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Non-Profit Hospital Tax Exemptions: Where Did They Come From and Where Are They Going?

For decades property taxes have generated the most substantial portion of revenues for local governments.¹ Yet, despite the huge percentage of general revenue such taxes produce, many entities have historically been afforded beneficial tax treatment in the form of exemptions.² Such preferential treatment was most commonly bestowed upon charitable organizations such as hospitals and may be traced back as far as seventeenth century England and the Statute of Charitable Uses.³ Such exemptions, invariably granted by the legislatures, create a trust between the healthcare organization and the public.⁴

In Pennsylvania, the legislature has granted such exemptions under the provisions of Article VIII of the Pennsylvania Constitution.⁵ The specific exemption for hospitals is set forth in Title 72 of the Pennsylvania Consolidated Statutes Annotated Sections 5020-204.⁶

1. *Utah County, Etc. v Intermountain Health Care*, 709 P2d 265, 268 (Utah 1985), citing the Advisory Commission on Intergovernmental relations, n 5, *The Property Tax in a Changing Environment* 99 (1974). The court estimated that from 1970 to 1971 property taxes accounted for 64% of local government revenue. *Intermountain Health Care*, 709 P2d at 268. A more recent estimate of 80% was suggested by Allegheny County Solicitor Ira Weis in a lecture at Duquesne University Law School in April of 1992.

2. Comment, *Nonprofit Hospitals and the State Tax Exemption: An Analysis of the Issues Since Utah County v Intermountain Health Care, Inc.*, 9 Va Tax Rev 599, 600 (1990).

3. Comment, 9 Va Tax Rev at 600.

4. *Id* at 601, n 14 citing William F. Frateher, IVA, *Scott on Trusts* §348 et seq (Little, Brown and Co., Supp 1992).

5. Pa Const, Art VIII § 2(a) states:

The General Assembly may by law exempt from taxation: (v) Institutions of purely public charity, but in the case of any real property tax exemptions only that portion of real property of such institutions which is actually and regularly used for the purposes of the institution.

Pa Const, Art VIII § 2(a).

6. Assessors Certification Act, 72 Pa Stat Ann § 5020-204 (Purdon 1992). The relevant text of this statute provides:

(a) The following property shall be exempt from all county, city, borough, town, township, road, poor and school tax to wit:

(3) All hospitals, universities, colleges, seminaries, academies, associations and

The charitable nature of hospitals in early America gave rise to the foundation for tax exemptions. In the nineteenth century, American hospitals typically provided shelter and treatment for the poor who were legitimate objects of charity.⁷ Indeed, during this era hospitals provided more of a welfare than a medical benefit to the poor.⁸ Patients were housed in large wards, often fended for themselves and frequently did not recover from their medical conditions.⁹ For these reasons, wealthy patients as well as physicians avoided hospitals.¹⁰

As advancements in aseptic technique and anesthesia evolved, there was a proliferation in the surgical treatment of disease.¹¹ Although the non-profit hospitals were able to physically accommodate the needs of such advancements, their previous sources of revenue such as endowments, donations and the support of religious entities proved inadequate.¹² In order to meet this new financial burden of increasing medical costs, hospitals began to charge patients for their care and limit such care to more acute illnesses.¹³

With the explosion of medical advancements of twentieth century America, hospitals had to face a never-ending challenge to keep pace with skyrocketing medical costs. With the ever-increasing demand for the highest quality of care by the public, a highly competitive healthcare market evolved. The dilemma was further compounded by constraints on hospital reimbursement by third party payers such as Medicare and Medicaid programs which were implemented in the 1950's and 1960's to promote technological growth.¹⁴

institutions of learning, benevolence, or charity, including fire and rescue stations, with the grounds thereto annexed and necessary for the occupancy and enjoyment of the same, founded, endowed, and maintained by public or private charity: Provided, [t]hat the entire revenue derived by the same be applied to the support and to increase the efficiency and facilities thereof, the repair and the necessary increase of grounds and buildings thereof, and for no other purpose;

