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## Protecting the Texas Nonprofit Property Tax Exemption: The Unintended Absence of a Nonproducing Mineral Exemption and Its Consequences

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# PROTECTING THE TEXAS NONPROFIT PROPERTY TAX EXEMPTION: THE UNINTENDED ABSENCE OF A NONPRODUCING MINERAL EXEMPTION AND ITS CONSEQUENCES

*By Marie-Claire Hart<sup>†</sup>*

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## I. INTRODUCTION

A. *Budget Crisis and Great Recession*

In 2010, faced with a \$140 million shortfall, the City of Honolulu was desperate for revenue.<sup>1</sup> While homeowners and businesses throughout the city continued to watch their property tax bills rise every year—4% on average the previous year—nonprofit organizations' property tax bills remained stagnant for almost two decades.<sup>2</sup> Honolulu nonprofits only paid the city's \$100 minimum tax—a nominal amount.<sup>3</sup> Over 1,000 properties in the city that were valued at over \$3.1 billion received the property tax exemption.<sup>4</sup> The City Council faced a hard decision: ask other taxpayers to continue subsidizing city services for nonprofits by keeping the minimum tax intact or taking funds from the already cash-strapped budget of nonprofits.<sup>5</sup>

Honolulu was not alone in its examination of the value of property tax exemptions for nonprofit organizations. In Boston, the city formed a special committee to develop new ways to obtain more revenue from the numerous hospitals, universities, and other large nonprofits in the city limits.<sup>6</sup> In 2011, Boston sent letters to its largest nonprofits asking them to make payments to the city that would eventually be worth one-fourth of the property taxes they would pay if not for the nonprofit exemption.<sup>7</sup> The City of New Orleans lobbied the state legislature to tighten the rules for granting the property tax exemptions in the first place.<sup>8</sup> In October 2006, the City of Urbana, Illinois stripped a hospital of its property tax exemption because the hospital did not provide enough free care for the poor.<sup>9</sup> Pittsburg asked its nonprofits, which own 17% of taxable property in the city, to subsidize \$9 million in city services they receive each year.<sup>10</sup>

In response to the fiscal crunch following the Great Recession, municipalities sought different approaches to offset the impacts of non-

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1. Gordon Y.K. Pang, *Honolulu Council May Change Property Tax Break for Nonprofits*, HONOLULU ADVERTISER, Feb. 17, 2010, available at <http://the.honoluluadvertiser.com/article/2010/Feb/17/ln/hawaii2170353.html>.

2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*

6. Harvy Lipman, *The Value of a Tax Break*, THE CHRONICLE OF PHILANTHROPY, Nov. 23, 2006, available at <http://philanthropy.com/article/The-Value-of-a-Tax-Break/54882/>.

7. Michael Cooper, *Squeezed Cities Ask Nonprofits for More Money*, N.Y. TIMES, May 11, 2011, available at <http://www.nytimes.com/2011/05/12/us/12nonprofits.html>.

8. *Id.*

9. Lipman, *supra* note 6.

10. *Id.*

profit property tax exemptions.<sup>11</sup> Some municipalities have instituted fees and charges including: user fees for services like trash collection, water, and sewage; special assessments to pay for improvements that benefit specific properties; and municipal service fees that are mandatory payments not directly related to the rate of service consumption.<sup>12</sup> Other municipalities have looked to voluntary payment arrangements including payments in lieu of taxes (“PILOTS”) that are made in place of property taxes and services in lieu of taxes (“SILOTS”) where nonprofits offer services to residents in place of paying property taxes.<sup>13</sup>

The fiscal crisis has driven a reexamination of nonprofit property tax exemptions at the local level.<sup>14</sup> Every state in the union currently grants property tax exemption to nonprofit organizations on properties used for charitable purposes.<sup>15</sup> Some municipalities advocate for state payments to those municipalities that host tax-exempt organizations because nonprofit property tax exemptions create an unfunded mandate from the state, forcing municipalities to subsidize nonprofits.<sup>16</sup> Others argue that the policy decision to grant nonprofits property tax exemptions should be a local one because it ultimately affects government at the most local level.<sup>17</sup> Lastly, some states have added requirements that allow more narrow enforcement of nonprofit property tax exemptions.<sup>18</sup>

Contrary to the current trend in public policy for municipalities to try to derive revenue from nonprofits, governments historically subsidized nonprofits. In San Francisco, city officials have relied on nonprofits to provide an array of services for over forty years.<sup>19</sup> There, officials focus on finding more money *for* nonprofits so that the organizations can provide services rather than ways for the city to raise revenue *from* nonprofits.<sup>20</sup> The shift in fiscal conditions has placed constraints and challenges on this traditional approach.

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11. DAPHNE A. KENYON & ADAM H. LANGLEY, URBAN INSTITUTE, THE PROPERTY TAX EXEMPTION FOR NONPROFITS AND REVENUE IMPLICATIONS 5 (2011), <http://www.urban.org/UploadedPDF/412460-Property-Tax-Exemption-Nonprofits.pdf>.

12. *Id.*

13. *Id.* at 6–7.

14. *See generally* KENYON & LANGLEY, *supra* note 11.

15. *Id.* at 2.

16. *Id.* at 8 (state payments to municipalities that host nonprofit organizations are currently used by both Connecticut and Rhode Island for certain large-scale organizations).

17. *Id.* (Fairfax County, Virginia took advantage of the State’s option to decide on exemptions locally and decided to make future property purchases by nonprofits subject to property taxes.).

18. *Id.* at 9.

19. Lipman, *supra* note 6.

20. *Id.* (quoting Pamela H. David, executive director of the San Francisco-based Walter & Elise Haas Fund and former director of the Mayor’s Office of Community Development, “In San Francisco, the attitude is that we need to find more money to fund the nonprofit institutions so they can provide more services to the city.”).

### B. *Impacts of the Barnett Shale*

Throughout the State of Texas, the oil and gas industry has somewhat insulated municipalities from the budget crisis felt elsewhere in the nation both from the direct revenues and as an economic driver. The Barnett Shale, located in North Texas, has become a regional economic driver and a popular area of study both legally and otherwise. The Shale covers an estimated 5,000 square-miles and is believed to be the largest onshore natural gas reserve in the country.<sup>21</sup> Development of the Barnett Shale was credited with adding nearly 120,000 jobs and an economic output of \$13.7 billion in 2011.<sup>22</sup> It constitutes about 8.5% of all business in the North Texas Region.<sup>23</sup> Beyond its general economic impact, the boon from the Barnett Shale has softened the blow of the Great Recession on state and local budgets as compared to other parts of the country. Between 2001 and 2011, local taxing authorities collected \$5.3 billion in taxes from the Barnett Shale and the State collected another \$5.8 billion.<sup>24</sup> However, even with the windfall from the Barnett Shale, local and state budgets have not been immune to the budget crisis caused by the Great Recession.

Property tax revenues are especially important to local entities in Texas—particularly smaller residential communities and school districts that derive most of their revenue from property taxes. Taxing authorities in Texas collected over \$40 billion in property taxes in 2009.<sup>25</sup> Mineral interests account for about 5% of the total property tax base. The scope of nonproducing mineral interest is marginal—just \$7.6 million taxable value out of a total of \$2.15 trillion in total property value in the entire state.<sup>26</sup> Nonetheless, asking taxing authorities to give up an additional share of their precious tax base cannot be easily justified.

The scope of nonproducing mineral interests as part of total property taxes in the State of Texas may seem small, but it can have major implications for individual property-owning nonprofit organizations. The Texas Legislature has taken measures to relieve the burden of mineral interests on small property owners by granting exemptions on mineral interests worth less than \$500, but no other exemptions for mineral interests exists.<sup>27</sup> Tax appraisers have not historically assessed

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21. RAILROAD COMMISSION OF TEXAS, BARNETT SHALE INFORMATION, <http://www.rrc.state.tx.us/barnettshale/index.php> (last updated Aug. 22, 2013).

