

The Morristown Decision and its Potential Impact on Tax-Exempt Entities

If determining the non-profit status of a hospital was once a relatively straightforward exercise, a New Jersey court has now made it a significantly more complicated endeavor. On June 25, 2015, Judge Vito Bianco of the Tax Court for the State of New Jersey affirmed the denial of property tax-exempt status for Morristown Memorial Hospital (the “Hospital”), a 700 bed acute care hospital located in Morristown, New Jersey.¹ Utilizing New Jersey statutes and case law, Judge Bianco examined multiple entities associated with the Hospital and found that, in the aggregate, the land and buildings on which the Hospital operates are “being used substantially for profit” in violation of New Jersey tax law.²

In order to understand why the court revoked the Hospital’s property tax-exempt status and how such reasoning may affect other hospitals, hospital administrators should identify the entities examined in Judge’s Bianco’s ruling and how these entities factored into the rationale behind the denial of tax-exempt status. Additionally, hospital administrators should be aware that each state has the ability to define “non-profit” status for state tax purposes, which may differ from the federal standards for non-profit status. This HC Topics article will discuss the case, the entities examined in the opinion, and how the reasoning utilized by the New Jersey Tax Court could apply to hospitals nationwide.

The case at hand, titled *AHS Hospital Corp., d/b/a Morristown Memorial Hospital v. Town of Morristown*, examines a critical issue for non-profit organizations: whether the organization operates in a *for profit* manner. Under federal law, a hospital, or other organization, may receive non-profit status if its primary purpose is to provide charitable, scientific, and educational services to the community.³ In contrast, the *Morristown* opinion utilized New Jersey tax law to examine the Hospital’s property tax exemption. The *Morristown* court followed a three-prong test, articulated in *Paper Mill Playhouse v. Millburn Twp.*, to determine whether a property can receive an exemption from property taxes under N.J.S.A. 54:4-3.6:

- (1) The property must be structured exclusively for a tax-exempt purpose;
- (2) The property must be “actually and exclusively used for the tax exempt purpose”; and,

- (3) The “operation and use of [the] property must not be conducted for profit.”⁴

The court focused solely on the “for profit” prong of the *Paper Mill* test, utilizing a “realistic common sense analysis of the actual operation of the taxpayer.”⁵ This approach is marked by considering whether there is a “significant and substantial comingling and entanglement of activities and operations” on the property at issue,⁶ and if an organization seeking property tax exemptions operates in this manner, the exemption should be denied.⁷

The court utilized this “comingling and entanglement” approach to analyze numerous entities affiliated with the Hospital. First, the court called into question the business and operational relationships between the Hospital and its affiliated physicians. The court highlighted three types of physicians that are present at *Morristown Memorial Hospital*: (1) voluntary physicians; (2) exclusive contract physicians; and, (3) employed physicians.⁸ In order to determine a distinction between the exempt verses the non-exempt portions of the hospital’s property, the court looked to the fluidity of where each type of physician worked.⁹ However, according to testimony cited by the court, these physicians were “allowed anywhere in the hospital” to conduct for-profit medical services, and were not limited to specific areas within the Hospital for *for-profit* or *not-for-profit* activities.¹⁰ If for-profit doctors were allowed to work in what was designated as a qualifying exempt part of the hospital, a clear distinction between those for-profit to not-for-profit spaces did not exist. Additionally, the court found that the Hospital President, Dr. Joanne Conroy, served as the sole shareholder in five *for-profit* physician practices,¹¹ that “all their financials were processed by the Hospital,”¹² and that the Hospital repeatedly provided loans to these practices that were forgiven by the Hospital.¹³ Considering these facts, the court found that “this comingling of effort and activities with for-profit entities was significant, and a substantial benefit was conferred upon for-profit entities as a result.”¹⁴

Valuation experts should take careful note of the court’s consideration of the expert testimony regarding executive salaries. In New Jersey, salaries for non-profit staff members must not be “excessive.”¹⁵ To determine whether salaries are “excessive,” the court considered the following factors: (1) whether the institution is for-

profit, non-profit, private or public; (2) the size of the institution; (3) the location of the institution; and, (4) the job duties of each executive.¹⁶ As part of this examination, the court considered the salaries of both Hospital executives as well as executives at *Atlantic Health System (AHS)*, the holding company for the Hospital and other for-profit and non-profit entities.¹⁷ Additionally, the court considered base salaries as well as the benefit plans that executives received, which included a car stipend, cell phone plan, and a golf club membership, bonuses and incentive compensations.¹⁸

