

More Non-Profit Hospitals Lose Property Tax-Exemptions

In his Health Law column, Francis J. Serbaroli discusses a recent court decision that upheld the revocation of the property tax-exemption of three not-for-profit hospitals in Pennsylvania. He warns that this court decision could trigger more reviews of the property tax-exemptions of other not-for-profit hospitals and health care providers, and urges them to review their compliance with the legal requirements for these tax-exemptions.

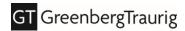
By Francis J. Serbaroli | January 21, 2022 | New York Law Journal

For decades, it has been almost an article of faith that not-for-profit hospitals, clinics, nursing homes and other institutions dedicated to serving the health care needs of the sick and elderly would be exempt from paying almost any type of taxation in recognition of their charitable purposes. The simple logic behind these exemptions was that these institutions should be able to devote 100% of their resources to fulfilling their charitable mission of serving their communities without the burden of paying levies to federal, state or local governments.

Over the years, some of these exemptions have been rescinded as a purely business matter. For example, many localities ended hospitals' historic exemptions from water and sewer taxes when the localities discovered that the hospitals could be reimbursed for these taxes as part of their Medicare or Medicaid payment rates.

Years ago, most hospitals were independent local charitable organizations, with strong ties to and support from the communities they served. Today, those same hospitals are more likely to have become part of

© 2022 Greenberg Traurig, LLP www.gtlaw.com



mammoth multi-billion dollar health care systems, run on sophisticated business models designed to maximize their revenues, with rigorously negotiated reimbursement rates. The media continue to report on situations where prestigious not-for-profit tax-exempt hospitals have over-charged uninsured patients for medical services, and then engaged in overly aggressive bill-collection practices. Other stories have exposed how some hospitals have misrepresented the amount of so-called "charity care" they provide by including in their calculations uncollectible deductibles and co-pays, care provided free or at a discount to employees' family members, and other amounts not qualifying as charity care. Lofty levels of executive compensation at not-for-profit hospitals and health systems have drawn both media and Congressional attention.

Provena Care

More localities are examining the business practices of not-for-profit hospitals that have property tax-exemptions, and in some cases, rescinding these exemptions. In 2006, Provena Covenant Medical Center, a Roman Catholic hospital system in Illinois, was denied renewal of its property tax-exemption by Illinois' Department of Revenue (DOR). In its decision, DOR cited a number of factors, including that Provena's charity care amounted to less than 1% of its total revenues; that Provena had outsourced a number of its medical departments and services to outside for-profit operators; that even after reducing a portion of a patient's charges pursuant to its charity care policy, Provena still referred the unpaid balances of those patients to collection agencies; and that Provena's funds were not primarily derived from public and private charity, but from third-party payors such as private health insurers and government health benefit programs such as Medicare and Medicaid. The Illinois Supreme Court ultimately upheld the revocation of Provena's property tax-exemption in 2010.

Health System Formation

A recent court decision from Pennsylvania's Court of Common Pleas should be of concern to not-for-profit hospitals, in New York and elsewhere, since it cites what has become a common model for structuring hospital systems as a justification for revoking the property tax-exemption of a multi-hospital system. *Appeal of Brandywine Hospital LLC et al.*, Nos. 17-11220 etc., Ct. Common Pleas, Chester Co., PA, Oct. 14, 2021.

The case involved Brandywine, Phoenixville, and Jennersville Hospitals, each of which is a limited liability not-for-profit corporation and has as its sole corporate member another not-for-profit entity known as Tower Health (formerly known as Reading Health System). Tower obtained a \$590,500,000 bond financing from the Berks County Industrial Development Authority that enabled Tower to acquire these three hospitals and two others. Although all of the acquired hospitals became part of the obligated group for bond financing purposes, and were required to pledge all of their revenues as collateral for payment of principal and interest on the Bonds, none of the hospitals received any of the proceeds from the bond issuance.

Tower then went about consolidating the hospitals, along with related physician practices previously acquired by Tower, into a regional health care system. Each of the hospitals filed for renewal of their property tax-exemption for tax year 2018, and each was denied by the Chester County Board of Assessment. The denials were appealed to the Chester County Court of Common Pleas. After finding that the hospitals lacked standing to appeal the denial of those exemptions due to the timing of their acquisition by Tower, the court went on to address the substantive reasons why tax-exemption was no longer justified.

Criteria

GT GreenbergTraurig

The court began by noting that, under Pennsylvania's General County Assessment Law, hospitals have to meet three criteria for property tax exemption:

- that it is purely a public charity;
- that it was founded by public or private charity; and
- that it is maintained by public or private charity.

The court also cited a decision of Pennsylvania's Supreme Court that had held that, to qualify as a "purely public charity", the charity had to meet five criteria:

- advance a charitable purpose;
- donate or render gratuitously a substantial portion of its services;
- benefit a substantial and indefinite class of persons;
- relieve the government of some of its burden; and
- operate entirely free from private profit motive.

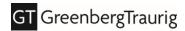
The hospitals advanced the argument that they were organized as not-for-profits under federal tax laws, but the court noted that federal tax-exempt status is irrelevant to whether a property is entitled to real estate tax-exemption under Pennsylvania law.