22. THE PERRYMAN GROUP, A DECADE OF DRILLING: THE IMPACT OF THE BARNETT SHALE ON BUSINESS ACTIVITY IN THE SURROUNDING REGION AND TEXAS 4 (2011), <http://www.fortworthchamber.com/am-site/media/barnett-shale-study.pdf>.

23. *Id.*

24. *Id.* at 4–5.

25. TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, ANNUAL PROPERTY TAX REPORT: TAX YEAR 2009 2 (2011) [hereinafter PROPERTY TAX REPORT 2009], <http://www.window.state.tx.us/taxinfo/proptax/annual09/96-318-09.pdf>.

26. *Id.* at 8.

27. TEX. TAX CODE ANN. § 11.146(a) (West 2011).

or taxed nonproducing mineral interests in the Barnett Shale for otherwise exempt properties owned by nonprofit organizations, which created a *de facto* charitable tax exemption.

The current property tax exemption for nonprofit organizations creates a potential unintended tax liability on organizations that own mineral interests, even when the mineral is undeveloped. When the current language of the Texas nonprofit property tax exemption passed in 1979, the Barnett Shale was unknown.<sup>28</sup> Since then new technologies have made the Shale developable, but as a result of either drilling restrictions or by choice of the owner not to drill, not all minerals in the Shale are developed. Nonetheless, tax assessors can still chose to assess and tax the interests. In the context of the budget crisis that puts pressure on officials to expand the tax base and the wealth of the Barnett Shale, taxing mineral interests may have appeal to tax assessors.

This Comment will address the current Texas property tax exemption for nonprofit organizations, its lack of exemption for nonproducing mineral interests, and the potential implications of the lack of such an exemption for nonprofit organizations with otherwise exempt land holdings. Taxation of nonproducing mineral interests held by nonprofits has very real policy implications. Should tax assessors choose to pursue this route, it creates serious liabilities on certain nonprofit organizations with large, nonproducing mineral interests under their otherwise tax-exempt property. This Comment proposes that the Texas Legislature create a narrowly tailored extension of the nonprofit organization property tax exemption for nonproducing mineral interests attached to otherwise exempt properties.

## II. BACKGROUND

### A. *Nonprofit Organizations in Context*

#### 1. Characteristics of Nonprofit Organizations

Coined *the voluntary sector*, *the third sector*, and *the independent sector* among other things, the nonprofit sector is unique from government and businesses/for-profits.<sup>29</sup> Nonprofits operate on a central organizational mission.<sup>30</sup> Nonprofits are unique in that: (1) they do not coerce participation; (2) they do not distribute profits; and (3) they lack clear ownership and accountability.<sup>31</sup>

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28. TEXAS RAILROAD COMMISSION, NEWARK, EAST (BARNETT SHALE) FIELD (Oct. 2, 2013, 9:27PM), <http://www.trc.state.tx.us/data/fielddata/barnettshale.pdf> (giving the discovery date of the Barnett Shale as October 15, 1981).

29. PETER FRUMKIN, ON BEING NONPROFIT: A CONCEPTUAL AND POLICY PRIMER 10 (2002).

30. JOHN ZIETLOW ET AL., FINANCIAL MANAGEMENT FOR NONPROFIT ORGANIZATIONS: POLICIES AND PROCEDURES 6–7 (2007).

31. FRUMKIN, *supra* note 29, at 3.

On its first unique characteristic, lack of coercive powers, the non-profit sector specifically differentiates itself from government.<sup>32</sup> Nonprofits lack the power to compel financial support, unlike government that has taxing powers. Instead they must depend on relationships and goodwill.<sup>33</sup> The lack of coercive powers situates nonprofits more closely to businesses in some respects; however, nonprofits lack the traditional market drivers for its services that make business a worthwhile venture.<sup>34</sup>

The second unique characteristic of the nonprofit sector is the nondistribution constraint.<sup>35</sup> The nondistribution constraint prohibits a nonprofit organization from distributing its net earnings to individuals who oversee the organization—including board members/trustees, directors, and staff.<sup>36</sup> The nondistribution constraint should not be confused with a bar on earning a profit or running a surplus—many nonprofits consistently do.<sup>37</sup> Rather, only the distribution of profits is prohibited.<sup>38</sup> Surpluses must be kept by the nonprofit organization and used entirely to provide services, directly or indirectly, as related to the organization's mission.<sup>39</sup>

As a final unique feature of nonprofits, there are no owners of nonprofit organizations.<sup>40</sup> Nonprofits management structure may take one of two governance forms: a self-perpetuating board or voting members. Nonprofits have a number of stakeholders—board members/trustees, managers, donors, beneficiaries, and even the general public—but none of these parties have an interest in the organization analogous to owners or shareholders of for-profit entities.<sup>41</sup> Self-perpetuating boards act more like a board of directors for a corporation and vote for their own replacements. In this structure, the board of

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32. *Id.*

33. *Id.*

34. *Id.* at 4.

35. See generally *id.*; Evelyn Brody, *The Legal Framework for Nonprofit Organizations*, in *THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK* 243, 246 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

36. Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 *Yale L. J.* 835, 838 (1980) (“By ‘net earnings’ I mean here pure profits—that is, earnings in excess of the amount needed to pay for services rendered to the organization; in general, a nonprofit is free to pay reasonable compensation to any person for labor or capital that he provides, whether or not that person exercises some control over the organization.” While the concept against profit distribution for nonprofit organizations has long been in place, Hansmann first coined the term “nondistribution constraint.”).

37. *Id.*

38. *Id.*

39. *Id.*

40. John Simon et al., *The Federal Tax Treatment of Charitable Organizations*, in *THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK* 267, 268 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

41. FRUMKIN, *supra* note 29, at 5.

directors serves as the final decision maker in the organization.<sup>42</sup> Voting memberships are generally used when an organization wants to be controlled by its constituents, and the constituents have a vested interest in the operation of the organization.<sup>43</sup> Nonprofit organizations enjoy the freedom of being accountable only to themselves, which grants them a unique flexibility not seen in the other sectors.

## 2. Size and Scope of the Nonprofit Sector

The nonprofit sector is a major force in the United States, accounting for one-tenth of the national economy.<sup>44</sup> Collectively, the nonprofit organizations in the country hold more than \$2 trillion in wealth.<sup>45</sup> The size and scope of the nonprofit sector in the United States is so large that if it “were a country, it would have the seventh largest economy in the world,”<sup>46</sup> or roughly the size of the entire California economy.<sup>47</sup> In 2010, an estimated one million organizations held IRS Code § 501(c)(3) designations accounting for two-thirds of all tax-exempt organizations in the United States.<sup>48</sup> Nonprofits often serve as major employers and provide services to residents of the host municipality and surrounding areas. However, their properties are also tax-exempt while still requiring public services at a cost to municipalities.<sup>49</sup>

In 2009, over 75,000 § 501(c)(3) organizations operated in Texas.<sup>50</sup> The nonprofit sector is Texas’s fifth largest sector, employing over 400,000 workers in 2008 (though much smaller as a total portion of Texas’s employment as compared to the national average).<sup>51</sup> The sector employed almost 70,000 more people than the entire state govern-

42. Ellis Carter, *Nonprofit Law Jargon Buster—Voting Members vs. Self-Perpetuating Boards*, CHARITY LAWYER (Apr. 26, 2011), <http://charitylawyerblog.com/2011/04/26/nonprofit-law-jargon-buster-voting-members-vs-self-perpetuating-boards>.

43. *Id.*

44. KENYON ET AL., *supra* note 11, at 2.

45. Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Oversight Board*, 19 CORNELL J. L. & PUB. POL’Y 1, 3 (2009).

46. JOHN M. BRIDGELAND ET AL., W.K. KELLOGG FOUNDATION, QUIET CRISIS: THE IMPACT OF THE ECONOMIC DOWNTURN ON THE NONPROFIT SECTOR 3 (2009), [http://www.dlc.org/documents/Quiet\\_Crisis.pdf](http://www.dlc.org/documents/Quiet_Crisis.pdf).

