Fatal Commingling of Profit and Non-Profit: New Jersey Tax Court Denies Non-Profit Hospital Property Tax Exemption – Now All Non-Profit Hospitals Are at Risk

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Many New Jersey non-profit hospitals must address whether their real property is still entitled to tax-exempt status following a recent decision by the New Jersey Tax Court and the predictable attempts by various taxing authorities to challenge the real estate tax exemptions of non-profit hospitals and health care systems in the future. In June 2015, the Tax Court determined that a non-profit hospital in Morristown was not entitled to property tax exemption because it operated too much like a for-profit business and the lines between the for-profit and non-profit activities conducted on the hospital property were sufficiently blurred so as to render nearly the entire hospital property taxable.

The matter came before the Court after the Town of Morristown ("Morristown") denied the property tax exemptions claims of AHS Hospital Corp., d/b/a/ Morristown Memorial Hospital (now Morristown Medical Center) (the "Hospital") for the years 2006, 2007 and 2008 and the Hospital challenged the denial. After extensive litigation, the Tax Court issued its opinion in *AHS Hospital Corp., d/b/a Morristown Memorial Hospital v. Town of Morristown,* 2015 WL 3956132 (N.J. Tax, June 29, 2015) ("MMH") and resolved the matter in favor of Morristown and against the Hospital.

But, beyond ruling against the individual Hospital, the Tax Court decision directly challenges whether any modern non-profit hospital, with its intermingling of for-profit and non-profit activities, is entitled to property tax exemption under New Jersey Law. The Tax Court found that the modern non-profit hospital was in essence a *"legal fiction"* because of the level of for-profit activity conducted within its walls and, to the extent that law permits such fiction, then it must flow from the law and not the other way around. The Tax Court kicked the ball squarely to the New Jersey Legislature to address the modern non-profit hospital and its entitlement, if any, to a property tax exemption going forward:

> If it is true that *all* non-profit hospitals operate like the Hospital in this case, as was the testimony here, then for purposes of the property tax exemption, modern non-profit hospitals are essentially *legal fictions;* and it is long established that "fictions arise from the law, and not law from fictions." **Accordingly, if the property tax exemption for modern non-profit hospitals is to exist at all in New Jersey going forward, then it is a function of the**

Legislature and not the courts to promulgate what the terms and conditions will be. Clearly, the operation and function of modern non-profit hospitals do not meet the current criteria for property tax exemption under *N.J.S.A.* 54:4–3.6 and the applicable case law.[1]

The Court's lengthy opinion can be summarized by the following concepts: were there activities conducted on the Hospital property that can be traced to another's "personal pocket;" if so, were such for-profit activities conducted on portions of the property that can be easily ascertained and deemed taxable or were such for-profit activities so inextricably commingled with the non-profit activities that the areas where the for-profit activities were conducted cannot be separated? The burden was on the Hospital to prove it was entitled to the property tax exemption and the Court found, after an analysis of all the operations and physical spaces of the Hospital that, with few exceptions, it did not meet this burden.

The New Jersey statute which specifically provides for property tax exemption to non-profit hospitals and the New Jersey Constitution both require that the tax-exempt entity not operate for profit. The Tax Court addresses, in part, how for-profit activities can create an unfair advantage over for-profit competitors and how entities operating for profit on non-profit property gain advantage at the burden of tax payers. The argument is that if a non-profit hospital is able to use its property for-profit and still be exempt from property tax, it would have an unfair advantage over for-profit hospitals. Further, if for-profit entities are able to operate on the hospital property and benefit from its property tax exempt status, they would have an advantage over other businesses - which advantage would be indirectly subsidized by the taxpayers.

Breaking Down the Tax Court Decision

The New Jersey statute that permits the non-profit hospital tax exemption is N.J.S.A. 54:4-3.6 which provides a property tax exemption to such hospitals for "all buildings actually used in the work of associations and corporations organized exclusively for hospital purposes." Portions of buildings that are leased to for-profit organizations or are otherwise used for non-exempt purposes are not entitled to the tax exemption.

