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LOCAL GOVERNMENT POWER TO IMPOSE FEES ON TAX-EXEMPT PROPERTY

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Churches, schools, hospitals, and government buildings dot the landscape of virtually every North Carolina community. Under state law, these properties, and others like them, are exempt from property taxation.[1] For local governments, exemption poses a real quandary. For while tax-exempt properties need to receive the same garbage service, fire protection, police patrols, and water supply as tax-paying properties, their contribution to the community "pot" is significantly less. This problem is especially acute for those communities where tax-exempt property represents a significant portion of the tax base.

As local government budgets grow leaner, the question of when, if ever, a local government may assess fees for the services it provides tax-exempt property has become more compelling. This bulletin will address local government power to impose such charges. Specifically, it will detail the capacity of local government to assess charges in three areas: (1) for services financed by the general fund, with no related fee charged to tax-paying recipients; (2) for services financed, in whole or in part, by user fees; and (3) for services and/or improvements financed by special assessment.

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1. N.C. CONST. art. V, § 3 reads as follows: "Property belonging to the State, counties, and municipal corporations shall be exempt from taxation. The General Assembly may exempt cemeteries and property held for educational, scientific, literary, cultural, or religious purposes . . . ."; in addition, N.C. CONST. art. V, § 2 permits the General Assembly to classify property for tax purposes. *See also* N.C. GEN. STAT. §§ 105-275 through -278.8.

A. Services Financed by the General Fund

In every community, local governments provide certain services to property owners free of charges other than tax. Such services, which typically include at least police and fire protection and sometimes garbage collection, are financed by property tax receipts and otherrevenues of the city or county general fund. Because tax-exempt property owners do not pay taxes, they receive these services truly free—at the expense of the local government. It is understandable then that local government policy makers may be tempted to compensate for this expense by charging tax-exempt property owners an "in lieu of tax" fee for services, providing tax-exempt property a lesser degree of service, or simply refusing to provide service at all. To what extent are these efforts permissible?

Probably not at all. Under existing law, local governments must provide the same type of tax-supported services to tax-exempt properties as they do to taxpaying properties. The rationale behind this conclusion is grounded in public policy.

The state, through express constitutional provisions and state statutes,[2] has exempted certain property from taxation because the property's use benefits the public. By granting the exemption, the state intends to subsidize the beneficial activities of the property owner. As one court summarized:

> The exemption statutes are a legislative recognition of the benefits received by society as a whole from properties devoted to appropriate objects of exempt institutions and the consequent lessening of burden on the government. They are designed to encourage these institutions to use their funds and property for such projects . . ."[3]

The entire purpose of tax exemption would be frustrated if a local government were to impose an "in lieu of tax" charge for services, require property owners to seek their own services, or force them to go without services.

2. *See* N.C. CONST. art. V, §§ 2,3; N.C. GEN. STAT. §§ 105-275 through -278.8.

3. South Iowa Methodist Homes, Inc. v. Board of Review, 136 N.W.2d 488 (Iowa 1965); *see also* Utah County v. Intermountain Health Care, Inc., 725 P.2d 1357 (Utah 1986); Des Moines Coalition for the Homelessness v. Des Moines City Bd. of Review, 493 N.W.2d 860 (Iowa 1992); Atrium Village, Inc. v. Board of Review, 417 N.W.2d 70 (Iowa 1987).

The one court that has addressed this issue concurs that tax exemption should not justify an exclusion from government services. In *Hillsboro Rural Fire District v. Washington County*,[4] a fire protection district brought an action against the county for the costs of fighting a fire on property owned by the county and exempt from taxation. The Oregon Supreme Court rejected the district's argument that because the property was tax-exempt, it was excluded from the fire protection district.[5] Instead the court reasoned as follows:

> Fire protection is a governmental service that is a general benefit to all property owners within the jurisdictional limits of the district. . . . The cost of the governmental services that tax-exempt property receives is born by the general tax. This tax exemption does not bear with it an exemption from governmental services. To require tax-exempt property to pay direct charges for governmental services received would render the tax exemption a nullity.[6]

In short, a local government policy (such as an "in lieu of" fee for general fund services) that sharply contradicts the state's public policy is not likely to be legal.