47. U.S. DEP’T OF COMMERCE BUREAU OF ECON. ANALYSIS, WIDESPREAD ECONOMIC GROWTH ACROSS STATES IN 2011 7 (2012) (the 2011 California economy is valued at over \$1.7 trillion, or 13% of the United States’ total \$13.1 trillion economy).

48. KATIE L. ROEGER ET AL., URBAN INSTITUTE, THE NONPROFIT SECTOR IN BRIEF: PUBLIC CHARITIES, GIVING, AND VOLUNTEERING, 1–2 (2011), <http://www.urban.org/UploadedPDF/412434-NonprofitAlmanacBrief2011.pdf>.

49. KENYON & LANGLEY, *supra* note 11, at 2.

50. NATIONAL CENTER FOR CHARITABLE STATISTICS, NUMBER OF NONPROFIT ORGANIZATIONS IN TEXAS, 1999–2009, <http://nccsdataweb.urban.org/PubApps/profile1.php?state=TX> (last visited Dec. 30, 2012).

51. LESTER M. SALAMON & STEPHANIE LESSANS GELLER, JOHNS HOPKINS NONPROFIT ECONOMIC DATA PROJECT, TEXAS NONPROFIT EMPLOYMENT UPDATE 1 (2010), [http://onestarfoundation.org/wp-content/themes/OneStar/documents/Texas\\_NP\\_Employment\\_Report-2008.pdf](http://onestarfoundation.org/wp-content/themes/OneStar/documents/Texas_NP_Employment_Report-2008.pdf).



ment.<sup>52</sup> The nonprofit sector is an important driver in the Texas economy, actually adding jobs during the Great Recession while for-profit employment shrank.<sup>53</sup>

By some estimates, property tax exemptions for nonprofits were valued at \$17 billion to \$32 billion dollars nationally, or 4% to 8% of all property taxes, in 2009.<sup>54</sup> In twenty-three of the nation's thirty most populous cities (seven of the cities do not assess the value of tax-exempt property), nonprofits owned tax-exempt property that cost those cities over \$1.5 billion in revenue in 2009 alone.<sup>55</sup> In some of largest cities in Texas, nonprofit property tax exemptions in 2006 equated to 1.9% to 4.2% of all property tax values, costing between \$2.3 million and \$35 million in uncollectable revenue for each city.<sup>56</sup>

### B. *Nonprofit Property Tax Exemptions*

#### 1. The History and Development of Nonprofit Tax Exemptions

Charitable organizations have a long-standing history of unique government treatment in Western and Judeo-Christian society.<sup>57</sup> Early Jewish religious texts emphasized the moral obligation of sharing with the less fortunate,<sup>58</sup> which led to the creation of the first Western charitable institutions.<sup>59</sup> In ancient Greek cities, philanthropy was treated as a civic duty of the wealthy.<sup>60</sup> Wealthy citizens were expected to patronize everything from the arts to religious institutions to public infrastructure.<sup>61</sup> The Romans were the first Western civilization to create legal regulations on donors and beneficiaries.<sup>62</sup> The Romans were also the first to establish foundations, first for personal benefit, such as maintaining the testator's tomb, but later for more stable bodies such as cities, burial clubs, guilds, and neighborhood associations.<sup>63</sup> Throughout these early civilizations, charities were exempt from taxation.

52. *Id.* at 2.

53. *Id.* at 4–5.

54. KENYON & LANGLEY, *supra* note 11, at 2.

55. Lipman, *supra* note 6.

56. *Id.* (the total property value that was tax exempt under nonprofit exemptions and the taxes that did not have to be paid to the City were, respectively, as follows: Houston — 3.1% and \$34.96 million; Dallas—2.9% and \$19.34 million; Fort Worth—4.2% and \$13.9 million; El Paso—1.9% and \$2.28 million. Neither Austin nor San Antonio assess information on the value of tax-exempt properties.).

57. Kevin C. Robbins, *The Nonprofit Sector In Historical Perspective: Traditions of Philanthropy in the West*, in THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK 13, 28 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

58. *Id.* at 14 (citing scriptures from the Torah—specifically from the Pentateuch, or the first five books of the Bible—that require the faithful to give to those less fortunate).

59. *Id.* at 15.

60. *Id.* at 16.

61. *Id.* at 15.

62. *Id.* at 17.

63. *Id.* at 18.

With the advent of Christianity, charitable giving, by way of alms giving, became a universal activity and a core value of the religion.<sup>64</sup> As Christianity grew from a covert sect to a virtually omnipresent religious and political institution, so too grew its charitable activities. The Christian Church of the Byzantine Empire established new philanthropic institutions, like hospitals, in accordance with Christian principles of benevolence, and the Roman Catholic Church created philanthropic centers, like monasteries, to perpetuate charity in the community.<sup>65</sup> As part of the religious-political nexus, charitable organizations were exempted from taxes levied by monarchs and the Church.<sup>66</sup>

The Reformation and subsequent dismantling of former Catholic charitable organizations led to increased efforts by the state to ensure more efficient use of charitable resources.<sup>67</sup> Such efforts included the 1601 Statute of Charitable Uses, enacted during the Elizabethan Period, which remains influential even in modern Anglo-American jurisprudence, though to a lesser extent in the United States.<sup>68</sup> Even as independent entities that no longer enjoyed the privileges of being part of the political institution, English law still protected charitable lands from taxation.

Early American colonial charitable organizations and the related law followed the traditional English form.<sup>69</sup> In England, charitable and educational activities had been the responsibility of the Church of England, and as such, colonial parishes assumed these responsibilities.<sup>70</sup> After the American Revolution, the concerns of the threat of factions espoused in *Federalist Paper No. 10* led nearly every state outside New England to limit the rights of corporations, including charitable institutions, and repeal much of the common law of charities.<sup>71</sup> Nonprofit organizations first gained formal legal status in the

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64. *Id.* at 19.

65. *Id.* at 20.

66. *Id.* at 22–23.

67. *Id.* at 24.

68. *Id.* (The Statute of Charitable Uses Act, 1601, 43 Eliz. 1, c. 4 (Eng.) states in the preamble charitable funds were to be used for the “relief of the aged, impotent, and poor people; maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, repair of bridges, ports, havens, causeways, churches, seabanks, and highways, education and preferment of orphans, for or towards relief of stock, or maintenance for houses of correction, marriages of poor maids, supportation, aid, and help of young tradesmen, handicraftsmen, and persons decayed, relief or redemption of prisoners or captives, aide or ease of any poor inhabitants concerning payments of fifteens, setting out soldiers of soldiers and other taxes . . .”).

69. Peter Dobkin Hall, *A Historical Overview of Philanthropy, Voluntary Associations, and Nonprofit Organizations in the United States, 1600–2000*, in *THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK* 32, 33 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

70. *Id.*

71. *Id.* at 35.

United States in *Trustees of Dartmouth College v. Woodward*.<sup>72</sup> In this case, the Court recognized charities as distinct legal entities and having rights as such.<sup>73</sup>

Despite the shift away from the English common-law treatment of charities, charities still maintained special tax treatment. Traditional nonprofit organizations have been tax exempt since the settlement of colonial America.<sup>74</sup> Charities were always exempt from local taxes.<sup>75</sup> Nonprofit tax exemption was never a concern at the federal level until the first income tax act was passed in 1894.<sup>76</sup> The Revenue Act of 1894 granted exemptions to “corporations, companies or associations organized and conducted solely for charitable, religious or educational purposes.”<sup>77</sup> Every subsequent federal income tax law has included similar exemptions for nonprofit organizations.<sup>78</sup>

In the late nineteenth century, approaches to the legal and regulatory treatment of charities existed in two forms: (1) “broad construction”—in a minority of states—where nonprofits were not only allowed but also encouraged with tax exemptions; and (2) “narrow construction”—in a majority of states, including Texas—where exemptions were only granted to organizations that could prove their redistributive and noncommercial purposes.<sup>79</sup> The turn of the twentieth century saw the modernization of charity law and creation of major grant-making foundations.<sup>80</sup>

The effects of the New Deal and the creation of a welfare state led to the formation of the modern nonprofit sector.<sup>81</sup> The nonprofit sector experienced unprecedented growth following WWII into the new millennium.<sup>82</sup> Modernly, nonprofit organizations have evolved into alternatives to and sometimes partners with government services both

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72. *Id.* at 36.

