

Health Law

Expert Analysis

Another Hospital Loses Its Property Tax Exemption

In an earlier column,¹ we analyzed the controversial revocation by the Illinois Department of Revenue of the real estate tax-exemption of Provena Covenant Medical Center, a not-for-profit Catholic hospital. That revocation was ultimately upheld by the Illinois Supreme Court. Since then, there have been more attempts by various taxing authorities to challenge the real estate tax-exemptions of not-for-profit hospitals and health care systems. A recent decision² from the Tax Court of New Jersey revoking most of the real estate tax exemption of Morristown Memorial Hospital has raised concern among not-for-profit hospitals in that state and elsewhere. The 88-page decision is as notable for its result as it is for the court's historical and legal analysis.

Exemption Criteria

New Jersey's tax exemption for hospitals³ reads, in relevant part:

The following shall be exempt from taxation under this chapter...all buildings actually used in the work of associations and corporations organized for hospital purposes, provided that if any portion of a building used for hospital purposes is leased to profit-making organizations or otherwise used for purposes which are not themselves exempt from taxation, that portion shall be subject to taxation and the remaining portion only shall be exempt...provided, in case of all the foregoing, the buildings, or the lands on which they stand, or the associations, corporations or institutions using and occupying them as aforesaid, are not conducted for profit....The foregoing exemption shall apply only where the association, corporation or institution claiming the exemption owns the property in question and is incorporated or organized under the laws of this State and authorized to carry out the purposes on account of which the exemption is claimed....

By
**Francis J.
Serbaroli**



In a 2008 decision,⁴ New Jersey's Supreme Court held that, to secure an exemption under this statute, three criteria (the "Profit Test") must be met by the applicant for an exemption:

1. the property owner must be organized exclusively for the exempt purpose;
2. its property must be actually and exclusively used for the tax-exempt purpose; and
3. its operation and use of its property must not be conducted for profit.

A decision in New Jersey revoking most of the real estate tax exemption of a hospital there has raised concern among not-for-profit hospitals in that state and elsewhere.

Hospital Case

Morristown Memorial Hospital (MMH) was granted tax-exemption for its real estate for many decades by the Town of Morristown. MMH, Overlook Hospital in Summit, N.J., and Mountainside Hospital in Montclair, N.J., came together into Atlantic Health Systems, Inc., a New Jersey not-for-profit corporation, in 1996. Thereafter, the town continued MMH's real property tax-exemption, but in 2006 and 2007 the town levied assessments on MMH's real estate and a tax assessment for 2008, claiming that MMH's operation and use of its property was for for-profit purposes. MMH challenged these assessments in the New Jersey Tax Court.

During the course of the trial, the court ruled that the property at issue was owned by an entity that was organized exclusively for a tax-exempt purpose,

and that nearly all of the property was being used for hospital purposes, thereby meeting two of the three criteria of the Profit Test for qualifying for a tax-exemption. At the conclusion of the trial, however, the court found that most areas of the hospital property were being used for for-profit purposes, that MMH thereby failed to satisfy the third prong of the Profit Test, and it denied MMH's claim for property tax exemption.

In its opinion, the court embarked upon a lengthy history of how hospitals began in the 18th century as purely charitable facilities for the sick, poor and the mentally ill whom physicians would care for at no charge. In the late 19th and early 20th centuries, the court noted, hospitals morphed into more sanitary and sophisticated centers of care catering largely to self-pay patients and the affluent. The court found that while non-profit hospitals were still considered charities and were exempt from income and property taxes, they were run much more like businesses. It concluded that "non-profit hospitals today bear little, if any, resemblance to hospitals in the 18th, 19th and early 20th centuries."

For-Profit Relationships

Turning to the corporate structure of MMH and its not-for-profit parent corporation, Atlantic, the court noted that Atlantic acts as a holding company with respect to MMH's various non-profit and for-profit subsidiaries, and the trustees who serve on MMH's board also constitute Atlantic's board. MMH, through one of its employed physicians, owns 100 percent of the stock of a number of for-profit physician practices and employs the physicians and staff who work at these so-called "captive PCs." Atlantic owns for-profit AHS Investment Corp. which owns, leases and operates real estate, provides home care and nursing services, and functions as the parent corporation for Atlantic's interest in other for-profit ventures. Atlantic also owns AHS Insurance Co., an offshore for-profit that provides insurance coverage for MMH and the other non-profit and for-profit entities under Atlantic.

FRANCIS J. SERBAROLI is a shareholder in Greenberg Traurig and the former vice chair of The New York State Public Health Council.

The court then focused on the business operations of MMH itself. It noted that MMH's medical staff consisted of employed physicians with incentive compensation provisions in their contracts; voluntary physicians who were in for-profit practice for themselves; and physicians with exclusive contracts to provide radiology, anesthesiology, pathology and emergency room services to MMH's patients on a for-profit basis. The court noted that all of these physicians practiced medicine throughout MMH's facilities, and that both the voluntary and exclusive contract physicians use MMH's facilities to generate medical revenue for themselves. Citing New Jersey case law,⁵ the court explained that tax-exempt organizations are permitted to have both exempt and non-exempt uses occurring on its property as long as the two purposes can be separately described and accounted for, and as long as the non-exempt use is never subject to the tax-exemption.

Accordingly, for-profit activities carried out on tax-exempt property must be "conducted so as to be evident, readily ascertainable, and separately accountable for taxing purposes."

[Citation omitted.]