B. Services Financed by User Fees

A significant number of services provided by local governments are financed by user fees or service charges. Such fees differ from taxes because the amount of the charge is based on the service received. Courts have gone to great lengths to distinguish fees from taxes. The Massachusetts Supreme Judicial Court delineated three frequently cited characteristics that may be used to define fees:

> "[F]ees share common traits that distinguish them from taxes: they are charged in exchange for a particular governmental service which benefits the party paying the fee in a manner 'not shared by other members of the society'; they are paid by choice, in that the party paying the fee has the option of not utilizing the governmental service and thereby avoiding the charge; and the charges are collected not to raise revenues but to

4. 392 P.2d 253 (Or. 1964).

5. *See id.* at 255.

6. *Id.*

compensate the governmental entity providing the services for its expenses."[7]

Notably, whether a charge should be defined as a fee or a tax is a frequent source of litigation between local governments and tax-exempt property owners.[8] Tax-exempt organizations are able to avoid government charges if those charges are labeled "property taxes." But if charges are classified as "fees," courts generally allow governments to assess them against all properties.

1. General Rule

Once again the general rule is that local governments must provide the same level of service to tax-exempt properties as they do to taxpaying properties. But local governments may assess user fees against tax-exempt properties if they assess those same fees against taxpaying properties. The rule is one of equal treatment.

Substantial case law supports this conclusion. For example, in *Board of Education v. Greater Peoria Sanitary and Sewage Disposal District*,[9] the Illinois Appellate Court rejected the plaintiff's argument that because the Peoria school district was tax-exempt it should be excused from paying a fee for sewer services. In finding the charge to be a fee, not a tax, the court noted that the charge was the obligation of the users (rather than the owners), the charge was based upon the quality and quantity of the use, and delinquencies became a lien upon the property.[10] "The charge in dispute is simply a charge for use of a service and is imposed only upon users of the system. Under the weight of authority, a charge for sewer service is not a tax."[11] Similarly, in *Young Men's Christian Ass'n ("YMCA") v. Rochester Pure Waters District*,[12] the court required the YMCA, a tax-exempt organization, to pay a fee imposed by the water district for the removal of sewage and surface water runoff. In construing conflicting New York statutory language, the court concluded that the "sanitary sewer charge" at issue (which was based on the amount of consumption and primarily used for the district's daily operation and maintenance expenses) was valid even though the fee included a built-in charge for capital improvements.[13] (See discussion of special assessments, *infra*). The court concluded, "Properties ordinarily exempt from taxation . . . are not exempt from user charges and are liable in full for their payment."[14]

2. Equal Treatment Requirement

Importantly, however, user fees assessed tax-exempt property owners must be equivalent to those assessed taxpaying property owners. State statute imposes a duty of non-discrimination on all private operators of utility companies.[15] This statutory prohibition of discrimination in utility rates and services has been characterized by the North Carolina Supreme Court as a development of the "common law obligation of equal and undiscriminating service."[16] Though this duty is not codified for publicly owned utilities, the North Carolina Supreme Court extended the prohibition on discrimination to utilities owned by local governments in 1967.[17] So, for all practical purposes, all utilities operating in North Carolina are under a duty not to discriminate among their customers with regard to service or rates.

Although the obligation to serve without discrimination forbids only "unreasonable" differences in treatment, courts have established that the only

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7. Emerson College v. City of Boston, 462 N.E.2d 1098 (Mass. 1984) *citing* National Cable Television Ass'n v. United States, 415 U.S. 336, 341 (1974) and Vanceburg v. Federal Energy Regulatory Comm'n, 571 F.2d 630, 644 (D.C. Cir. 1977). *See also* Roseburg Sch. Dist. v. City of Roseburg, 851 P.2d 595 (Or. 1993) (storm drainage utility fee was a fee, not a tax, because it was imposed on the user of the service and could be eliminated if service was not being used).

8. *See Emerson College*, 462 N.E.2d 1098.

9. 400 N.E.2d 654 (Ill. App. Ct. 1980).

10. *See id.* at 1103.

11. *Id.* at 1104 *citing* 64 C.J.S. Municipal Corporations § 1805(d)(1) (1950).

12. 354 N.Y.S.2d 201 (App. Div. 1974).

13. *See id.* at 204–5.

14. *Id.* at 205 *citing* Silkman v. Water Comm'r, 152 N.Y. 327 (1897); *see also* Town of Poughkeepsie v. City of Poughkeepsie, 255 N.Y.S.2d 549 (App. Div. 1964). For further authority on a local government's right to assess user fees, *see* Dewberry Engraving Co. of Alabama v. North Shelby Co. Fire and Emergency Med. Dist., 519 So. 2d 490 (Ala. 1987); San Marcos Water Dist. v. San Marcos Unified Sch. Dist., 720 P.2d 935 (Cal. 1986); Housing Auth. v. City of Blythville, 310 S.W.2d 222 (Ark. 1958).

