IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

No. 32695

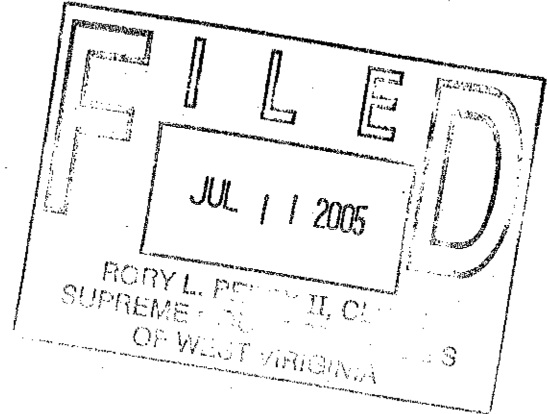
APPALACHIAN EMERGENCY
MEDICAL SERVICES, INC.,
a West Virginia nonprofit corporation,

Petitioner,

v.

REBECCA MELTON CRAIG,
State Tax Commissioner,

Respondent.



TAX COMMISSIONER'S BRIEF

VIRGIL T. HELTON,
STATE TAX COMMISSIONER OF
THE STATE OF WEST VIRGINIA

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v.

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State Tax Commissioner,

Appellee.

TAX COMMISSIONER'S BRIEF

Virgil T. Helton, State Tax Commissioner of the State of West Virginia ("Tax Commissioner"), submits this brief in accordance with the briefing schedule set by the Court and in response to the initial brief of Appalachian Emergency Medical Services, Inc. ("Taxpayer").

KIND OF PROCEEDING AND NATURE OF THE RULING BELOW

This case arose out of a dispute between Taxpayer and the Assessor of Cabell County, West Virginia. The Assessor claimed that Taxpayer's property is subject to *ad valorem* taxation, while Taxpayer claimed that its property was exempt as being used for charitable purposes. The parties brought the matter before the Tax Commissioner pursuant to the provisions of W. Va. Code § 11-3-24a. By Property Tax Ruling 02-09, issued 28 February 2002, the Tax Commissioner determined that Taxpayer's property is subject to *ad valorem* taxation. Taxpayer timely filed an appeal to the Circuit Court of Cabell County pursuant to the provisions of W. Va. Code § 11-3-25. The Circuit Court heard evidence presented at a hearing on 5 February 2003, and the parties submitted briefs in

support of their positions. By an Order dated 19 October 2004, Judge Cummings affirmed the Tax Commissioner's Property Tax Ruling 02-09, and Taxpayer is appealing from that Order.

STATEMENT OF FACTS

Taxpayer is a nonprofit corporation, organized for the purpose of assisting emergency medical services in a part of West Virginia, including Cabell County. The Internal Revenue Service has deemed Taxpayer exempt from federal income taxes pursuant to the provisions of section 501(c)(3) of the Internal Revenue Code. Taxpayer is affiliated with West Virginia Emergency Medical Services Technical Support Network, Inc. ("TSN"), which is also designated as exempt from income taxes pursuant to IRC § 501(c)(3). TSN is funded through federal and State grants, while Taxpayer has no income other than the rent it receives from TSN.

In March of 2000, Taxpayer bought the property at question in this case, renovated it and began leasing it to TSN. Because Taxpayer has no income other than the rent it receives from TSN for the building, TSN guaranteed the loan that enabled Taxpayer to buy the property. Tr. 17. The interest rate on the 15 year loan was 9.25%, but that rate is adjusted annually and at the time of the hearing in this matter the rate had declined to 5%, with the result that Taxpayer anticipates that the loan will be repaid early (before 2015).[1] Tr. 26-27 The original terms of the 15 year lease between Taxpayer and TSN provided for monthly rent payments of $5,500.00, but that amount has since been decreased to $5,100.00 because Taxpayer had built up enough in an escrow account to cover future maintenance and repairs. Tr. 20. Taxpayer and TSN believed that this arrangement would allow

[1]In other words, Taxpayer is collecting more in rent than it is required to pay under the mortgage, but has chosen to use the difference between the rent it charges and the required mortgage payment to amass equity quicker, rather than passing on the savings to TSN.