73. *Trs. of Dartmouth Coll. v. Woodard*, 17 U.S. 518, 645 (1819) (The New Hampshire legislature attempted to change Dartmouth College—a private funded institution chartered by the British Monarchy—into a state university. The legislature changed the school’s corporate charter and transferred control of trustee appointments to the governor. Woodward, a former trustee, challenged the change.).

74. John D. Colombo, *Why Is Harvard Tax-Exempt? (and Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 844 (1993).

75. *Id.*

76. *Id.* at 845.

77. Revenue Act of 1894, ch. 349 § 32, 28 Stat. 509, 556 (1893) (While the Act was overturned by *Pollock v. Farmer’s Loan & Trust*, 157 U.S. 429, 555 (1895), on the grounds that the taxes imposed on income from property were unconstitutional, the drafters’ intent espoused in the act are still reflected in current values toward nonprofit organizations.).

78. Colombo, *supra* note 74, at 845.

79. Hall, *supra* note 69, at 37.

80. *Id.* at 46–47.

81. *Id.* at 50–52.

82. *Id.* at 54 (Between 1971 and 1999, the federal government saw virtually no change in the number of civilian employees and state governments saw a 30% increase in employees. Contemporaneously, the nonprofit sector employment numbers grew almost 45% between 1981 and 1999.).

under the liberal values of redistribution and the conservative approach to reducing large-scale government social welfare programs.<sup>83</sup>

The United States offers the most complex tax treatment of nonprofit organizations in the world.<sup>84</sup> There are two major types of nonprofit organizations: the traditional “charitable organizations” designated as § 501(c)(3) and the “noncharitable nonprofits” designated as §§ 501(c)(4)-(29) organizations.<sup>85</sup> Section 501(c)(3) organizations are those that are “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes”<sup>86</sup> and traditionally viewed as charities.<sup>87</sup> The term “nonprofit” may generally be applied to a number of organizations including twenty-nine categories codified in the IRS tax code; however, only the § 501(c)(3) charitable designation is given tax-deductible status.<sup>88</sup> This Comment focuses on the § 501(c)(3) organization for the purposes of discussing *charitable*, *nonprofit*, or *tax-exempt* organizations and corporations.

To receive a § 501(c)(3) designation, organizations are required to file a request for exemption with an IRS Form 1023, generally within fifteen months of incorporation.<sup>89</sup> The § 501(c)(3) designation exempts organizations from federal income tax and also allows donations made to the organization tax deductibility on personal income tax returns.<sup>90</sup> Maintaining the § 501(c)(3) status requires record keeping of all financial and nonfinancial activities, annual information returns (generally Form 990s for organizations with over \$250,000 in revenue), and disclosure requirements allowing for public inspection of records upon written request.<sup>91</sup>

## 2. Rationales for Nonprofit Property Tax Exemptions

A number of theories exist to support the tax exemption of nonprofits falling into two general categories: tax-base theories and subsidy theories.<sup>92</sup> Generally, the tax-base theories justify exemptions as a result of the inability to accurately measure an organization’s income because of the inherent characteristics of the field.<sup>93</sup> Conversely, the subsidy theories view the tax exemption as an indirect

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83. *Id.* at 56.

84. Simon et al., *supra* note 40, at 267.

85. *Id.* at 268.

86. I.R.C. § 501(c)(3) (West 2010).

87. Simon et al., *supra* note 40, at 267.

88. I.R.C. § 501(c).

89. I.R.S., APPLYING FOR 501(c)(3) TAX EXEMPT STATUS, PUBL’N 4220 (REV. 8–2009) CATALOG NO. 37053T 10–11.

90. I.R.C. § 501(a).

91. I.R.S., *supra* note 89, at 7–9.

92. Colombo, *supra* note 74, at 857.

93. *Id.*

subsidy to the nonprofit organization for the amount of taxes the government forewent as a result of exemption.<sup>94</sup>

Under the major tax-base theory, nonprofits are exempt from taxation because it is inherently difficult to measure their income and assess the incidence of tax—sometimes referred to as the “no income theory.”<sup>95</sup> Additionally, challenges arise from selecting an appropriate tax rate for charitable organizations.<sup>96</sup> The theory is limited in that the nature of nonprofits has changed such that most operate in a very business-like fashion.<sup>97</sup> Specifically in this Comment, the theory fails almost completely. To serve as a rationale for state property tax exemption, the theory would have to become a “no property” theory, which is in all manners impracticable if not impossible.<sup>98</sup>

Under the various subsidy theories, nonprofits are given tax exemptions, both on income and ad valorem taxes, as subsidies with varying rationales for doing so.<sup>99</sup> A major theory among legal scholars, and growing rationalization by governments for the exemption, is that nonprofits serve as a quid-pro-quo function to government and provide services the government would otherwise have to provide.<sup>100</sup> The Community Benefit Theory argues subsidies can be rationalized because nonprofits exist to benefit the community by improving society by serving as complements to government.<sup>101</sup> The Capital Subsidy Theory rationalizes that tax exemptions are justified because nonprofits offer capital subsidy by providing services without a market in the for-profit sector, and nonprofits fulfill the altruistic desires of society.<sup>102</sup> Subsidy theories, regardless of the rationale behind granting the subsidy, provide a logical reasoning for nonprofit property tax exemptions.

The judiciary rationalizes the nonprofit property tax exemptions on one of two (or a combination of both) bases: (1) the use of property serves as a substitute for government service, relieving the government of a financial burden, or (2) the use confers a benefit on society.<sup>103</sup> The judiciary’s burden theory is analogous to a quid-pro-quo subsidy theory.<sup>104</sup> Courts have only operated on the assumption, not

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94. *Id.*

95. *Id.* at 858.

96. *Id.*

97. *Id.* at 859.

98. *Id.* at 858.

99. *Id.* at 861.

100. See Evelyn Brody, *The States’ Growing Use of a Quid-Pro-Quo Rationale For The Charity Property Tax Exemption*, 56 EXEMPT ORG. TAX REV. no. 3 269, 270 (2007); Colombo, *supra* note 74, at 862–64 (while Colombo argues the theory is limited, Brody and others argue its increased incidence).

101. Colombo, *supra* note 74, at 864.

102. *Id.* at 868.

103. William R. Ginsberg, *The Real Property Tax Exemption of Nonprofit Organizations: A Perspective*, 53 TEMPLE L. Q. 291, 306–07 (1980).

104. *Id.* at 308; see also Colombo, *supra* note 74, at 861.

the verification, of the validity of the burden theory.<sup>105</sup> In actuality, the quid-pro-quo subsidy theory is not fundamentally true in all situations.<sup>106</sup> The benefit theory is broader and encompasses charitable property uses that benefit society but are not performed by government programs, such as religion and frequently the arts.<sup>107</sup>

The Supreme Court has recognized the property tax exemption of nonprofit organizations as an acceptable practice.<sup>108</sup> In the case of religious organizations, the Court has held the exempt status of such organizations as almost untouchable, not because of the social benefit of the organization, but rather as a result of the constitutional requirement of separation of church and state.<sup>109</sup> Interestingly, the *Camps Newfound/Owatonna* Court seems to have refused to accept the subsidy theory of property tax exemptions.<sup>110</sup> While the Court recognized that subsidies and exemptions serve similar means, it argued that they are different in important and relevant respects.<sup>111</sup> In the same case, a vocal four-member minority consisting of the most conservative and liberal justices on the court at the time,<sup>112</sup> noted “the tax exemption for certain Maine charities . . . is, in truth, no different than a subsidy paid out of the State’s general revenues . . . .”<sup>113</sup>

### 3. Implications of Lost Tax Exemptions

In the recent fiscal crises felt by cities, school districts, and other taxing authorities around the country, a new state interest has arisen, or at least been exacerbated—the need to secure a tax base. Local governments are starting to question the value of nonprofit property tax exemptions.<sup>114</sup> With falling property values and increasing demands for services, cities have been forced to seek out new funding

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105. Ginsberg, *supra* note 103, at 308.

