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IS THERE THEORETICAL JUSTIFICATION FOR PAYMENTS IN LIEU OF TAXES?

Darryll K. Jones*

I. INTRODUCTION

What conclusions should be made when local governments virtually demand financial tribute from tax exempt charitable organizations? Payments in lieu of taxes (PILOTs) are said to be voluntary payments from tax exempt entities to local government. To call such payments "voluntary," though, is essentially to indulge a legal fiction that allows us to avoid the implication that the public may ultimately think it unfair and a sure waste of money to exempt certain revenue generating entities from taxation. Ultimately, given the implicit threats usually accompanying requests for payments in lieu of taxes, PILOTs are voluntary only in the sense that taxes, themselves, are voluntary. This article suggests that when local government officials ask charities to make PILOTs and charities do so without question or explanation, it is only natural that the public comes to view tax exemption as inequitable and inefficient. Indeed, why would a *tax exempt organization* pay what are essentially *ad hoc* taxes, except that the organization itself doubts its own deservedness? Local officials are probably happy to leave that impression because it serves their ultimate purpose; the purpose is not to seriously question the history and institution of tax exemption but merely to obtain financial support from apparently well-endowed, but politically weak constituents. Except in rare cases, Civil Society seems too eager

* Professor of Law, Stetson University College of Law. J.D. University of Florida 1986, LL.M (Tax), University of Florida 1994. The author is presently on leave of absence at Florida A&M University College of Law where he serves as Associate Dean for Research and Faculty Development.
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to make the payment and be done with the matter, suggesting that it would rather not discuss or defend the notion that tax exemption is a legitimate characteristic of a taxing system.

The goal of this article is to dispel and disprove the common and unfortunately reflexive notion that accompanies PILOTs, both from a motivational and explanatory standpoint. It is easy, though intellectually lazy, to conclude that PILOTs are motivated by local taxing authorities' belief that tax exempt charities greedily consume public services while simultaneously depriving cities and counties of revenues needed to produce those public services. There are legitimate reasons, other than a disbelief in the efficacy of tax exemption, supporting local government's requests for PILOTs as well as Civil Society's typically unquestioned agreement to make PILOTs. Those reasons have never been adequately explained; this article attempts to do so. It begins by acknowledging the commonly held perception that PILOTs represent Civil Society's "comeuppance" to some degree. Section I explains the genesis of the public perception that large tax exempt organizations – institutions of higher education and prominent nonprofit health care organizations primarily – ought to be made to pay taxes. In Section II, the article surveys possible explanations preferable to the suspicion that exempt entities are undeserving free riders. It continues in Sections III through VII by explaining alternative motivations for PILOTs. The article seeks to be convincing, rather than merely state probable or even just possible alternative motivations for PILOTs. In other words, the alternative motivations are not offered as rhetorical gamesmanship in an effort to side-step the unpleasant suggestion that property tax exemption is counterproductive, particularly when charitable organizations congregate in urban locations most dependent upon property tax revenues. The alternative motivations seek to really explain why PILOTs need not be evidence that property tax exemptions should be repealed in their entirety. Section VIII concludes

defensively. Where prior sections objectively examine the issue from the viewpoints of local taxing authorities as well as Civil Society, Section VIII defends tax exemption against the easy implication derived from the request for and concession to PILOTs. Section VIII is not intended to articulate the entire positive case for property tax exemption; it is intended merely to defend charitable property tax exemption from the accusation implicit only in PILOTs. Section VIII resolves, in charity's favor, the worry that PILOTs inevitably signal the end of charitable property tax exemptions.

II. PILOTs AND THE FREE RIDER PERCEPTION

State and local governments[1] are hardly immune from recession[2] and other economic hard times such as the United States is presently experiencing.[3] As businesses downsize, and high unemployment rates persist,[4] local governments typically suffer severe cash flow problems[5]

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[1] Congress recently heard testimony regarding the importance of state economies on overall social welfare: "State and local governments account for over 14 percent of total U.S. employment and they contribute approximately 12 percent to our national gross domestic product (GDP) with over $2 trillion in operating and capital expenditures. The fiscal health of states is therefore critical to the economy." *State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues: Hearing Before the H. Judiciary Committee, S. Comm. on Commercial and Administrative Law,* 111th Cong. 2 (2010) (statement of Scott D. Pattison, Executive Director, national Association of State Budget Officers) *available at* http://judiciary.house.gov/hearings/pdf/Pattison100415.pdf.

[2] According to the United States Department of Labor, the last three recessions in the United States last from (1) July 1990 to March 1991, (2) March 2001 through November 2001, and (3) December 2007 to the present. U.S. Department of Labor, *Issues In Labor Statistics,* 1, (March 2010) *available at http://www.bls.gov/opub/ils/pdf/opbils79.pdf.*

[3] For a comprehensive discussion of the origins, history and implications of the present financial crisis, see Dick K. Nanto, THE U.S. FINANCIAL CRISIS: THE GLOBAL DIMENSIONS WITH IMPLICATIONS FOR U.S. POLICY (Congressional Research Service, Jan. 30, 2009)

[4] During the current recession, *supra* note 2, the unemployment rate reached a high of 10 as of the December 31, 2009, higher than any other rate since 1980. Steven F. Hipple, *The Labor Market in 2009: Recession Drags On,* MONTHLY LABOR REVIEW, March 2010 at 3. As of March, 2010, the unemployment rate fell slightly to 9.7%. Ann Belser, *Extension of Jobless Benefits Delayed,* PITT. POST-GAZETTE, April 7, 2010 at A12.

[5]

attributable, in most instances, to declining tax revenues[6] and user fees as consumers curtail spending[7] and investors withdraw capital from the tax revenue-generating market. At the same time, demand for social services remain steady or even increases as the recession worsens and families feel the pinch of job losses, declining asset values and inability to access credit.[8] In such times, legislators are loathe to curtail public spending or, barring that, raise taxes. And yet the vicious cycles that typically characterize recessions impose almost inexorable political pressure to "do something."

> Our data shows that during the last two fiscal years, state general fund expenditures have shown an unprecedented decline even with the assistance of the federal government through the American Recovery and Reinvestment Act (ARRA). For two consecutive years revenues and expenditures have decreased dramatically. Fiscal 2009 general fund expenditures declined 3.4 percent compared to fiscal 2008 levels and enacted budgets for fiscal 2010 show a 5.4 percent decrease in general fund expenditures. These decreases in general fund expenditures are the largest declines in the history of our data collection. Prior to 2009, actual state general fund spending had only declined one other time, in 1983, by 0.7 percent. Overall, more than half the states (28) enacted general fund budgets with negative spending growth in fiscal 2009, and over two-thirds of states (37) enacted fiscal 2010 budgets with general fund spending lower than the previous year.

State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues: Hearing Before the H. Judiciary Committee, S. Comm. on Commercial and Administrative Law, 111th Cong. 2 (2010) (statement of Scott D. Pattison, Executive Director, national Association of State Budget Officers) *available at* http://judiciary.house.gov/hearings/pdf/Pattison100415.pdf.

[6] *See generally* National Conference of State Legislatures, STATE BUDGET UPDATE: MARCH 2010, 4-13 (2010) (describing the history of revenue declines since the present recession began in 2009). *See also* Kail Padgitt, *State Revenue Changes from 2008 to 2009* (Tax Foundation, May 12, 2010) (noting that state tax revenues declined "significantly" in 45 states).

[7] "(S)tate finances are not expected to recover for at least two years. History shows that state budgets continue to struggle long after a national recession ends as high unemployment rates erode earnings, affecting personal income tax collections. Job losses also undermine consumers' willingness to spend money, which affects sales tax collections." *Id.* at 4.

[8] *Id.* at 4-5 ("Although the bulk of state fiscal problems can be traced to revenue declines, spending pressures are mounting. Far and away, Medicaid was the most common program exceeding budgeted levels, with 21 states and Puerto Rico reporting Medicaid or other health program overruns. Spending in other social service programs, education and corrections also was exceeding budgeted levels in many states."). For a rather dire report on the effect of the present recession on states' abilities to provide social services see Nicholas Johnson, Phil Oliff and Erica Williams, CTR. ON BUDGET & POLICY PRIORITIES, AN UPDATE ON STATE BUDGET CUTS: GOVERNORS PROPOSING NEW ROUND OF CUTS FOR 2011; AT LEAST 45 STATES HAVE ALREADY IMPOSED CUTS THAT HURT VULNERABLE RESIDENTS (April 19, 2010) http://www.cbpp.org/files/3-13-08sfp.pdf.

The options are not at all attractive. Local governments can either borrow money[9] or raise taxes in one form or another. Borrowing, of course, is simply a way of deferring the present impact of inevitable taxation.[10] Thus, in the final analysis – and assuming it is politically inexpedient to eliminate social spending – legislators are eventually faced with the unpleasant prospect of raising taxes.[11] The omnipotent effects of a deep recession, coupled with the public's seemingly irrational demand to maintain or increase favored social spending without raising taxes, make it impossible to escape the conclusion that states must engage in the proverbial exercise of squeezing blood from a turnip.[12]

At least since George H.W. Bush's ill-fated campaign rhetoric – "read my lips, no new taxes!"—legislators understand that doing that which is necessary may well lead to their being turned out of office.[13] Naturally, then, legislators seek to raise taxes only in a manner that

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[9] For a succinct overview of municipal borrowing see Paul S. Maco, *Building a Strong Subnational Debt Market: A Regulator's Perspective* 2 RICH. J. GLOBAL L. & BUS. 1 (2001).

[10] For a general overview of the power of local governments to borrow, voter approval requirements, and local government repayment obligations see 4-66 ANTIEAU ON LOCAL GOVERNMENT LAW §66 (Sandra M. Stevenson, 2ND ed. 2010). To qualify for tax exemption, interest payments on municipal bonds must generally be made from the issuer's tax revenues. *See generally* Treas. Reg. 1.141-4 (2008) (regarding the "private payment test," under which a municipal bond will not qualify as tax exempt if the more than 10% of the debt service payments are derived from private sources. As a result, most states now require voter approval before the issuance of municipal debt. *See* Tracy Nichols Eddy, *The Referendum Requirement: A Constitutional Limitation on Local Government Debt in Florida*, 38 U. MIAMI L. REV. 677, 685 (1984) (noting that a constitutional amendment requiring voter approval of municipal bonds is motivated by the fact that bonds will be repaid by taxpayers and therefore taxpayers should be given the authority to approve or disapprove of new bonds).

[11] *Id.* at 5 ("The combination of anemic revenues and growing spending pressures is presenting difficult and often painful choices for lawmakers across the country.")

[12] State policymakers eventually admit this inevitability publicly, as revenues decrease and demand remains. "In the scramble to find something, anything, to generate more revenue, states are considering new taxes on virtually everything: garbage pickup, dating services, bowling night, haircuts, even clowns." Monica Davey, *States Seeking Revenue Hope to Expand Taxes to Services,* N.Y. Times, March 28, 2010 at A1, *available online at* http://www.nytimes.com/2010/03/28/us/28taxes.html?th=&emc=th&pagewanted=all.