Taxpayer to become more involved with the regional EMS system, while building equity in an income-producing asset. Tr. 18. Currently, the rent charged is sufficient to pay down the mortgage ahead of schedule; and Taxpayer fully intends to continue collecting rent after the mortgage is paid off. See Tr. 19. In other words, Taxpayer fully intends to realize a net profit on the rental of its property.

Other provisions in the lease provide that TSN has sole discretion regarding how the premises will be used during the lease term (Ex. J, p. 2, § 5), TSN will pay all utilities and taxes (Ex. J, p. 3, § 6), TSN is responsible for both interior and exterior maintenance of the property (Ex. J, p. 3-4, § 8), TSN is responsible for carrying insurance on the property "in such amounts as would be carried by a prudent owner" (Ex. J, p. 4, §§ 10, 13), and TSN has unfettered right to sublet the premises without prior consent of Taxpayer (Ex. J, p. 5, § 16).

RESPONSE TO ASSIGNMENT OF ERROR

THE CIRCUIT COURT CORRECTLY HELD THAT TAXPAYER'S PROPERTY IS NOT USED FOR CHARITABLE PURPOSES, AND IS THEREFORE SUBJECT TO *AD VALOREM* PROPERTY TAXATION.

ARGUMENT

A. GENERALLY

This case presents a matter of first impression in West Virginia. The issue is whether property owned by one charitable entity and rented to another, related charitable entity is exempt from *ad valorem* property taxation.

The West Virginia Constitution provides that all property is subject to *ad valorem* taxation unless expressly exempted. W. Va. Const. Art. X, § 1 ("Subject to the exceptions in this section contained, . . . all property, both real and personal, shall be taxed"). Exemptions from taxation are strictly construed against the person claiming the exemption. See Syllabus Point 2, In re Hillcrest Memorial Gardens, 146 W. Va. 337, 119 S.E.2d 753 (1961) (". . . It is encumbent upon a person who claims his property is exempt from taxation to show that such property clearly falls within the terms of the exemption; and if any doubt arises as to the exemption, that doubt must be resolved against the one claiming it"). The West Virginia Constitution authorizes the Legislature to exempt several types of property, including "property used for . . . charitable purposes". W. Va. Const. Art. X, § 1 (emphasis added). The use contemplated by the charitable use exemption must be primary, direct and immediate, not secondary or remote. Central Realty Co. v. Martin, 126 W. Va. 915, 30 S.E.2d 720 (1944).

The Constitutional provisions only authorize the Legislature to exempt certain types of property; it is still up to the Legislature to act on that authorization. However, any statute conferring an exemption cannot expand beyond the constitutional authorization. See People ex rel. Nordlund v. Association of the Winnebago Home for the Aged, 40 Ill.2d 91, 237 N.E.2d 533, 538 (1968) (determination of compliance with constitutional requirement is judicial function which legislature may not usurp), Eden Retirement Center, Inc. v. Department of Revenue, 213 Ill.2d 273, 290 Ill. Dec. 189, 821 N.E.2d 240, 250 (2004) ("It is for the courts, and not the legislature, to determine whether property in a particular case is used for a constitutionally specified purpose").

Legislative regulations explain what constitutes charitable use of property:

> § 110-3-119. Property Used For Charitable Purposes, And Not Held Or Leased Out For Profit.
> 19.1 Charities must be operated on a not-for-profit basis, must directly benefit society, must be for the benefit of an indefinite number of people, and must be exempt from federal income taxes under 26 U.S.C. § 501(c)(3) or 501(c)(4). Moreover, in order for the property to be exempt, the primary and immediate use of the property must be for one or more exempt purposes.
> 19.2 The beneficiaries of a charity may be limited to a class of beneficiaries bearing a rational relationship to the purpose of the charity. . . .
> 19.3 A purported charity may not, however, limit the class of beneficiaries in such a way as to violate the definition of charity.