To analyze whether the Hospital qualified for the tax exemption, the Court looked to three criteria derived from the case of *Paper Mill Playhouse v. Milburn Township*, 95 *N.J.* 503 (1984): 1) whether the property owner is organized exclusively for the tax exempt purpose; 2) whether the Hospital's property is actually used for the tax exempt purpose; and 3) whether the Hospital's operation and use of the property is

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conducted for profit. The Court found that the failure to satisfy any one of the three criteria would destroy the exemption.

Having found the Hospital satisfied the first two prongs of the test in prior opinions, the Court focused on the third prong referred to as the "*profit test*" and concluded that with minor exception, the Hospital ran afoul of the profit test. The Court examined in detail each of the following areas of the Hospital's operations as further described below: the Hospital's relationship with private and exclusive contract physicians (i.e. RAP doctors); its relationship with affiliated and non-affiliated for-profit entities including the simultaneous roles played by Hospital executives in such entities; its executive's salaries; its direct-employed physicians' contracts; its third-party agreements for parking and ancillary services; its gift shop; and its auditorium, day care, fitness center and cafeteria. The only parts of the Hospital property ultimately found to qualify for the tax exemption were the visitor parking lot, the auditorium and the fitness center. The Court found the for-profit activities permeated the Hospitals operations.

Unconfined For-Profit Physicians

The Court found that N.J.S.A. 54:4-3.6 requires any for-profit activity conducted on tax exempt property be done in such a way that it is "evident, readily ascertainable, and separately accountable for taxing purposes." However, when that is not the case and "where there is significant and substantial "commingling of effort and entanglement of activities and operations" on the property. … 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." … It does not matter whether the for-profit entities are related or unrelated to the organization claiming exemption."[2]

Using this standard, the Court examined the physicians that practiced on the Hospital property. Out of the three types of physicians that work at the Hospital, the Court found that, as opposed to physicians employed directly by the Hospital, two groups of physicians practice for-profit. One of the for-profit physician groups consists of the voluntary self-employed physicians from the community with privileges at the Hospital. The other for-profit group consists of physicians with exclusive contracts with the Hospital that work in the areas of radiology, anesthesiology, pathology, and emergency services (RAP doctors).

Since these two groups of physicians worked for-profit and represented taxable activity not entitled to the exemption, the Court analyzed whether such physicians were restricted in where they practiced so such areas could be separated and identified as taxable. Unsurprisingly, the Court found, that these "for-profit" physicians were not confined to specific areas of the Hospital property but rather "worked throughout the Subject Property without limitation or restriction."[3] Further, the testimony underscored that physicians were "actually … allowed anywhere in the hospital."[4] The Court went on to find that not only did the "for-profit" physicians operate throughout the Hospital's property, they also engaged in private medical billing for which they receive the proceeds.

The Court concluded that because these physicians who were acting for profit were not confined in a readily ascertainable separate space and the Court could not delineate between the physical areas of for-profit and non-profit activity, most of the Hospital property was thus, taxable.

Affiliated and Non-Affiliated For-Profit Entities

The Court next examined the Hospital's relationship with various affiliated entities (*i.e.*, captive PCs, Atlantic Health Management Corp. and A.H.S. Insurance Co. Ltd.) as well as non-affiliated entities to which the Hospital made loans. The Court looked not only to the benefits flowing to the Hospital from such relationships but also the benefits flowing to the other for-profit entities. The result was that based on the proofs provided with respect to Hospital transactions with all the affiliated and non-affiliated entities, the Hospital was determined to be in violation of the profit test.

Atlantic Health System, Inc. ("Atlantic") is the holding company for the Hospital and was created to be the sole member of the Hospital. The Hospital was the 100% owner of the stock of five for-profit physician practices (the captive PCs). The Vice-President of Atlantic and Chief Operating Officer of the Hospital (and later President of the Hospital), was the sole shareholder of the captive PCs holding the stock in trust for the Hospital. The doctors and other employees of the captive PCs were employed by the Hospital. The Hospital was responsible for all income and expenses of the captive PCs. The captive PCs all generated losses and the Hospital loaned them millions subsidizing the losses in order to meet the needs of the community. The Hospital also provided recruitment loans to private physicians to transition their practices. The captive PCs lacked accounting departments and the Hospital processed their financials. The Court found that based on the dual roles, it was not possible for there to be arm's length transactions.

