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## Morristown Hospital, Princeton University and Beyond: Property Tax Exemption for Nonprofits in New Jersey

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# The Property Tax Exemption Statute

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

- N.J.S.A. 54:4-3.6 provides a tax exemption for hospital purpose property.
- N.J.S.A. 54:4-3.6 provides in pertinent part that:

The following shall be exempt from taxation under this chapter ... all buildings actually used in the work of associations and corporations organized exclusively 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.

# The “3-Prong” Test of Paper Mill

- To secure an exemption under N.J.S.A. 54:4-3.6, the following three criteria must be met: (1) the owner of the property 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. Hunterdon Medical Center v. Township of Readington, 195 N.J. 549, 562, (2008) (quoting Paper Mill Playhouse v. Millburn Township, 95 N.J. 503, 506 (1984)).

# How did it all start?

- Morristown Medical Center (“MMC”) was classified by Morristown assessor as exempt at all times prior to October 1, 2005, and October 1, 2006 (for the 2006 and 2007 tax years.)
- In 2005, Morristown hired a new tax assessor who inspected MMC in late 2006 or early 2007.
- After the tour, the tax assessor placed a regular assessment on the Property for 2008 of \$63,596,200 and levied omitted assessments for 2006 and 2007 of \$37,430,000. This assessment was meant to tax the part of the property attributed to the leased physician space and leased café space.

# Were Omitted Assessments Legally Imposed?

- Pursuant to N.J.S.A. 54:4-63.26, only when use or ownership of exempt property changes after the October 1 date, may a tax assessor assess the property as omitted property for the taxable year.
- Therefore, 2006 added/omitted and 2007 omitted assessments were not legally imposed and arguably should have been dismissed by the court. See Salt & Light Co., Inc. v. Mount Holly Twp., 15 N.J. Tax 274 (Tax 1995), aff'd., 16 N.J. Tax 40 (App. Div. 1996), certif. denied, 148 N.J. 458 (1997).
- N.J.S.A. 54:4-63.26 does not authorize the municipality to look back two years because it changed its legal conclusion re tax exemption.

# Are Omitted Assessments Limited in Amount?

- Morristown's omitted assessments for 2006 and 2007 relate only to the leased space and do not include the entire hospital. Therefore, even if not dismissed, the omitted assessments relate only to the leased space (medical office and café space). (Note: Morristown did file counterclaims for 2006 and 2007 but arguably any counterclaim should relate only to exemption and valuation of the omitted assessment and not the entire property.)

# Property Partially Taxed in 2008

- Morristown placed an assessment of \$63,596,200 on the tax roll for 2008. (Morristown had a total assessed value on the property of \$101,026,200 when property was fully exempt).
- AHS filed a tax appeal claiming both exemption and valuation.
- Morristown filed an Answer but did not file a counterclaim claiming property was underassessed. Morristown merely asks that assessment of \$63,596,200 be “affirmed.”
- Therefore, if AHS eventually withdraws its 2008 complaint, Morristown should be “stuck” with the \$63,596,200 assessment because it did not counterclaim as to value.

# Early Settlement Proposals

- After appeals filed, attempts at settlement based on for-profit leased space.
- Appeals filed by Morristown challenging exempt status and valuation for successive years (2009-2015).
- Settlement talks repeatedly fall apart.
- Successful AHS motions on 1<sup>st</sup> and 2<sup>nd</sup> prongs of Paper Mill test; denial of summary judgment on merits of tax exemption.
- In 2014 trial on the merits of tax exemption for 2006, 2007, 2008.



# What Went Wrong at the Trial?

- Lawyers for AHS introduce no expert testimony on hospital operations/industry.
- No legislative history or argument as to legislative intent in enacting statute in 1913.
- Lack of understanding of 3<sup>rd</sup> prong of HMC and Paper Mill decisions. Argued if 2<sup>nd</sup> prong “use” test met, 3<sup>rd</sup> prong “not for profit” does not need to be met.

# The Decision

## June 25, 2015

- In AHS Hospital Corp., d/b/a Morristown Memorial Hospital v. Town of Morristown, 28 N.J. Tax 456 (Tax Court 2015), having found that the hospital satisfied the first two prongs of the test in prior opinions, the Tax Court decision focused on the third prong of the test, namely, that the operation and use of the property must not be conducted for profit. In this regard, the Court examined the following areas of MMC's operations as follows:
  1. MMC's relationship with private and exclusive contract physicians;
  2. MMC's relationship with affiliated and non-affiliated for profit entities including the related roles played by hospital executives in such entities;

# The Decision

## June 25, 2015

3. MMC's direct-employed physician contracts;
4. MMC's third-party vendor agreements for parking and ancillary services;
5. MMC's gift shop; and
6. MMC's auditorium, day care, fitness center and cafeteria.