72 Pa Stat Ann § 5020-204 (Purdon 1989).

7. Paul Starr, *The Social Transformation of American Medicine* 145-70 (1982).

8. Starr, *Social Transformation of Medicine* at 145-170.

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. Melvin Horowitz, *Corporate Reorganization: The Last Gasp or Last Clear Chance for the Tax Exempt, Nonprofit Hospital?*, 13 *American Journal of Law and Medicine* 527, 527-59 (1988). Although payment by third parties were guaranteed, the collectible fees were essentially dictated by the payor rather than the hospital. Horowitz, 13

One method used by non-profit healthcare organizations to keep pace with these costs was corporate reorganization. Specifically, the polycorporate enterprise model was adopted whereby hospitals primarily controlled by administrators created chain enterprises consisting of non-profit and for-profit entities.¹⁵ This hybrid allows the non-profit hospitals to generate revenues from its for-profit entities and utilize such revenue to offset operating costs of the healthcare facility under the charitable exemption advantage.¹⁶

However, with the socio-economic crises of today leading to increasing concerns for availability of healthcare to indigents as well as to the middle class, coupled with a decreasing tax base, the exempt status of these institutions has come under intense fire since the early to mid 1980's. Many of the Pennsylvania cases turned on whether the defendant institution constituted a "purely public charity."¹⁷ Pennsylvania courts were therefore compelled to draw upon the definition of purely public charity rooted in *Episcopal Academy v Philadelphia*,¹⁸ decided in 1892.

The court in *Episcopal Academy* held that a purely public charity relieved the public of its burdens, advanced the public good and had as its beneficiary the public with no private or pecuniary return to the giver or any particular person.¹⁹ However, the court further held that such an entity should not lose its tax exempt status simply because it received revenue from the beneficiaries of its services as long as such revenues were limited to those necessary to continue operation.²⁰ Furthermore, the court stated that if at any time the operation of such a facility took on the appearance of a business for profit, the charity would incur tax liabilities as would any other business.²¹ The court thus concluded that the word "purely" was analogous to the word "wholly."²²

The Pennsylvania Supreme Court further clarified the meaning of a purely public charity in 1936 when it stated in *YMCA Association of Germantown v Philadelphia* that such an institution:

must possess an eleemosynary characteristic not possessed by institutions or property devoted to private gain or profit. What is "given" must be more

American Journal of Law and Medicine at 527-59.

15: Id.

16: Id.

17: Pa Const, Art VIII § 2(a)(v).

18: 150 Pa 565, 25 A 55 (1892).

19: *Episcopal Academy*, 25 A at 56.

20: Id.

21: Id.

22: Id.

nearly gratuitous than for a price which impresses one as being proportionate to the services rendered.²³

The YMCA court further rationalized the tax exemption of such charitable entities by stating:

[a]ny institution which by its charitable activities relieves the government of part of this burden is conferring a pecuniary benefit upon the body politic, and in receiving exemption from taxation it is merely being given a "quid pro quo" for its services in providing something which otherwise the government would have to provide.²⁴

The Pennsylvania Supreme Court in *Ogontz School v the Township of Abington and the School District of Abington Township*²⁵ sought to apply the theories developed in *YMCA* to determine whether the Ogontz School was exempt from property tax.²⁶ Ogontz School, which was formerly operated by a for-profit business corporation, had been transferred to a non-profit corporation and granted charitable tax exemption by the lower courts under Pennsylvania constitutional and statutory law.²⁷ Using the basic analytical foundations of *YMCA*, the Pennsylvania Supreme Court reversed the lower courts and revoked Ogontz's tax exempt status.²⁸ In so holding, the court focused primarily on three areas.