The Court then analyzed the Hospital's relationship with Atlantic Health Management Corp. ("Atlantic Management"), a subsidiary of Atlantic that owned several affiliated for-profit entities. The Court noted that during the time in question, the Vice President of Finance and Chief Financial Officer for Atlantic (the "CFO") also served in those roles for the Hospital and was a statutory officer for multiple other affiliated for-profit subsidiaries of Atlantic. Like other board members with dual roles, the CFO was compensated only for work done for the Hospital and Atlantic but not for the for-profit entities for

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which he served as a statutory officer. Again, the Court found that based on this dual role, it was not possible for there to be arm's length transactions.

Atlantic Management's revenue was approximately 3% of Atlantic's revenue. Separate audits were conducted for Atlantic's non-profit and profit entities as well as Atlantic Management and its subsidiaries. No Hospital employees were employed by the for-profit subsidiaries of Atlantic Management other than for one surgical center, which also received a $2.6 million transfer to cover the Hospital employee's expenses. The surgical center further received a capital loan from the Hospital to purchase equipment for which no interest rate was indicated. The Court noted that the Hospital also made loans to other for-profit subsidiaries of Atlantic Management such as AHS Investment Corp. (the primary for-profit company of Atlantic).

The Hospital also had a relationship with AHS Insurance Co. Ltd. ("AHS Insurance"), a for-profit subsidiary of Atlantic, which is a "single-parent captive" insurance company acting as a self-insurance trust fund for the Hospital against professional and general liability. As a "single-parent captive," AHS Insurance did not sell insurance commercially but rather only provided coverage to Atlantic. The Hospital paid the insurance premiums for all of Atlantic's for-profit and non-profit subsidiaries and received charge-backs for such costs from the for-profits. The Vice President and General Counsel of Atlantic and the Hospital during the time in question (the "GC") also served as president of AHS Insurance. The GC was only compensated for work at the Hospital and Atlantic but not for the work at AHS Insurance which included review and signing of policy documents and hiring professionals. However, the GC's work for AHS did not include determining the premiums paid to it.

AHS Insurance did not process claims against its insureds but rather served as a "bank account."[5] Claims against any of the insureds were processed by the risk and insurance department of the Hospital. However, the GC was in charge of the Hospital's risk department and made determinations as to amounts paid from AHS Insurance. The employees in the risk department were all Hospital employees. The GC and the CFO served on the Board of AHS Insurance, the Executive Board of Atlantic and several of its for-profit and non-profit subsidiaries. The Hospital paid the expenses of AHS Insurance and then billed AHS Insurance's parent company Atlantic Health Investment Corp. The Hospital also guaranteed a line of credit for AHS Insurance and provided capital transfers to AHS Investment to cover stock market losses. The Court found that there was no meaningful separation between the Hospital and AHS Insurance as the Hospital "called all the shots."

The Court concluded that all of the above relationships, in addition to the loans the Hospital gave to non-affiliated for-profit entities, were evidence that the use of the Hospital property was for a profit-making purpose and was providing a pecuniary benefit to for-profit entities in contravention of the profit test and the tax exemption statute.

Executive Salaries

The Court's executive compensation analysis focused on four executives: 1) the President and CEO of Atlantic and the Hospital; 2) the Vice President of Human Resources and Chief Administrative officer for Atlantic and the Hospital; 3) Vice President and General Counsel of Atlantic and the Hospital and 4) the Vice-President of Atlantic and COO (and eventual President) of the Hospital. The Court looked to whether their compensation, which included base salaries, bonuses, and benefit plans, was excessive. In order to determine if such compensation was excessive and thereby offensive to the profit test, the Court looked to salaries of other people in similar positions paid by similar institutions. The Court summed up the factors to be considered in the analysis as follows: (1) the nature of the institution (*i.e.*, for-profit or non-profit, private or public), (2) the size of the institution, (3) the location of the institution, and (4) the position for which the salary is paid and the work being performed."[6]

In keeping with the rest of the opinion, the Court found the Hospital failed to show that the compensation paid to its executives was reasonable and not excessive. A recurring theme in the opinion is the Court's assertion that the Hospital failed to produce proof. What is not clear is the extent to which proof was absent versus the extent to which the Court deemed the proof presented as insufficient. For example, the Hospital's expert stated that the Hospital's compensation committee recognized the Morristown, NJ Hospital was located in the New York metropolitan area and thus competes for talent with other institutions in New York City, and the suburbs of New York, Connecticut and New Jersey. But the Court found that this conclusion was "unsupported by any evidence, testimony or reliable data" that the Court could evaluate. (The Court then cited an article stating that medicine is practiced locally and doctors generally have affiliations near their practices.)

