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Legal Issues for Nonprofits

## Property Tax Exemption for Affordable Housing

This Legal Lines briefly explains and discusses the application of Michigan's property tax exemption for charitable organizations, specifically in the context of charitable organizations providing affordable housing. Recommended considerations, based on this discussion, for nonprofits seeking property tax exemption are found at the end of this memorandum.

### The Exemption And The Test Applied By The Courts

Under Michigan law, nonprofit charitable organizations that own and occupy real property are exempt from paying property tax under certain circumstances:

Real or personal property owned and occupied by a nonprofit charitable institution while occupied by that nonprofit charitable institution solely for the purposes for which it was incorporated is exempt from the collection of taxes under this act.

MCLA § 211.7o(1). Because tax-exemptions remove a burden placed on all landowners to share in the support of local government, courts strictly construe exemption statutes against those seeking an exemption and in favor of taxing units. *Michigan Baptist Homes and Development Company v. City of Ann Arbor*, 396 Mich. 660, 669-70 (1976).

Michigan courts have long relied on a four-part test to determine whether a nonprofit organization is exempt from paying property tax:

- (1) The real estate must be owned and occupied by the nonprofit claiming the exemption;
- (2) The nonprofit claiming the exemption must be a library, benevolent, charitable, educational or scientific institution;
- (3) The nonprofit must have been incorporated under the laws of the state of Michigan; and
- (4) The exemption exists only when the nonprofit is occupying the buildings and other property on the land solely for the purposes for which the nonprofit was incorporated.

*Id.* at 670 (relying on test articulated in *Engineering Society of Detroit v. City of Detroit*, 308 Mich. 539 (1944)). Requirement (3) was found to be unconstitutional because it denied equal protection to institutions registered out-of-state. See *OCLC Online Computer Library Center, Inc. v. City of Battle Creek*,

224 Mich.App. 608 (1997). Typically, most disputes regarding the application of the test revolve around requirements (2) and (4). Those organizations seeking a tax exemption must prove by a preponderance of the evidence (i.e., that it is more likely than not) that the exemption it claims was intended by the Michigan Legislature. *Retirement Homes of the Detroit Annual Conference of the United Methodist Church, Inc. v. Sylvan Township*, 92 Mich App 560, 563 (1979) (denying property tax exemption for nonprofit apartment homes because no “gift” was provided to the public).

### **Discussion: The Courts’ Analysis Of The Exemption**

Courts appear to blur the analysis for requirements (2) and (4). Originally, the Michigan Supreme Court simply required that the property being occupied for charitable or benevolent purposes “benefit the general public without restriction.” *Id.* at 671. Later, the Supreme Court reaffirmed this requirement, but also introduced an alternative way of analyzing whether an organization’s purposes were charitable or benevolent. The Supreme Court noted that

Charity is a *gift* to be applied consistently with existing laws, *for the benefit of an indefinite number of persons*, either by bringing their minds or hearts under the influence of education or religion, by relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves for life, or by erecting or maintaining public buildings or works or otherwise lessening the burdens of government.

*Retirement Homes of the Detroit Annual Conference of the United Methodist Church, Inc. v. Sylvan Township, Washtenaw County*, 416 Mich 340 (1982). The Supreme Court thus concluded that the key issue is whether the organization uses the land in such a way that there is a gift for the benefit of the general public without restriction or for the benefit of an indefinite number of persons.

Michigan courts have closely scrutinized whether housing that is paid for through a monthly fee or rent is a gift (and accordingly, charitable or benevolent in purpose). The Michigan Supreme Court has repeatedly held that just because a nonprofit charges recipients its costs for the benefits and services it provides, it does not mean that the nonprofit is not providing a gift. *Michigan Baptist Homes*, 396 Mich at 670; *Retirement Homes*, 416 Mich at 349-50. That said, the nonprofit has to do more than show it provides services.<sup>1</sup> *Michigan Baptist Homes*, 396 Mich at 670. There should be some benefit for which the recipients do not pay. *Retirement Homes*, 416 Mich at 350. And, at the very least, it is clear that the nonprofit cannot charge more than the cost of the services. *Id.*