First, the court rejected the notion that Ogontz relieved the government of any of its educational burdens.²⁹ In doing so, the court noted that although 10% of the students received scholarships, the revenue generated by the tuition paid by the other 90% more than offset the scholarship grants.³⁰ Second, the court addressed the fact that the corporation was not founded wholly by public or private charity and that the purpose of the corporation was to take over the assets of the previous business corporation.³¹ Third, the court rejected the assertion that the requisite eleemosynary characteris-

23. *YMCA Association of Germantown v Philadelphia*, 323 Pa 401, 187 A 204, 208 (1936). The definition of eleemosynary is of or relating to alms or the giving of alms. Contributed as an act of charity: Gratuitous. *Webster's II New Riverside University Dictionary* 423 (Houghton Mifflin Company 1984).

24. *YMCA*, 187 A at 210. For an excellent review of the case law history of Pennsylvania in this area see Comment, *Nonprofit Hospitals: Should They Continue To Receive A Charitable Organization Tax Exemption Under Pennsylvania Law?* 28 Duq L Rev 727 (1990).

25. 361 Pa 284, 65 A2d 150 (1949).

26. *Ogontz*, 65 A2d at 153.

27. *Id* at 152.

28. *Id* at 164.

29. *Id* at 153.

30. *Id*.

31. *Id*.

tics existed, noting that profits in excess of operating expenses were used to pay off other debts.³²

It is also interesting that in this 1949 case, the court mentioned in closing, the ever growing tax burden placed on the American citizens, implying the need for increased scrutiny of such so called charitable organizations.³³ This paragraph in the opinion proved to be quite prophetic as the case law moved into the mid 1980's.

Significantly, in 1982 the Pennsylvania Supreme Court upheld the tax exempt status of West Allegheny Hospital in *West Allegheny Hospital v Board of Property Assessment*.³⁴ This was apparently inconsistent with *Ogontz* as West Allegheny Hospital, like the *Ogontz* School, covered the vast majority of its operating expenses and cost of capital acquisition through fees collected from patients.³⁵ The court rationalized its decision, however, by interpreting 72 PS s 5020-204 (a) (3) to authorize such revenue to not only "support" the institution but also "to increase the efficiency of the facilities thereof, the repair and the necessary increase of the grounds thereof. . . ."³⁶

The dissent characterized the majority opinion as merely concluding that because a hospital promotes health and is public that it should be tax exempt.³⁷ The dissenters further alleged that a clear three point test had been synthesized by Pennsylvania case law which was not utilized to determine tax exemption under 72 PS 5020-204(a)(3).³⁸ This test, as set forth in the *Wood School Tax Exemption Case*³⁹ established that:

[t]o obtain the claimed exemption from taxation, (appellant) must affirmatively show that the entire institution, (1) is one of "purely public charity;" (2) was founded by public or private charity; (3) is maintained by public or private charity.⁴⁰

Although the dissenters conceded that its open admission policy, along with its anti-discriminatory by-laws *may* satisfy the first prong of the test, they opined that West Allegheny had failed to

32. Id at 164.

33. Id.

34. *West Allegheny Hospital v Board of Property Assessment*, 500 Pa 236, 455 A2d 1170 (1982).

35. *West Allegheny*, 455 A2d at 1172.

36. Id at 1172-73 citing 72 PS proviso to § 5020-204 (a) (3) (Purdon Supp 1982).

37. 455 A2d at 1173. Justice Nix filed the dissenting opinion which was joined by Justice Hutchinson. Id.

38. Id.

39. 406 Pa 579, 584, 178 A2d 600, 602 (1962).

