

MEMORANDUM

RE: Not-For-Profit Clients Seeking Illinois Property and Sales Tax Exemption

A. Introduction

Many nonprofit organizations have long enjoyed broad entitlement to property and sales tax exemptions under Illinois law, such as for religious programs, educational activities, traditional social services, and other charitable programs. The current trend at the Illinois Department of Revenue (DOR) – the government agency charged with approving and monitoring such exemptions -- is increasing scrutiny of programs that charge fees, programs receiving significant government funding, child care centers, property used for more than one type of exempt use or by more than one user, and other novel or innovative programs. This memorandum provides background guidance and specific recommendations to nonprofit organizations for securing state tax exemptions.

B. Exemption Qualifications: Prohibited “View to Profit”

A key consideration in exemption analysis is whether an organization is operating with a “view to profit,” which is incompatible with state tax exemption principles. Accordingly, to the extent a nonprofit operates like a commercial venture -- charging fees, rejecting those who cannot afford the fees, using collection agencies, and competing with the commercial sector in offering similar services – it risks losing tax exemption. While a nonprofit may not intend any prohibited “view to profit” by its activities, it nevertheless may face significant legal expenses to challenge and disprove the DOR’s contrary perception. Consequently, novel fund-raising ideas and new social service programs may seem appealing, and they may well be worthwhile methods to advance the organization’s goals, but their impact on the organization’s tax exemption deserves careful prior evaluation.

C. Exemption Categories

Of the several statutory categories of exemption, the three most relevant to this memorandum are religious, educational, and charitable.

1. Religious Exemption

Churches generally qualify for religious exemption based on their worship and related religious activities. In addition, church-operated elementary and secondary schools may qualify under either the religious or educational exemption depending on how they are organized and operated. (Churches also may qualify under the charitable exemption for certain programs that are primarily aimed at serving social needs, particularly if the programs operate within a separately incorporated organization.)

2. Educational Qualifications

By statutory definition, a school operated exclusively for “educational” purposes qualifies for exemption. This is a fairly straightforward category, and schools routinely can obtain exemption. The term “school” narrowly connotes a program with regular faculty, curriculum, student body and classrooms. Self-improvement courses, adult education schools and programs that focus on a specific skill set often do not qualify as “educational” for purposes of tax exemption.

3. A Note on Child Care Centers and Preschools

Neither the religious nor the educational exemption category includes child care centers or preschools. The law defines “educational” as encompassing only education that relieves a government burden (e.g., grammar school). Thus far, Illinois courts have rejected arguments that child care centers and preschools, despite their educational components and recognized societal value, relieve any government burden. Although Illinois religious organizations with such programs – particularly preschools -- have historically qualified for exemption, the DOR has become much more hostile to applications involving preschools and child care, especially when fees are charged.

4. Charitable Exemptions

While many nonprofits operate preschools, day care centers, and other social service programs out of religious convictions, the DOR does not grant religious or educational exemptions for them. Accordingly, organizations seeking exemption for these activities most likely will need to base their exemption applications on the charitable exemption category.

a. Six-Factor Test for Charitable Exemption

In 1968, the Illinois Supreme Court established a six-factor test for charitable tax exemptions, to be applied based on the particular facts and circumstances of each case. See Methodist Old Peoples Home v. Korzen, 39 Ill. 2d 149, 157, 233 N.E.2d 537, 541-42 (1968). Specifically, an applicant must show the following:

- (1) the benefits derived are for an indefinite number of persons;
- (2) the organization has no capital, capital stock or shareholders, and earns no

profits or dividends;

(3) the organization derives its funds mainly from public and private charity and holds them in trust for the objects;

(4) the organization dispenses charity to all who need and apply for it;

(5) the organization does not appear to place obstacles of any character in the way of those who need and would avail themselves of the charitable benefits it dispenses; and

(6) the organization actually and exclusively uses any subject real estate for charitable purposes.

In applying these factors on a case-by-case basis, hearing officers and courts have discretion regarding the weight to accord each factor. No one factor is determinative. Furthermore, under Illinois constitutional and statutory tax principles, these factors are to be construed strictly against the applicant taxpayer.

b. “Charity” Defined

i. History and Current Trends

The aim of the above six-factor test is to determine whether, in fact, an organization and its property use are “charitable.” More than one hundred years ago, the Illinois Supreme Court defined the term “charity” as follows:

A charity, in a legal sense, may be more fully defined as a gift, to be applied consistently with existing laws, *for the benefit of an indefinite number of persons*, either by bringing their hearts under the influence of education or religion, by relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves for life, or by erecting or maintaining public buildings or works, or *otherwise lessening the burdens of government*.

Crerar v. Williams, 145 Ill. 625, 34 N.E.2d 467 (1893) (quoting *Jackson v. Phillips*, 96 Mass. 539, 556 (1867)).

Consistent with recent scrutiny of hospitals and other large nonprofit entities, the DOR has recently been defining the term “charity” more narrowly, thereby raising significant policy concerns as to what really constitutes “charity.” The DOR has also been suspicious of potential charitable abuses and more critical of many charitable operations, particularly those with some apparent commercial viability.

c. Guidelines for Satisfying the Six-Factor Charitable Exemption Test

No charitable exemption should be sought without careful planning and, as necessary and appropriate, revision of corporate documents and organizational policies. Failure to take these measures may be fatal to an exemption application, resulting in unanticipated property tax liability and costly legal expenses to challenge the DOR on appeal. To satisfy the six-factor test for charitable exemptions, and to avoid unnecessary complexity, delay, and even exemption denial, nonprofit organizations should comply with the following recommendations.