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> (T)he experience of the first President Bush is also instructive. As many will recall, at the 1988 Republican National Convention, President Bush made his now signature pledge, "Read my lips," a part of his resolute position against raising taxes. The

generates the least amount of risk to their reelection. The imposition of "hidden taxes"[14] – fees and other charges imposed on the public without using the term "taxes" -- represents a typically generic response to the conflicting urge to retain one's office and still generate the revenue for services illogically demanded by a tax averse public. [15] Another method, one variation of which is the topic of this paper, is to impose taxes on constituents who, for various reasons, represent the least threat to political incumbents. At the state and local level, it is most likely that the poor

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> same President Bush later was forced by the economy to stand by and let Congress raise taxes to reduce potential budget deficits - effectively recanting his pledge. While the recantation may have been for sound reasons, it contributed to his subsequent defeat by a then obscure Arkansas governor, William Jefferson Clinton. For President Bush, the reversal of his position was fatal to his presidential aspirations.

Leo Martinez, Guinn v. Legislature of Nevada: *Tax Legislation and Democratic Discourse: The Rhetoric of Revenue and Politics*, 4 NEV. L. J. 510, 512-13 (2004) (citations omitted).

[14]

> The political science and psychological literatures suggest other ways in which "hidden taxes" may reduce voter ire. For instance, voters tend not to notice the full impact of small fees and sales taxes on their financial situation, because these taxes arrive bit by bit, and often hidden inside other prices (quick: how much of the price of your gallon of gas is tax?). Voters also tend not to take the time or mental effort to add up these costs, even if they notice them. Thus, there is strong evidence that political opposition to "hidden taxes" of these forms is rather low compared to, for example, the individual income tax.

Brian Galle, *Federal Grants, State Decisions* 88 B.U.L. REV. 875, 907 (2008).

[15] One author notes, for example, that revenue can be raised without explicitly acknowledging that there has occurred a tax increase:

> Of course, another way to sustain services in the absence of tax revenues is to impose unconventional "taxes" of various sorts. As tax revenues fall, it's common for governments to impose user charges for services that were previously free or provided at nominal cost. Hidden taxes can also take other forms, such as tuition increases at state universities. Tuition increases, in effect, impose a stiff tax on a narrow class of citizens: parents with college-age kids, and the kids themselves. Even more exotic are the "time taxes" we pay whenever we are stuck in traffic on a road that would have been improved if excises on motor vehicle fuels had been increased. It takes time for citizens to connect the dots that link tuition increases and traffic jams to reductions in tax revenue. But eventually they will. It also takes time for citizens to realize that creating a just society and providing equal opportunity sometimes requires tax-supported spending on universities, roads, and parks, not just increased tuition, highway tolls, and user charges.

Thomas F. Field, *The Emperor Has No Clothes,* 101 TAX NOTES 1125, 1126 (2003).

represent the smallest risk to incumbency.[16] The problem, of course, is that while they are not likely to represent a significant threat to incumbency, the poor, by definition, comprise an insufficient tax base.[17] The middle and wealthy classes comprise a larger tax base but a significantly greater political risk.[18] A legislator who concedes to a tax affecting the middle class is certain to face populist rhetoric against her incumbency. Indeed, as a matter of political rhetoric, it is safer to characterize a tax as one affecting only the wealthy. The wealthy are fewer in number, yet represent a larger pool of capital from which government revenue may be had.[19] Their fewer numbers[20] and larger capital base, though, allows the wealthy to easily leverage their voting power in some form or another.[21] Campaign finance laws are not entirely effective in the effort to diffuse the power of wealthy taxpayers to control political incumbency.[22] Some even argue that campaign finance laws are entirely ineffective.[23] Political action committees

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[16] Ryo Arawatari, *Informatization, Voter Turnout and Income Inequality,* 7 J. ECON INEQUAL 29 (2009)("a common feature of industrial countries is that agents with low income, low human capital or limited information tend to abstain from voting.")

[17] As of 2007, 13% of United States individuals and 9.5% of United States families lived below the poverty level. U.S. Census Bureau, THE 2010 STATISTICAL ABSTRACT, 698 (2010) (Table 693). Those comprising the lowest earners in society earn only 3.4% of the total income in the United States as of the same year. *Id.* at 678 (Table 678).

[18] Any tax affecting the middle class is likely to draw the wrath of a numerically larger voter base. *See supra* note 14. A tax on the wealthy, though more palatable as a rhetorically political manner, is nevertheless risky because the wealthy can use their income to exponentially increase their ability to control political outcomes. According the U.S. Census Bureau, households in the top 20%, by income, earned nearly 49.7% of all income in 2007. *Id.* The top five percent accounted for 21% of all income. *Id.*

[19] *Supra* note 19.

[20] United States households earning $200,000 per year or more comprise only 4% of all U.S. households. U.S. Census Bureau, THE 2010 STATISTICAL ABSTRACT, 695 (2010) (Table 690). (showing a total of 112,370,000 households in the United States, 4,449,000 of which earn $200,000 or more in 2007).

[21] *See* James R. Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity*, 61 VAND L. REV. 1129, 1154-63 (2008) (describing the ability of the wealthy to disproportionately affect the political process and the general ineffectiveness of campaign finance laws to correct that result).

[22] *Id.*

[23] "Political speech is so ingrained in our culture that speakers find ways to circumvent campaign finance laws." Citizens United v. Federal Election Commission, 558 U.S. _____, _____ (2010).

(PAC's), for example, are oftentimes funded by wealthier individuals and represent a true threat to an incumbent. Practically and theoretically, PAC's allow disaffected wealthy and even middle class taxpayers to pool their resources and thereby present a real threat to an incumbent faced with the need to satisfy the demand for social services and the simultaneous disdain for new or higher rates of taxes.[24] A final less optimal solution might be to impose taxes on corporate entities.[25] A corporate tax can often and quite successfully be characterized as a tax on nobody in particular.[26] At least nobody individual taxpayers care about. Here too, though, the incumbent is not entirely without risk of being turned out from office. Dissaffected corporations, like disaffected wealthy individuals, may have disproportionate influence over the political process and can also present a threat to incumbents.[27] Hence, there simply is no perfect way for

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[24] *Id.* at 1155. ("In fact, a majority of the individuals contributing to political candidates have high incomes. A study of congressional campaign contributions made in 1997 found that 81% of the contributors of $ 200 or more to congressional candidates had annual family incomes of over $ 100,000. Forty-six percent of the donors had annual family incomes over $ 250,000, and 20% had incomes over $ 500,000.")

[25] "Since no one really knows who bears the "incidence," or economic burden, of the corporate tax, individual voters tend to prefer it to other options." Brian Galle, *Federal Grants, State Decisions,* 88 B.U. L. REV. 975, 907 (2008).

[26] "Cognitive theory, however, helps to explain at least the political appeal of the corporate income tax. The corporate income tax is attractive precisely because it is hidden by its uncertain incidence." Edward J. McCaffery, *Cognitive Theory and Tax,* 41 U.C.L.A. L. REV. 1861, 1884 (1994). To the extent lawmakers can convince a taxpayer that a proposed tax has no affect her, it should be more likely that the taxpayer will, at most, be indifferent to the adoption of the tax.

[27] The United States Supreme Court's recent decision in *Citizens United v. United States,* 558 U.S. ____ (2010) struck down campaign finance laws designed to limit corporations' ability to finance campaign speech. The dissent in *Citizens United* thought that corporations will soon be allowed to thoroughly dictate the results of political elections, stating, "the Court's blinkered and aphoristic approach to the First Amendment may well promote corporate power at the cost of the individual and collective self-expression the Amendment was meant to serve. It will undoubtedlycripple the ability of ordinary citizens, Congress, and the States to adopt even limited measures to protect against corporate domination of the electoral process. Americans may be forgiven if they do not feel the Court has advanced the cause of self-government today."558 U.S. at _____ (Stevens, J. dissenting). The extent to which the Court's decision will, in fact, lead to greater corporate influence over political elections is, to say the least, a hotly contested issue. *See* How Corporate Money will Influence Elections, http://roomfordebate.blogs.nytimes.com/2010/01/21/how-corporate-money-will-reshape-politics/ (Jan. 21, 2010 12:45 EST). What is important, though, from an incumbent's point of view is not the reality but the possibility that corporations have sufficient financial means to generate risks to incumbency.

incumbents to satisfy their constituents' near entitlement mentality without running afoul of an implicit condition of staying in office – disdaining any new taxes.

It is here, finally, that payments in lieu of taxes (PILOTs) become relevant. The wise policy maker, sensitive to her own desire to remain in office, must achieve two conflicting goals during a time of severe budget shortfalls – maintaining or even increasing social services without imposing more costs on voting constituents. After eliminating all other possibilities, the incumbent is left with only the hope of securing "voluntary" payments from a politically weak but economically strong constituent.[28] As she surveys her jurisdiction, the incumbent will inevitably note the presence of at least one type of constituent – large tax exempt organizations – with the apparent, if not real financial ability to make such payments and which lack sufficient political clout to represent a real threat to her office.[29] Thus is born the idea for oxymoronic

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[28] This is an option primarily for those states that have excluded the possibility of simply revoking charitable tax exemptions altogether. *See* Stephanie Strom, *States Move to Revoke Charities Tax Exemptions,* N.Y. TIMES, Feb. 28, 2010 at A21. (describing the growing trend, sparked by budget shortfalls, towards eliminating all charitable property tax exemptions). *See also* Terry Schwadron, *To Tax or Not to Tax? Cities Ask the Billion Dollar Question,* N.Y. TIMES, Nov. 12, 2007 at H30 (same).

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> On the political front, the legislators were faced with a loss in the tax base, an aging population, a manufacturing state that was losing jobs, and declining revenues in general. This climate favored tax cuts or at least an abstention from raising taxes. There never is a positive climate for raising taxes and the legislators looked for ways to reduce taxes and to gather revenue in the most politically acceptable manner. Charities became viewed as the easiest and most politically justifiable targets for "reform."
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> Nonprofits have been targeted, among other reasons, because they are perceived as politically weak and disorganized, not just because the government sees nonprofit organizations as potential sources of revenue.

George S. Forde, Jr. & Christopher E. Cummings, *Payments In Lieu of Taxes: The Philadelphia Experience,* 37 CATH. LAW. 133, 142 and 150 (1996) (citations omitted).

"payment in lieu of taxes" (PILOTs);[30] ultimately the concept of PILOTs boils down to a tax exempt corporation or other entity nevertheless paying taxes.[31] Even the completely uninterested ought to be provoked enough to wonder why a tax exempt entity would ever concede such a thing. The range of answers considered in this article is important because each answer has its own logical and sometimes implications –from a conclusion that the entity or its generic class does not deserve tax exemption to an implication that the entity is simply acting in accordance with the charitable mandate.

This article proceeds in search of the most logical implication of PILOTs. First, though, it acknowledges the legal realism underling PILOTs. That is, by most accounts PILOTs are nothing more than payments made to local government by a "free-rider," not at all voluntarily, but instead under threat of legitimate or at least deserved governmental sanction.[32] Most people

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[30] Since charitable tax exempt organizations are under no obligation to pay taxes, it is somewhat oxymoronic that they should "voluntarily" make a payment *in lieu of* a nonexistent obligation. But this is a theoretical, rather than a pragmatic consideration of the matter, such as this article engages in Section ___, below. *Supra* notes ___ through ___ and accompanying text. A tax, by the way, is "an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental or public purposes." Treas. Reg. 1.141-4(e)(2) (2008); *see also* Sprik v. Regents of the University of Michigan, 204 N.W.2d 62, 66 (Ct. Appeals, Mich., 1972) ("A tax is an enforced proportioned burden, charge, or contribution from persons and property, levied by the state, by virtue of its sovereignty, for the support of government in discharge of its various functions and duties for all public needs.").

