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MEMORANDUM

To: Reed Sander, Education Executive
Lutheran Church - Missouri Synod
Northern District of Illinois Office

From: Sally R. Wagenmaker

Date: July 21, 2008

Re: Recent Policy Changes Affecting Churches' Property Tax Exemptions

A. Introduction

Churches have traditionally enjoyed broad entitlement to property tax exemptions under Illinois law, for both their religious worship activities and their related ministries. Recently, however, such exemptions have come under the Illinois Department of Revenue's (DOR) increasing scrutiny. Accordingly, churches with changing property uses or newly acquired property must be cognizant of these trends. This memorandum provides background information on property tax exemptions, analyzes exemptions in light of recent policy changes, and provides specific recommendations to churches and their ministries.

B. Available Property Tax Exemptions

The Illinois Constitution and certain Illinois statutes authorize property tax exemptions for various categories, such as religious, educational, and charitable ownership and use. Churches generally qualify under the statutory 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.

Property tax exemptions are also available to churches in a variety of other circumstances, including property development, recreational use, and parsonages. For property development, it is critical that sufficient documentation is available (e.g., permits, plans, photos) to show that such development is actively being carried out at all times. Churches' recreational activities may qualify for religious exemption, but they must be conducted regularly and be directly related to religious

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purposes (e.g., church-wide picnics, evangelism, prayer walks, youth ministry activities, etc.) Parsonage tax exemptions are available so long as the property is occupied by a pastor who performs “religious-related activities” as a condition of employment. Church-owned real estate may also be exempt if used for church parking or storage of church-related property.

If no exemption is available, such as for vacant or underutilized property, then the church may need to consider filing a real estate valuation complaint to seek a reduced tax assessment.

C. Exemption Qualifications

1. Exclusivity Requirement

To qualify for property tax exemption, Illinois law requires that the property be used “exclusively” for exempt purposes. This term has long been interpreted as “primarily” for exempt purposes. Accordingly, if a church 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.”

For example, if a large church operates a small preschool in a portion of its facility, particularly if such portion is also used for religious activities such as Sunday school and church nursery, then the entire building likely will qualify for religious exemption. (The preschool activity is not automatically viewed as a qualified use, as more fully explained below.) If the portion used for preschool or other non-exempt purposes is specifically set aside only for such use, then the DOR may treat that portion as taxable and the remaining church facility as exempt. The more complicated or indistinct the uses are, the more likely it is that an exemption application will be initially rejected or raise issues that are challenging to resolve in favor of exemption.

If the church allows non-exempt uses of its property to the extent that it cannot be reasonably said that it is “exclusively” used for exempt purposes, then the church may lose its entire property tax exemption. For example, if a church allows patrons from nearby stores to use its parking lot without any geographic restrictions, then the church may lose its entire exemption for the parking lot. On the other hand, if the church 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 church regularly allows others to use its facilities for private events, then the church’s exemption for the entire facility may be at risk.

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2. Prohibited “View to Profit”

A key consideration in exemption analysis is whether an organization is operating with a “view to profit,” because that is incompatible with property tax exemption principles. Accordingly, to the extent a church 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 its property tax exemption. While a church may not intend any prohibited “view to profit,” it may have to incur 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 Gospel, but their impact on the church’s property tax exemption deserves careful prior evaluation.

3. Educational Qualifications

By statutory definition, a school that owns and uses property exclusively for “educational” purposes qualifies for exemption. This is a fairly straightforward category, and schools routinely can obtain exemption simply by showing their status as a school, their ownership of the subject property, and their exclusive use of all the property for educational purposes.

4. Child Care Centers and Preschools

The educational exemption category does not include child care centers and 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 churches 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.

Alternatively, one could argue that church-run child care centers and preschools qualify under Illinois’ religious property tax exemption statute, but unfortunately the DOR has disagreed. Most recently, in Zion Lutheran Church of Hinsdale’s appeal regarding its new church-run child care center and preschool, the DOR approved the hearing officer’s finding that the church’s program was not “primarily” for religious purposes and therefore was not a qualified religious use. The hearing officer rejected such religious qualification despite extensive evidence showing that the program was an integral part of the Church’s outreach ministry and had a strong religious focus in caring for the children. The hearing officer then determined that the Church was entitled only to a forty percent exemption, based on evidence that the Church used the property forty percent of the time for church administration, Sunday school, and other church meetings. This ruling is somewhat

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unusual in that the hearing officer did not completely deny the exemption under the “primary use” criteria, since the property was used almost equally for the Church’s religious functions and its child care and preschool program. Other hearing officers have been much less liberal, completely denying exemption for such mixed use.