106. Brody, *supra* note 100, at 270.

107. Ginsberg, *supra* note 103, at 308.

108. See *Walz v. Tax Comm’n*, 397 U.S. 664, 672 (1970).

109. *E.g., id.* at 674.

110. *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 588–89 (1997) (The camps involved challenged a Maine law that it denied a property tax exemption because it served mainly out-of-state residents. The Town argued, among other things, that the exemption was valid because it created a subsidy where the Town had a valid interest in promoting local activities or that the subsidy “purchased” goods as to grant the Town a market participant exception. Ultimately, the Court struck down the law on the grounds that it violated the Dormant Commerce Clause by treating in-state and out-of-state organizations differently.).

111. *Id.* at 589.

112. *Id.* at 595 (the minority consisted of the three most conservative justices on the *Camps Newfound/Owatonna* Court—Justice Scalia, Chief Justice Rehnquist, and Justice Thomas—as the well as Justice Ginsberg, the Court’s most liberal justice).

113. *Id.* at 640.

114. *E.g., Pang, supra* note 1; Charles Taylor, *Counties Challenge Hospitals’ Tax Exemptions*, COUNTY NEWS, NATIONAL ASSOCIATION OF COUNTIES (Dec. 3, 2012), available at <http://www.naco.org/newsroom/countynews/Current%20Issue/12-3-12/Pages/Counties-challenge-hospitals%E2%80%99-tax-exemptions.aspx>.

sources.<sup>115</sup> Once allies of the government, certain nonprofit institutions are coming under fire for not paying their fair share. Such attacks have left many in the nonprofit field feeling alienated from their former partner.<sup>116</sup> Weakening the bond between government and the nonprofit sector threatens the critical relationship for service delivery crucial to both nonprofits' missions and government purpose.

Nonprofits exist to serve a mission.<sup>117</sup> Very few charities operate solely on volunteer efforts with no overhead costs. This is especially true of larger, more established nonprofits. Overhead costs for nonprofit organizations are a critical part of serving the mission.<sup>118</sup> Money spent on property taxes would be money taken away from service provision. Even the less imposing forms of limits on the value of property taxes (*e.g.*, fees, charges, and voluntary payments) are drains on finite nonprofit resources. While property taxes may be part of "doing business," paying property taxes still does not negate the reality that money spent is money taken away from this mission.

In the aggregate, a loss of nonprofit resources from increased expenses like property taxes results in a decrease in the ability to provide services. Loss of services from health and human services and education organizations is especially germane to government because these organizations provide a substitute for government services. Without nonprofit services, the government becomes responsible for providing these services or those in need go without. While at the individual level the value of a nonprofit property tax exemption may seem modest compared to the entirety of the organization's expenses, when aggregated the costs of losing exemptions has major implications sector-wide—including major losses in service provisions.

### III. TEXAS'S TREATMENT OF NONPROFIT ORGANIZATIONS

Texas nonprofits that hold a § 501(c)(3) designation from the IRS, generally enjoy exemption from sales and use taxes and the Texas franchise tax by a blanket approval from the Texas Comptroller's office.<sup>119</sup> These exemptions are available to any designated nonprofit organization, not just those that receive charitable status. Property tax exemptions are more laborious to obtain than other state and local tax exemptions. The property tax exemption is only available to

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115. See Lipman, *supra* note 6.

116. *Id.*

117. ZIETLOW ET AL., *supra* note 30, at 6.

118. David Greco, *Nonprofits Need to Stop Begging For Scraps*, THE CHRONICLE OF PHILANTHROPY (Feb. 25, 2011), available at <http://philanthropy.com/blogs/money-and-mission/nonprofits-need-to-stop-begging-for-scraps/27724>.

119. TEXAS C-BAR, FORMING A NONPROFIT TAX-EXEMPT CORPORATION IN TEXAS 14 (2010).

§ 501(c)(3) charitable organizations and must be scrutinized and approved by each taxing authority in which property is located.<sup>120</sup>

### A. *Texas Nonprofit Property Tax Exemptions*

The current Texas Property Tax Code grants qualified nonprofit organizations property tax exemptions on buildings, tangible personal property, and real property with incomplete, but under active construction, improvements.<sup>121</sup> The nonprofit property tax exemption does not cover all forms of real property under the tax code<sup>122</sup> as a matter of policy because non-exempt property generally does not meet the “exclusiveness” and “charitable use” requirements. One of the most common types of non-exempt properties owned by nonprofit organizations is income-generating properties like rental properties, retail operations, and mineral interests.

For purposes of the property tax exemption, the organization must: (1) be organized exclusively to perform religious, charitable, scientific, literary, or educational purposes by performing one of the enumerated charitable purposes; (2) comply with the nondistribution constraint; and (3) use its assets to perform and govern its charitable function.<sup>123</sup> The property tax exemption is not an automatic result of an organization’s § 501(c)(3) status.<sup>124</sup> A nonprofit must file a Form 50-115 describing its qualifications for the exemption and the property in order to be exempt.<sup>125</sup> Applications must be filed with the chief appraiser of each appraisal district in which the nonprofit holds property and claims to have a right to exemption.<sup>126</sup> Once charitable exemptions are granted, they need not be claimed in subsequent years, until ownership of property changes, or the organization’s qualifications change.<sup>127</sup> Once granted, the exemption is not without review. The chief appraiser may, upon delivering written notice, require a

120. *Id.*

121. TEX. TAX CODE ANN. § 11.18(a) (West 2011).

122. §1.04 (defining ‘Real property’ as: (A) land; (B) an improvement; (C) a mine or quarry; (D) a mineral in place; (E) standing timber; or (F) an estate or interest, other than a mortgage or deed of trust creating a lien on property or an interest securing payment or performance of an obligation, in a property enumerated in Paragraphs (A) through (E)).

123. TEX. TAX CODE ANN. § 11.18(c)–(g) (West 2011) (For fundraising and grant-making organizations under § 11.18(d)(15), the organization must be affiliated with a recognized volunteer charitable fundraising organization, qualify for a § 501(c)(3) exemption, be governed by a volunteer board, and make distributions to at least five other exempt organizations.).

124. GLEN A. YALE, STATE BAR OF TEXAS GOVERNANCE OF NONPROFIT ORGANIZATIONS AUSTIN CHAPTER, DON’T TAX US, WE’RE EXEMPT 9 (2010), <http://www.yalelawfirm.com/pdf/Don't%20Tax%20Us,%20We're%20Exempt.pdf>.

125. See generally TEXAS COMPTROLLER, FORM 50-115 APPLICATION FOR CHARITABLE ORGANIZATION PROPERTY TAX EXEMPTION (2012), <http://www.window.state.tx.us/taxinfo/taxforms/50-115.pdf>.