15 *See* N.C. GEN. STAT. § 62-140.

16. North Carolina Pub. Serv. Co. v. Southern Power Co., 179 N.C. 18, 101 S.E. 593 (1919).

17. *See* Dale v. City of Morganton, 270 N.C. 567, 155 S.E.2d 136 (1967) (holding that a city may not discriminate "unreasonably" among customers desiring services).

"reasonable" (i.e., acceptable) excuses for differences in service are those bearing a definite relationship to the particular service provided.[18] Factors affecting the type or cost of the service provided are most likely to fall within the scope of this relationship and justify discrimination. "Any matter which presents a substantial difference as a ground for distinction between customers, such as quantity used, time of use, or manner of service, is a material . . . factor."[19] For the purposes of this bulletin, it is important only to note that tax-exempt status is *not* the type of factor that will justify a reasonable differentiation in utility services or user fees. Nothing about tax-exempt status changes the nature of the property. Whether tax-exempt or not, a given piece of property will have the same needs for quantity of service, time and manner of service, equipment required, etc. So, while a utility may charge a tax-exempt property owner a higher user fee because of service requirements, it may not do so simply on the basis of the property's tax-exempt status.

In sum, local governments may charge tax-exempt property owners any fee for the use of services that they also charge taxpaying property owners as long as that charge is equivalent to the fee assessed from taxpaying property owners.

C. Services Financed by Special Assessment

Finally, on occasion, a local government may choose to finance a service or, more often, a capital improvement by special assessment. When a local government determines to make certain improvements to public land, such as paving a street, laying a water line, or installing sidewalks, the government may opt to have the properties benefited by the improvement finance the project. In such a case, the city or county will "specially assess" affected properties for their proportional share of the public improvement. Because the improvement will permanently benefit the affected property and increase its value, courts have upheld special assessments that place on affected property some or all of the cost for the improvement.

1. General Rule

As they do with user fees, owners of tax-exempt property frequently challenge special assessments. Tax-exempt owners argue that special assessments are a species of tax and that their tax-exempt status should excuse them from payment.[20] North Carolina courts have conclusively rejected this argument. In *Town of Tarboro v. Forbes,*[21] the leading case on this issue, the North Carolina Supreme Court wrote:

> Both the Constitution of North Carolina and the statute law provide that property belonging to the State or to municipal corporations shall be exempt from taxation . . . But there is a distinction between local assessments for public improvements and taxes levied for the purposes of general revenue. It is true that local assessments may be a species of tax and that the authority to levy them is generally referred to the taxing power, but they are not taxes within the meaning of that term as generally understood in constitutional restrictions and exemptions.[22]

The Court went on to enumerate the ways special assessments differ from taxes.

> [Special assessments] are not levied and collected as a contribution to the maintenance of the general government, but are made a charge upon property on which are conferred benefits entirely different from those received by the general public. They are not imposed upon the citizens in common at regularly recurring periods for the purposes of providing a continuous revenue, but upon a limited class in return for special benefits.[23]

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18. Wall v. City of Durham, 41 N.C. App. 649, 255 S.E.2d 739 (1979). *See* Halifax Paper Co., Inc. v. Roanoke Rapids Sanitary Dist., 232 N.C. 421, 61 S.E.2d 278 (1953); *see also Dale*, 270 N.C. 572, 155 S.E.2d at 141 ("It is well settled that a privately owned supplier of electric power, or other public service, may not lawfully refuse its service because of a controversy with the applicant concerning a matter which is not related to the service sought.").

19. State *ex. rel*. Utilities Comm'n v. Municipal Corps., 243 N.C. 293, 90 S.E.2d 519 (1955).

20. Tax-exempt property owners in North Carolina who make this argument generally rely on art. V, § 3 of the state constitution. *See supra* note 1.

21. 185 N.C. 59, 116 S.E. 82 (1923).

22. *Id*. at 61–62; *see also* CHESTER JAMES ANTIEAU & JOHN MICHAEL ANTIEAU, ANTIEAU'S LOCAL GOVERNMENT LAW 2 § 14.28 (1997).

