Challenge to Act 55 Fails — Tax Exempts Win Huge Case

On December 31st, the Pennsylvania Supreme Court gave tax-exempt service providers in Pennsylvania a huge reason to celebrate. The Court rebuffed a challenge to the constitutionality of Act 55 (now known as the Institution of Purely Public Charity Act or the Charity Act) which sets forth the basis for an entity’s entitlement to real estate tax exemption. In so doing, the Court clarified the “relieving-the-government-of-a-burden” test, holding that there is no requirement for private funding as a criteria for satisfying this test. This result is great news for so-called “pass-through” entities that do little fund-raising through the private sector, and rely almost entirely on payments from governmental agencies to fund operations (most notably, Medicare, Medicaid, Title XIX, or waiver programs). The Court’s decision eliminates the threat that failure to raise private funds places these entities at risk for a per se disqualification of their real estate tax exemption.

The case involves a community service entity known as Community Options. Community Options arranges for services and residential housing for mentally retarded adults. It is a “pass-through” entity, receiving most of its funds for operations from the state and very little from private donations. The case is interesting because it spans the years just before the enactment of the Charity Act (1996 and 1997) and the years immediately afterwards (1998 and forward).

The case was originally heard by Judge Wettick in Allegheny County, a respected judge who is well versed in local taxation and tax exemption cases (he was the trial court judge in the St. Margaret Seneca Place case). Because the Charity Act had not yet been enacted for tax years 1996 and 1997, Judge Wettick had to rely solely on the HUP criteria and the case law interpreting the HUP criteria for these two tax years. The controlling precedent for pass-through entities was the Commonwealth Court’s decision in Community Services Foundation (CSF). CSF was a pass-through human service agency similar to Community Options. CSF held that pass-through entities (like CSF or Community Options) could not satisfy the fourth prong of the HUP test unless they were able to demonstrate significant non-governmental support. If the government was paying the entire cost, Commonwealth Court concluded that the government was not relieved of any burden.
Because of CSF, the trial court had to rule that Community Options was not exempt for 1996 and 1997.

But for 1998 and thereafter, the trial court found that the enactment of the Charity Act changed the landscape. The Charity Act established a series of quantitative tests that Community Options satisfied. The trial court was still faced with the dilemma of reconciling the CSF case (which took a more restrictive view of the fourth HUP prong) against the Legislature’s interpretation of the fourth prong in the Charity Act. Judge Wettick found that legislative codification of the fourth HUP prong in the Charity Act was both proper and constitutional. He further found that Community Options met these tests and was entitled to exemption for years 1998 and following.

In a lengthy and well-reasoned decision, concluded that HUP and the Charity Act were consistent and that the Charity Act’s quantitative tests did not undercut or conflict with HUP or the previous Supreme Court interpretations of HUP. In other words, the Charity Act was not unconstitutional, even though in some instances an entity could qualify under the Act but not qualify under the pre-Act HUP cases.

The trial court’s decision prompted the question of how an entity could fail a constitutional test in one year, but be “saved” by a statute in the following year. In other words, could a statute pre-empt a constitutional test? This is an important question because the section of the Pennsylvania Constitution at issue only permits the Legislature to exempt entities if they are purely public charities, which means that the Legislature has no power to confer or create an exemption unless an entity qualifies as a purely public charity in the first instance. Observers have long wondered whether satisfying the quantitative tests set forth in the Charity Act would automatically satisfy the constitutional test (set forth in HUP) or whether it would also be necessary to independently satisfy both the constitution (HUP) and the statutory (the Charity Act) tests. Obviously, the Charity Act was designed to mimick the HUP criteria and establish quantitative and measurable criteria to the open-ended and vague HUP prongs. The preamble to the Charity Act indicates that it was not intended to create new or expansive exemption criteria.

The real issue underlying this appeal, of course, is whether the Charity Act is constitutional, i.e., do the Charity Act’s quantitative tests pre-empt or modify the Supreme Court’s HUP criteria or do they merely implement them?

Both parties appealed to the Commonwealth Court. The Commonwealth Court dodged the issue of whether the Charity Act conflicted with the HUP test and whether the Legislature had the authority to enact such a statute (in other words, was the Charity Act constitutional). Instead, the Court held that, because Community Options (like CSF) had failed the fourth prong of the HUP test before the Charity Act’s enactment, it failed it for 1998 as well. The Court viewed the HUP test as the first step of the analysis and if the charity could not pass that phase, it never had to reach the second or statutory phase. Consequently, it did not directly tackle the constitutionality of the Charity Act.
Community Options appealed to the Supreme Court for 1998 and subsequent years. It did not challenge its loss of exemptions in 1996 and 1997 (which, with the benefit of hindsight, is unfortunate because it would have won for those years as well).

The Supreme Court, by Justice Zappala, dismissed the Commonwealth Court’s interpretation of government burden. It held that the test is not whether an entity is fully funded by the government, but whether the institution “bears a substantial burden that would otherwise fall to the government.” Using language aimed directly at Commonwealth Court, the Supreme Court held that there is not now, nor has there ever been, a specific threshold level of private funding as a criteria for relieving the government of some of its burden. The Court identified numerous ways that an entity can relieve the government’s burden including, as examples, the compensation of its employees, its fee structure, and whether the cost to the government would be greater if the charity’s activities were conducted by the government itself.

The crux of the Court’s decision is its recognition of the reality of how nonprofits save the government time and money. Nonprofits, in health care, mental health, and education make it cheaper and easier for the government to operate. Similar to the “rent” or “buy” analysis in business, by relying on a myriad of voluntary nonprofits, the state is spared all the operational risks and expenses of conducting an enterprise itself. In effect, it is renting the service rather than duplicating it itself. By paying a “per diem,” the state’s only risk or concern is funding the per diem payment. It is the entity that faces all the problems and risks of finding and training employees, finding and maintaining facilities, finding and training a board, and maintaining operational solvency.

**THE CHARITY ACT IS PRESERVED.**

Importantly, the Court did not directly examine or rule upon the constitutionality of the Charity Act as the taxing jurisdiction would have liked. Unlike the exhaustive and scholarly analysis prepared by Judge Wettick, the Supreme Court did not directly address the constitutionality of the Charity Act. In one sense, the argument of whether an entity has to present evidence of satisfying both HUP and the Charity Act is still open. While the Court did not affirmatively address the relationship between HUP and the Charity Act, it made it clear that HUP would not, in this instance, be a bar to the application of the Charity Act.

By confirming its analysis of the fourth HUP prong, the Court endorsed a wider view of nonprofits’ eligibility and at the same time preserved the Charity Act. The former is important because it prescribes a more practical approach to satisfying the HUP test, and the latter is important because it preserves a statute that has created relative peace and stability in the previously contentious nonprofit versus tax jurisdiction world.

**WHAT DOES THIS MEAN?**

There are at least two reasons for nonprofits to be extremely happy with this decision.
1. While the Court did not rule on its constitutionality, the Charity Act was not compromised. If anything, challenges to the Charity Act are likely to diminish. The Court made it quite clear that it supports the HUP—Charity Act template.

2. The Court adopted a practical and holistic view of nonprofit “pass-through” community service organizations. These institutions and agencies play a vital and indispensable role in the delivery of health, education, and social services. Without voluntary agencies, the state simply could not provide the range, depth, and quality of human social services. By adopting the more enlightened and realistic view of voluntary agencies, the Court has (in lockstep with the Legislature) clarified the grounds for exemption. Even if the constitutionality of the Charity Act is subsequently challenged, the broader view of relieving the government of a burden remains intact.