126. TEX. TAX CODE ANN. § 11.43(a) (West 2011).

127. YALE, *supra* note 124, at 9.



nonprofit organization to file a new application confirming its current qualification for the exemption.<sup>128</sup> If a chief appraiser denies an organization a property tax exemption, the organization may then challenge the denial in court.<sup>129</sup> However, the court strictly construes statutes conferring tax exemptions in favor of the taxing authority, placing the burden of proof on the nonprofit organization seeking exemption.<sup>130</sup>

### B. *History of Nonprofit Property Tax Exemptions in Texas*

Since adopting the Texas Constitution in 1867, Texas has recognized the importance of property tax exemptions for charities by vesting in the Legislature the power to grant such exemptions.<sup>131</sup> However, the Texas Supreme Court has held that exemptions from taxes are generally disfavored because the exemptions are at the burden of other taxpayers.<sup>132</sup> The Texas Constitution has been amended at various times to expand the types of exemptions and the scope of exempt organizations.<sup>133</sup> To receive such exemptions, the property must be owned and used exclusively by an institution of pure charity.<sup>134</sup>

Original language of the section implies the exemptions were intended to apply to real property owned by the charitable organization.<sup>135</sup> It was only after the insertion of words concerning school buildings that the right to charitable exemptions became associated with “buildings.”<sup>136</sup> While the current nonprofit property tax exemption only directly grants long-term exemptions to buildings and tangible personal property, the Legislature has not so strictly interpreted the language of the Texas Constitution as to completely prohibit any exemption on other real property. Furthermore, local taxing authorities have not taken efforts to separate the building a nonprofit organization uses from the land the building sits on so long as the property meets the exclusiveness and charitable requirements.

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128. *Id.*

129. *See generally* TRQ Captain’s Landing L.P. v. Galveston Cent. Appraisal Dist., 212 S.W.3d 726, 730 (Tex. App.—Houston [1st Dist.] 2006, pet. abated).

130. *See generally id.* at 731.

131. TEX. CONST. art. VIII, § 2.

132. *See* N. Alamo Water Supply Corp. v. Willacy Cnty. Appraisal Dist., 804 S.W.2d 894, 899 (Tex. 1991).

133. *See* TEX. CONST. art. VIII, § 2 historical notes (West 2007).

134. *Id.* § 2.

135. GEORGE D. BRADEN ET AL., THE CONSTITUTION OF THE STATE OF TEXAS: AN ANNOTATED AND COMPARATIVE ANALYSIS 601 (1977).

136. *Id.*

### 1. Exclusiveness Requirement

The first major overarching element of the nonprofit property tax exemption the court defined was the exclusiveness requirement.<sup>137</sup> The property owned by a nonprofit organization must be used exclusively by the charitable organization to receive a property tax exemption.<sup>138</sup> Ownership of the property by the nonprofit organization alone is not sufficient.

The City of Houston brought suit against the Scottish Rite Benevolent Association, a masonic organization, to recover property taxes not paid on the Association's lodges, which the Association claimed were entitled to property tax exemption.<sup>139</sup> At the time, to receive the property tax exemption, the property had to be used and owned "exclusively by an institution of purely public charity."<sup>140</sup> In the charter of the Association, the organization's purpose was to benefit needy masons, their widows, children, and mothers.<sup>141</sup> The properties in question were used exclusively for the purpose of being social lodges.<sup>142</sup> The Court recognized that "charity need not be universal to be public;" instead it can be "public when it affects all the people of a community . . . that which otherwise might become the obligation or duty of the community or state."<sup>143</sup> Specifically at issue was whether the property was used *exclusively* by the organization.<sup>144</sup>

The Court held that revenue from the lease of the property to others, even when dedicated to purely public charitable work, was insufficient for the exemption.<sup>145</sup> Nor was the nonpayment of rent sufficient for the exclusivity test.<sup>146</sup> The actual, direct use must be exclusive to the institution receiving the exemption.<sup>147</sup> However, it should be noted that the Texas Constitution has been amended so that the *purely* portion of the public charity requirement has been removed, but the exclusiveness test still remains.<sup>148</sup>

### 2. Charitable Use Requirement

The other major element of the nonprofit property tax exemption Texas courts defined was the charitable use requirement that dictates

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137. *E.g.*, *Morris v. Lone Star Chapter No. 6, Royal Arch Masons*, 5 S.W. 519, 519 (Tex. 1887); *Red v. Johnson*, 53 Tex. 284, 288 (1888).

138. *Houston v. Scottish Rite Bev. Ass'n*, 230 S.W. 978, 980 (Tex. 1921).

139. *Id.* at 979–80.

140. *Id.* at 980.

141. *Id.*

142. *Id.* at 981.

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

148. *McLennan Cnty. Appraisal Dist. v. Am. Hous. Found.*, 343 S.W.3d 509, 511 (Tex. App.—Waco 2011, pet. denied).

the way property could be used.<sup>149</sup> Property must be used to further charitable goals of the nonprofit organization, not only used by the organization. Without both requirements, nonprofit organizations cannot enjoy the property tax exemption.

In 1990, Baptist Memorial Geriatric Center, a nonprofit organization that operated a large facility including a hospital, nursing home, and senior living center, was denied its property tax exemption for the senior living center by the Tom Green County Appraisal District.<sup>150</sup> Some of the residential properties were sold for a profit with no indications that doing so provided a charitable service.<sup>151</sup> The Texas Supreme Court has long extended the charitable use requirement to dictate that the use of the property be “in furtherance of [the organization’s] charitable purposes.”<sup>152</sup> A property tax exemption cannot be granted on the findings of ownership and use by the nonprofit; the property must also be used in furthering the charitable purposes of the organization.<sup>153</sup> Furthermore, the facilities on the property (*i.e.*, each building) may be evaluated individually for its use in furthering the charitable purpose rather than the parcel as a whole.<sup>154</sup> The court did note, however, that a nonprofit does not lose its property tax exemption simply because activities nonrelated to the charitable purpose of the organization occur on the property so long as they are incidental to the main charitable purpose.<sup>155</sup>

### 3. Industry-Specific Requirements

The tax-exempt status of certain nonprofits, particularly those that have major assets and for-profit equivalents, has come under scrutiny in recent decades. Hospitals, universities, and other large institutions have often been the target of political fire.<sup>156</sup> Legal scholars have debated the value of such exemptions.<sup>157</sup> With the tightening of revenue

149. *E.g.*, *Morris v. Lone Star Chapter No. 6, Royal Arch Masons*, 5 S.W. 519, 519 (Tex. 1887).

150. *Baptist Mem’ls Geriatric Cent. v. Tom Green Cnty. Appraisal Dist.*, 851 S.W.2d 938, 941 (Tex. App.—Austin 1993, writ denied).

151. *Id.* at 945.

152. *Id.* at 943 (quoting *Morris v. Lone Star Chapter No. 6, Royal Arch Masons*, 5 S.W. 519, 519 (Tex. 1887)).

153. *Id.* at 944.

154. *Id.*

155. *Id.* at 944 n.5.

156. See Michelle Hirsch, *The Case for Making Harvard Pay Taxes*, THE FISCAL TIMES (Oct. 7, 2011), available at <http://www.thefiscaltimes.com/Articles/2011/10/07/The-Rich-University-The-Mother-of-all-Tax-Breaks.aspx#page1>; Peter Frost, *Medicaid Cuts, Property Tax Battle a Stress Test for Many Hospitals*, CHICAGO TRIBUNE (Mar. 12, 2012), available at [http://articles.chicagotribune.com/2012-03-29/business/ct-biz-0327-childrens-hospital-20120324\\_1\\_medicare-cuts-charity-care-illinois-hospitals](http://articles.chicagotribune.com/2012-03-29/business/ct-biz-0327-childrens-hospital-20120324_1_medicare-cuts-charity-care-illinois-hospitals); Anita Anand, *Much-Needed Property Tax Relief for the Affordable Housing Industry*, GEORGIA AFFORDABLE HOUSING COALITION (June 23, 2011), <http://www.gahcoalition.org/viewarticle.asp?id=150&newsid=33>.

157. See generally Colombo, *supra* note 74; see also Ginsberg, *supra* note 103.

streams and increasing demands for services, cities and other property tax dependent entities are re-sparking the debate on the value of property tax exemptions for nonprofit organizations.

The Texas Tax Code, “Special Charity Care and Community Benefits Requirements,” requires hospitals to provide minimum levels of indigent care in order to maintain their property-tax exemptions.<sup>158</sup> The requirements were passed during a time of national concern that nonprofit hospitals were receiving substantial tax benefits while providing services no different, including cost, from their for-profit counterparts.<sup>159</sup> Since the adoption of § 11.1801, no major challenges have arisen to the property tax exemptions of nonprofit hospitals in Texas.<sup>160</sup> These requirements are similar to SILOTS<sup>161</sup> but are imposed by the state rather than as voluntary agreements between the organization and the taxing authority.