[31] In at least two private letter rulings, the IRS ruled that a PILOT is essentially a tax. I.R.S. Priv. Ltr. Rul. 2006-40-001 (July 11, 2006); I.R.S. Priv. Ltr. Rul 2006-41-002 (July 19, 2006). Those two private letter rulings later served as the foundation for regulations that essentially define PILOTS as taxes, if only by another name. Treas. Reg. 1.141-4(e)(5) (2008) (stating the circumstances under which a PILOT will be deemed a "generally applicable tax"). Most PILOTS will indeed meet the "tax" definition provided in Treasury Regulation 1.141-4(e)(5). Thus, if we were to substitute the substantive definition of PILOTS in the acronym, and replace the word "tax" with that which the organization is actually giving up, the result would be a "tax in lieu of tax exemption." This deduction ultimately begs the question why an entity would ever voluntarily relinquish its tax exemption.

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> While these PILOT payments are nominally voluntary outlays by the exempt institution, the political reality is usually more complex as the municipality brandishes any number of potential sanctions to induce the PILOT payment. These sanctions range from the municipality marshaling public opinion against

assume that PILOTS are entirely motivated by the foregoing discussion; a local government is subject to popular demand for social services and must find a way to raise the revenue to pay for those services without alienating constituents to the point that incumbents will be voted out of office. The larger tax exempt organizations within the relevant jurisdiction is cast in the role of an undeserving "free-rider" [33] whose exemption from taxation results in regressive tax burdens for taxpayers within the jurisdiction.[34] Having successfully cast the conspicuously wealthy tax exempt organization as a free rider, the incumbent may then demand tribute from the exempt organization without fear of negative political consequence. Besides being an unabashedly arbitrary justification, the free-rider rationale carries with it even more significantly negative implications. A government's request for a PILOT, and an exempt organization's agreement to make a PILOT inevitably raises the issue whether the exempt organization should be immune

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> the exempt entity if it declines to make PILOT payments to the denial of zoning relief or building permits desired by the tax-exempt entity to, in the extreme case, the municipality's threat to seek political or judicial revocation of the entity's tax-exempt status.

Edward A. Zelinsky, *The Once and Future Property Tax: A Dialogue with My Younger Self,* 23 CARDOZO L. REV. 2199, 2215-16 (2002).

[33] The suspicion that tax exempt entities are not paying their fair share is summed up in the following quote from a recent article in the New Hampshire Bar Journal. "One aspect of tax-exempt entities, however, that raises the ire of tax assessors and citizens alike is that the entities pay no taxes yet take advantage of municipal services such as trash pickup, fire and ambulance services, and public works. As a result, many municipalities have developed PILOT ("payment in lieu of taxes") programs whereby a charitable organization makes a negotiated payment in "good faith" to its host community to compensate it for utilities and services used." Glen Fries, *Annual Survey Article by Pierce Law Students: To Tax, or not to Tax? Elder Trust v. Town of Epsom Answers the Questions,* 48 N.H. B. J. 14 (2007).

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> The 1990-91 recession financially strained many state and local governments, and motivated searches for new tax revenue sources. Municipalities also have faced tax base erosion as a result of the flight of businesses and residents to outlying areas. Meanwhile, public outcries against higher property and income taxes have strengthened, and voters have opposed proposed measures to increase taxes. These financially strapped state and local governments have targeted nonprofits as one means of resolving their pinched monetary and tax base dilemmas.

Nina J. Crimm, Why All is Not Quiet on the "Home Front" for Charitable Organizations, 29 N.M. L. REV. 1, 8-9 (1999).

from taxes at all.[35] If indeed there is no justification for PILOTs other than the popular conception that exempt organizations do not pay their fair share, it should not be a much further leap to conclude that colleges, universities, and nonprofit hospitals[36] should not enjoy tax exemption in the first place. This is the conclusion that should worry Civil Society enough that stakeholders become motivated to seek out and articulate one or more theoretical justifications for PILOTs. If the law can settle upon a theoretical justification, other than a shared visceral desire to expose an alleged free-rider, it can then identify and limit the circumstances under which a PILOT, and the worrisome logical implication that nonprofit organizations should not be tax exempt in any event, is justified. Without a theoretical justification for PILOTs, it ought to be admitted that tax exemption is never really justified, particularly if it can be revoked arbitrarily under the readily accepted rationale that charitable organizations do not pay their fair share. Civil Society is therefore rightly concerned that PILOTs are merely the first admission along a line of reasoning that ends in the complete elimination of tax exemption.[37]

III. SURVEYING THE POSSIBLE THEORETICAL JUSTIFICATIONS FOR PILOTS

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[35] "In some cases, PILOTs represent an erosion of statutory tax exemption." Evelyn Brody, *The States Growing Use of a Quid-Pro-Quo Rationale for the Charity Property Tax Exemption,* 26 EXEMPT ORG. TAX REV. 269, 286 (2007). *See also*, John A. Swain, *The Taxation of Private Interests in Public Property: Toward a Unified Theory of Property Taxation,* 2000 UTAH L. REV. 421, 459 (2000) ("Taken to their logical extreme, PILOTS would negate the government property tax exemption.")

[36] So called "eds and meds"(colleges and universities, and nonprofit hospitals) are the most likely tax exempt institutions to be targeted by local governments seeking PILOTs. Evelyn Brody, *The States' Growing Use of a Quid-Pro-Quo Rationale for the Charity Property Tax Exemption,* 56 EXEMPT ORG. TAX REV. 269, 288 (2007)("PILOTs usually focus on hospitals, institutions of higher education, nursing homes and retirement homes."); Janne G. Gallagher, *When Local Governments Come Calling: The Movement to Tax Charities,* 18 EXEMPT ORG. TAX REV. 25, 31 (1997) ("As government officials look around their communities, they see some large institutions, generally hospitals and universities, that possess considerable financial resources.")

[37]The value of the property tax exemption to tax exempt organizations is difficult to quantify with any specificity, due to the "heterogeneity in state tax systems and revenue sources." Molly F. Sherlock, AN OVERVIEW OF THE NONPROFIT AND CHARITABLE SECTOR at 45 (Congressional Research Service 2009). Nevertheless, the value ranges from $17 to $32 billion dollars annually. *Id.* at 46.

Although PILOTS have been relied upon by municipalities to raise revenue in tough economic times for decades,[38] very little scholarly attention has been devoted to the topic as it relates to the extraction of payments – taxes, really – from ostensibly tax exempt charitable organizations.[39] The few articles that address the topic readily, and without much question,

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[38] "The systematic use of PILOTs can be traced to Boston's 1925 pioneering agreement with Harvard and the Massachusetts Institute of Technology." Evelyn Brody, *The States' Growing Use of Quid-Pro-Quo Rationale for the Charity Property Tax Exemption,* 56 EXEMPT ORG. TAX REV. 269, 287 (2007). Professor Crimm traces the first PILOT agreement to 1929 when Harvard College became "the first major institutional university to formally agree to a PILOT plan." Nina J. Crimm *supra* note ___ at 10.

[39] *See, e.g.,* George S. Forde, Jr. and Christopher E. Cummings, *Payments in Lieu of Taxes: The Philadelphia Experience,* 37 CATH. LAW 133 (1996) (describing the use of PILOTS in Pennsylvania). The term "PILOT" has been used to describe a wide variety of tax substitute payments. In this article, it is used specifically to refer to a request from a municipal taxing authority to a charitable tax exempt organization for a contribution to the municipalities' fisc.

> PILOT payments come in a variety of configurations. In one version of PILOT, a higher level of government that owns property reimburses from its general revenues the lower level jurisdictions in which such property is located for some or all of the taxes such property would yield if taxable. Thus, for example, the federal government in a variety of instances reimburses states and localities for taxes such jurisdictions would otherwise receive from federally-owned land. Many states similarly compensate municipalities for state-owned (i.e., tax-exempt) properties within the borders of such municipalities. In yet other versions of PILOT payments, states reimburse localities for properties owned by governmental instrumentalities. In still other variations of PILOT programs, such instrumentalities (e.g., publicly-owed utilities, housing authorities, airport commissions) are directed or authorized to make payments from their own operating revenues to localities in lieu of taxes. At least two states (Connecticut and Rhode Island) make PILOT payments from general revenues to reimburse municipalities for the presence of certain private, nonprofit institutions within the municipalities' boundaries.
> In another version of PILOT payments, such payments come to the locality by agreement between the locality and a private tax-exempt entity, which sends a check to the municipal fisc while the entity retains its exempt status. While these PILOT payments are nominally voluntary outlays by the exempt institution, the political reality is usually more complex as the municipality brandishes any number of potential sanctions to induce the PILOT payment. These sanctions range from the municipality marshaling public opinion against the exempt entity if it declines to make PILOT payments to the denial of zoning relief or building permits desired by the tax-exempt entity to, in the extreme case, the municipality's threat to seek political or judicial revocation of the entity's tax-exempt status. In practice, it is typically in everyone's interest to compromise on a "voluntary" PILOT payment which is often less than the full taxes that would be

conceptualize the issue as one of pure politics and pragmatism, having nothing to do with good or bad tax policy.[40] Perhaps this striking legal realism is the correct approach. The implication is worrisome, though, because it directly contradicts the entire theory upon which tax exemption rests and, indeed, suggests that tax exemption is a waste of resources.[41] The dominant theory

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> paid on loss of exempt status, but which, from the municipality's perspective, provides immediate financial succor.

Edward Zelinsky, *The Once and Future Property Tax: A Dialogue With My Younger Self,* 23 CARDOZO L. REV. 2199, 2215-16 (2002).

[40] Edward Zelinsky *supra* note ____; Evelyn Brody *supra* note ___ ("PILOTS represent a compromise between the parties using what leverage they have available and negotiating in light of the hazards of litigation.") George S. Forde, Jr. & Christopher E. Cummings *supra* note ____ at 144-45. The latter article provides this interesting account of the advent of PILOTS in Philadelphia:

> In Philadelphia, while information regarding nonprofits was being collected, a negative newspaper campaign erupted against charities. The newspapers' negative influence was aggravated by the citizens' collective cry for tax relief. The Board of Revision formed a commission, which included members of the Board and members of the municipal government, but did not include any representatives of the nonprofits or their clientele. It produced a brief, labeled as a report of their study, for the proposition that all exempts should pay for police, fire, and other services rendered by the city and the public school system. The commission began to develop and implement the payments-in-lieu-of taxes and services-in-lieu-of-taxes programs, or PILOT and SILOT programs, through which the municipality requested nonprofit organizations to voluntarily pay a percentage of the amount that would be due under their property's tax assessment and to provide Services In Lieu of Taxes ("SILOTS") as well.

[41] "The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare." H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938). For a thorough discussion of the theory that tax exemption is conditioned upon an organization's lessening the burdens of government, see Lars Gustafsson, "*Lessening the Burdens of Government:" Formulating a Test for Uniformity and Rational Federal Income Tax Subsidies,* 45 KANS. L. REV. 787 (1997). States, too, generally justify tax exemption on the theory that the exempt entity reduces government burdens:

> One ground upon which exemptions from taxation of charitable institutions ... can be justified in a constitutional sense is that they minister to human and social needs which the state itself might and does to a greater or less extent undertake to satisfy. The ultimate obligation of the state thus is discharged by the private charity. To that extent the state is relieved of its burden.