110 C.S.R. 3, § 19.

The legislative regulations define the term "charity" as follows:

> 2.10 The term "charity" means a gift to be applied consistently with the existing laws, for the benefit of an indefinite number of people, either by bringing their hearts under the influences of education or religion, by relieving their bodies from disease, suffering or constraint, by erecting or maintaining public buildings or works, or otherwise lessening the burdens of government. It is immaterial whether the purpose is called charitable in the gift itself if it is so described as to show that it is promotive of science or tends to education, enlightenment, benefit or amelioration of the condition of mankind or the diffusion of useful knowledge, or is for the public convenience is a charity.

110 C.S.R. 3, § 2.

To qualify for exemption from property tax based on charitable use, the property must: (1) be owned by an entity designated as a charity under the provisions of Internal Revenue Code §§ 501(c)(3) or (4), and (2) be used for charitable purposes. Maplewood Community, Inc. v. Craig, 216 W. Va. 273, 607 S.E.2d 379 (2004). Without question, property owned by a person or entity that is not qualified under IRC § 501(c)(3) or (4) will fail the "status test" and will not be exempt, even if it is rented to a charitable entity.

While Taxpayer's status as a 501(c)(3) entity is not contested, it is also well-established in West Virginia that property owned by a charitable entity and rented to a commercial tenant is subject

to taxation, regardless of whether the rental income is used by the charitable lessor to further its charitable goals. See Syllabus Point 1, Central Realty Co. v. Martin, 126 W. Va. 915, 30 S.E.2d 720 (1944) ("Real estate owned by a fraternal association, used for purely commercial enterprises, is not exempt from taxation under Article X, Section 1, Constitution, and Code, 11-3-9, as amended by Acts 1933, c. 40; Const. art. 10, § 1"); see also State v. McDowell Lodge No. 112, A.F.&A.M., 96 W. Va. 611, 123 S.E. 561 (1924) (property of a charitable and benevolent organization, leased for profit, is not exempt even though rents are used to retire debt, for maintenance of the property, and for charitable and benevolent purposes).

Thus, the implications for exemption of leased property where either the lessor or the lessee are charitable entities is fairly clear. What makes this case unique in West Virginia's experience is that both the lessor and lessee are charitable entities.

B. TAXPAYER DOES NOT USE THE PROPERTY FOR CHARITABLE PURPOSES

Taxpayer's primary and immediate use of the property is as a rental property, which is not an exempt use. The contention that receipt of rental income allows Taxpayer to build equity and have an income stream that can be dedicated to its charitable mission in the future merely addresses a remote and secondary use of the property, rather than a primary and immediate use. Although TSN uses the property in furtherance of its charitable purpose, TSN is neither the property owner nor the taxpayer, and thus TSN's use of the property as the lessee is also remote and secondary to Taxpayer's ownership.

Taxpayers claim that "[t]he facts show that the lease payment equals the mortgage payment", and so the property is not leased or held out for profit. Taxpayer's brief at 12. This is either

demonstrably wrong or a fine example of clever wording. What the facts actually show is that the mortgage rate originally was 9.25%, producing a mortgage payment of $5,100 per month. The rent under the lease was also set at $5,100 per month, so that all rent received by Taxpayer went toward payment of the mortgage. However, at the time of the hearing before Judge Cummings, the mortgage rate had declined to 5%, with a concomitant decline in the principal and interest due each month. This decline in the amount due under the mortgage did not result in a decline in rent charged per month. Since the decline in mortgage interest rate, Taxpayer has collected more in rent than is due under the mortgage. However, the amount Taxpayer pays on the mortgage has stayed the same, so technically Taxpayer can claim that "the lease payment equals the mortgage payment", although such a characterization ignores the fact that the payment made on the mortgage is in excess of what is due under the mortgage schedule. In other words, Taxpayer is turning a profit with regard to the property, just as Judge Cummings found. Taxpayer is merely taking its profit and plowing it back into the property as extra payments on principle.