Organizations that provide low-income and affordable housing are also subject to special expanded requirements for property tax exemptions. Improvements on property for low-income housing are only granted a three-year exemption.<sup>162</sup> Community Housing Development Organizations (“CDHOs”)—nonprofit organizations that produce affordable housing—are another specialized type of nonprofit that are subject to special requirements to receive property tax exemptions.<sup>163</sup> However, unlike hospitals whose standards for exemptions have become well settled in the Texas courts, CDHOs still often face challenges to their exempt status.<sup>164</sup> In addition to the general requirements set forth in § 11.18 for all nonprofits to receive property tax exemptions, CDHOs are subject to additional reporting requirements.<sup>165</sup> In determining whether it is charitable, a CDHO must demonstrate that it allocates statutorily defined amounts of its expenses to providing affordable housing to eligible persons in the county where the property is located<sup>166</sup>—a practice similar to the general SILOTS system. The organization must also undergo annual in-

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158. TEX. TAX CODE ANN. § 11.1801 (West 2011).

159. Terri L. Brooks, *Billions Saved in Taxes While Millions Underserved—What Has Happened to Charitable Hospitals?*, 8 HOUS. BUS. & TAX L.J. 391, 401 (2008).

160. See *Atascosa Cnty. v. Atascosa Cnty. Appraisal Dist.*, 962 S.W.2d 188 (Tex. Ct. App.—San Antonio 1998, pet. withdrawn) (The county and school district sought to compel the county appraisal district to revoke retroactively charitable exemption granted hospital. The case, which was one of the last major challenges to a Texas hospital’s tax-exempt status, occurred before the passage of Tex. Prop. Code § 11.182 in 2001.).

161. KENYON & LANGLEY, *supra* note 11, at 7–8.

162. TEX. TAX CODE ANN. § 11.181 (West 2011).

163. § 11.182(b) (West 2011 & Supp. 2013).

164. See generally *AHF-Arbors at Huntsville LLC, I v. Walker Cnty. Appraisal Dist.*, 55 Tex. Sup. Ct. J. 835, 2012 WL 2052948, \*2 (Tex. June 8, 2012); see also *TRQ Captain’s Landing L.P. v. Galveston Cent. Appraisal Dist.*, 212 S.W.3d 726, 733–36 (Tex. App.—Houston [1st Dist.] 2006, pet. abated).

165. TEX. TAX CODE ANN. § 11.182(e)(3).

166. § 11.182(d).

dependent audits that are submitted to the chief appraisal district where the exempt property is located.<sup>167</sup>

Because of the special nature of church-state relations, religious organizations are given the most liberal requirements for property tax exemptions. They are granted exemptions on all real property and tangible personal property used as a place of regular religious worship.<sup>168</sup> Religious organizations also enjoy exemptions on clergy residences and property reasonably attached to the residence.<sup>169</sup>

### C. *Mineral Interests Generally*

Mineral interests exist as a fee simple in Texas and are entitled to the same rights as any other fee simple.<sup>170</sup> Until severance, the mineral interest is part of the real property consisting of the surface estate.<sup>171</sup> It is only after production that mineral interests become personal property.<sup>172</sup> The owners of mineral estates have the right to: (1) develop the mineral; (2) lease the interest; (3) receive bonus payments on a lease; (4) receive delay rentals from a lease; and (5) receive royalties from a lease.<sup>173</sup> Implicitly, the mineral estate also has the right to decline development and leasing. While the nature of some substances like limestone and lignite as a mineral in place has been questioned and ultimately determined not to be minerals, hydrocarbons, like oil and gas, are clearly minerals in place so that an interest in them is taxable as real property.<sup>174</sup>

As a defined piece of real property, mineral interests are considered an asset that can be appraised and subsequently taxed even when they are nonproducing. Mineral interests are generally taxable unless they have a value of less than \$500.<sup>175</sup> The exemption aggregates all mineral interest in each taxing unit, so that multiple parcels are treated as one interest within the same taxing authority.<sup>176</sup>

## IV. NONPRODUCING MINERAL INTERESTS AND NONPROFIT PROPERTY TAX EXEMPTIONS

### A. *Proposal for New Legislation*

With the potential tax liability on nonproducing mineral interests owned by nonprofit organizations created by the current language of the Texas Tax Code, a clarification is necessary to correct the defi-

167. § 11.182(g).

168. § 11.20(a)(1).

169. § 11.20(a).

170. *Types of Interests*, [June 2013] 1 TEX. L. OIL & GAS (2d), § 1.2.

171. *Id.*

172. *Ownership of Oil and Gas*, [June 2013] 1 TEX. L. OIL & GAS (2d), § 1.3(A).

173. *Types of Interests*, *supra* note 170, § 2.1(A)(1)(b).

174. *Titles and Conveyances*, [June 2013] 1 TEX. L. OIL & GAS (2d), § 3.6(C)(2).

175. TEX. TAX CODE ANN. § 11.146(a) (West 2011).

176. § 11.146(b).

ciency in the law. The Texas Legislature did not intend the liability, but rather it arose from a change in circumstances that did not exist at the time the statute was enacted. While the Texas Supreme Court disfavors property tax exemptions as a matter of equity, public policy supports property tax exemptions for qualified nonprofit organizations for a number of reasons previously discussed in this Comment.

As an issue of public policy, the Legislature is the appropriate body to address the issue. The Texas Constitution does not grant property tax exemptions; rather, it grants the Legislature the right to do so and to determine how it should best be done. The granting language of the current property tax exemption<sup>177</sup> was enacted in 1979, over two decades before the appreciation of the Barnett Shale, and has not been updated since. To avoid the unintended tax liability, Texas Tax Code § 11.18 should be amended to include the following language:

- The real property owned by the charitable organization consisting of:*
- (A) *a nonproducing mineral in place, that:*
    - (i) *is not severed from a surface estate entitled to exemption under Paragraph (1),<sup>178</sup>*
    - (ii) *is not developed;*
    - (iii) *is not subject to a lease;*
    - (iv) *is not entitled to or has not received bonus payments, delay rentals, or royalties.*
  - (B) *an estate or interest, other than mortgage or deed of trust creating a lien on a property or interest securing payment or performance of an obligation, in a property under Paragraph (A) of this section.*

This language extends the current exemption for property owned by nonprofits only to minerals and interest in those minerals that are specifically attached to the nonprofit organization's otherwise exempt properties (*i.e.*, only estates where the surface and mineral estates have not been severed) so as to meet the exclusiveness requirement for the larger property tax exemption. Additionally, the language is crafted so that it only covers mineral interests that do not generate income. Producing mineral interests are no longer in line with the charitable use requirement of the larger property tax exemption requirement when they generate income.

### B. *Rationales for the Exemption*

Tax exemptions for nonprofit organizations are deeply rooted in historical precedent. The exemptions embody the special value society places on charitable work, whether it is as pragmatic as viewing charity as a quid-pro-quo for government services or more abstract as filling an altruistic need. From the earliest Western cultures, including

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177. § 11.18(a).

178. § 11.18(a)(1).

the Jewish, Greek, and Roman civilizations, there has been a heavy emphasis on the concept of charity.<sup>179</sup> Throughout these cultures, charitable institutions were exempt from government duties because of the special role they played in society. With the development of early Christianity, charitable giving became a universal activity that developed into a nearly omnipresent charitable system housed by the Catholic Church.<sup>180</sup> Both because of the political power of the Church and its special religious and charitable purposes, the wealth of the Church—a great deal of which was land—enjoyed tax exemption from sovereignties and their taxes. Even with the Reformation and the creation of an independent Anglican Church, charitable activities, which were clearly defined in the 1601 Statue of Charitable Uses, consistently enjoyed tax exemptions.<sup>181</sup> In early American law, charities were always exempt from taxation. Even within Texas, charities have been granted the right to property tax exemption since the early Texas Constitution.<sup>182</sup>

Until recent times, the root of most nonprofit organizations' wealth has been in the form of land. As a result, the most consequential exemptions, whether by statute or practice, have been exemptions on real property. While perhaps not always explicitly stated in the law, the centuries-long practice of exempting charitable wealth, which notably includes extensive property, represents a customary practice of valuing the special role of nonprofit organizations over the revenue from their assets. An exemption for nonproducing mineral interests is not a deviation from this principle; it is exactly in line with the centuries old historical precedent.