Massachusetts General Hosptial v. Belmont, 233 Mass 190, 203, 124 N.E. 21, 23 (1919).

states that tax exemption is a worthy expenditure[42] because the foregone revenue is compensated for by the public goods and services provided by the tax exempt organization.[43] The free-rider mentality that apparently underlies the imposition of PILOTs implicitly expresses a belief that recipients of tax exemption are not in fact contributing to the common good; instead, PILOTs suggest just the opposite. In some instances, PILOTs are motivated by a belief that the presence of a tax exempt entity actually causes, or at least contributes to, a municipality's inability to provide public goods and services to its citizens.[44] In the absence of a more nuanced explanation

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[42] Tax exemption is often viewed as an indirect payment made for the accomplishment of some governmentally approved outcome, such as education or assisting the poor. *See Stanley S. Surrey & Paul R. McDaniel,* TAX EXPENDITURES *220 (1985).*

[43] *Id.* While the lessening of government burden rationale is the most widely accepted theories, there are other theories that are likewise threatened by the lack of a fundamental policy rationale for PILOTS:

> First, the role played by nonprofit organizations is not only desirable but may very well be a prerequisite to the continuation of a democratic society. It is through such institutions that we harness the energies and finances of our private citizens to humane, experimental, creative, and controversial purposes... (Charity) is often a unique pathfinder in social welfare and the sciences to be followed only at a later date by governmental or profit-oriented resources. It affords our citizens the opportunity to participate in public service while maintaining private employment. It organizes parts of our society for social purposes through nongovernmental means where governmental action is inappropriate, would be inconsistent with our way of life or is not possible because the purpose is too controversial. It allows individuals to voluntarily tax themselves in time and money to advance the good of society according to their individual preferences. In an increasingly complex world, where the individual feels frustrated because of his apparent inability to influence the policies of government, charity affords a clear arena in which an individual can act and make his influence felt for the social good. It provides a unique and flexible form of social organization that counterbalances the vast power of government and the concentrated wealth of the private sector. Therefore, in regulating the conduct of the exempt sector and in its provisions for tax benefits, the purpose of government should be to maintain a maximum of freedom of action and the continued healthy growth and survival of this sector.

Lawrence M. Stone, Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy, 1968 U. So. Cal. Tax Inst. 27. In short, the demand for PILOTS contradicts the idea that nonprofits give more than they get from society.

[44] *See, e.g.,* Tom Louis Macaluso, *The Untaxables,* Rochester City Newspaper, Jan. 6, 2010 at ____ *available at* http://www.rochestercitynewspaper.com/news/articles/2010/01/The-untaxables/

for PILOTS, it might as well be concluded that most nonprofits do not provide public benefit commensurate with their government subsidy.[45]

There are, to this author's mind, at least four more satisfactory theoretical justifications for PILOTS than the simple implication that the charitable sector represents an uncompensated drain on government revenue. First, a PILOT may be viewed as the result of an alternative dispute resolution concerning the extent to which a particular charitable entity actually meets a state law requirement for property tax exemption. A municipal government may have legitimate concerns that a *particular* exempt entity is insufficiently charitable; that is, insufficiently supportive of the common good such that it does not deserve tax exemption. Instead of pressing that claim in court, the municipality might instead logically request that the particular entity make a payment to address the shortfall in its perceived public support.[46] The entity's agreement to make that payment should, under this conception, be viewed as an intermediate means of resolving a dispute as to whether the entity satisfies the requirements for tax

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(suggesting that the large concentration of tax exempt organizations in Rochester, New York inhibit the city's ability to provide municipal services).

[45] *See* Evelyn Brody, Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption, 23 IOWA J. CORP. L. 585 (1998). (discussing the conceptualization of tax exemption as a government subsidy).

[46] Prior to the enactment of IRC 4958, stakeholders realized that it was often extremely inefficient to revoke or deny federal income tax exemption to a nonprofit organization even if that organization operated, to an objectionable extent, for private rather than public interests. Revocation of tax exemption might lead to unwanted collateral consequences, such as job losses or the denial of needed public goods and services to needy people having no influence over the noncharitable activities engaged in by the nonprofit organization. *See* John F. Coverdale, *Preventing Insider Misappropriation of Not-For-Profit Health Care Provider Assets: A Federal Tax Law Prescription,* 73 WASH. L. REV. 1, 9-10 (1998) (noting that the only sanction for private inurement was revocation and that revocation often did more harm than good); Robert C. DeGaudenzi, *Tax-Exempt Public Charities: Increasing Accountability and Compliance, 36* CATH. LAW. 203, 209 and n. 36 (1995) (noting that revocation of tax exempt status was rarely imposed because it effectively punished innocent bystanders). IRC 4958, however, allows for the imposition of an "intermediate sanction" when a nonprofit is only insufficiently charitable, as opposed to entirely non-charitable. See Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 1311-1314, 110 Stat. 1452, 1475-81 (1996) (codified at I.R.C. 4958 and scattered sections of 26 U.S.C.). Likewise, a request for a PILOT may be motivated by a view that though an entity provides some degree of public goods and services, it is otherwise operating for a private non-charitable purpose. In other words, a PILOT may be conceptualized as an "intermediate sanction."

exemption. Instead of risking the chance that a court might rule against the entity, or that the municipality will ultimately bear the cost of a pyrrhic victory,[47] the entity and municipality may instead "settle" through the use of a PILOT.

A related theoretical explanation is that PILOTs represent a review of the initial decision to grant tax exemption. In most cases, the grant of tax exemption is made by a higher governmental authority, typically according to a state constitutional provision or statute.[48] While there is a dearth of empirical data, conventional wisdom suggests that there is very little oversight of either the initial grant of tax exemption[49] or the extent to which an entity adheres to the requirements for tax exemption after the initial grant.[50] If an application for tax exemption is substantially complete, the grant of tax exemption is essentially a *fait accompli*.[51] Under these circumstances, PILOTs could be conceptualized as a more rigorous evaluation of the extent to which an entity deserves tax exemption by the governing authority affected most by the

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[47] *See id.*

[48] Evelyn Brody, *Hocking the Halo: Implications of the Charities' Winning Briefs In Camps Newfound/Owatonna, Inc.*, 27 STETSON L. REV. 433, 436 n. 20 ("Exemption typically appears in a state constitution or statute, while the impact of lost revenue falls on the property-tax dependent municipality where the real estate is located").

[49] Since many states historically "piggy-backed" on the federal grant of tax exemption when it came to determining whether an entity qualified for state tax exemption, it was very easy to obtain tax exemption at the state level. Nina J. Crimm, *Why All is Not Quiet on the "Home Front" for Charitable Organizations,"* 29 N.M. L. REV. 1, 11 n. 62. ("Historically many states have permitted tax exemptions, whether for income, property or sales tax based on a non-profit organization obtaining a tax exemption by the IRS."). A recent study, for example, found that nearly 98% of all applications for federal tax exemption are approved. Rob Reich, Lacey Dorn, and Stefanie Sutton, ANYTHING GOES: APPROVAL OF NONPROFIT STATUS BY THE IRS at 8 (2009) *available at http://www.stanford.edu/~sdsachs/AnythingGoesPACS1109.pdf*. Indeed, it appears that 37 states still grant tax exemption merely upon a showing that an entity has been granted federal tax exemption. *Id.* at 6.

[50] Nina J. Crimm *supra* note ___ at 25-26 (describing the historical lack of state oversight of nonprofit organizations and some of the reasons therefore).

[51] *Id.* at 3. ("Oversight of the creation of nonprofit organizations, and the conferral of tax privileges that accompany nonprofit status, is weak, bordering on non-existent.")

exemption.[52] A third alternative would conceptualize PILOTs as something akin to a "shakedown." This conceptualization involves a municipality requesting payment from the tax exempt entity under threat of an economic boycott;[53] it necessarily carries negative, illegitimate implications which may or may not be justifiable given the other alternative theories underlying PILOTs. Finally, PILOTs may be viewed as an attempt by the requesting municipality to more fairly allocate the costs of tax exemption throughout the state under whose laws the entity has been granted tax exemption.[54] Each of these potential theories is addressed individually in Sections IV through VII below.

Ultimately, the article concludes that any one of these theories are preferable to the readily accepted notion that PILOTs represent a tax exempt entity's payment of its "fair share." As a practical matter explaining PILOTs as a function of one of the theories articulated here avoids the debate that nobody wants to have. That is, do tax exempt entities really lessen the burdens of government? If they do, then PILOTs are unjustifiable since tax exempt charities provide public benefit as compensation for tax exemption and therefore already pay their "fair

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[52] "Exemption typically appears in a state constitution or statute, while the impact of lost revenue falls on the property-tax dependent municipality where the real estate is located." Evelyn Brody *supra* note ____ at 436 n. 20.

[53] Several nonprofit hospitals in the Pittsburgh, Pennsylvania area alleged as much nearly 20 years ago:

> The heart of the complaint was the allegation that the defendant governmental units had attempted and were attempting to "coerce" or "force" tax-exempt member hospitals to make payments in lieu of taxes by "indicating that those (hospitals) which (did) not agree to such payments and/or agreements 'in lieu of taxes' (would) have their tax exempt status challenged, (would) be likely to run into difficulties in obtaining zoning approvals, and (would) not be offered the opportunity to provide services to the taxing authority." The complaint alleged that members had been harmed and were immediately threatened with harm as a result of the defendants' actions. The complaint also specified agreements reached between the defendants and various hospitals within their jurisdictions.

The Hospital Council of Western Pennsylvania v. City of Pittsburgh, County of Allegheny, City of Erie and City of Johnstown, 949 F.2d 83, 85 (3rd Cir. 1991).

[54] *See supra* note 51.

share." If tax exempt entities exacerbate rather than lessen the burdens of government then they should simply not be tax exempt. Even the most aggressive pursuers of PILOTs express a reluctance to force this debate.[55]

IV. PILOTs AS ALTERNATIVE DISPUTE MECHANISMS

As a general matter, opposing parties resort to alternative dispute resolution (ADR) when they perceive themselves as having a legitimate claim but also unacceptable risks and costs, or at least suboptimal risks and costs, associated with resort to traditional dispute resolution mechanisms. The unacceptable or suboptimal risks and costs may be purely financial; litigation may simply be too costly. The risks and costs may also relate to the strength of each party's claim or the desire to avoid collateral consequences that may arise from a public, winner-take-all outcome.[56] This is especially true with respect to disputes regarding whether an entity is entitled to property tax exemption. In situations involving PILOTs, the answers are typically

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[55] REPORT OF THE MAYOR'S SPECIAL COMMITTEE ON PAYMENTS-IN-LIEU-OF-TAXES (PILOTS) AND SERVICES-IN-LIEU-TAXES (SILOTS) at 2 *available* via Lexis (State Tax Today) at 94 STN 132-28. ("In recognition of the valuable contributions many nonprofit organizations make their importance to Philadelphia's economy, this document outlines a reasonable program through which nonprofits can return to the City a limited measure of what the City provides them in essential tax-supported services. This program calls for modest payments and services from nonprofits that amount to far less than what they would owe were they not privileged with tax-exempt status.")