But even if the fees approximate costs, courts may still be inclined to reject a purpose or objective as benevolent or charitable. One such basis for rejection is grounded in how freely such

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<sup>1</sup> In *Retirement Homes*, the Michigan Supreme Court’s conclusion that no gift was provided was underscored by the fact that residents who became unable to pay were transferred and no evidence was offered to show whether the cost of the homes were subsidized in part by the nonprofit organization. *Retirement Homes*, 416 Mich at 350, n.16. The Supreme Court suggests, by distinguishing the facts in *Retirement Homes* from other cases, that the use of property might have been construed as a “gift” if services and/or housing provided to the residents were subsidized, monthly fees were waived or reduced, operations were being conducted at a loss or rents were actually substantially less than costs. *Id.* at 350. One can also infer that the Court might have found a gift was being provided had the plaintiff nonprofit organization pointed to some type of support services that it provided to the residents of the apartment homes (as opposed to the volunteer services that were provided by the residents themselves).

services are provided. That is, courts look to see whether there are any restrictions imposed on who receives the services or how the services are delivered. In *Michigan Baptist Homes*, the Supreme Court concluded that the plaintiff nonprofit corporation did not operate its home for the aged for the benefit of the general public without restriction. The Court highlighted the fact that the home was not for the elderly in general, but rather was for certain elderly individuals (i.e., those who were healthy and those who had the money to afford the housing). *Michigan Baptist Homes*, 396 Mich at 671. Similarly, in *Retirement Homes*, the Court also indicated that the nonprofit apartment homes in that case were not for the benefit of the general public because the residents were selected based on their good health, ability to pay the monthly charge and ability to live independently. *Retirement Homes*, 416 Mich at 350. Indeed, the evidence demonstrated that any individual who was living in the apartments and became unable to pay the monthly fee was transferred from the apartments. At no time were the fees waived or reduced for these individuals.

Subsequent court opinions have fleshed out the test further. In *Kalamazoo Aviation History Museum v. City of Kalamazoo*, 131 Mich App 709 (1984), the Michigan Court of Appeals applied the test (i.e., whether property is used in such a way that there is a gift for the benefit of the general public without restriction or for the benefit of an indefinite number of persons) to determine whether a museum qualified for property tax exemption. In reversing the Michigan Tax Tribunal and granting an exemption, the Court of Appeals focused on how much the museum's activities enhanced the general public's knowledge, thereby bringing an indefinite number of persons under the influence of education and satisfying the *Retirement Homes* test. *Id.* at 716. Notably, the Court of Appeals found that the Museum only charged \$3 for adult admission and \$1 for senior citizens and children ages 7-11. Even though it charged a fee for services, the museum, whose operating costs greatly exceeded revenue, operated at a significant loss with a \$536,270.76 deficit in 1979 and a \$246,589.79 deficit in 1980. *Id.* at 712. Consistent with the Michigan Supreme Court's earlier decisions, the Michigan Court of Appeals acknowledged that had the evidence revealed that the Museum did not waive admission fees for those who could not afford it, the Museum probably would not have qualified for a charitable exemption. *Id.* at 718.

More recent decisions of the Michigan Court of Appeals demonstrate a fairly stringent application of the exemption test. In *Holland Home v. City of Grand Rapids*, 219 Mich App 384 (1996), the Court of Appeals found that a contractual agreement between residents of two independent-care apartment facilities and the nonprofit owner of the facilities included a continuing care plan as part of the bargain. As such, the Court of Appeals rejected the nonprofit's claim that it was providing a gift to the residents by providing residents with care for the remainder of their lives without regard for their ability to pay because the provision of such care was actually a promise (and thus, obligation) under the contractual agreement. Moreover, the Court of Appeals also concluded that the operation of the independent-care apartment facilities did not fit the nonprofit organization's overall charitable purpose. In particular, the Court of Appeals focused on the organization's mission (to assist the infirm elderly, the indigent elderly or the elderly who have no satisfactory place to live) and once again noted that the organization failed to meet its charitable purpose since it had never once waived the entire residency fee of a particular resident and for those who had exhausted their own personal financial resources, the residency fee was deducted from only from the portion of the fee that was deemed "refundable" (i.e., returned to the resident should he or she leave the apartment facility) and not from the portion retained by the organization. The decision in *Holland Home* is noteworthy mostly because the Court of Appeals was not moved by the fact that the nonprofit's

operations were funded by charitable contributions, insurance programs and governmental programs (in addition to resident fees) and that the organization maintained a significant deficit for several years (ranging from \$422,000 to \$1,700,000).