More impactful than even the long-standing historical precedent of charitable property tax exemptions are the current practices of taxation in the State of Texas. Despite statutory language that ensures only property tax exemptions for buildings and tangible personal property owned by nonprofit organizations, tax assessors in practice apply the exemption to the land attached to the exempt structures. Two of the five most populated counties in Texas do not appraise the value of exempt nonprofit properties.<sup>183</sup> Even where exemptions for the actual land nonprofits own does not exist in statute, it exists as a *de facto* law as a matter of practice. When a mineral interest is not severed, it remains part of the surface estate<sup>184</sup> that exempt buildings sit on. As a result, the *de facto* law, which is created by the general

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179. ROBBINS, *supra* note 57, at 13–16.

180. *Id.* at 17–18.

181. *Id.* at 20–23.

182. BRADEN ET AL., *supra* note 135, at 601; *see generally* Houston v. Scottish Rite Bev. Ass'n, 230 S.W. 978, 979–81 (Tex. 1921).

183. Lipman, *supra* note 6 (neither San Antonio, as part of Bexar County and its appraisal district, nor Austin, as part of Travis County and its appraisal district, assess information on the value of tax-exempt properties).

184. *See supra* note 171 and accompanying text.

practice of exempting the land attached to a building of nonprofits, extends to the mineral interests the estate contains. Particularly, non-producing mineral interests fall comfortably into this reasoning.

Additionally, the Texas Legislature has not read the Texas Constitution as to completely exclude tax exemptions specifically for real property. In special circumstances, namely when a property is being improved but not directly used by a qualified nonprofit organization, the Legislature has been willing to extend the property tax exemption to real property so long as other requirements are met to ensure the property does not violate the exclusiveness and charitable use requirements.<sup>185</sup> A narrowly applied exemption to nonproducing mineral interests owned by nonprofits would not detour from the patterns of previous legislative actions. Instead, it falls into a pattern of creating exemptions for specific instances where an unintended gap exists in the law that is counterintuitive to public policy.

Furthermore, all mineral interests owned by nonprofit organizations—producing or not—are given the same tax treatment despite significant differences. When mineral interests are not producing, they are more analogous to the land that nonprofit buildings sit on, rather than traditional income-producing assets that are not granted tax exemption. Nonprofits often own property that is not tax-exempt like rental facilities, retail operations, and even producing mineral interests. These properties are similar in that they are generally income producing; however, this is not the case for nonproducing mineral interests. On paper, nonproducing mineral interests are an asset because of their potential future value for leasing and development. In reality, nonproducing interests can create major tax liabilities for land-rich nonprofit organizations. Nonprofit organizations that cannot practicably produce because of drilling restrictions or those that chose not to produce for other reasons still carry a heavy liability on their so-called asset.

The most salient issue for the Texas nonprofit organization property tax exemption centers on the exclusiveness and use of property requirements.<sup>186</sup> A mineral interest attached to a property that is exclusively owned by a nonprofit organization implicitly meets the exclusiveness requirement. When a mineral interest is nonproducing it does not generate income so as to conflict with the charitable use of a property as required for an exemption. A nonproducing, unsevered mineral interest in an otherwise exempt property is in line with current Texas practices to also be exempt.

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185. TEX. TAX CODE ANN. §11.18(a)(2) (West 2011) (The nonprofit organization property tax exemption is extended for up to three years on real property that is being improved so long as active construction is ongoing during the exempt period as required in § 11.18(m).).

186. BRADEN ET AL., *supra* note 135, at 601; *see generally* *Houston*, 230 S.W. at 979–81.



The value of mineral interests in Texas, especially the Barnett Shale in recent times, cannot be downplayed. They are a major driver of the economy. The Barnett Shale has been a major revenue source for the state and local municipalities, but that revenue comes in many forms—permit fees, royalties, and bonuses from minerals under publicly owned land—in addition to property taxes from the value of the mineral interests.<sup>187</sup> Nonproducing mineral interests make up a marginal portion of all property tax.<sup>188</sup> Even smaller is the value of non-producing mineral interests held by nonprofit organizations. As such a small portion of the tax base, even the aggregate cost of forgoing taxes on mineral interests attached to otherwise exempt property is heavily overshadowed by the impact that such tax liabilities would have on nonprofit organizations and their ability to provide services.

This Comment and its proposed legislation are not intended to exempt all mineral interests owned by nonprofit organizations. Instead, it is intended to continue the public policy of granting nonprofit organizations property tax exemptions on property that is owned and used exclusively for charitable purposes. The language is meant to be limited only to mineral interests that provide no revenue to the organization that owns them and that are attached to property (*i.e.*, not severed from the surface estate) that is already entitled to exemption under the current Texas Tax Code. This approach is in line with statutory treatment of property tax exemptions for nonprofit organizations, not a deviation from it. It only seeks to extend the current public policy of granting exemptions on property owned by nonprofit organizations that meet the constitutionally mandated exclusivity and charitable use requirements.

## V. CONCLUSION

Throughout the United States, state and local governments have struggled with budgets in the face of shrinking revenues from the economic downturn. Especially hard hit were the property tax dependent municipalities because of high rates of foreclosures, dropping property values, and increased delinquency on property taxes. While Texas has weathered better, both generally in economic terms and stability in property values, it has not been entirely immune to the problems seen elsewhere. Narrowing of municipalities' tax bases should not be done without substantial countervailing reason.

In the case of property taxes on nonprofit organizations, the monetary value of tax revenues does not outweigh the value of those funds for the organization and the greater societal benefit nonprofit organi-

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187. THE PERRYMAN GROUP, A DECADE OF DRILLING: THE IMPACT OF THE BARNETT SHALE ON BUSINESS ACTIVITY IN THE SURROUNDING REGION AND TEXAS 5 (2011).

188. PROPERTY TAX REPORT 2009, *supra* note 25, at 2.

zations provide. Property taxes take money away from nonprofits and ultimately their missions. Service reductions are countervailing to the subsidy theory that rationalizes nonprofit property tax exemptions. Property taxes on nonprofit organizations are also countervailing to over 2,000 years' worth of historical custom in Western civilizations. More narrowly, the 1876 Texas Constitution intended charitable property tax exemptions to extend to real property generally. It was only after a series of poorly executed amendments to the language of the Texas Constitution that the exemption became associated with buildings. Current practices of not taxing the land buildings sit on that are owned by nonprofits perpetuates this approach, even when the language of the statute does not directly do so.

Property taxes on nonproducing minerals attached to property entitled to the nonprofit property tax exemption go against the larger intent of nonprofit property tax exemptions. The original intent of the Texas Constitution was to exempt all charitable property, which encompasses nonproducing mineral interests, so long as it was exclusively owned by the charity and used for charitable purposes. Subsequent changes muddied this meaning by trying to add exemptions. Never did they attempt to reduce exemptions. Nor is the language of the statute intended to exclude nonproducing mineral interests. The language granting exemptions was created more than two decades before the realization of the Barnett Shale issues. The issue at hand is an inadvertent consequence of poor and incomplete drafting, both of the Texas Constitution and the statute.

The aim of these changes is not to overhaul the entire system. The purpose is only to fill in an unintentional gap in the current law to protect nonprofit organizations from a potential tax liability that was created by a change in circumstance, rather than by skillful drafting. The focus is protecting nonprofits from substantial, unintended tax liabilities that go against the very spirit of the nonprofit property tax exemption.

