the *Sutter Hospital* case was construed by the court of appeal in a later welfare exemption case, as eliminating "the ban on profits resulting from fees charged for charitable activities." (*San Francisco Boys' Club, Inc. v. County of Mendocino* (1967) 254 Cal.App.2d 548.)

The provision that a hospital "shall not be deemed to be organized or operated for profit if … operating revenues, exclusive of gifts, endowments and grants-in-aid [do] not exceed operating expenses by an amount equivalent to 10 percent of those operating expenses" is presented in the negative and does not provide a bright-line rule concerning the maximum amount of profit that a hospital may earn. (See RTC

§214(a)(1).) In *Rideout Hospital Foundation, Inc. v. County of Yuba* (1992) 8 Cal.App.4th 214, the court of appeal held that the hospital was eligible for the welfare exemption although its earned surplus was greater than 10%. The court noted that the legislative history of this statutory provision indicated that it was not intended to deny exemption to a nonprofit organization earning excess revenues if those revenues were to be used for debt retirement, facility expansion or operating cost contingencies. The court concluded that while a hospital earning such excess revenue does not receive the benefit of being deemed nonprofit, it can still qualify for the exemption if it can show, that, in fact, it is not operated for profit, and meets the other statutory requirements for the exemption.

PREVIOUS LEGISLATION

SB 610 (Alacon, 2005 - vetoed) proposed establishing an identical rebuttable presumption. However, that bill also deleted the safe harbor profit provision. Governor Schwarzenegger vetoed SB 610, commenting that:

> [t]his bill financially penalizes non-profit hospitals which are increasing reserves to invest in important and necessary charitable activities including purchasing state-of-the-art technology to improve the quality of patient care, complying with costly seismic safety mandates, and expanding facilities to increase access to care for low-income uninsured Californians. This bill provides that non-profit hospitals whose operating revenues exceed operating expenses by more than ten percent would be rebuttably presumed to be operated for profit for tax purposes, regardless of whether the reinvestment of excess dollars is for legitimate charitable activities. Existing law provides adequate safeguards against the inappropriate use of any excess operating revenues. Hospitals should be encouraged to increase investment in our communities rather than penalized for it. For this reason, I cannot support this measure.

AB 1614 (Klehs, 2005) was nearly identical to the June 2, 2005 version of SB 610. As introduced, AB 1614 appeared to create a bright-line test on profit earnings, whereby a hospital would be ineligible for the welfare exemption if its profits exceeded 10%. Because such an interpretation was inconsistent with declaratory statements of existing law, the term "deemed" was replaced with the phrase "rebuttably presumed" to ensure that the prior allowable uses of excess profits would be retained. AB 1614 was gutted and amended to address other issues.

COMMENTS

1. **Sponsor and Purpose.** According to the California Nurses Association, the rebuttable presumption is consistent with existing law. However, in the event that a local tax assessor questioned a covered entity's continuing entitlement to a property tax exemption (exceeding the 10% mark), the entity would be required to demonstrate that it is not operated for profit and meets the exemption's other statutory conditions.

2. **There is no requirement in current law or this bill for hospitals to provide charity care or a certain level of community benefits to receive the welfare exemption.** This bill provides that the RTC amendment is declaratory of existing law. The codified legislative intent language in the Health in Safety Code states that nonprofit hospitals and multispecialty clinics have a social obligation to provide community benefits and charity care but this bill does not explicitly amend the RTC to make it a requirement for welfare exemption purposes.

3. **This bill restates the profit margin safe harbor provision in the affirmative and establishes a rebuttable presumption.** A provision is added to restate existing law from a double negative (if revenues did **not** exceed 10%, the hospital shall **not** be deemed to be organized or operated **for profit**) to an affirmative statement (if revenues are more than 10%, the hospital shall be rebuttably presumed to be **for profit**). This presumption is consistent with the requirement for claimants to demonstrate it is entitled to the welfare exemption. Attorney General Opinion 79-508 concluded that an organization that claims it is exempt from property taxation has the burden of demonstrating its exempt status.

4. **BOE review of hospital organizations.** In 2012, the BOE issued a report of its examination of organizations operating hospitals and multi-specialty clinics. Consistent with case law, BOE concluded that all organizations with excess revenues directed them towards allowable purposes, including debt retirement, plant and facilities expansion, and operating cost contingencies. In the review, community benefits and charity care information was gathered to better understand how these organizations operate. The BOE's Report is available at its website.

5. **Under existing law, a profit of more than 10% does not necessarily disqualify a hospital from receiving the welfare exemption, provided the excess profits are dedicated to specific purposes.** As provided in the uncodified legislative intent language of 1953 and the 1992 *Rideout* holding, the qualifying uses of excess profit include debt retirement, plant and facility expansion, and operating cost contingencies. But existing statutory law does not specifically detail these three allowable uses. Adding these uses in statute may assist tax administrators and practitioners since these uses are only detailed in case law and uncodified language. However, the *Rideout* holding did not indicate that these were the *only* allowable uses. The court concluded that while a hospital earning such excess revenue does not receive the benefit of being deemed nonprofit, it can still qualify for the exemption if it can demonstrate that it is not operated for profit, and meets the other statutory requirements for the exemption. To date, the need to identify other allowable excess profit uses has not arisen.

6. **The property tax provisions of this bill have no substantive impact since, as noted above, an organization that claims it is exempt from property taxation under the welfare exemption already has the burden of demonstrating it is not operating for profit.** Under current administrative practices, the BOE does not annually review whether an organization continues to qualify for a BOE-issued OCC. This bill would change the BOE's exemption administration as it applies to organizations operating hospitals to determine those organizations that have surplus revenues and examine the documents and records the organizations use to rebut the "for profit" presumption annually.

COST ESTIMATE

A detailed cost estimate is pending. But the BOE could not absorb costs to examine hospital documents and records when hospitals rebut the "for profit" presumption of excess profits annually. Other costs include updating forms and documents, and answering public inquires.

REVENUE ESTIMATE

Since this measure is declaratory of existing law, there should be no property tax revenue impact. The BOE has examined organizations operating hospitals and multi-specialty clinics and found that all organizations with surplus revenues continued to qualify for the welfare exemption by using surplus revenues for qualifying purposes.

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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 BOE's formal position.