[56] For a concise overview of the advantages attendant to alternative dispute resolution see Robert B. Moberly and Judith Kilpatrick, *Introduction: The Arkansas Law Review Symposium on Alternative Dispute Resolution,* 54 ARK. L. REV. 161, 166-68 (2001) (ADR can (1) preserve ongoing party relationships because it is more "congenial," (2) reduce the level of "nastiness and tension associated with the adversarial system, (3) provide a swifter resolution, (4) provide more effective management of disputes, by facilitating early and direct communication between the parties, (5) allow the parties to have more input and control over their disputes, (6) select the applicable norms, (7) provide more flexibility and "make the process more streamlined" (8) save money, (9) preserve confidentiality and reduce negative publicity.) *See also* Roger J. Patterson, *Dispute Resolution in a World of Alternatives,* 37 CATH. U.L. REV. 591 (1988) (describing the various forms of alternative dispute resolution and the considerations taken into account in choosing a particular form).

diametrically opposed – the entity is either exempt or not.[57] ADR, in whatever form, is particularly suitable for disputes regarding an organization's support of the common good since the underlying threatened sanction from more formal process is revocation, a sanction that would ultimately be disadvantageous for both parties.

As noted earlier, most municipalities seeking PILOTs focus their attention on tax exempt hospitals and institutions of higher learning.[58] This seems easily understandable because those institutions are stereotypically larger land owners than most other exempt entities, oftentimes portrayed as occupying an "oasis" of sorts within relatively blighted downtown or urban areas.[59]

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[57] At the federal level, there are "intermediate" outcomes. *See supra* note ___ (regarding the imposition of excise taxes when an entity violates a condition of income tax exemption under circumstances indicating that complete revocation would not be optimal for either party). *See also* I.R.C. 511 – 513 (2010) (regarding the imposition of the unrelated business income tax when a federally tax exempt organization engages in non-charitable activities). Under state law, too, a tax exempt entity may retain tax exemption as to a portion of its property, though lose its eligibility with respect to another parcel of property. In addition, a singular piece of property may be entitled to a percentage of the state authorized tax exemption based on the pro rated use of the property. See, e.g., The City of Chicago v. The Illinois Department of Revenue, 147 Ill. 2d 484, 590 N.E. 2d 478 (Ill. 1992) (building used and owned by city was entitled to tax exemption but underlying property owned by a private party was not); Cedars of Lebanon Hospital v. County of Los Angeles, 35 Cal. 2d 279, 221 P.2d 31 (Cal. 1950) (hospital property used to house essential personnel and to conduct nurses training were entitled to tax exemption; properties used for a tennis court for hospital employees and a thrift shop were not entitled to exemption).
[58] *See supra* note ___ and accompanying text.
[59] Here, too, perception is more important than reality. It cannot be proven that colleges and universities comprise idyllic oases in the midst of urban blight. The University of Chicago, Yale, and Harvard University may well support the picture, as do some authors:

> There has been a disturbing push over the past quarter century to argue that the professed high purpose of eleemosynary institutions exempt them from the common burdens of corporate social responsibility – from paying their fair share of taxes in the communities in which they are located, from tort liability, and so on. This had led to the kind of ethical grotesqueries in which cities like New Haven provide major subsidies to world-class medical complexes like Yale-New Haven Hospitals – but have the infant mortality rates of Third World countries – and in which Yale's status as a world-class cultural institution is subvented by a city which, until recently, had to virtually close down its public library.

Janne G. Gallagher, *When Local Governments Come Calling: The Movement to Tax Charities,* 18 EXEMPT ORG. TAX REV. 25, 31 (1997). *See also Id.* at 31 ("Crumbling core cities, high rates of crime and unemployment, and the other problems that accompany poverty create substantial difficulties for all nonprofit institutions."). While it may be true that many beautiful college and

Indeed, it is their size, location, land-ownership and resulting community impact that lends credibility to their "halo" based protestations and resistance to PILOTs. The leverage exercised by municipalities, though, is based on the difference of opinion between state and federal officials as to the meaning of "charity." Under federal law, which even today serves as the basis for most state law conceptions of charity,[60] there is no explicit requirement that charity include service to the poor, or even the provision of goods and services at less than market rates.[61] State and local policy makers, perhaps because they are more directly impacted by growing demands for social welfare, more frequently conceive of charity as necessarily addressing poverty and the extension of public goods – such as education – to those who cannot afford market rates. The largest expenditures by state and local governments are for health and education; it stands only to

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university campuses are situated in the midst of blight and urban neglect, one suspects that many others spawn re-gentrification and urban renewal. The point is that the debate regarding the extent to which tax exempt colleges and universities should rather pay taxes is often confused by unsupported hyperbole.

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61 "Relief of the poor" constitutes one of many charitable purposes under federal law. Treas. Reg. §1.501(c)(3)-1(d)(2) (1990). In 1969, however, the IRS ruled that hospitals could obtain tax exemption even in the absence of a commitment to serve patients who could not afford to pay for medical care. Rev. Rul. 69-545, 1969-2 C.B. 117. *See also* John D. Colombo, *The Failure of Community Benefit,* 15 HEALTH MATRIX 29 (2005) (describing the history of the requirement to serve the poor as a condition of tax exemption for hospitals). Prior to Revenue Ruling 69-545, federal law required tax exempt hospitals to be "Operated to the extent of its financial ability for those not able to pay for the services rendered." Rev. Rul. 56-185, 1956-1 C.B. 202, 203. Revenue Ruling 69-545 survived a subsequent judicial challenge based almost entirely on the basis that the ruling eliminated the necessity for service to the poor as a condition of tax exemption for hospitals. Eastern Kentucky Welfare Rights Organization v. Simon, 506 F.2d 1278 (D.C. Cir. 1974). Professor Colombo believes that the IRS almost immediately began to disavow Revenue Ruling 69-545 in a series of cases involved nonprofit health maintenance organizations. John D. Colombo *infra* at 32-37. In 1983, however, the IRS seemed to confirm that assistance to the poor was not an absolute requirement. *See* Rev. Rul. 83-157, 1983-2 C.B. 94 (relying on Revenue Ruling 69-545 to conclude that a specialty medical clinic that did not provide free medical care or operate an emergency room open to all comers regardless of ability to pay nevertheless qualified for income tax exemption). The uncertainty regarding the extent to which service to the poor is a necessary component of charitable tax exemption is thoroughly discussed in Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law,* 73 FORDHAM L. REV. 2437 (2005). Educational institutions, unlike hospitals and other health care providers, have more explicit statutory authority for tax exemption without regard to their service to the poor. IRC 501(c)(3) (2010) (providing federal tax exemption for entities organized for "educational purposes" without mentioning relief of the poor).

reason, then, that lessening the burden of government sufficient to obtain tax exemption ought necessarily to include helping local governments pay those expenses that cannot be paid by direct consumers within their jurisdictions.[62] Tax exempt hospitals and institutions of higher education that demonstrate no concerted effort in this regard should therefore clearly expect to be cast in the role of free rider and to thereafter receive a veiled demand for tribute.

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[62] "While the practice of courts has often deviated from the strict logic of the "burden" theory, the general pattern is that "burden" jurisdictions generally require some degree of almsgiving or unpaid services for the granting of a charitable tax exemption." Utah County v. Intermountain Health Care, Inc., 709 P2d 265, 279 (1985). To lessen the burden of state and local government, one must first identify and define that burden:

> The Medicare and Medicaid programs, for example, allocate health care costs into three categories: Responsibility for many hospital and physician costs for the elderly and disabled is assigned to the federal government. The remainder of those costs, as well as other health care costs incurred by low-income elderly and disabled individuals and health care for low-income families with children, are assigned to a joint federal-state program. Costs associated with care for childless adults and other low-income individuals not qualifying for a federal-state cash assistance program are left to the states. The federal government also assumes primary responsibility for providing cash assistance to low-income elderly and disabled individuals, while leaving states with partial responsibility for low-income families with children and full responsibility for other indigent childless adults.

David A. Super, *Rethinking Fiscal Federalism,* 118 HARV. L. REV. 2544, 2565 (2005) (citations omitted). The Illinois Supreme Court stated the proposition in an even more unmistakable manner:

> Conditioning charitable status on whether an activity helps relieve the burdens on government is appropriate. After all, each tax dollar lost to a charitable exemption is one less dollar affected governmental bodies will have to meet their obligations directly. If a charitable institution wishes to avail itself of funds which would otherwise flow into a public treasury, it is only fitting that the institution provide some compensatory benefit in exchange. While Illinois law has never required that there be a direct, dollar-for-dollar correlation between the value of the tax exemption and the value of the goods or services provided by the charity, it is a *sine qua non* of charitable status that those seeking a charitable exemption be able to demonstrate that their activities will help alleviate some financial burden incurred by the affected taxing bodies in performing their governmental functions.

Provena Covenant Medical Center v. The Department of Revenue, No. 107328 (Ill. March 18, 2010), 2010 Ill. LEXIS 289.

Historically, at least, exempt hospitals and universities have had a rather strong basis to resist the demand, setting aside for the moment the reputational costs associated with doing so.[63] They were supported, for the most part, by federal law.[64] As noted earlier, federal law imposed no requirement that tax exempt entities explicitly provide service to those who represented the largest burden for local governments. Education, as a charitable endeavor, still remains so without regard to the extent to which it is made available to those who cannot afford ever rising tuition. The same might be true for health care, though there is a perceptible shift back to the days when charitable health care necessarily meant care for the poor.[65] Recent state judicial decisions have made it much more risky for nonprofit hospitals to insist upon state tax exemption even while avoiding, if not actively eschewing, service to the poor. In each of the most prominent of such cases, beginning with *Utah County v. Intermountain Health Care, Inc.,*[66] in Utah, continuing with *Hospital Utilization Project v. Commonwealth of Pennsylvania*[67] in Pennsylvania and expounded upon most recently in *Provena Covenant Medical Center v. Department of Revenue in Illinois,*[68] the common factor leading to the denial or revocation of state tax exemption has been the claimant's failure to demonstrate a sufficient commitment to

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[63] Typically, requests for PILOTs are preceded by a media campaign during which local officials bemoan the growing presence of charities who horde wealth, occupy large swaths of prime real estate, consume fire and police protection yet contribute nothing to the public fisc. *See, e.g.,* _____

[64] *See supra* note ____.

[65] *See* Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law,* 73 FORDHAM L. REV. 2437, 2490 (2005)("Let us create a new subcategory of charitable organizations – call them vulgar charities – whose missions and resources are devoted exclusively to serving the poor . . . health care organizations and educational institutions that serve the general public and do not focus on the poor will not qualify.")

[66] 709 P.2d 265 (Utah 1985).

[67] 507 Pa. 1, 487 A.2d 1306 (Penn. 1985)

[68] Provena Covenant Medical Center v. The Department of Revenue, No. 107328 (Ill. March 18, 2010), ____ N.E. 2d ____, 2010 Ill. LEXIS 289

provide service to those who could not afford to pay.[69] Hence, the historically strong basis upon which nonprofit hospitals relied in opposition to PILOTs or any other infringement upon their tax exemption is waning, at best, and nearly dissipated at worst.[70]

Institutions of higher education, too, have reasons to be concerned about their property tax exemption. Like hospitals, their concern originates from the growing popular belief that colleges and universities are large wealthy landowners whose services are increasingly inaccessible to even the middle class, nevermind the poor. Nothing calls charitable tax exemption into greater question than that the entity granted that status is both well-endowed and accessible only to those of more than modest wealth.[71] What might ultimately be a caricature is nevertheless perpetuated to some degree by empirical data, prominent opinion makers, and scholars.[72] A recent Government Accountability Office report, for example, concludes that even

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[69] *See* John D. Colombo, *The Failure of Community Benefit* 15 HEALTH MATRIX 29, 37-41 (2005) (regarding the trend amongst states to insist upon demonstrable "charity care" as a condition for property tax exemption). For a more comprehensive review of state cases demonstrating the same trend see Kelllen McClendon, *What the National Health Care Debate Tells Us About Whether Hospitals are Entitled to Exemption from Real Estate Taxes,* 6 WIDENER J. PUB. L. 41 (1996).