The decision in *Holland Home* is interesting when compared to the Court of Appeals' decisions in *Huron Residential Service Youth, Inc. v. Pittsfield Charter Township*, 152 Mich. App. 54 (1986) and *Redford Opportunity House v. Township of Redford*, No. 241718, 2004 WL 133985 (Mich. App. Jan. 27, 2004). In *Huron Residential*, the Court of Appeals first acknowledged the blended treatment the Michigan Tax Tribunal gave to requirements (2) and (4) of the four-prong tax-exemption test, advising that each prong should be evaluated separately.<sup>2</sup> In evaluating requirement (4) (i.e., whether the nonprofit is using the property for charitable purposes), the Court of Appeals applied the test articulated in *Retirement Homes* to the plaintiff's residential treatment programs for youths ages 10-18. The Court suggested that the test was not whether the nonprofit is paid for the services it provides, but whether the recipients of the services pay for those services and whether the recipients pay more than those services cost to deliver. The Court noted that the fact that the state paid the nonprofit a per-diem rate based on its costs and that these payments comprised more than 99% of the nonprofit's funding was consistent with the suggestion that the nonprofit was offering a gift. This was also consistent with the Michigan Supreme Court's earlier belief that to obtain tax exempt status, a portion of the services provided to residents had to be subsidized by some other than the residents themselves. *See supra*, n1. The Court additionally recognized that the nonprofit did not limit admission based on ability to pay and it had a history of occasionally accepting residents without reimbursement from the state of Michigan.

The appellate court drew a similar conclusion in *Redford Opportunity House*. In that case, the Michigan Court of Appeals affirmed a Tax Tribunal decision granting the nonprofit plaintiff a property tax exemption for its licensed facility for developmentally disabled adults. The Court acknowledged that as with the nonprofit services in *Huron Residential*, the services provided by Redford Opportunity House were a gift because the state (and not the residents) paid for the costs of the services. The Court further noted that the facilities appeared to benefit the general public because the residents were not only individuals who were healthy or had an ability to pay for services provided; rather, the residents were individuals who were unable to care for themselves, whose families were unable to care for them and who had no state-run facility in which they could live.

The Court of Appeals also granted a property tax exemption to a nonprofit environmental education and conservation institute for several acres of real property that it owned. *See Pieve v. Baltimore Township et al.*, No. 247422, 2004 WL 2451670 (Mich. App. Nov. 2, 2004). Although the nonprofit imposed certain restrictions on the public use of its property, the Court of Appeals found that these restrictions were reasonable and consistent with advancing the organization's mission. Moreover, the Court of Appeals was not troubled by the fact that the organization charged some fees for programs, lodging and facility use. The Court noted that the organization offered many programs and services for free and that when it did charge a fee, the fee was small and covered only

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<sup>2</sup> The Court of Appeals recognized that requirement (2) examines the corporation's "general character," while requirement (4) looks to the organization's specific operation. As the Court stated, "[a] charitable corporation will be taxed for its nonexempt occupancy of property but the loss of the exemption does not deprive the corporation of its charitable status or its exemptions as to charitable occupancy of other property." Thus, a nonprofit can still be a charity and do charitable works, but the use of certain property may not be a charitable purpose warranting a tax exemption.

a fraction of program costs. Indeed, the nonprofit organization's expenses significantly exceeded its revenues. As such, the Court, which also acknowledged that the charging of fees did not destroy the charitable nature of the organization, concluded that the organization clearly did not profit from the fees it charged.

