STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/22/05**	Bill No:	**AB 1614**
Tax:	**Property**	Author:	**Klehs**
Related Bills:			

BILL SUMMARY

This bill would amend a welfare exemption eligibility requirement by recasting the criteria for determining whether a hospital is "not organized or operated for profit."

ANALYSIS

Current Law

Under existing law, one of the qualifying requirements for the welfare exemption is that the owner is not organized or operated for profit. The law specifies that organizations that own and operate hospitals shall not be deemed to be organized or operated for profit if, during the immediately preceding fiscal year, operating revenues, as defined, did not exceed operating expenses, as defined, by an amount equivalent to 10 percent of those operating expenses.

In essence, this provides a "safe harbor" for hospitals in that they may earn excess operating revenues of up to 10% and still be considered "not organized or operated for profit." However, pursuant to uncodified legislative intent language added in 1953 and a court of appeal decision interpreting that language, a hospital organization's operating revenues may exceed its operating expenses by more than 10% and it may still qualify for the welfare exemption, provided the revenue in excess of 10% is devoted to debt retirement, expansion of plant or facility, or reserve for operating contingencies.

Proposed Law

Currently, paragraph (1) of subdivision (a) of Section 214 of the Revenue and Taxation Code sets forth the requirement as a conditional statement in the negative (by providing that if operating revenues did **not** exceed 10%, the hospital shall **not** be deemed to be organized or operated for profit).

The bill would amend that paragraph by stating the requirement in the inverse. That is, in the case of hospitals, the organization shall be deemed 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 percent of those operating expenses, as defined.

This bill states that its provisions do not constitute a change in law and is declaratory of existing law.

REVISED REVENUE ESTIMATE

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.

In General

Welfare Exemption. Section 1(a) of Article XIII of the California Constitution provides that all property is taxable unless otherwise provided by that 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.

In exercising the above constitutional authority, the Legislature enacted Revenue and Taxation Code Section 214, which sets forth numerous qualifying conditions for receiving the exemption. In general these include:

- The property must be irrevocably dedicated to religious, hospital, scientific, or charitable purposes.
- The owner must not be organized or operated for profit and must be qualified as an exempt organization for income tax purposes by the Internal Revenue Service or the Franchise Tax Board.
- No part of the net earnings of the owner may inure to the benefit of any private shareholder or individual.
- The property must be used for the actual operation of the exempt activity.

Hospital Purpose Aspect of the Welfare Exemption. California statutory law and regulations do not define the term, "hospital," nor does statutory law specify separate requirements that must be met by a nonprofit hospital in order for the organization and its property to qualify for exemption from property taxation. While the Legislature has not defined "hospital" for exemption law purposes, the California Supreme Court has provided a definition.

> 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]

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

Historically, only properties falling within this definition have been considered eligible properties under the hospital purposes aspect of the exemption. The exception is outpatient clinics, which are eligible for exemption under Section 214.9 which includes in the definition of "hospital" outpatient clinics of two types; a clinic that provides psychiatric services for emotionally disturbed children, and a nonprofit multispecialty clinic as described in Health and Safety Code Section 1206(l). Therefore these multispeciality clinics are considered within the scope of the *hospital* purpose of Section 214.

The California Supreme Court also interpreted the phrase *property used exclusively for ...hospital ... purposes* to mean:

> ... any property which is used exclusively for any facility which is incidental to and reasonably necessary for the accomplishment of hospital purposes; or, in other words, for any facility which is reasonably necessary for the fulfillment of a generally recognized function of a complete modern hospital.[2]

In addition, the property of certain nonprofit organizations, which are not hospitals, may be considered exclusively used for hospital purposes if the requirements of Section 214.11 are met. The statute provides that property owned and operated by a nonprofit organization, otherwise qualifying for exemption under Section 214, *shall be deemed to be used exclusively for hospital purposes* so long as the property is exclusively used to meet the needs of hospitals which qualify for exemption from property taxation under Section 214 or any other law of the United States or this state.[3] Needs of hospitals includes any use incidental to and reasonably necessary for the functioning of a full hospital operation. Property owned and operated by a nonprofit organization may be deemed exclusively used to meet the needs of hospitals if it qualifies for exemption under Section 214, and is used by the organization to provide support services to hospitals including, but not limited to, purchasing, food services, laundry, collections, or waste disposal.[4]