[70] There is, indeed, enough concern regarding the extent to which federally tax exempt hospitals provide free or below cost ("charity care") that the recent health care reform act mandates that those hospitals implement specific plans designed to ensure the provision of charity care. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, §9007 ___ Stat. ___ (2010) (codified at IRC 501(r)).

[71] *See, e.g.,* Tamar Lewin, *College Presidents Defend Rising Tuition, but Lawmakers Sound Skeptical,* N.Y. TIMES, Sept. 9, 2008 at A18. (describing rising tuition at colleges and universities around the country, and the perception that colleges do not spend enough of their endowments for financial aid.)

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> Colleges and universities are sitting on a fortune in tax-free funds, and sharing almost none of it. Higher education endowment assets alone total over $340 billion. Sixty-two institutions boast endowments over $1 billion. Harvard and Yale top the list with endowments so massive, $28 billion and $18 billion respectively, that they exceed the general operating funds for the states in which they reside. It's not just elite private institutions that do this; four public universities have endowments that rank among the nation's top 10. The University of Texas' $13 billion endowment is the fourth largest nationwide, vastly overshadowing most of the Ivy League. . . Paradoxically, it is precisely the meager financial aid outlays of endowment-rich colleges and universities that make the true miserliness of low payout practices most apparent. Stanford University spends $76 million on

as college and university endowments have suffered losses recently, they still total more than $400 billion, a 400% increase since 1989.[73] The perception, at least in some quarters, is that college and universities horde large tax exempt piles of wealth while tuition costs continue to rise, precluding attendance by "minority and low income individuals."[74] At least since 2009, though, the empirical data do not entirely support those perceptions. The colleges and universities with the largest endowments, by value and per FTE students, use between 11 and 68 percent of their yearly endowment distributions (ranging from 3 and 5% of endowment value)[75] for student financial aid.[76] Still, perceptions are as valuable or damaging, as the case may be, as reality with respect to a hospital or university's decision to make a PILOT. Thus, even those

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> undergraduate financial aid, a sum that sounds generous but amounts to a mere 0.5 percent of the value of its endowment. The university spends just 4 percent of its $14 billion endowment toward operating expenses. If the 5 percent payout rule required Stanford to spend another 1 percent of its endowment, and that money was directed toward financial aid, students would enjoy $211 million in additional support. That is precisely the cost of letting all 6,600 Stanford undergraduates attend tuition-free.

Lynn Munson, *Robbing the Rich to Give to the Richest,* INSIDE HIGHER ED, July 26, 2007 at ____ *available at* http://www.insidehighered.com/views/2007/07/26/munson. *See also* Posting of John D. Colombo Pittsburgh Mayor Reaches Deal with Nonprofits to Nonprofit Law Professors Blog http://lawprofessors.typepad.com/nonprofit/2009/12/pittsburgh-mayor-reaches-deal-with-nonprofits.html (December 30, 2009) (noting that tuition at tax exempt Carnegie Mellon University "runs over $53,000 per year and questioning whether Carnegie Mellon University should, because of that fact and others, retain its tax exempt status).

[73] U.S. Gen. Accountability Office, *Postsecondary Education: College and University Endowments Have Shown Long-Term Growth, While Size. Restrictions, and Distributions Vary,* at 1, GAO-10-393 (Feb. 2010).

[74] "In congressional hearings and academic literature, some have argued that some college and university endowments have grown very large without a concurrent increase in the use of endowment proceeds to reduce the cost of attending those schools. . . many are concerned that increases in the cost of college may be discouraging large numbers of individuals, particularly minority and low income individuals from pursuing higher education." *Id.*

[75] *Compare* IRC 4942 (2010) (generally requiring private foundations to distribute only 5% of the investment returns on their stored wealth for charitable purposes).

[76] U.S. Gen. Accountability Office, *Postsecondary Education: College and University Endowments Have Shown Long-Term Growth, While Size. Restrictions, and Distributions Vary,* at 26-72 GAO-10-393 (Feb. 2010) (describing endowment values, distribution rates and percentage used for financial aid for Berea College, Harvard University, Howard University, Smith College, St. Mary's University, Stanford University, University of Colorado, University of Kentucky, University of Texas System, and the University of Virginia).

universities with generous financial aid policies must assume a certain amount of vulnerability with respect to their tax exempt status.

PILOTs are appropriate, then, to resolve legitimate disputes regarding property tax exemption where neither side is clearly right and both sides have something to lose regardless of the outcome. As the foregoing discussion shows, exempt hospitals and higher education institutions are not "bullet proof" with regard to their exempt status. As the law moves closer to a conception of charity as that which necessarily benefits the poor, those institutions have lesser claims to tax exemption. Neither can be certain that litigation would only confirm their exempt status and both have a certain amount of public relations problems concerning the extent to which they engage in historically quintessential charitable activities – i.e., relief of poverty. On the other hand, both institutions undoubtedly generate significant financial benefits for the municipalities in which they are situated. Universities, in particular, serve as net importers of consumers. Beyond serving as medium or large employers, universities serve as magnets to the jurisdiction for academic, art, and athletic events, all of which generate financial and reputational benefits for the municipality in which they sit. Nonprofit hospitals, particularly those with a large research component generate similar benefits, though perhaps to a lesser degree than universities. Obviously, then, there are advantages that could be lost regardless of which side prevailed in a full scale, formal dispute regarding property tax exemption.

Under the foregoing conception, PILOTs allow for the proverbial win-win outcome and do not necessarily undermine the entire concept of tax exemption. Instead, they represent an intermediate remedy, of sorts, that allows an allegedly insufficiently charitable entity to compensate for its shortcomings, whether real or perceived. Thus, PILOTs need not be viewed as a concession to the popular notion that exempt entities represent free-riders and that tax

exemption is an outdated, bankrupt concept. PILOTs can, instead, be viewed as a means by which an otherwise charitable entity is allowed to achieve the minimal level of public good some officials believe is necessary to justify tax exemption.

Where this conception of PILOTs fails, as it relates to the question whether states should exempt *any* entity from property taxation, is in its application to tax exempt entities that adhere closely to the historical and reemerging conception of charity, or simply present the municipality with no legitimate reason to question tax exemption. Anecdotal evidence, particularly from Philadelphia, Pennsylvania suggests that when municipal revenues are especially strained, local officials make requests for PILOTs from all exempt entities within their jurisdiction, not just those about whom there is reason to question tax exemption.[77] If there is a thought process seriously questioning the appropriateness of tax exemption, as opposed to a view that exemption is a mere luxury, it occurs only when recipients inquire about the reasons for the PILOT request.[78] Only then do local governments officials make individualized distinctions as to the

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[77] In Philadelphia, city officials sent out 300 requests for PILOTs in 1994 but only 45 recipients ultimately made any payments. Pamela J. Leland, *Property Tax Exemption and Municipal Revenue: Philadelphia's Efforts to Solicit Payments in Lieu of Taxes from Charitable Organizations,* 1 THE INT'L J. NOT-FOR-PROFIT L. (JUNE 1999) http://www.icnl.org/KNOWLEDGE/ijnl/vol1iss4/art_1.htm.

[78] "Representatives from the City (of Philadelphia) strongly assert that every organization was individually examined and that only those organizations which appeared to meet Pennsylvania's definition of a charity were granted "home-free" status." *Id.* The inner workings of Philadelphia's PILOT program is described in fascinating detail by two practitioners. The description also serves as anecdotal evidence that PILOTS serve to resolve questions regarding an entity's entitlement to tax exemption:

> In reality, requiring a hearing for each charitable organization would not have been logistically feasible in Philadelphia (and probably, was not in Erie either, because we concluded that many small fish were returned to the stream). The large number of property owners who would have needed hearings would have occupied the Board calendar for years and, likely, the courts for beyond that. . . After the initial stages of the PILOT and SILOT programs, the government began notifying charitable organizations of "voluntary" contributions "requested" by the City . . .
> It turned out that the Board's plan in sending the PILOT mailings was to generate inquiries from the recipients, and to selectively suggest to some that they might

amount of effort they will expend pursuing a PILOT from any particular exempt entity. Even so, this suggests that officials implicitly evaluate the extent to which a particular entity deserves tax exemption at some point and more often than not conclude that exemption is in fact deserved and, even more specifically, that PILOTs are inappropriate or unnecessary.[79] This conclusion is no less probable merely because some exempt entities that would not have been pursued had they questioned the request simply make a PILOT that is accepted without further adieu.[80]

V. PILOTs AS A GATEKEEPING TOOL

Recall that the purpose of the present inquiry is to identify a more acceptable and plausible explanation for PILOTs than the uncomfortably reflexive assumption that exempt organizations are largely and correctly characterized as "free-riders."[81] If, indeed, that is the

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> safely ignore the notice and to others that they make an appointment to visit City Hall and find out what the City really wanted from them. The City was eager to meet with any institution which owned any substantial property. . . The City considered the PILOT program a way to settle tax issues concerning nonprofit organizations in a benign fashion. Also in light of the fact that the City's tax records were often inaccurate, it provided a way to resolve things without embarrassing itself. The City government believed this program would bring money in much faster, especially because the City did not have the necessary records or staff to discern which organizations were the real abusers and which were really exempt, even after several years of investigation.

George S. Forde, Jr. & Christopher E. Cummings *supra* note ____ at 145-46

[79] *Id.*

[80] *Id.* (noting that some recipient of PILOT requests simply paid the suggested "contribution" without ever questioning the underlying reasons for having received the request).

[81] That the issue is both old and yet recurring was recently demonstrated by a National Public Radio Broadcast wherein the "free-rider" implication was raised yet again:

> State and local governments, eager to close their budget gaps, are increasingly going after charities and other tax-exempt groups. Government officials are proposing new fees on nonprofits to help pay for services. They're also challenging the exemptions these groups get from sales and property taxes. In Concord, Mass., for example, the Board of Selectmen sent a letter to the town's nonprofits earlier this year. It said that local property taxes were so high they were

justification for PILOTs – or even if it is one of many justifications – there is very little in the way of explicitly repealing all tax exemptions as luxuries that cannot be afforded during difficult financial times. Section IV identified the first of four alternative justifications for PILOTs, each of which are preferable not only because they are grounded in more than mere stereotype but because they do not lend support to the notion that charitable tax exemptions should be categorically repealed. Intellectual honesty would force this conclusion if the free-rider justification is accepted without protest or challenge.

The first alternative theory is based primarily on the notion that certain individual charities operate in a manner that cause local taxing authorities to question their entitlement to tax exemption.[82] The discussion of that theory acknowledged, though, that local authorities typically make PILOT request on a wholesale basis,[83] thereby lending credence to the popular conception that PILOT requests are motivated less by individual behaviors than by characteristics common, or perceived as such, to the entire civil society. A rejoinder is that local authorities make wholesale PILOT requests not as an indictment of the entire sector but simply as an expedient alternative to culling through the records of each charity within their jurisdiction. Instead of weeding out deserving nonprofits themselves, local authorities allow deserving charities to self-select and present their case individually.[84] That this process appears to result in

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> driving residents away. The board asked the town's private schools, hospitals, charities and churches if they could start paying their fair share.

