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Morristown Memorial Hospital: A Tax Exemption Ruling All Nonprofit Hospitals Need to Know About.

A recent New Jersey Tax Court decision has nonprofit entities on edge. The decision may offer tax authorities the opportunity to pursue payments from nonprofit hospitals and may result in the redefining of tax exemptions by state legislators.

On June 25, 2015, the Tax Court of New Jersey held that Morristown Medical Center, a federally tax-exempt organization and New Jersey nonprofit corporation, should pay property taxes on virtually all of its 40-acre property in Morristown, New Jersey. Judge Vito Bianco ruled that the hospital failed to meet the legal test that it operated as a nonprofit, charitable organization under the state tax law for tax years 2006 through 2008. The ruling puts $2.5 million per year in play for each year covered by the decision.

The decision is unique in that it evaluated the entangled nature of the hospital's for-profit and nonprofit affiliates as compared to the more traditional approach of counting charitable contributions as the principal indicator of nonprofit status in order to decide to eliminate the hospital's property tax exemption. The ruling was limited to the hospital's state property tax exemption and did not affect its federal tax status as a nonprofit.

The Court stated that 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." In rendering the decision the Court focused on the "blurred lines" between the hospital's nonprofit and for-profit activities with a specific focus on several aspects of its "labyrinth" and "entangled infrastructure." Specifically, Judge Bianco focused on the hospital's executive compensation arrangements with hospital executives, compensation paid to employed physicians, and third-party arrangements with service providers.

In evaluating the hospital's executive compensation arrangements, the Court held that the hospital failed to meet its burden of proof concerning the reasonableness of the compensation paid to some of its senior executives. In certain instances, executives were paid unreasonably high salaries (e.g., $5 million to its CEO in 2005) and received other benefits (such as automobile stipends and golf club memberships) that were unreasonable and excessive as compared to executive compensation arrangements for similarly situated executives. In making such a decision, the Court ruled that the hospital failed to convince it that the standard applied by the IRS to determine appropriate compensation should be adopted in New Jersey. The ruling also identified that productivity incentive payments contained in the hospital's contracts with its employed physicians demonstrated a "profit-making purpose" in instances in which employed physicians received additional compensation based on, in one instance, the number of new patients and number of surgeries performed.

Lastly, the hospital's management contract with a third-party service provider to manage the cafeteria was problematic for Judge Bianco since it included a split of budgetary savings and resembled incentive compensation or profit sharing disguised as cost savings. Specifically, Judge Bianco stated that the management contract "demonstrates that both parties contemplated the generation of additional revenue in the form of reduced expenses. This additional revenue was then split between the hospital and the third party. The Court found there is no meaningful distinction whether profit comes in the form of increased revenues or decreased expenses. Only the hospital's auditorium, fitness center and visitor's garage were held to be exempt from property taxes.

The activities which the Court found to be evidence of a "profit-making purpose" are activities in which federally tax-exempt hospitals have routinely engaged throughout the United States. If upheld, the ruling could have significant precedential value in New Jersey and beyond. As of July 9, 2015, the hospital and the municipality announced that they were engaging in "talks in an effort to end the court case." One possible resolution would be for the parties to enter into a PILOT program, which allows nonprofits to negotiate voluntary and arranged payments to municipalities in lieu of making payments for taxes. These types of arrangements can preempt the tax-exempt litigation on display in this case.

Regardless of the outcome, tax-exempt hospitals and nonprofit entities nationwide should be on notice. Municipalities suffering from budgetary constraints may use the ruling as the basis for additional challenges to a hospital's tax-exempt status. Hospitals and nonprofit entities should use this decision as the catalyst to audit their internal infrastructure to ensure sufficient distinctions between their for-profit and nonprofit activities.

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Attorneys in Ballard Spahr's Health Care Group represent clients across the health care industry, including hospitals, health systems, clinical laboratories, pharmacies, long-term care facilities, insurance companies, and pharmaceutical manufacturers. Our attorneys counsel clients on regulatory, compliance, privacy and data security, transactional, financing, benefits and compensation, and labor and employment matters.

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