Background

Prior to 1953, the law (Section 214, subdivision (3)) required, that the property could not be operated for profit, in addition to the owner not 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 which had intentionally earned an eight percent surplus of income over expenses to be used for debt retirement and facility expansion could not qualify for the welfare exemption.[5] In response to *Sutter Hospital* case holding that purposely charging fees in excess of expenditures in order to finance expansion violated Section 214, subdivision (3), the Legislature in 1953 amended Section 214, subdivision (3) to provide only that the property must be "used in the actual operation of the exempt activity." At the same time, former Section 214, subdivision (1) was expanded to authorize a qualified nonprofit hospital to make an annual net profit of

[2] *Cedars, supra* at page 736.
[3] Revenue and Taxation Code Section 214.11.
[4] See Assessors' Handbook Section 267, *Welfare, Church, and Religious Exemptions* pages 7-8 and 32-35 for additional information in regard to the hospital purpose and exempt uses.
[5] 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 to the Legislature rather than the courts because subdivision (a)(3) compelled the court's holding. (*Sutter Hosp*. supra at pages 40-41).

ten percent of total expenditures including depreciation based on cost of replacement and amortization of, and interest on, indebtedness. In addition, the 1953 amendment specified, in an uncodified section expressing the Legislature's intent, 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. It is noteworthy that the *Sutter Hospital* case has been 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* (254 Cal.App. 548)

The specific statutory language in Section 214, subdivision (a)(1), that a hospital is not deemed to be organized or operated for profit if its operating revenues (not including gifts, endowments and grants-in-aid) are not more than 10 percent of its operating expenses does not provide a bright line rule concerning the maximum amount of profit that a hospital may earn. 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 ten percent. 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.

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 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 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]

"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.

"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."

COMMENTS

1. **Sponsor and Purpose.** The author is the sponsor of this measure. The purpose is to clarify an uncertainty in the existing statute.

2. **Stating the requirement in the affirmative.** This bill restates 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 10% or more, the hospital shall be deemed to be **for profit**).

3. **This bill states that it is declaratory of existing law.** This bill includes uncodified language that states that its provisions do not constitute a change in law and that it is declaratory of existing law.

4. **If the intent of this bill is to restate existing law for clarity, then additional technical amendments are needed.** On its face the amendment implies that a hospital is ineligible for the welfare exemption if its profits are 10% or greater because it **"shall be deemed"** to be organized or operated **for profit** regardless of the purposes for which the profits in excess of 10 percent are dedicated. Such an interpretation is inconsistent with the uncodified declaratory of existing law statement. Under existing law, a profit of 10% or greater does not necessarily disqualify a hospital from the welfare exemption provided the profits in excess of 10% are dedicated to specific qualifying purposes. As provided in the uncodified legislative intent language of 1953 and the Rideout holding as noted in the Background section, these qualifying uses of excess profit include debt retirement, facility expansion and operating cost contingencies.

5. **Technical Amendment.** The phrase "**shall be deemed…for profit**" can be construed to mean that a hospital that earns a profit of 10% or more is ineligible for the welfare exemption regardless of how the profit is spent. If the intent is not to create a bright line test and to allow hospitals to earn more than 10% and qualify for the welfare exemption by showing that excess profits further the purpose of the organization, the following technical amendment is suggested.

   (1) The owner is not organized or operated for profit. However, in the case of hospitals, the organization shall be ~~**deemed**~~ **rebuttably presumed** to be organized or operated for profit if, during the immediately preceding fiscal year, operating revenues, exclusive of gifts, endowments and grants-in-aid, exceed operating expenses by an amount equivalent to 10 percent or more of those operating expenses. As used herein, operating expenses include depreciation based on cost of replacement and amortization of, and interest on, indebtedness.

   Alternatively, if the intent is to create a bright line test, then the declaratory of existing law statement should be deleted to avoid confusion and possible future litigation.

COST ESTIMATE

The Board would incur minor costs in informing and advising local county assessors, the public, and staff of the law changes and update welfare exemption related documents.

REVENUE ESTIMATE

If this bill is declaratory of existing law and is not intended to affect current law and the existing administration of the welfare exemption as it applies to hospitals, then it would have no revenue impact. However, if it this language is ultimately construed as creating a bright line test or results in some hospitals losing the property tax exemption because they are determined to be acting in a "for profit" manner, then twelve organizations (some owning multiple hospitals) would be potentially impacted.

Staff identified twelve organizations that would be at risk of not being able to qualify for the welfare exemption because profits exceed 10%. According to data provided by the county assessors, the exempt value of the hospitals owned by these organizations total $4.62 billion for 2004-05. If all of these hospitals could not qualify for the welfare exemption, the annual revenue increase at the basic one percent property tax rate is $4.62 billion x 1 percent, or $46.2 million. The revenue impact would be significantly smaller if one or more of these organizations were found to be eligible for the welfare exemption even though a profit of 10% or more was earned.

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