D. Charitable Exemptions

1. “Charity” Defined

While many churches 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, churches seeking exemption most likely will need to base their exemption applications on the charitable exemption category.

More than one hundred years ago, the Illinois Supreme Court defined 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.

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.

For property tax purposes, the definition of charity has been judicially expanded into a six-factor test that is applied based on the particular facts and circumstances of each case. Specifically, the 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;

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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 the property 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.

Many nonprofit organizations presume that their programs qualify for charitable tax exemption simply because of the organization's tax-exempt status. But that, alone, is insufficient. Both the organization and its actual property use must satisfy the above six-factor test. Most notably, the applicant organization must show that its program is not operated with a "view to profit," that no obstacles exist to applicant's participants, and that it is supported "mainly" by charitable contributions. With careful planning and evaluation, organizations can determine whether and how they can meet these factors and how they can best plan for successful exemption applications.

3. 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, churches and their related ministries should comply with the following recommendations.

1. The organization should have a well-written mission plan that articulates the Church's religious (and/or charitable) goals to be implemented through any property acquisition and consequent program development (e.g., to spread the gospel, to provide outreach opportunities for the church, to serve church facilities, and to encourage church growth).
2. The organization should have, to the extent applicable, a strong religious dimension of all programs including clear articulation of how charitable activities advance the cause of Christ.

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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 church 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 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. The organization should establish a charitable fund for fee waivers and reductions, and document its funding and use.
10. The organization should document and keep track of all fee waiver/reduction applicants, the amounts given, and the amounts waived.
11. Ideally, before applying for any charitable property tax exemption, the organization should have some fee waivers and reductions already granted, to establish a track

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record of charitable services.

E. Space-Sharing Arrangements and Property Tax Exemption

As an exercise of good stewardship, to promote mutual ministry goals, or for other reasons, a church 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 church 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.

F. Exemption Application Process

Property tax exemptions may be obtained through an administrative filing process. Having legal counsel in preparing, submitting, and following through on applications is generally recommended. New owners of previously exempt property must apply in their own right for property exemption. The county Boards of Review may well issue tax bills to unsuspecting new nonprofit owners, who are unaware of their obligation to file new applications. Although refunds are available for up to three years' back taxes, the property tax bills will have to be paid while such exemption applications are pending.

Exemption applications should contain the following materials. First, all corporate documents must be in proper order. The applicant's articles of incorporation and bylaws must set forth qualified tax-exempt purposes and specify that no stock ownership exists. In addition, the bylaws may need to include fee waiver language if a charitable exemption is involved. Organizations other than churches must submit an IRS §501(c)(3) determination letter; if a church has an IRS letter, that will be helpful. The applicant organization should also have a sales tax exemption letter, which is also very helpful because the DOR approves both sales and property tax exemptions. A supporting affidavit should be submitted as well, describing the organization, its activities, and the property use. If the applicant allows other persons or organizations to regularly use the property, then additional similar documentation should be submitted showing that these other parties' property uses are consistent with property tax exemption.

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Exemption applications are submitted to local County Boards of Review, and they are then reviewed by both the local Boards and the DOR. If the application provides sufficient information to demonstrate qualification for exemption, it should be approved. If the initial application is denied, however, then the applicant organization must proceed to an administrative appeal, involving settlement negotiations and an evidentiary hearing if no settlement can be reached, and subsequent potential court appeals.

After exemption is successfully obtained, churches do not need to file any further documentation unless their property use significantly changes, in which case notification is legally required to be filed with the County Assessor's office within thirty days of such change. For other nonprofit organizations with exempt real estate, however, annual certifications must be filed with the County Assessor's office in order to maintain exemption. Our office is aware that some County Assessor offices routinely send annual certification forms to all exempt owners including churches. However, churches are required to file these forms only in the event of significant property use changes.

G. Conclusion

The legal landscape for property 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, churches and their related ministries – 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.