The hospitals argued that they were money-losing operations. The court demolished this argument, citing testimony that their losses were attributable to the hefty "management fees" assessed against them by their corporate parent, Tower Health. The court also noted that Tower charged the hospitals for the IDA Bond interest, even though the Bond was an obligation of Tower Health, and even though none of the Bond proceeds were allocated to the hospitals.

The hospital reasoned that they donate or render gratuitously a substantial portion of their services, since Medicare and Medicaid payments did not cover the hospitals' costs of providing services to the beneficiaries of those programs, and that their bad debt should be considered part of their donations. The court determined that there was not enough evidence presented to quantify the amount of the hospitals' uncompensated care. There was also testimony that the hospitals had written off as bad debt unpaid accounts for patients that the hospital determined had the financial means to pay. Moreover, the court commented: "Bad debt is a business expense, not a charitable contribution," and found that the evidence presented did not support a conclusion that the three hospitals donate or render gratuitously a substantial portion of their services.

Profit

Next, the court turned to whether the hospitals operated free of a profit motive. It analyzed the incentive compensation plan that was offered to the members of the management team of each hospital, who were offered sign-on bonuses to incentivize them to stay after Tower Health took them over, and annual bonuses the single largest component (40%) of which was based upon attaining a certain profit margin for the hospital. The court pointed out that the top four hospital executives could earn up to \$345,000 in yearly



bonuses, 70% (\$250,000) of which was directly tied to financial performance, and designed to reward them for the hospital's making a profit/surplus.

The court then turned to the "management fees" assessed against each hospital by Tower, and the compensation that Tower paid to its top executives. Tower charged each hospital a management fee, a central business office fee, and a Bond interest payment obligation fee. In 2018, Tower imposed a management fee of \$3,500,000 upon Phoenixville Hospital, which increased to \$21,700,000 per year by 2020, and a central business office charge of \$2,500,000 which rose to \$3,800,000 over the same period. Tower imposed management fees on Brandywine Hospital as follows: 2018: \$2,718,000; 2019: \$7,422,480; 2020: \$15,587,155. It imposed these management fees on Jennersville Hospital: 2018: \$1,080,000; 2019: \$3,094,200; 2020: \$6,101,534. The court noted that the management fees paid to Tower by just these three hospitals in 2020 alone was \$43,000,000.

The court then pointed out that the evidence at trial disclosed that Tower executives received millions of dollars in compensation and bonuses following the alliance of the hospitals, and that Tower used approximately half of the management fees charged to the hospitals just to fund the compensation of Tower executives. As to what the Tower executives did for the hospitals, the court found: "The Tower Health executives did nothing more, according to the testimony, than facilitate the assimilation. These executives were not involved in the daily operation of the hospital. These executives did not provide medical services or care. Yet the evidence at trial also revealed that there were other executives at each hospital who were responsible for the operation of each hospital and patient care."

The court also observed that the Tower executives' compensation drew scrutiny from the Internal Revenue Service, which deemed their compensation excessive and assessed an excise tax against Tower, which Tower then passed along to the hospitals.

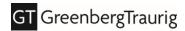
Lastly, the court noted that under Pennsylvania law, real estate is taxable if "any income or revenue is derived, other than from the recipients of the bounty of the institution or charity," which the court interpreted as barring the hospitals from using property to derive income from sources other than patients. It found that through various arrangements with physician groups, the hospitals paid these physician groups, which in turn billed the patients for services above and beyond what the hospitals themselves charged the patients. The court concluded that the hospitals' property was being used to generate substantial income and revenue by and from people other than the recipients of the bounty provided by the hospital. Given all of the circumstances, the court denied the hospital's appeals for property tax-exemption.

Prior to concluding its decision, the court took note of this denouement:

Within three weeks of trial, Tower dismissed as employees the President of Jennersville and Brandywine Hospital along with other executives and announced that Jennersville would close. Other Hospitals have been sold, are for sale, or will just be given away as seems will be the case with Brandywine Hospital. The goal as evident from the financial documentation offered at trial was simple and direct—drain the juice out of the hospitals until there was nothing left but a dried-out husk and then leave, close the doors, or sell what was left. Jennersville is now closed, Brandywine for sale and while this harvesting strategy may not have killed Phoenixville, it is left with little more than a skeleton.

Conclusion

State and local governments are always looking at new sources of revenue to fill gaps in their spending. Hospitals and other not-for-profit health care facilities often own and occupy very valuable real estate. The real estate holdings of large hospital systems can be enormous. As part of their compliance program, these



institutions should periodically review the real estate tax exemption provisions of state and local laws, and determine whether any of their operations are not consistent with the requirements for tax exemption. They should not just assume that since they are incorporated as a not-for-profit and have an exemption from federal income taxes, that their real estate tax-exemptions are safe.

This Pennsylvania court decision will undoubtedly be read with interest by many state and local real estate taxing authorities, and as a result, we may see more tax-exemptions being curtailed or even revoked if the authorities become aware that even some of the practices detailed in this case are being followed by tax-exempt health care facilities in their jurisdiction.

Reprinted with permission from the January 21, 2022 edition of New York Law Journal © 2020 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited, contact 1.877.257.3382 or reprints@alm.com.

About the Author:

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

© 2022 Greenberg Traurig, LLP www.gtlaw.com | 5