The Court also rejected outright the Hospital's proposition that the three step process applicable to the IRS regarding income tax should be applied to New Jersey. The Court was perplexed as to how the standard for the federal income tax exemption would be relevant to tax in the exclusive realm of state and local government "based on the true value of real property."[7] The Court was not persuaded by the Hospital's expert as to why the IRS standard should apply and again lobbed the ball back to the Legislature.

Employed Physician Incentive Compensation

The Court next examined the compensation paid to physicians employed directly by the Hospital. These physicians

received a base salary in addition to incentive compensation. The incentive compensation which factored in the specialty area of the physicians was based on "qualitative factors, such as decreasing ventilator-associated pneumonia or central line infections during a stay at the hospital" and "quantitative factors, such as the number of patient visits."[8] The incentive compensation was paid from "incentive pools" which were derived from a set aside portion of department revenues.

Again, as with the analysis of executive compensation, the Court looked at whether the compensation of the employed physicians was excessive. The tax-exemption "death knell" in this area arose from incentive compensation paid to these physicians as part of their compensation package because it involved the sharing in Hospital revenue. In other words, because the Hospital revenues ended up in another's "personal pocket" through the incentive compensation, they violated the profit test. The employment contracts were found to evidence a profit-making purpose since through the incentive compensation the physicians shared the *profits* with the Hospital.

Third Party Agreements

The Court analyzed two third-party agreements with the Hospital: one for management of the visitor parking garage by Gateway Security Systems and the other for support services such as "food and nutrition services, catering, environmental services, laundry and linen distribution, patient transportation, and plant operations maintenance" with Aramark Healthcare Support Services, Inc. The management contract with Gateway for the visitors parking garage was the only relationship to come out unscathed and in compliance with the profit test because Gateway was paid in essentially the same manner as Hospital employees (other than the physician-employees) and the pay was not alleged to be excessive. The Court found that the Hospital paid Gateway a fixed fee and the Hospital was responsible for operating the garage. Further, the Court found it operated the garage at a loss. Thus, the Court was satisfied that the profit test was met and the visitors parking garage was found exempt from taxation.

In contrast, the Aramark contract had incentives for efficiency. Specifically, if there were costs in excess of the agreed upon budget, Aramark paid the excess up to 25%. Similarly, if expenses were below budget, Aramark could keep 10% of the savings and the Hospital received the remainder. The Court found that the 90-10 split of the savings, whether it was "characterized as incentive compensation or profit-sharing disguised as cost-savings" is proof of a profit-making purpose.[9] The Court further found "no meaningful distinction whether profit comes in the form of increased revenues or decreased expenses" and that the sharing of the excess costs as well as savings is typical of a "commercial activity or business venture."[10] Thus, the profit test was violated and the Court found the areas where Aramark operated to be subject to taxation.

The Gift Shop

Adding insult to injury, the property used for the Hospital's gift shop, run by volunteers through the Women's Auxiliary was also determined to be taxable. The Court found that the gift shop was not reasonably necessary for the tax exempt purpose of the Hospital. The Court noted that although the gift shop did not serve a core hospital purpose it could still be exempt under the use test if the activity is reasonably necessary for the hospital purpose. But the Court found the gift shop was a mere "convenience for hospital visitors who could otherwise purchase similar gift items at a variety of stores" other than at the Hospital and which represents "a form of competition to commercially owned facilities."[11] Thus, the gift shop is taxable.

The Auditorium, Day Care Fitness Center and Cafeteria

Finally, the Court analyzed the remaining areas of the Hospital. The Court found that the Hospital's auditorium, for which no fees appeared to be collected, and the fitness center, for which only a *de minimis* fee was collected, were exempt from taxation. However, the cafeteria which was run through the contract with Aramark, which the Court had already found to involve profit-sharing, failed the profit test and was taxable. The Hospital did not provide information regarding the collection of fees from the day care center and thus, the Court found it did not meet its burden and, as a result, the day care area was taxable.

