PUBLIC HEARING ON BILL 16-950, "NONPROFIT LEASING TAX EXEMPTION AMENDEMENT ACT OF 2006"

Before the
Committee on Finance and Revenue
Council of the District of Columbia

The Honorable Jack Evans, Chairman

November 2, 2006, 11:00 a.m.
Council Chamber (Room 500)
John A. Wilson Building

Testimony of
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Good morning, Chairman Evans and members of the Committee on Finance and Revenue. I am Sherryl Hobbs Newman, Deputy Chief Financial Officer for the Office of Tax and Revenue ("OTR") of the District of Columbia ("District"). I am pleased to present testimony today on Bill 16-950, the "Nonprofit Leasing Tax Exemption Amendment Act of 2006."

Section 2(a) Of The Bill

The purpose of the bill is twofold. First, section 2(a) proposes to amend D.C. Code § 47-1002(8) by creating two separate paragraphs. The first paragraph, (A), would contain the current language in D.C. Code § 47-1002(8), which exempts from real property taxation buildings belonging to and operated by nonprofits, and which are used for purposes of public charity principally in the District.

A new second paragraph, (B), will also be added. It would, in effect, exempt from real property taxation, buildings owned by for-profit entities or any natural person, if the buildings are leased to nonprofits and are used for purposes of public charity principally in the District.

Section 2(b) Of The Bill

The second purpose of the bill is to add a special exemption under a new D.C. Code § 47-1074 entitled "H Street Playhouse—Lot 829, Square 1027." Section 2(b) of the bill would exempt the real property "comprising a portion of the Lot 829 of Square 1027" (the "Property") in the District from real property taxation so long as, and to the extent that, the Property is leased entirely to one or more

institutions, all of which are not organized or operated for private gain, and which are used for purposes of public charity principally in the District.

The Property is located at 1365 H Street, NE. We understand that the Property is currently being used by the Theater Alliance, a charitable organization for Internal Revenue Code ("IRC") § 501(c) (3) purposes. The Theater Alliance's mission is to present new or rarely produced work geared towards attracting diverse and alternative audiences to the northeast community.

According to our real property records, the Property is owned by H Street Playhouse LLC, a for-profit entity. According to the Theater Alliance's website, Mrs. Robey and her husband own the Property. Mrs. Robey is also the registered agent for H Street Playhouse LLC. Additionally, Mrs. Robey is on the Board of Directors and a Co-Founder of the Theater Alliance. Mrs. Robey also serves the Theater Alliance as a graphic designer and her husband is listed as its photographer. Moreover, according to D.C. Department of Consumer and Regulator Affairs, the legal owner of the Property, H Street Playhouse LLC, had its LLC status revoked on November 14, 2005 due to a failure to file the required two-year report for LLCs.

In light of these facts, in essence, section 2(b) of the bill appears to allow a closely-held for-profit entity basically to set up a nonprofit entity, and then allow the for-profit entity to lease its property to the nonprofit entity and receive lease payments, while avoiding real property taxes. At the same time, the lease payments will probably be funded, at least in part, by tax deductible donations to the nonprofit entity.

We strongly recommend that you do not pass Bill 16-950 because:

1. Section 2(a) of the bill will undermine the legal validity of the existing D.C. Code § 47-1002(8) and thus trigger a major long-term revenue loss for the District;
2. The proposed new paragraph B in section 2(a) and section 2(b) in its entirety are unconstitutional; and
3. The bill dramatically departs from the District's 64 year-old policy of granting real property tax exemptions only to buildings that are owned by nonprofit entities.

Undermine The Validity Of D.C. Code § 47-1002(8)

In enacting D.C. Code § 47-1002(8), Congress conferred on the District a valuable benefit that is unique to the District. That section allows only the District to grant a real property tax exemption for a building operated by a nonprofit entity and used for purposes of charity which principally benefits the public (the residents) within the District. See District of Columbia v. Cato Institute, 829 A.2d 237 (D.C. 2003). The principal geographic target and distribution of an institution's charitable activities located in a given building must be for the residents of the District under D.C. Code § 47-1002(8).

If any other state or local jurisdiction in the United States enacted such a statute, it would be unconstitutional due to the U.S. Supreme Court ruling in Camps Newfound/Owatonna v. Town of Harrison, Maine, 520 U.S. 564 (U.S. 1997). In that case, the court struck down a Maine statute that would not grant full real property tax exemptions to nonprofit summer camps unless they primarily served

Maine residents because such a statute discriminated against interstate commerce in violation of the Commerce Clause of the U.S. Constitution.

The Commerce Clause, however, imposes no limitations on Congress itself. For this reason, the unique property tax exemption law that Congress wrote for the District can limit real property tax exemptions to nonprofit public charities that principally benefit District residents and still be constitutional.