In a noteworthy section of the opinion, the court took exception to the Hospital's expert testimony regarding the reasonableness of executive compensation, specifically the role of federal tax law in determining reasonable executive compensation. According to the court, the Hospital's expert noted that the AHS Compensation Committee, which reviews and approves executive compensation, were responsible for "follow[ing] the process for meeting the requirements for the presumption of reasonableness, as defined in [Internal Revenue Code] § 4958."¹⁹ The court rejected the legitimacy of this IRS standard for determining executive compensation for non-profit executives in New Jersey, stating:

*"It is unclear to this court why a standard designed for a federal tax system based on income...is at all relevant to a tax exclusive to state and local government based on the true value of property. Clearly, the expert provided no compelling reason why the court should employ the IRS standard other than it's generally the only one out there. Even if the IRS standard were somehow applicable to New Jersey, it would seem to this court that it would only apply, by analogy, to taxes similar to those in the federal system for which it was designed."*²⁰

As a result, the court found the IRS standard inapplicable to the case at hand, thereby leading the court to hold the Hospital did not properly establish the reasonableness of its executive compensation.²¹

The decision to eliminate Morristown Memorial Hospital's tax-exempt status has not prompted an immediate appeal. However, the decision could spark a change in non-profit taxation that would have consequences for other non-profit hospitals, both in New Jersey as well as nationally. The court's denial of the Hospital's property tax exemption may impact tax litigation for other New Jersey health-care non-profit entities whose appeals are currently under review.²²

Additionally, the *Morristown* decision could lead to more vigilant property tax assessments in New Jersey, which could impact property containing day cares, universities, and schools held within churches.²³

While, for hospitals outside of New Jersey, the impact of the *Morristown* decision is still unknown. Administrators and their legal counsel are being admonished to closely follow further developments in the taxation of non-profit organizations. Hospital administrators should note that the *Morristown* decision rests on a reading of property tax law specific to the state of New Jersey, especially regarding executive compensation. However, if courts outside of New Jersey utilize the *Morristown* decision as persuasive authority in their own considerations of non-profit status, leadership for non-profit hospitals may be wise to consider the entities examined in the *Morristown* case and how similar entities in their institution could be subject to similar scrutiny.

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- 1 AHS Hospital Corp. v. Town of Morristown, No. 000406-2008, 2015 WL 3956132 at *1 (N.J. Tax Ct. June 25, 2015).
 - 2 *Ibid*, p. 88.
 - 3 26 U.S.C. § 501(c)(3) (2012).
 - 4 AHS Hospital Corp. v. Town of Morristown, No. 000406-2008, 2015 WL 3956132 at *40-41 (N.J. Tax Ct. June 25, 2015) (quoting Paper Mill Playhouse v. Millburn Twp., 95 N.J. 503, 506 (1984)).
 - 5 AHS Hospital Corp. v. Town of Morristown, No. 000406-2008, 2015 WL 3956132 at *41 (N.J. Tax Ct. June 25, 2015) (quoting Paper Mill Playhouse v. Millburn Twp., 95 N.J. 503, 521 (1984)).
 - 6 AHS Hospital Corp. v. Town of Morristown, No. 000406-2008, 2015 WL 3956132 at *46 (N.J. Tax Ct. June 25, 2015).
 - 7 *Ibid*.
 - 8 *Ibid*, p. 23.
 - 9 *Ibid*, p. 24.
 - 10 *Ibid*, p. 47.
 - 11 *Ibid*, p. 54.
 - 12 *Ibid*, p. 55.
 - 13 *Ibid*, p. 60-61.
 - 14 *Ibid*, p. 60.
 - 15 *Ibid*, p. 63.
 - 16 *Ibid*, p. 33.
 - 17 *Ibid*.
 - 18 *Ibid*, p. 31.
 - 19 *Ibid*, p. 70.
 - 20 *Ibid*, p. 71.
 - 21 *Ibid*, p. 66.
 - 22 "Tax Ruling in Morristown Could Have Implications for Pequannock" NorthJersey.com, 2015, <http://www.northjersey.com/news/crime-and-courts/court-ruling-could-jeopardize-chilton-tax-exemption-status-1.1370588> (Accessed 8/20/15).
 - 23 "Morristown hospital tax case is 'credit positive' for N.J. municipalities: Moody's" NJ.com True Jersey., 2015 http://www.nj.com/morris/index.ssf/2015/07/morristown_hospital_tax_case_is_credit_positive_fo.html (Accessed 8/25/15).



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