40. *Wood*, 178 A2d at 602.

satisfy the second and third prongs.⁴¹

In reference to the second prong, the dissent revealed that the original property was purchased in 1956 for a below market value of \$40,000.00 by Drs. Roberts and Grilli.⁴² The deed was placed in the name of the Tioga Corporation, not known to be a non-profit corporation, and subsequently sold to West Allegheny for \$590,000.00.⁴³ The incorporators of the non-profit West Allegheny Hospital included, inter alia, Drs. Roberts and Grilli.⁴⁴ Based on this record, the dissenters concluded that the institution had not been founded by gift, either public or private, and thus it failed the second prong of the test.⁴⁵

In addressing the failure of West Allegheny to meet the third prong, the dissent related the fact that 97% of the amounts billed for in-patient care and 80% of the amounts billed for out-patient care were paid or caused to be paid by patients.⁴⁶ Furthermore, the dissent noted that the hospital retained a collection agency to recover outstanding patient accounts.⁴⁷ The dissent also took exception to the majority's perception that this income constituted revenue under the proviso to section 204 (a) (3); they reasoned this merely masked the fact that operating costs were actually being covered by patients, thereby violating the concept of a "purely public charity."⁴⁸

When reading the opinion rendered in *Ogontz* together with that in *West Allegheny*, it is difficult to deny that the main distinction between the two cases is that *Ogontz* was an educational institution and *West Allegheny* was a healthcare institution.

In the opinion of the Pennsylvania Supreme Court in *Hospital Utilization Project v Commonwealth*, Justice Nix, a dissenter in *West Allegheny*, brought the court one step closer to applying a stricter construction of the constitutional and statutory provisions relating to tax exemption in the healthcare setting.⁴⁹ In this case, a

41. *West Allegheny*, 455 A2d at 1174. The dissent notes in footnote 1 that the pure charity element cannot be satisfied merely by a showing that medical services are rendered. *Id.* n 1.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* Footnote 2 of the dissent reveals that although loans were made to West Allegheny at the outset of the project that these loans were repaid with interest therefore not qualifying as gifts. *Id.* at n 2.

46. *Id.* at 1174.

47. *Id.*

48. *Id.* at 1175.

49. *Hospitalization Utilization Project v Commonwealth*, 507 Pa 1, 487 A2d 1306

provider of statistical analysis of patient treatment sought tax exemption from sales and use taxes.⁵⁰

The company, Hospital Utilization Project ("HUP"), was formed in 1963 by the Hospital Council of Western Pennsylvania and was funded primarily with charitable contributions from the Allegheny County Medical Foundation as well as many other private and public donations of like kind from 1963-1966.⁵¹ By 1967, HUP was financially secure and the Hospital Council and Medical Societies divested themselves from HUP.⁵² HUP was subsequently funded by fees which were collected from hospitals which utilized their services.⁵³ Since HUP was associated with the Hospital Council and Medical Societies at its inception, it was granted a sales tax exemptions by the Pennsylvania Bureau of Sales and Use Tax in 1965.⁵⁴ In 1969, HUP was granted non-profit status under Pennsylvania Law.⁵⁵

In December 1980, the Board of Appeals of the Department of Revenue revoked HUP's tax exempt status based on their finding that it was neither a charitable organization nor engaged in manufacturing.⁵⁶ HUP promptly appealed to the Board of Finance and Revenue and the Commonwealth Court⁵⁷ who both affirmed the decision of the Board of Appeals of the Department of Revenue denying HUP tax exempt status.⁵⁸

On appeal, the Pennsylvania Supreme Court applied a new five point test in determining whether HUP was a "purely public charity" according to the Pennsylvania Constitution.⁵⁹ In enunciating the five elements of the so called HUP test, the court stated:

From the foregoing it can be concluded that an entity qualifies as a purely public charity if it possesses the following characteristics:

- (a) Advances a charitable purpose;
- (b) Donates or renders gratuitously a substantial portion of its services;
- (c) Benefits a substantial and indefinite class of persons who are legit-

(1985).

50. *Hospital Utilization Project*, 487 A2d at 1308-9.

51. *Id* at 1309.

52. *Id*.

53. *Id*.

54. *Id* at 1310.

55. *Id*.

56. *Id* at 1308-09.

57. *Id* at 1309.

58. *Id*.