1. The organization should have a well-written mission plan that articulates the religious and/or charitable goals to be implemented through any property acquisition and consequent program development (e.g., to spread religious beliefs, to provide outreach opportunities, to serve as worship facilities, and to encourage congregational growth).
2. If the organization has a religious purpose, its programs should have strong and clearly evident religious aspects.
3. If fees are charged, the organization's bylaws should explicitly state that no one will be denied services for financial inability to pay fees. This and the following recommendations regarding fees address the above factors requiring that charity is dispensed to all without obstacles.
4. The organization should also have a well-publicized, Board-approved financial assistance policy that (a) sets forth eligibility criteria, and (b) explicitly states that no one will be denied services for financial inability to pay fees.
5. The organization should structure any program fees to not be "commercial" in nature (e.g., below market rates, no late fees, no collection activities). The more a program looks like it is operated "with a view to profit," the more likely it is that exemption will be denied or lost.
6. To the extent possible and practicable, the organization's programming should not rely primarily on fee revenue. Ideally, the program should have extensive charitable funding through organizational contributions, individual contributions, foundation grants, and other donations. This will help satisfy the requirement for charitable exemption that its activities are funded "mainly" by charitable contributions. With respect to organizations receiving significant direct government program funding, the DOR's current view – as upheld by a plurality of Illinois Supreme Court justices in the 2010 *Provena* decision – is that such funding does not constitute the requisite "charitable contributions" but rather is more in the nature of a "business contract" devoid of any charitable nature.
7. In charging fees, the organization should allow for fee waivers and reductions that are actively used, documented, and publicized (e.g., through parent handbooks, informational brochures, posted notices, and website information).

8. Additionally, it is essential that financial assistance applications be readily available and used.
9. Fee waivers and reductions should be based on evaluation of the participants' ability to pay, not just on their income or on the cost of services provided.
10. The organization should establish a charitable fund for fee waivers and reductions, and document its funding and use.
11. The organization should document and keep track of all fee waiver/reduction applicants, the amounts given, and the amounts waived.
12. Ideally, before applying for any charitable tax exemption, the organization should have some fee waivers and reductions already granted, to establish a track record of charitable services.
13. To the extent possible, the organization should articulate how its programs relieve burdens of government (e.g., through social services that reduce homelessness and violence, through enrichment activities that alleviate juvenile delinquency, or through programs that enable adults to find gainful employment).

D. Property Tax Exemption

For property tax exemption under Illinois law, additional legal requirements exist regarding ownership and property usage. As an initial matter, qualified ownership must exist. For educational and charitable tax exemption, the owner must be a qualified tax-exempt organization. This legal requirement has consistently been interpreted to mean a section 501(c)(3) entity, such as a church, school, social service provider, or other public charity. With respect to religious qualification, a religious organization need not necessarily be the owner, but any "rent" or other facility charges will likely defeat exemption qualification, since such fee structure presumably constitutes an impermissible "view to profit."

On a related note, and regardless of the exemption category, the subject property must be used "exclusively" for exempt purposes. This term has long been interpreted as "primarily" for exempt purposes. Accordingly, if a nonprofit wants to operate or allow a program that does not qualify for property tax exemption, such activity will be permissible so long as it is only "incidental" or secondary."

If the nonprofit allows non-exempt uses of its property to the extent that one cannot reasonably say it is "exclusively" used for exempt purposes, then the nonprofit may lose its entire property tax exemption. For example, if a nonprofit allows patrons from nearby stores to use its parking lot without any physical restrictions, then the nonprofit may lose its entire exemption for the parking lot. On the other hand, if the nonprofit allows such usage but chains off or otherwise separates certain parking spaces for the patrons' use, then only those rented parking spaces may be subject to property tax and the rest of the parking lot should remain exempt. Likewise, if a nonprofit regularly allows others to use its facilities for private events,

then the nonprofit's exemption for the entire facility may be at risk.

In contrast, and as an exercise of good stewardship, to promote mutual ministry goals, or for other reasons, a nonprofit owner may allow another organization or group to use its facility as a regular guest. Such use should not, however, be allowed to jeopardize the property's tax-exempt status or to pose any undue risk to the owner. Accordingly, and to avoid any appearance of a "view to profit", the owner should have a written space-sharing agreement (*not* a commercial lease) that specifies the amount of financial contribution (not rent) to be paid to help cover property-related costs. These costs may include mortgage service, utilities, ordinary wear and tear, landscaping, cleaning, security, and depreciation. In addition, the agreement should address the times of usage, rules governing such use, insurance requirements and indemnification, and termination of use. To help support the exemption qualification, the space-sharing agreement should also articulate the parties' mutual religious, educational, and/or charitable goals for space usage. The owner should carefully investigate potential guests to ensure that their activities qualify for property tax exemption, including review of their corporate documents, policies regarding fees, and their activities.

E. Conclusion

The legal landscape for Illinois tax exemptions has changed significantly in recent years, resulting most notably in more restrictive administrative and judicial interpretations of previously unquestioned charitable and religious exemptions. Accordingly, nonprofit organizations – particularly those with fee-based programs – should proceed carefully, plan wisely, and evaluate the above considerations in light of their overall mission, the law, and other practical considerations.