Amid Red Inc, Tax-Exempts Asked to Add to Coffers (NPR radio broadcast May 24, 2010) *available at* http://www.npr.org/templates/story/story.php?storyId=127092795 (last visited May 25, 2010).

[82] *See* Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption,* 23 IOWA J. CORP. L. 585, 600-01 (noting that property tax exemption challenges occur more often when organizations act in a more commercial manner and provide fewer benefits to poor people).

[83] George S. Forde, Jr. & Christopher E. Cummings *supra* note ___ at 144-47.

[84] *Id.* at 145 ("It turned out that the Board's plan in sending the PILOT mailings was to generate inquiries from the recipients, and to selectively suggest to some that they might safely ignore the

the vast majority of charities not making PILOTs supports the speculation that PILOT requests are not mass indictments.

Even if the foregoing possibility was incorrect, we might explain local authorities' actions in another manner preferable to the free rider explanation. Local authorities may simply be filling a gate-keeping function that is otherwise unattended. It is accepted that obtaining tax exemption is largely a matter of completing rather routine paperwork;[85] it is also well accepted that state attorneys general often devote little time or resources to policing charitable property tax exemptions once those exemptions are granted.[86] From a state-wide perspective, the harm from the unchecked granting of tax exemption is hardly noticeable[87] and certainly overshadowed by other wrongs to which state-wide enforcement budgets must be directed. The harm, if any, is sufficient to cause the diversion of resources only at the local level.[88] Thus, it should be expected that local authorities would most likely assume the gate-keeping function. In the

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notice and to others that they make an appointment to visit City Hall and find out what the City really wanted from them.")

[85] *Supra* note ___ (regarding the grant of federal tax exemption and the impact of federal tax exemption on state tax exemption); Henry J. Aaron WHO PAYS THE PROPERTY TAX: A NEW VIEW, 82-85 (1975) (regarding the ease with which property tax exemptions are granted and, having once been granted, "continue automatically or with only cursory review in most jurisdictions.").

[86] *Id.* "The attorney general's responsibility for being the guardian for the welfare of charitable organizations and their intended beneficiaries has been poorly executed over the years. This may be attributable to personnel constraints, the stress of more important duties, the lack of full information about nonprofit organizations within his or her jurisdiction, political pressures that attach to the position as a political officer and the infrequency of public complaints about particular nonprofit organizations. " Nina J. Crimm, *Why All Is Not Quiet on the "Home Front" for Charitable Organizations,* 29 N.M. L. REV. 1, 24-25 (1999). The author notes that the lax enforcement trend is likely changing as result of the business operations of nonprofit hospitals in particular. *See id.*

[87] "Furthermore, exemptions, usually initiated at the state level, reduce revenues of localities, thereby enabling one level of government -- the state -- to reap the political gains from responding to pleas for relief, while another -- the locality -- pays the cost. In general, the system by which exemptions are granted and extended in most states seems almost deliberately designed to promote irresponsible legislative behavior." Henry J. Aaron, WHO PAYS THE PROPERTY TAX: A NEW VIEW, 84 (1975).

[88] "Because property tax units are local (either municipal, county, or special districts, such as school districts), the burden of exemption is distributed unevenly throughout the state."

manner described above, where local authorities send PILOT request on a wholesale basis,[89] PILOTs can be conceived of as a re-examination of each charity's initial entitlement to tax exemption. One would expect such a closer examination to be undertaken during the initial application process. Failing that, it makes sense that the jurisdiction whose tax revenues decrease as a result of the exemption would have incentive to perform the task.

The very real implication to be avoided is that charitable organizations do more harm than good and therefore should neither be subsidized nor even encouraged; they should instead be made to pay for the harm they cause. The gate-keeping explanation allows us to avoid that implication by instead recognizing that states do not adequately monitor those who are allowed exemption. One might think, of course, that monitoring is unnecessary because the prohibition against the distribution of profits serves to discourage many who would otherwise take advantage of the lack of monitoring from obtaining tax exemption.[90] Recent law changes, particularly at the federal level, undercut the strength of this assumption.[91] Nonprofit service providers can actually do quite well financially using the nonprofit form, notwithstanding the legal prohibition against distributing profits.[92] The public's recognition of that fact helps fuel the

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[89] *See supra* note ___ and accompanying text.

[90] Federal law prohibits charitable fiduciaries from operating tax exempt entities for private profit. I.R.C. 501(c)(3) (2010); IRC 4958 (2010). Likewise, most states prohibit tax exempt entities from operating for private profit. *See, e.g.,* Hospital Utilization Project v. Commonwealth of Pennsylvania, 487 A.2d 1306, 1317 (Pa. 1985) (regarding the requirement that state charitable entities operate "entirely free from private profit motive").

[91] Nonprofit organizations are permitted, under federal law, to pay salaries that are commensurate with salaries paid by for-profit entities. *See* Treas. Reg. 53.4958-4(b)(1) (2002) (stating, in essence, that reasonable compensation is based on comparing the nonprofit's prevailing rates of compensation offered by similarly situated entities, whether taxable or tax exempt.

[92] This is especially true for exempt hospitals and colleges and universities where executive compensation is essentially indistinguishable for executive compensation paid by taxable hospitals and professional sports organizations. *See* Internal Revenue Service, *Exempt Organizations Hospital Compliance Project Final Report* at 51-76 (2009) *available at* http://www.irs.gov/pub/irs-tege/frepthospproj.pdf. (regarding compensation paid to nonprofit hospital officers); Internal Revenue Service, *Exempt Organizations Colleges and Universities*

suspicion that some nonprofits are charitable in name only and therefore rightly ought to make PILOTs.[93] In any event, the prohibition against profit-taking by nonprofit fiduciaries does not generate a sufficient gate-keeping affect; it does not prevent fiduciaries from obtaining the same financial benefits those with ownership powers in for-profit entities can obtain. Hence, there is both motive and opportunity to conceive of PILOTs not as confirmation that civil society is comprised of free-riders but instead as a means by which local authorities exercise a gate-keeping function otherwise left unattended.

VI. PILOTs AS A BURDEN ALLOCATING DEVICE

A third conception of PILOTs is as a device by which local governments can more fairly allocate the cost of tax exemption. A parable, of sorts, penned by one court provides excellent context for this discussion:

Compliance Project Interim Report, 51-67 (2010) *available at* http://www.irs.gov/pub/irs-tege/cucp_interimrpt_052010.pdf. (regarding compensation paid to highest earning college and university employees)

[93] *See, e.g.,* Press Release, Grassley: Private College Salaries Soar as Tuition Goes Up (Nov. 2, 2009) *available at* http://finance.senate.gov/newsroom/ranking/release/?id=8e69a8a4-7e4a-422f-9739-29e80a2be490.

> Sen. Chuck Grassley today expressed concern that private college presidents' salaries continue to go up even as tuition increases for students, according to a new survey from The Chronicle on Higher Education. Grassley keeps an eye on tax-exempt organizations such as colleges to ensure adherence to their charitable mission in keeping with their special tax-exempt status.
> "The executive suite shouldn't be insulated from belt-tightening," Grassley said. "The pressure on students and families gets greater all the time. The fact that these salaries are growing right now is out of sync with the reality for most parents and students who are trying to pay for college in the midst of high unemployment and after savings for education were either wiped out or greatly diminished last year due to the stock market falling."

Id.

> Every adult person in the Commonwealth carries on his back an invisible sack into which the government periodically drops an ever-increasing burden of taxes. If any person somehow manages to keep his sack closed and empty and the tax-man passes him by, this does not mean that the tax which the escaping person does not pay is lost to the government. The tax-man places the weight of that uncollected tax into other sacks so that the other persons in that given area or classification are required to carry heavier loads than otherwise would be theirs. For that reason, if for no other reason, every citizen is interested in seeing to it that there is not lifted to his shoulders a millstone which belongs to someone else.[94]

The simple moral of the parable is that tax exemptions are not free; other taxpayers pay for them. Thus, the parable puts concrete meaning to the notion that tax exemption, as an economic matter, represents a subsidy.[95] Tax exempt nonprofit entities consume roads, police, fire, and other municipal services largely paid for by property tax revenues.[96] Assuming, as we should, that the costs of those municipal services are fixed or constantly increasing, tax exemptions granted to one class of taxpayer necessarily increases the costs allocated to other taxpayers within the

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[94] University of Pittsburgh Tax Exemption Case, 180 A.2d 760, 764 (Mussmanno, J. dissenting) (Pa., 1962)

[95] The notion of tax exemption as "subsidy" is oft repeated but rarely explained. The quoted language in the text makes the notion immediately understandable with elegant simplicity. Typically, the subsidy theory is explained as "government" support of an activity that is insufficiently addressed through market or other political processes. What is often lost is a necessary definition often attributed to Theodore Roosevelt to the effect that "the *government is us;* we are the government, you and I." *See* Victor Kamber, *Discharging Our Civic Responsibilities,* CHRIS. SCI. MONITOR at 20 (Jan. 2, 1996). Thus, a government subsidy is essentially a passing of the hat to all taxpayers for the sake and benefit of a particular taxpayer who is exempt from contributing for one reason or anohter. For a thorough discussion of the subsidy and other theories as they relate to charitable tax exemption see David A. Brennen, *A Diversity Theory of Charitable Tax Exemption – Beyond Efficiency, Through Critical Race Theory, Toward Diversity,* 4 PITT. TAX REV. 1 (2006); EVELYN BRODY, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998).

[96] *See, e.g.,* Utah County by County Board of Equalization v. Intermountain Health Care Inc., 709 P.2d 265, 278 (Utah 1984) (noting that all hospitals "use tax-supported public services, including road construction and maintenance, police protection, fire protection, protection, water and sewer maintenance, and waste removal, to name a few. Exempt hospitals use those services at the expense of nonexempt health care providers and other taxpayers, commercial and individual."). Indeed, a few states have considered imposing user fees for certain municipal services James G. Gallagher, *When Local Governments Come Calling: The Move to Tax Charities,* 18 EXEMPT ORG. TAX REV. 25, 30 (1997). "Some governments appeal to charities' sense of fairness, arguing that since nonprofits benefit from taxpayer-funded services, such as fire and police protection, it is only just for them to pay a share of those costs." *Id.* at 28.

municipality.[97] This conclusion must be compared to the fact that property tax exemption is normally a state-wide matter based on the assumption that nonprofits are deemed beneficial to the entire state not just the locality in which they reside.[98] If this is true, then it is ultimately unfair that only the tax burdens of those within the jurisdiction hosting the nonprofit should be increased. If property tax exemption is granted at the state level because the benefits are state-wide, the tax burden should likewise be allocated on a state-wide basis.

A rejoinder to this assertion may be that the benefits generated by nonprofits inure disproportionately to the host jurisdiction. If the rejoinder is true, local authorities could be characterized as an attempting to obtain an undeserved windfall via PILOTs rather than just compensation. Whatever its rhetorical logic or appeal, neither position is capable of proof except on a case-by-case basis, if at all. Nor is it necessary that the debate be resolved. The initial assertion's inherent logic is sufficient to rebut the implication that the request for a PILOT is an accusation that nonprofits are free-riders; the agreement to make a PILOT need not be viewed as a concession to that accusation, much less the first step towards admitting that exemptions are

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[97] *Id. See also*

[98] On occasion, local officials have unsuccessfully sought to explicitly condition charitable property tax exemption on an entity's agreement to primarily serve residents of the local jurisdiction. *See* Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564 (1997) (holding unconstitutional a state property tax exemption that discriminated based on the extent to which the nonprofit entity provided services to in-satte residences rather than nonresidents.); Institute for Professional Practice, inc. v. Town of Berlin, 811 A.2d 1238 (Vt. 2002) (rejecting local official's argument that property tax exemption could constitutionally be conditioned on whether a nonprofit entity operates for the primary benefit of the citizens of the jurisdiction in which the nonprofit is located).