On the other hand, exemption will be denied where there is significant and substantial "commingling of effort and entanglement of activities and operations" on the property. [Citation omitted.] Exemption is properly denied when the court is unable to discern between non-profit activity and "activities in the same location that [are] in furtherance of the interests of various for-profit entities." [Citation omitted.] It does not matter whether the for-profit entities are related or unrelated to the organization claiming exemption.

Applying this standard to MMH, the court found itself unable to discern between the non-profit activities carried out by MMH on its property, and the for-profit activities carried out by the voluntary and contract physicians on that same property. Assuming that non-exempt for-profit hospitals have similar arrangements with for-profit physicians, the court stated that to grant an exemption to a non-profit hospital that has the same relationship with for-profit physicians would result in "an inequitable advantage" to the non-profit.

The court then addressed MMH's relationship with various affiliated and non-affiliated for-profit entities. Among other things, the court noted that:

- MMH owned five for-profit captive PCs, the staff of which, including physicians, were all MMH employees; MMH loaned millions of dollars to the captive PCs and was responsible for all income and expenses of the PCs.

- MMH transferred \$2.6 million to Atlantic Health Management Corp. (AHM), a for-profit subsidiary of non-profit Atlantic, to cover expenses for MMH employees who worked at AHM-owned for-profit Morristown Surgical Center; MMH also made a capi-

tal loan of \$550,000 to Morristown Surgical Center to purchase equipment.

- MMH issued loans to other Atlantic for-profit subsidiaries, including three loans totaling \$910,000 to AHS Investment Corp.

- MMH paid \$6.4 million of the expenses of AHS Insurance Co. Ltd., the offshore for-profit subsidiary of Atlantic Health Investment Corp. that provides insurance coverage for MMH, Atlantic, and their for-profit and non-profit affiliates. MMH made two capital injections into AHS Insurance in 2009 and 2010 totaling \$12 million to cover stock market losses and large claim payouts. MMH also guaranteed AHS's \$10 million bank line of credit.

- MMH made a number of loans to for-profit physician practices that were not affiliated with MMH or Atlantic.

The court concluded:

...the operation and use of the subject property was conducted for a for-profit purpose, and advanced the activities of for-profit entities. By entangling and commingling its activities with

In the MMH case, the court found itself unable to discern between the non-profit activities carried out by MMH on its property, and the for-profit activities carried out by the voluntary and contract physicians on that same property.

for-profit entities, the Hospital allowed its property to be used for forbidden for-profit activities. The Hospital, therefore, fails to satisfy the Profit Test, and is thus precluded from exemption.

In a kind of judicial coup de grace, the court then zeroed in on the compensation paid to MMH's senior executives, and employed physicians. For example, the court noted that the total compensation of the president and chief executive officer of Atlantic was as follows:

2005: \$5,034,313;
2006: \$1,574,023;
2007: \$5,978,816.

In 2007, MMH's chief administrative officer received \$715,174 in compensation and an additional \$792,909 contribution to an employee benefit plan. In that same year, MMH's general counsel received \$708,047 in compensation and a \$776,919 contribution to an employee benefit plan.

The court found that MMH failed to meet its burden of establishing the reasonableness of the compensation paid to its executives. It also found that the contracts with employed physicians, which included base compensation and an incentive component, demonstrated a profit-making purpose since the incentive component was based on sharing prof-

its and cost savings between the hospital and the employed physicians.

Lastly, the court examined various ancillary operations, and found that MMH's gift shop and cafeteria were both for-profit users of MMH's property, and therefore those premises were not entitled to an exemption. The court found that the auditorium and fitness center qualified for tax-exemption, but that MMH failed to establish that its day care area qualified for an exemption.

Analysis

While the court's decision is likely to be appealed by MMH, this case is just the latest indication that more municipalities are looking to limit or even eliminate real estate tax exemptions for non-profit hospitals and other charitable organizations that are engaged in anything other than demonstrably charitable activities. Many municipalities are carrying very high debt, and are facing severe financial pressures. Ironically, a significant financial pressure on many localities is their increasing share of the costs of state Medicaid programs, which pay hospitals for caring for poorer patients who can't afford to buy health insurance, and is one of the factors driving up local property taxes.

Another irony is that the Affordable Care Act is encouraging more hospitals to enter into what are supposed to be cost-sharing or cost-saving arrangements with for-profit health care providers, including large medical groups. As to identifying and separating areas that are used for for-profit versus not-for-profit purposes, that is a difficult—if not impossible—task for many hospitals.

After the Provena decision was upheld in Illinois, a law⁶ was enacted allowing hospitals to deduct the expenses associated with providing charity care from their property tax bill. This and similar accommodations may allow municipalities to increase their property tax revenues while also putting pressure on not-for-profit hospitals to hew more closely to their charitable mission and purpose. One thing is clear: The once sacrosanct property tax exemptions of not-for-profit hospitals can no longer be taken for granted.

1. Serbaroli, "Revoking a Hospital's Property Tax Exemption," NYLJ, Jan. 31, 2007, p. 3.

2. *AHS Hospital Corp., d/b/a Morristown Memorial Hospital v. Town of Morristown*, Nos. 01900-2007, 010901-2007, 000406-2008, Tax Court of New Jersey June 25, 2015.

3. N.J.S.A. 54:4 - 3.6.

4. *Hunterdon Medical Center v. Township of Readington*, 195 NJ 549; 951 A.2d 931 (2008), quoting *Paper Mill Playhouse vs. Millburn Township*, 95 NJ 503, 472 A2d 517 (1984).

5. *International Schools Services, Inc. vs. West Windsor Township*, 207 NJ 3 (2011).

6. 35 ILCS 200/15-86.