A primary rationale behind providing an exemption for property used for charitable purposes is that charity lessens the burdens of government. 110 C.S.R. 3, § 2.10. In this case, the scenario concocted by Taxpayer and TSN has the effect of perpetuating a burden of government and providing government support of an entity that government otherwise does not choose to financially support. Taxpayer does not receive government funding, but TSN does. If TSN had bought the property in this case, instead of guaranteeing payment on Taxpayer's purchase of the property, then federal and State grants would only have had to fund TSN's use of the property for the length of the mortgage. When the mortgage was paid, TSN's expenses would go down, and thus so would the burden on government to fund it. However, under the scheme put forth by Taxpayer and TSN, where

TSN continues to pay rent to Taxpayer after the mortgage on the property is paid in full, the government never stops paying for TSN's use of the property. While rent is a legitimate expense properly funded by grants to carry out TSN's mission, the scenario in this case allows TSN to claim rental expenses longer than necessary while allowing Taxpayer, a related entity, to build equity risk-free. While this is a wonderful outcome for TSN and Taxpayer, the effect on government is to increase the economic burden beyond what it should be, rather than decrease that burden.

Furthermore, although the mission and activities of Taxpayer may be worthwhile, federal and State government have not chosen to fund Taxpayer directly. While the government funding sources apparently came to the conclusion that efficiency mandates that they fund fewer entities, Taxpayer has apparently unilaterally decided to perpetuate itself by becoming a landlord to "build equity in the property and develop a funding stream". Tr. 32; see also Tr. 11 (". . . the federal government wished to have increased deficiency [*sic*, efficiency], so the funding streams were changed from seven managing organizations to three, and then to two. And then in 1994 those two then were merged into one organization, TSN"). Government should not be asked to indirectly fund that which it has chosen not to directly fund.

Any time a tax exempt organization acts as a landlord (as distinguished from a mere landowner using its land for its tax exempt purpose), it effectively competes with other property owners who rent out land, buildings or other property. If a charitable entity's property was exempt from *ad valorem* taxation even though it rented that property to another entity, then it would enjoy a competitive advantage over other commercial lessors. From a policy perspective, this should not be a function of a charitable entity. The services offered by charitable entities are normally not in competition with commercial providers, simply because there usually is not a viable commercial

market for the services. There is a viable market for commercial real estate, and Taxpayer should not receive a tax-preferred advantage while participating in it as a landlord.

Several cases beyond West Virginia's own Central Realty express concern about the dual issues of charitable entities competing as landlords with taxpaying entities, and the difference between using property for charitable purposes and using income from the property for charitable purposes. In a personal injury case where a critical issue was whether rental premises were a charitable asset of a church, the Court of Appeals of Georgia stated:

> 'The scheme of exemption as to other than public property seems to be this: To exempt all that is used immediately and directly as a part of the establishment in the conduct of the regular business, there carried on, but not such as may be devoted to other uses, such as farming, merchandising, manufacturing, etc., and from which profit or income is derived. It is the use of the property which renders it exempt or nonexempt, not the use of the income derived from it. Property used to produce income to be expended in charity is too remote from the ultimate charitable object to be exempt. If property is allowed to be used as taxed property it also is to be taxed. If it competes in the common business and occupations of life with the property of other owners, it must bear the tax which theirs bears.

Mack v. Big Bethel A.M.E. Church, Inc., 125 Ga.App. 713,188 S.E.2d 915, 916 (1972) (emphasis added).

In a mandamus action brought by a disgruntled taxpayer to force an assessor to assess property owned by a hospital and partially rented out to private businesses, the Florida Supreme Court held:

> To afford the exemption the Constitution contemplates the actual, total and immediate use. The use by renting to persons in competition with taxpayers and applying the rents to charity is too remote.
>
> Exemptions from taxation are special favors frowned upon by the courts. They invariably cast a greater burden on other taxpayers. Statutes granting exemptions should be strictly construed.

State *ex rel.* Miller v. Doss, 146 Fla. 752, 2 So.2d 303, 304 (1941) (emphasis added).