> Larger institutions naturally serve a wider population base than the jurisdiction where their physical plant is located. Linking exemption too strongly to a particular community would create inefficiencies, as services are restructured to follow the existing Balkanization of city and suburb. Focusing too heavily on local benefit denies society's interest in maintaining the broad public benefits that charitable organizations confer as they carry out the purposes for which they were created.

Janne G. Gallagher, *When Local Governments Come Calling: The Movement to Tax Charities,* 18 EXEMPT ORG. TAX REV. 25, 31 (1997).

unnecessary luxuries or worse. It is much more logical to assume that a PILOT is a tool by which a local government reallocates an unfair tax burden necessarily imposed upon it by the grant of tax exemption.

It is telling, in this regard, that the federal government and many states explicitly accept the notion that property tax exemption places a disproportionate burden on a particular host jurisdiction. The federal government[99] and many states[100] have formal programs whereby general revenues are used to compensate local governments for the revenue lost when state or federally owned or operated properties are exempt from local taxation. Government-funded PILOTs are demonstrably more efficient, though, than entity paid PILOTs in many respects. Government funded PILOTs theoretically allocate the costs generated by the exempt entity's consumption of fire, police and other municipal services more evenly to all taxpayers within the state.[101] In addition, they avoid the arbitrary nature of exempt entity funded PILOTs, whereby the largest and most conspicuous exempt entities essentially fund payments on behalf of the many other exempt entities that may go unnoticed within the local jurisdiction. Finally, reliance on government funded PILOTs would likely encourage government officials to consider the costs of each application for tax exemption and thereby encourage more meaningful review of applications for tax exemption.

Federal and state taxpayer funded PILOT programs expose a logical flaw in municipalities' efforts to obtain PILOTs directly from exempt entities. Logically, other

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[99] *See, e.g.*, Payment in Lieu of Taxes Act, 31 U.S.C. 6901 – 6907 (1982). "The Payment in Lieu of Taxes Act, 31 U.S.C. 6901 et seq., compensates local governments for the loss of tax revenues resulting from the tax-immune status of federal lands located in their jurisdictions, and for the cost of providing services related to these lands." Lawrence County v. Lead-Deadwood School District, 469 U.S. 256 (1985).

[100] *See, e.g.*, Ind. Code 36-3-2-10 (2010); Conn. Gen. Stat. §12-20a (2010); R.I. Gen. Laws. §45-13-5.1 (2010). The Indiana statute specifically refers to the reallocation of the "costs of providing governmental services" to property exempt from taxes. Ind. Code 36-3-2-10(a)(2) (2010).

[101] This conclusion holds true only where taxes, themselves, are imposed fairly.

taxpayers should help pay the cost of tax exemption, assuming the exemption inures to the entire state's benefit. Obtaining a PILOT directly from the exempt entity is inefficient "rough justice" at best. A PILOT derived from the exempt entity itself, rather than from a statewide, taxpayer funded program, hardly assures an even allocation of the expenses generated by the nonprofit's existence in a particular local jurisdiction. The burden of an entity funded PILOT falls most heavily, it would seem, on the beneficiaries directly served by the particular tax exempt organization. Nevertheless, PILOTs settle the question, at least theoretically, whether nonprofits disproportionately burden or benefit the host jurisdiction. The existence of a PILOT allows local authorities to assert that the extra burdens incurred by the local government exceed whatever benefits provided to the tax exempt entity, but is compensated for by a special charitable expenditure – a PILOT – exclusively for the host city or county jurisdiction. From the nonprofit's point of view, the making of a PILOT allows the nonprofit to rebut the free rider accusation so often implicit in statements made by local authorities.

Thus, the optimal use of PILOTs as a cost allocation mechanism would instead involve state funded PILOTS to local jurisdictions hosting nonprofits exempt under state law. The most workable solution would involve the government's calculation of each payment as a function of property tax revenue lost. Those city or county jurisdictions hosting the tax exempt entities owning or using the most real property would obviously make the highest payment. A PILOT made directly from the state would more likely ensure the cost of tax exemption is allocated across the state. Obtaining PILOTs directly from the exempt entity achieves that goal, if at all, only coincidentally.

VII. PILOTs AS EXTORTIONARY BEHAVIOR

The accusation that local authorities use extortion[102] to obtain PILOTs is an analog, of sorts, to the accusation that exempt nonprofits are undeserving free-riders who should be made to pay their fair share. Both assertions rely on caricature to achieve a desired end, either payment or avoidance of PILOTs. The free-rider sentiment is useful for local authorities because it so easily incites public wrath against tax exempt charitable organizations. The resulting public wrath helps pressure exempt organizations to make PILOTs. Charitable stakeholders view the tactic of inciting public wrath as evidence of extortion. Characterizing PILOTs as "extortion," allows charitable fiduciaries to assume the role of unappreciated, misunderstood victim. What precisely is meant by "extortion," is the denial of certain municipal or county benefits to an exempt entity solely on the basis of the entity's refusal to make a PILOT. The withheld benefits include municipal contracts, zoning approvals, building or special use permits, and general governmental courtesies otherwise extended as a matter of course. Unlike the free-rider characterization, though, there is more than mere caricature attendant to the accusation that local officials use extortion to obtain PILOTs.

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[102] In the few cases where PILOTs are actually challenged, the accusation that local officials are engaging in extortion seems inevitable. *See, e.g.,* Northwestern University v. City of Evanston, 2002 U.S. Dist. LEXIS 23402 ("Evanston takes issue with this Court's conclusion that there was some evidence that Alderman Drummer engaged in a plan of extortion when he allegedly made a proposal to Mr. Sunshine that conditioned exclusion of University property from the local district on the University's agreement to make contributions to the City.); Northwestern University v. City of Evanston, 2002 U.S. Dist. LEXIS 17104 ("Northwestern contends, though, that the City's institutional expansion arguments is mere pretext for its real motivation – the extortion of funds from the University."); The Hospital Council of Western Pennsylvania v. City of Pittsburgh, County of Allegheny, City of Erie and City of Johnstown, 949 F.2d 83, 85 (3rd Cir. 1991) ("The heart of the complaint was the allegation that the defendant government units had attempted and were attempting to coerce or force tax-exempt member hospitals to make payments in lieu of taxes by indicating that those hospitals which did not agree to such payments and/or agreements in lieu of taxes would have their tax exempt status challenged, would likely to run into difficulties in obtaining zoning approvals and would not be offered the opportunity to provide services to the taxing authority.").

Indeed, it is not hyperbole to label the process by which some local governments obtain PILOTs as "extortion." Some local officials candidly admit to, and just as candidly defend the government's right to harbor and act upon a certain degree of "animus" against exempt entities that refuse to make a PILOT. In those instances, local officials seem confident enough in the characterization of exempt entities as free-riders, that they make no effort to hide or disguise their attempted extortion. In Pittsburgh, for example, local officials even threatened to impose a tax on other, politically weak constituents in an effort to extract PILOTs from exempt entities. Nevertheless, as evidenced by the few written opinions addressing those tactics, local officials clearly run afoul of state and federal constitutional rights when they resort to extortion as a means of obtaining a PILOT.[103]

The unfortunate consequence of focusing on the outrage of government-sanctioned extortion, as with the characterization of charities as free riders, is that the entire exercise discourages the self reflection charitable stakeholders should undertake. Simply labeling a PILOT request, even one backed by veiled threats of retaliation, an attempted "extortion" precludes an exploration such as that undertaken in this article. The gist of the problem is that characterizing PILOTs as extortion conflates illegitimate means with arguably legitimate ends. The goals, in fact, are quite legitimate even if the free rider characterization and retaliatory threats are not. PILOTs are ultimately a vehicle by which local authorities (1) challenge a particular entity's entitlement to tax exemption based on particular organizational behaviors, (2) apply a minimally rigorous evaluation of each charity's entitlement to property tax exemption, or (3) allocate the cost of tax exemption fairly within the state jurisdiction benefited by the entity. Extortion for its own sake is certainly an illegitimate motivation for requesting a PILOT but the reasons why a misguided official might resort and even admit to extortion are legitimate. As a

[103] *See supra* note ___.

rhetorical tool, though, the label "extortion" obscures local authorities' real and legitimate objections, thereby deferring the day of reckoning that charities will ultimately face. Just as it is unfortunate and misguided for local authorities to label exempt charities "free-riders," it is unfortunate and misguided for exempt entities to label requests for PILOTs as extortion. In both instances, the opposing parties are talking past each other in a manner that will likely force resort to a more adversarial, winner-take-all process.

VIII. CONCLUSION

It is easy and even logical, in the absence of sober reflection, to view payments in lieu of taxes as a concession by all involved that tax exempt charities really do not increase social welfare. The demand for tribute from organizations traditionally considered beneficial enough that society exempts them from taxation necessarily calls into question the entire concept of tax exemption. This is especially true when demands increase during times of difficult economic times. The implication is that tax exemption is simply another luxury to be foregone when governments are forced to make do with less. Not only that, the demand for financial tribute suggests that tax exempt charities actually contribute to the necessity to make do with less. In this respect, PILOTs carry with them the implication that whatever good is achieved by tax exempt charities is invariably outweighed by the costs. Certainly, this notion seems implicit in the reflexive decision to essentially withdraw tax exemption whenever governments find it difficult to provide public goods and services. PILOTs necessarily imply that the public good achieved via tax exemption is of little enough consequence that decreasing charities' ability to provide those goods is ultimately beneficial.

Fortunately, though, PILOTs need not necessarily raise or even prove the foregoing implications. There are many factors involving the administration of tax exemption that legitimately explain PILOTs without undercutting the worthiness of tax exemption. We might still conclude that charitable tax exemption results in an aggregate gain to social welfare when properly administered. Overall, PILOTs should be viewed as a corrective tool that addresses rather gross and unfair imperfections in the administration of tax exemption. These include the insufficiency of the mechanism whereby tax exemption is granted, resulting in simply too many charities that do not actually meet to the requirement of serving the public good and thereby lessening the burdens of government. Thus, PILOTs serve as reinforcement of the initial screening process whereby organizations are granted tax exemption. Likewise, there is an insufficiency in the supervision of charities, resulting in the perception that too few charities actually act charitably after having been granted tax exemption. In this instance, PILOTs serve as an additional supervisory tool to ensure that revenue generating organizations continue acting in a manner that justifies tax exemption.

Even if PILOTs were viewed illegitimately, as disguised "extortion," for example, that characterization would be preferable to the perception of PILOTs as evidence that tax exempt charities are "free-riders." While both the extortion and free-rider claims are grounded in legitimate though ultimately incorrect perception fostered by local government officials and charitable organizations, respectively, they serve only to obscure the real issues. Both characterizations are unfortunate and unhelpful hyperbole. The ultimate issues raised by PILOTs have to do with the ever-evolving conception of "charity" and the extent to which society wishes to encourage and support whatever is meant by that term. After all else is said, PILOTs serve as

a reminder that government officials and charitable stakeholders need to engage in a more systematic assessment of the purposes of, and reasons for property tax exemption.