23. 185 N.C. at 62; *see also* Raleigh Cemetery Ass'n v. City of Raleigh, 235 N.C. 509, 510–11, 70 S.E.2d 506, 508 (1952); City of Raleigh v. Raleigh City Admin. Unit, 223 N.C. 316, 319, 26 S.E.2d 591, 593 (1943); Hollingsworth v. Town of Mount Airy, 188 N.C. 832, 125 S.E. 925 (1924);

Using the *Tarboro* rationale, North Carolina courts have required municipal corporations,[24] public school systems,[25] owners of cemeteries,[26] and recent purchasers of previously tax-exempt land[27] to pay their share of local improvement assessments. With the limited exceptions discussed below, today's local governments may expect the same result. Tax-exempt property owners may be required to pay special assessments for government improvements that benefit their property.

2. Limited Exceptions

a. Property Owned by the Federal Government

Lands owned by the federal government are the most significant exception to the general rule that "no land within a county [or city] is exempt from special assessments."[28] Absent an explicit statement from Congress allowing land to be assessed, federal property is exempt from assessment.[29] Local governments may assess federal property for local improvements if Congress explicitly provides for that occurrence. Thus far, Congress' approach to such authorization has been rather scattershot,[30] so local government officials are best advised to check federal statutes directly any time federal property is benefited by a local improvement being financed by special assessments.

Notably, the rule that federal property is exempt from taxation absent explicit congressional authorization is contrary to the language of the state statute governing exemptions from assessments. The general statute provides: "[N]o land within a county is exempt from special assessments except land belonging to the United States that is exempt under the provisions of federal statute. . . ."[31] The statute's implication that federal property is subject to assessment unless *exempted* by federal statute is overridden by a U.S. Supreme Court decision finding that federal property is not liable for local improvement assessments.[32] Consequently, local government officials should assume that, in most instances, federal property is exempt from special assessment.

b. Property Owned by the State Government

Finally, the state statute dictates special treatment for property owned by the state. These lands may be assessed, but only with specific permission from the Council of State.[33] The Council of State, which is entitled to delegate their approval power to the Secretary of Administration, can approve or disprove requests.[34] If a request is approved, the Council is responsible for designating the project's funding source.[35]

D. Conclusion

The extent to which local governments may assess fees for services provided to tax-exempt properties depends entirely on how the service is funded. Governments will not be able to assess fees for services financed by general fund resources. Any additional charge to tax-exempt property would contravene the public policy behind exemption. But for services funded by user fees (charges based on services received), governments may require tax-exempt property owners to pay fees to the same extent and on the same basis as taxpaying property owners. The rule in this arena is one of equal treatment. Equal treatment also governs those projects financed by special

City of Raleigh v. Mechanics and Farmers Bank, 223 N.C. 286, 293–94, 26 S.E.2d 573, 577 (1943).

24. *See Forbes*, 185 N.C. at 63, 116 S.E. at 85.

25. *See Raleigh City Admin. Unit*, 223 N.C. at 316, 26 S.E.2d at 591.

26. *See Raleigh Cemetery Ass'n*, 235 N.C. at 511, 70 S.E.2d at 508.

27. *See Mechanics and Farmers Bank*, 223 N.C. at 294, 26 S.E.2d at 577.

28. N.C. GEN. STAT. §§ 153A-188 and 160A-220.

29. *See* 70A AM. JUR. 2D *Special Assessments* § 62 (1987).

30. *See* 42 U.S.C. § 1592g (1997) (authorizing the Secretary of Housing and Urban Development to pay taxes and special assessments for housing of persons engaged in national defense); 50 U.S.C.S. § 24 (1997) (authorizing the Alien Property Custodian to pay any tax or special assessment assessed against any money or property held by him or the Treasury Secretary under the Trading with the Enemy Act of 1917); Philadelphia v. United States Housing Corp., 124 A. 669 (Pa. 1924) [Congressional statute authorizing fulfillment of wartime "obligations" (both contractual and otherwise) allowed the city to assess federal property for street improvements].

31. N.C. GEN. STAT. § 153A-188.

32. *See* Mullen Benevolent Corp. v. United States, 290 U.S. 89 (1933); see also Van Brocklin v. Anderson, 117 U.S. 152 (1885) (holding that a state may not tax federal property because that property is being used for public purposes.).

33. *See* N.C. GEN. STAT. 153A-189.

34. *See id.*

35. *See id.*

assessments. With the specialized exceptions of federal and state-owned property, both tax-exempt and taxpaying property owners are required to pay special assessments.

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