Taxpayer's use of its property as an income-producing asset puts it in competition with taxpaying landlords and takes the property out of the realm of charitable use.

C. TAXPAYER AND TSN ARE SEPARATE ENTITIES BY CHOICE, AND SHOULD BE TREATED THAT WAY.

Taxpayer argues that, because of the intertwined nature of the boards and missions of itself and TSN, the rental arrangement in this case should be viewed no differently than if TSN, rather than Taxpayer, owned the property. This is essentially an argument to ignore the form by which Taxpayer and TSN chose to own and use the property. Taxpayer and TSN determined that it worked to their advantage from a funding perspective to have two entities involved in a purchase-and-rental scenario, and they cannot now disavow that form for property tax purposes. See W. Va. Tractor & Equipment Co. Hardesty, 167 W. Va. 511, 280 S.E.2d 270, 274 (1981) (form chosen by taxpayer is binding on the taxpayer); see also Commissioner of Internal Revenue v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967) (form chosen by taxpayer is binding on the taxpayer).

Like Taxpayer in this case, the taxpayers in Archdiocese of Philadelphia, 151 Pa.Cmwlth. 480, 617 A.2d 821 (1992) argued that the lessee was furthering one of the "top priorities" of the lessor. The Court in Archdiocese of Philadelphia interpreted this argument as "an attempt to demonstrate that Lessee shares with Lessor an identity of purpose which equates to owner occupancy". Id. at 825. The Court in Appeal of Archdiocese of Philadelphia rejected this argument, noting that the lessor and lessee were clearly separate entities. Id. at 825-26. In doing so, the Court noted an earlier case where the lessee had actually been the parent organization of the lessor, and the Court had held the parties to their chosen separate structures. Id.

The statute at issue in Archdiocese of Philadelphia provided that "property from which any income or revenue is derived, other than from recipients of the bounty of the institution or charity, shall be subject to taxation". The Court in Archdiocese of Philadelphia found that the lessee charity was "not the 'recipient of the bounty'" of the lessor charity, where the lessee paid rent of $12,000 per year; maintained comprehensive insurance liability naming the lessor as an additional insured; paid all costs pertaining to zoning, use and occupancy permits or licenses; paid all real estate and other taxes; paid all costs of remodeling and repairs; paid all utilities; provided regular interior and exterior maintenance and upkeep; and provided indemnity and defense of the lessor in case of losses or liabilities from occurrences on or about the premises. 617 A.2d at 824. The Court stated that "[u]nder these lease terms, it is difficult to envision a cost to Lessor that is not either paid directly by Lessee or reimbursed as additional rent." Id. The Court held that, even if the annual rent of $12,000 was below market value, "we can hardly view it as charity when considered in the total context of the terms of the lease", since the lessee appeared to be assuming the "full financial burden of the property, over and above rent payment." Id.

The terms of the lease in this case are very similar to the terms of the lease at issue in Archdiocese of Philadelphia. In this case, TSN has sole discretion regarding how the premises will be used during the lease term, it can sublet the premises without the consent of Taxpayer, it is contractually bound to pay all utilities and taxes, it is responsible for both interior and exterior maintenance of the property, and must carry insurance on the property as if it were the owner. Like the lessee in Archdiocese of Philadelphia, TSN in this case is not a "recipient of the bounty" of the lessor – Taxpayer. Like the property in Archdiocese of Philadelphia, the property in this case is not exempt from taxation.