Tax Court finds entire hospital is not entitled to exemption, except for minor space (auditorium, fitness center).

# Judge Bianco's Conclusions Based on 3.6 Exemption

- For-profit activity conducted on tax exempt property must be done in a way it is “evident, readily ascertainable, and separately accountable for taxing purposes.”
- Exemption is denied when the court is unable to discern between nonprofit activity and activities in same location that are in furtherance of the interest of for-profit entities.
- It does not matter whether for-profit entities are related to or unrelated to organization claiming the exemption.
- Voluntary physician groups and physicians with exclusive contracts were acting for-profit. They were not confined to a separate space and, therefore, most of hospital was taxable.

# Additional “for-profit” Violations

- Affiliated and non-affiliated for-profit entities relationships were evidence that use of hospital property was for a profit-making purpose and providing pecuniary benefit to for-profit entities.
- Hospital failed to show compensation paid to its executives was reasonable and not excessive.
- Employed physician compensation put hospital revenue in another’s “personal pocket” through incentive compensation.
- Third-party vendor agreements with incentives for efficiency were proof of a profit-making purpose.
- Gift shop was not a hospital use and represented a “form of competition to commercially-owned facilities.”

# Judge Bianco Called for Legislative Action

“Accordingly, if the property tax exemption for modern nonprofit 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.”

# Where do we end up?

- “Universal” settlement of the litigation covering the years 2006-2015 and providing for an Agreement for tax payments for the years 2016-2025. The Stipulation of Settlement provides as follows:
- AHS will pay the Town \$10,000,000 to settle the tax appeals for the 2006-2008 years. AHS and the Town will agree to assessments for 2006, 2007 and 2008 that result in 100% of the Hospital property being subject to property tax. The \$10,000,000 will be allocated to pay the taxes and interest/penalty on the agreed tax assessments.
- In addition to the \$10,000,000 payment AHS will agree to pay an additional sum of \$5,500,000 of interest/penalty due on the tax assessment liability for the years 2006, 2007 and 2008. This \$5,500,000 payment of interest/penalty will be deferred and paid in ten annual installments of \$550,000 commencing in the tax year 2016 through 2025.

# Where do we end up?

- As part of the settlement, the tax appeals for tax years 2009-2015 for the Hospital property will be withdrawn. The tax rolls currently reflect the Hospital property as exempt for those years.
- For 2016 and forward, AHS and the Town agree to a total annual payment of \$1,600,000. This is broken down as follows:
- AHS and the Town agree to an assessed value of \$40,000,000 (\$46,767,216 FMV) to be placed on the Hospital property which results in an annual tax of \$1,050,000. This \$40,000,000 of assessment is based on 444,000 total square feet of the Hospital being taxed which is 24% of the Hospital property.
- The \$5,500,000 deferred interest/penalty from 2006, 2007 and 2008 summarized above, is paid in equal installments of \$550,000 annually over ten (10) years commencing in the 2016 tax year. The \$550,000 yearly payment will be adjusted yearly by the Consumer Price Index (“CPI”).
- Community benefit obligation.



# What was the “real” tax exposure?

- The tax appeals on the valuation part of the Hospital property never went to trial as the case was settled. Therefore, it is impossible to determine what any “original” amount might be since the Tax Court did not decide any valuation issues. During the litigation neither party submitted valuation/appraisal reports to the court on the valuation of the entire Hospital. Note: Based upon the tax assessments the Town placed on the property the tax exposure alone was @ \$20,000,000. Interest and penalty would add @ \$15,000,000 for a total of @ \$35,000,000 as of 2015.

# LEGISLATIVE INITIATIVE

## Senate 3299/A4903

- Maintains property tax exemption for certain nonprofit hospitals with on-site for-profit medical providers;
- Requires hospitals to pay a community service contribution (“CSC”) to host community based on \$2.50/day on licensed bed;
- Establishes a study commission;
- Provides for relief from CSC for financially distressed hospitals;
- Provides for retroactive relief as to omitted assessments for 2014-2015;
- Pocket vetoed by Gov. Christie.

# CURRENT TAX EXEMPT STATUS OF NONPROFIT HOSPITALS

- Request for “Further Statements”
- Chapter 91 requests for income/expense
- Omitted assessments for 2014/2015
- Taxation of hospital for 2016
- Maintain exempt status of hospital and file tax appeal so as to not distort ratable base.
- Payment of tax not required by hospital contesting/alleging exempt status

# Statutory Exemption for Colleges and Schools

- N.J.S.A. 54:4-3.6 provides an exemption for all buildings actually used for colleges, schools, academics or seminaries.
- Provided if any portion of such buildings are leased to profit-making organizations or otherwise used for purposes which are not themselves exempt from taxation, said portion shall be subject to taxation and the remaining portion only shall be exempt.
- Provided the building or lands or the corporation occupying them are not conducted for profit.
- The 3-prong test of Paper Mill applies.