What's Next?

As acknowledged in the Court's decision, hospitals have come a long way from what they were in the mid-18th century – primarily places where poor and helpless patients went to die and where, consequently, doctors loathed to go – to the present day where they are cutting edge centers of knowledge, technology and innovation that can drive the entire economics and culture of a community.

Ironically, 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. These very practices of the Hospital that served to create efficiencies and encourage the provision of quality care, thereby also making it competitive in a challenging marketplace, are the very practices that the Court determined were too similar to regular commercial activity to entitle it to tax exemption.

Although the opinion suggests that New Jersey non-profit hospitals are taking unfair advantage of for-profit competitors through tax exemptions, the evidence may suggest otherwise. In fact, this summer saw the bankruptcy filing of yet another New Jersey non-profit hospital when St. Michael's Medical

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Center filed for Chapter 11 protection on August 10, 2015. Similarly, a 2014 report by the Health Professionals and Allied Employees,[12] part of the AFL-CIO, stated that in the preceding decade, 19 hospitals had either closed or filed for bankruptcy and 8 non-profit hospitals were sold to for-profit entities with 6 more pending.[13]

Although it is possible that the MMH decision is of narrow impact, resulting in part from either insufficient proofs submitted by the Hospital to support its exemption or the dismissal of sufficient proofs by the Court; the Judge made it clear that his decision could have a wide reach. One thing is certain, municipalities hungry for new tax revenue may have been handed an unprecedented opportunity to fill their coffers with new revenue from an unlikely source.

Barring a reversal on appeal, the only viable solution may be a legislative one. By virtue of decreased governmental and commercial reimbursement, increased competition by outpatient facilities that are not required to provide free charity care, and the extraordinary regulatory burdens and oversight imposed by the State and ACA, hospitals have been forced, out of self-preservation, to behave more like commercial enterprises than ever before. In the face of this dilemma, where the next bankruptcy filing of someone's beloved community hospital is all but inevitable, the New Jersey Legislature may need to intervene to preserve the hospitals' property tax-exempt status despite their modern business attributes. However, legislative signals from Trenton suggest to the contrary. New Jersey Senate President, Stephen Sweeney, has stated publicly that he believes that modern non-profit hospitals are really conducting business like for profit entities and has committed to pursuing tax legislation that will requrie non-profit hospitals to pay their fair share of taxes like other businesses in the community.[14]

This debate will require a delicate balance between the realities of modern day non-profit hospitals, the value they bring to the communities in which they are located, and the financial needs of local municipalities. This may not be an easy task but it is one worth addressing. In the interim, non-profit hospitals need to reexamine their business model and begin by separating the non-profit activities from any for-profit activities, permitting no commingling of funds, profits or loans, and establishing independent boards of directors and personnel among related entities.

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Endnotes

[1]MMH at *43 (emphasis added) (internal footmarks omitted).
[2]MMH at *23 (internal citations omitted).
[3]MMH at * 24
[4] Id.
[5]MMH at *29.
[6]MMH at *33.
[7]MMH at * 36.
[8]MMH at *36.
[9]MMH at *40.
[10]MMH at *40.
[11]MMH at *42.
[12]The Health Professionals and Allied Employees ("HPAE") is a healthcare labor union comprised of nurses and other health care workers. HPAE is affiliated with the American Federation of Teachers and AFT and the American Federation of Labor and Congress of Industrial Organizations.
[13]See Bob Herman, Report: *Poor Oversight in New Jersey Leading to "Destabilized" Hospitals.* Becker's Hospital CEO Report E-Weekly, (March 26, 2014), http://www.beckershospitalreview.com/finance/report-poor-oversight-in-new-jersey-leading-to-destabilized-hospitals.html.
[14]Susan K. Livio, *NJ Senate prez pushing for paid sick leave law, taxing hospitals,* NJ.com, (Aug. 31, 2015), http://www.nj.com/politics/index.ssf/2015/08/passing_paid_sick_leave_and_taxing_hopsitals_on_sw.html.