D. CASES CITED BY TAXPAYER ARE EASILY DISTINGUISHABLE

Taxpayer cites to the 1964 decision of the Virginia Supreme Court in Board of Supervisors of Wythe County v. Medical Group Foundation, Inc., 204 Va. 807, 134 S.E.2d 258 (1964). This case is easily distinguishable on several grounds. First, the exemption is one for property used for hospitals, and Virginia had a history under its 1902 Constitution, of liberally construing that exemption so that "as to such property exemption is the rule and taxation the exception." 134 S.E.2d at 261. Virginia is now operating under a Constitution drafted in 1971, which is in agreement with the law of West Virginia and most other states, that "exemption from taxation is the exception, and any doubt is resolved against the one claiming the exemption." Mariner's Museum v. City of Newport News, 255 Va. 40 495 S.E.2d 251, 253 (1998), *quoting* DKM Richmond Assocs. v. City of Richmond, 249 Va. 401, 407, 457 S.E.2d 76, 80 (1995). The Virginia Supreme Court, in Mariner's Museum, upheld taxation of property owned by one 501(c)(3) entity (a museum) and leased to another 501(c)(3) entity (a hospital). In distinguishing the Wythe County case, the Virginia Supreme Court in Mariner's Museum noted that "[i]t is the use to which the property is put, not the use to which profits that are realized from such property are put, that determines whether the property shall be exempt." Id. at 254. In contrast to decisions reached under its former constitution, the Virginia Court is now in agreement with the standard used by this Court. Under current decisions of the Virginia Supreme Court, property used by its owner solely to generate rent (like the property in this case) is subject to taxation.

Second, the Virginia Court in Medical Group Foundation held that the exemption was available not only to owners but to lessees of the subject property. Id. at 261-62. No West Virginia court has ever made a similar holding absent a freely assignable bargain lease that is, itself, taxable.

See Maplewood, *supra* at 392-93.[2] Third, the Virginia Court found that the property was not a source of revenue or profit, while the Circuit Court in this case made an express finding of fact that "the property is held out and leased at a market rate for profit." Compare Medical Group Foundation, 134 S.E.2d at 262 *with* opinion of the Cabell County Cir. Ct. at 2. Given these differences, the Virginia case relied upon by Taxpayer is not helpful in analyzing this case.

Taxpayer also relies on City of Nome v. Catholic Bishop of Northern Alaska, 707 P.2d 870 (Alaska 1985). In that case, the Supreme Court of Alaska considered a case in which, among other things, a group of churches leased property to several charitable organizations. After acknowledging that the Court had previously denied charitable exemptions in cases where the lessor or the lessee (but not both) were charitable entities, the Alaska Court in Nome noted:

> We have not yet decided a case in which a nonprofit charitable group leased its property at "charitable rates" for another group's exempt activity. Here, we are confronted with eight such situations. We hold that the exempt status of the property turns on both the lessor's and lessee's use of the property. The lessor's use depends upon the terms of the lease or rental agreement.

707 P.2d at 892.

The Alaska Court did not determine whether the properties at issue in that case met its test concerning use of the property, but remanded the matter back to the trial court for that determination. Id. However, unlike the Nome case, this case does not present a situation where property is rented at "charitable rates". The rent Taxpayer receives in this case is intended by all parties to allow Taxpayer to build equity in a valuable income-producing asset. Such intent is incompatible with finding that the property is used for charitable purposes by the lessor.

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[2]Although TSN is not before the Court as the taxpayer in this case, it very well could be if the facts are as Taxpayer claims them to be. The lease is clearly freely assignable (Ex. J, p. 5, § 16); and, if Taxpayer's contention that the lease is below market value is correct (contrary to the findings of the Circuit Court), then it is a bargain lease.

CONCLUSION

Taxpayer leases out its property for profit, and so the property cannot be exempt from taxation as being used for charitable purposes.

Respectfully submitted,

VIRGIL T. HELTON,
State Tax Commissioner of the
State of West Virginia

By Counsel

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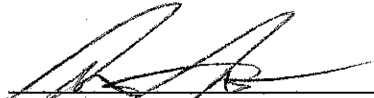
ATTORNEY GENERAL



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REBECCA MELTON CRAIG, State Tax Commissioner,

Respondent.

CERTIFICATE OF SERVICE

I, Stephen Stockton, Senior Assistant Attorney General, do hereby certify that a true and exact copy of the foregoing, *"Tax Commissioner's Brief"* was served by depositing the same, postage prepaid, via United States Mail, this 11th day of July 2005 to the following:

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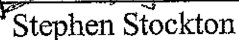

Stephen Stockton