On the other hand, the Commerce Clause does apply to laws enacted by the District of Columbia Council ("Council"). This is because when Congress legislates for the District, it is exercising its general legislative powers delegated to Congress by the U.S. Constitution. But, when the Council enacts laws, it is acting no different from any other state or local legislature. Legislation passed by Council is not a congressional enactment, and thus is subject to Commerce Clause scrutiny just as any other state or local legislation. See District of Columbia v. Helen Dwight Reid Educ. Found., 766 A.2d 28, 37 (D.C. 2001), and Milton S. Kronheim & Co. v. District of Columbia, 319 U.S. App. D.C. 389, 394-397 (D.C. Cir. 1996).

If the D.C. Council significantly amends D.C. Code § 47-1002(8), as the bill proposes to do, a very strong argument can be made that this code section will no longer be regarded as enacted by the U.S. Congress, but rather as one enacted by the D.C. Council. Under those circumstances, the District could no longer require that charities principally benefit District residents as a condition to granting real property tax exemptions without violating the Commerce Clause.

The bill, if enacted, would also cause a large revenue loss because under current law, the District is not required to simply grant real property tax exemptions to every nonprofit entity that holds IRC § 501(c)(3) status. IRC § 501(c)(3) has a charitable purpose requirement without stating where or whom the benefits should target. If D.C. Code § 47-1002(8) becomes subject to the Commerce Clause, the District will have to grant real property tax exemptions to IRC §501(c)(3) organizations even though they do not meet the requirement of principally benefiting District residents.

The Bill Is Unconstitutional

If the Council enacts new paragraph B of section 2(a) and section 2(b) of the bill, those sections will violate the Commerce Clause because 1) those sections were enacted by the Council and not by the U.S. Congress, and 2) therefore, those sections cannot require that District residents be the principal beneficiaries of the charitable activities, before the exemption can be granted.

Only Nonprofits Are Entitled To Exemptions Under D.C. Code § 47-1002(8)

The bill is also bad tax policy. Under the current D.C. Code § 47-1002(8), the building must be both owned and operated by a nonprofit public charity that principally benefits District residents, although ownership and operation does not have to be concurrent in one entity. All entities involved, however, must be nonprofit public charities.

The bill would go beyond our current law, and allow buildings being used by nonprofit public charities to be owned by for-profit entities or natural persons and

still qualify for a real property tax exemption. This is a needless and wasteful real property tax exemption for several reasons.

First, if a for-profit entity has a choice between a) leasing to another for-profit entity and paying real property taxes, or b) leasing to a nonprofit and paying no real property taxes, for the same amount of rent in both cases, then the for-profit entity will lease to the nonprofit, all other things being equal. The for-profit entity is able to obtain market value rent without paying any real property taxes. This distorts the marketplace, and it is firm tax policy that taxes should not distort business decisions. The bill, in particular, does not state whether a below-market lease is required for the nonprofit public charity leasing the Property. Even if there were a below-market lease, it would be difficult for OTR to verify such arrangements annually.

Second, there should be a degree of separation between nonprofit lessees and for-profit lessors to prevent the possibility that a nonprofit's earnings could be distributed directly or indirectly to individuals who exercise control over it. In this regard, the U.S. Supreme Court in Camps Newfound, stated that "[a] nonprofit entity is ordinarily understood to differ from a for-profit entity because it is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees." Similarly, the Property at issue in this bill appears to have an influential relationship between the lessor and lessee because the Property owner also helps manage the nonprofit. Such arrangements should not be allowed because it provides an opportunity for the nonprofit to funnel tax deductible donations to its lessor under the guise of lease payments.

Third, the legislative intent of Congress in enacting the predecessor of D.C. Code § 47-1002(8) was to permit only nonprofit charitable organizations to operate without the burden of taxation. Neither the owner nor operator of the building should be a for-profit entity.

For all of the above reasons, we strongly recommend that Bill 16-950 not be enacted. Furthermore, no special stand-alone exemption should be granted to the real property located in Lot 829, Square 1027. A special stand-alone exemption creates significant inconsistencies among similarly-situated real property owners. Equal treatment within a class of taxpayers is fundamental to an equitable administration of tax laws.

Fiscal Impact of Bill 16-950

We estimate that the proposed legislation would result in a considerable loss of real property tax revenue over time given that charities that do not principally benefit the District will also be eligible to receive real property tax exemptions. In the first year of implementation of this legislation, we estimate the District would face a revenue loss of about $19 to $26 million in the first year of implementation. We also anticipate staffing costs of $225,000, and programming and other operating costs of approximately $106,500.

Thank you, Chairman Evans, for the opportunity to comment on this bill. I would be happy to answer any questions you or other Councilmembers might have at this time.