# Princeton University I

Estate of Eleanor Lewis, Kenneth Fields, Mary Ellen Merino, Joseph King and Kathryn King v. Trustees of Princeton University; Princeton University; Borough of Princeton

- 2010 and 2011 complaint filed by certain Princeton taxpayers alleging property tax exemption for parts of the campus were improper and requesting that approximately 20 properties on the main Princeton campus (and its surrounding area) be placed back on the tax rolls.

# Summary Judgment Denied

- Defendant filed a summary judgment motion in October of 2012 arguing the 3-prong test of Paper Mill is met, namely, (1) Princeton University (“PU”) is organized for college or school purposes; (2) PU uses the subject buildings to further that purpose; and (3) PU’s operation and use of its property is not conducted for-profit. Tax Court denied summary judgment in July 2013 for 2011 tax year but did dismiss 2010 year as untimely.

# Princeton II

Kenneth Fields, Mary Ellen Merino, Joseph King and Kathryn King v. Trustees of Princeton University; Princeton University and Borough of Princeton

- 2014 and 2015 case alleging PU is not entitled to tax exemption in its entirety because of violation of the 3<sup>rd</sup> prong of Paper Mill (the “not for profit” requirement).

# Motion to Dismiss Denied

- Complaint is poorly drafted but it seems to allege that payments to faculty arising from licensing of research technologies defeats the not-for-profit status of a tax exempt educational institution. PU brought motion to dismiss complaint for failure to state a claim of action which was denied. Interlocutory review denied by Appellate Division.



# Burden of Proof and Standing Motions Denied

- PU brought motion in regard to both cases for a determination that plaintiffs had burden of proof and that plaintiffs lacked standing. Motion was denied.

# Application of Exemption Statute

- Same exemption statute – N.J.S.A. 54:4-3.6 but PU is “school or college” purpose and AHS is “hospital purpose” as to use test.
- Same 3-prong test of Paper Mill should apply. Although PU lawyers argue Kimberley case is the authority for a school or college property and, therefore, the relevant inquiry is whether PU operates the University “for the dominant motive of making a profit.” Absent evidence of such a motive, the “mere fact” that PU realizes revenues from operations that may otherwise be viewed by some as commercial in character is not sufficient to divest a nonprofit school or its property of tax exempt status.

# Does Kimberley call for a different result?

- At pg. 42-45 of AHS decision, Judge Bianco is very clear that the cases following Kimberley do not support the contention that the test for exemption is a look to the “dominant motive” of the organization and says the considerations of the court in Kimberley have been incorporated into the 3-prong test of Paper Mill and says Paper Mill is now the standard. This language in the AHS decision should be of concern for PU lawyers. At oral argument of the dismissal motion, Judge Bianco told PU lawyers they were wrong in their reading and reliance on Kimberley.

# PU is a good neighbor – does it matter?

- PU (like AHS) is a “good neighbor” to the municipality. PU makes voluntary PILOT payments and leaves certain properties on the tax rolls that arguably could qualify for exemption.

# 2<sup>nd</sup> Prong of Paper Mill at issue in Princeton I

- PU case will involve 2<sup>nd</sup> prong of Paper Mill as to whether buildings and operations are “school or college” use. AHS was able to establish early on in its litigation that 2<sup>nd</sup> prong of Paper Mill was met and almost all of hospital satisfied “hospital purpose” test. PU has to argue that a modern “school” or “college” has evolved and all PU uses fit that definition.

# 3<sup>rd</sup> Prong – Does profit end up in someone's pocket?

- As to the 3<sup>rd</sup> prong of Paper Mill, PU does have issue of “sharing” royalty payments with faculty. There are arguments that these payments are not profits, not the sharing of revenue or profit, and any faculty compensation is “reasonable.”

# Unlikely entire PU campus is tainted

- Even if PU has a problem with the royalty payment issue and/or the use/operation of certain buildings, it is unlikely to “taint” the entity and the entire campus. For example, the court can isolate the royalty payment issue to science/lab building and isolate any other building that may have a “use” or “profit” issue. It is very unlikely exemption would be lost in its entirety.

# The “Standing” Issue

- The litigation in the PU cases is brought by taxpayers against PU and the municipality. The tax assessor exempted the property. The municipality has been somewhat neutral to date. The case is arguably harder to settle.
- Will legislation be necessary to shift the burden of proof and resolve standing issue for future litigation?