### **Conclusions to Draw**

Based on a review of the several court and tribunal opinions that discuss property tax exemptions for nonprofit housing projects, there appears to be a clear distinction in how the Michigan Tax Tribunal and the Michigan courts view (1) housing that requires residents to pay rent and encourages "independent living," (2) housing that requires residents to pay rent, yet shelters those who cannot live independently and (3) housing that does not require residents to pay rent. With respect to the category (1) housing, the triers of fact usually deny property tax exemption. With respect to housing that falls under categories (2) and (3), the adjudicating bodies are more inclined to grant property tax exemption. This is probably because category (2) housing is more like a "gift" in that it usually tends to offer additional programs and services beyond housing. Similarly, category (3) housing is more like a gift because the residents are not required to pay out of pocket for the housing or they are using their state or federal benefits, which are specifically awarded to the residents to pay for their support needs. In either case, the "rent" for category (3) housing is mostly being paid by someone other than the resident.

### **Recommendations for Nonprofits Requesting Property Tax Exemption**

Going forward, nonprofits should evaluate and weigh the following facts before requesting a property tax exemption from local taxing authorities or appealing adverse exemption decisions to the Tax Tribunal or the courts. In providing evidence of the below facts, a nonprofit should be prepared to offer testimony from employees with first-hand knowledge of this information. It should also be ready to offer direct evidence of this information by providing documentary evidence.

#### **Operating Costs**

- Nonprofits should evaluate their operating costs and be prepared to explain how much it costs to operate the housing units and what sources of funding cover the costs of operation.
- Nonprofits will need to show that operating costs are mostly funded by sources other than residents' rental payments. If this showing cannot be made, then it may be difficult to obtain a tax exemption.
- If the nonprofit is obtaining rent directly from the residents, then it should be able to explain what percentage of per unit operating costs are covered by a resident's rent.

### Funding

- Nonprofits should be able to identify all sources of funding for the housing. If charitable contributions make up a portion of the funding, the client should be prepared to identify those contributors and to provide total dollar values for the amount of funding received from each particular source (e.g., government funding, private contributions from individuals, donations from corporations, donations from private foundations, rental payments from residents, etc.).
- Nonprofits should be able to tell the adjudicating body whether a resident's rent/fee is underwritten or subsidized by the government or private sources of funding, or whether the rent/fee comes directly from the nonprofits' own resources or is funded by a government benefit or subsidy that the resident receives.
- If the nonprofit receives a subsidy, then the nonprofit should provide evidence of the subsidies, their amounts and what percentage of operating costs is covered by the subsidies.

### Availability

- Nonprofits should provide evidence that the housing they offer is not restricted to certain individuals based on ability to pay or other characteristics. If a nonprofit is not able to do this, they may find it difficult to obtain a property tax exemption.
- Nonprofits need to be familiar with the process they use to find residents and whether that process discriminates among applicants based on their ability to pay, their health or other factors.
- If the nonprofit limits its residents to those who have an ability to pay, it should be ready to explain what it does in those situations where certain residents are no longer able to pay for housing. Specifically, the nonprofit should demonstrate whether it grants waivers of payment, moves residents to alternative facilities or evicts residents from the housing.
- If the nonprofit does waive rental payments, it should be prepared to provide evidence of the payments that have been waived by listing the residents who have benefited from a waiver and detailing that amount of rent that was waived in each instance.

### Supplemental Services

- If residents pay rent for housing, nonprofits should be prepared to show that they provide additional services to the residents and that these services are not covered by the rent, but rather are subsidized by other sources of funding.

- If the nonprofit offers services to its residents (apart from housing), it should be prepared to provide evidence that describes these services in detail, explains how they are administered and provided, explains whether these services are included in the operating costs of the housing units and explains whether the residents' rent/fees fully or partially fund these additional services.
- If the nonprofit wants to argue that its rents are significantly less than market value, it should be prepared to provide evidence of what the market rate would be for comparable housing at the same location, involving the same size unit with the same number of rooms and same range of services.

### Charitable Purpose

- The nonprofit will need to establish that its housing (and the way the housing is operated) is consistent with its charitable purpose as set forth in its Articles of Incorporation. This requires more than simply stating that the housing is consistent with the organization's mission. The nonprofit will need to show exactly how the charitable purpose is furthered by citing examples of how the charitable purpose is accomplished through the provision of housing.
- When discussing the charitable purpose of the organization, it is better to be specific about what that purpose is. The description should not be so vague that it is impossible for an adjudicating body to determine exactly what services are provided by the agency.

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