59. *Id* at 1317. See note 5 and accompanying text.

imate subjects of charity;

(d) Relieves the government of some of its burden; and

(e) Operates entirely free from private profit motive.⁶⁰

As to the first prong, the court concluded that HUP failed as its purpose of promoting the maintenance of high quality care and the effective use of healthcare services did not meet the legal definition of charitable.⁶¹ The definition applied by the court was that enunciated in *Hill School Tax Exemption Case* which stated:

The word "charitable," in a legal sense, includes every gift for a general public use, to be applied, consistent with existing laws, for the benefit of an indefinite number of persons, and designed to benefit them from an educational, religious, moral, physical or social standpoint. In its broadest meaning it is understood 'to refer to something done or given for the benefit of our fellows or the public.'⁶²

HUP failed the second prong because clients had to pay fees consistent with actual costs in order to receive services, therefore, these services were not donated or rendered gratuitously.⁶³ It was also asserted that HUP did not possess the eleemosynary attributes affiliated with charitable organizations.⁶⁴

The court found the third prong was not satisfied because the beneficiaries of HUP's services were a definitive number of hospitals and health care institutions which, when classified as administrative entities, were not legitimate objects of charity.⁶⁵

In an attempt to meet the fourth element of the test, HUP argued that if it did not offer its service the government would have to carry the burden of doing so.⁶⁶ This argument was rejected by the court, which noted that these services were not traditionally done by the government and that HUP had presented no evidence showing that the government would engage in such research.⁶⁷

In reference to the fifth prong, it was stated that HUP was virtually indistinguishable from other commercial enterprises as it was able to generate significant profits which were used to upgrade their computer equipment and pay its officers and directors gener-

60. Id.

61. Id.

62. Id, citing *Hill School Tax Exemption Case*, 370 Pa 21, 25, 87 A2d 259, 262 (1952).

63. *Hospital Utilization Project*, 487 A2d at 1317.

64. Id.

65. Id.

66. Id.

67. Id at 1318 n 10.

ous salaries.⁶⁸

After the decision in *HUP*, the guidelines for defining a charitable institution under Pennsylvania law had finally been set. The only question remaining was how this test would be applied to institutions whose primary purpose was that of healthcare provider. Three years after *HUP*, and seven years before Pennsylvania would attempt to answer the question, the Supreme Court of Utah took the lead by utilizing their own test in revoking the tax exempt status of two non-profit hospitals in *Utah County v Intermountain Health Care, Inc.*⁶⁹

As in Pennsylvania, the Utah law of charitable tax exemptions is founded in its Constitution.⁷⁰ Utah also attempts to clarify the Constitutional provisions by statute in the Utah Code Annotated.⁷¹ Thus, the Utah Supreme Court in *Intermountain Healthcare* applied a six point test⁷² for the charitable purpose exemption derived from that which was set forth in section 59-2-30 of the Utah Code,⁷³ a provision strikingly similar to that which evolved through Pennsylvania case law. Section 59-2-30 states:

[a]ny property whose use is dedicated to religious worship or charitable purposes including property which is incidental to and reasonably necessary for the accomplishment of such religious worship or charitable purposes, intended to benefit an indefinite number of persons is exempt from taxation if all of the following requirements are met:

- (1) The user is not organized to produce a profit from the use of the property.
- (2) No part of any net earnings, from the use of property, inures to the benefit of any private shareholder or individual, but any net earnings shall be used directly or indirectly, for the charitable or religious

68. *Id* at 1318.

69. 709 P2d 265 (Utah 1985).

70. Utah Const, Art XIII § 2. The relevant text provides:

The property of the state, cities, counties, towns, school districts, municipal corporations and public libraries, lots with the buildings thereon used exclusively for either religious worship or *charitable purposes*, . . . shall be exempt from taxation.

Utah Const, Art XIII § 2 (emphasis added) compare to text of Pa Const, Art VIII § 2 in note 5.

71. Utah Code Ann §§ 59-2-10 and 59-2-31 (The Michie Company 1974) (repealed in 1987).

72. *Intermountain Healthcare*, 709 P2d at 269-70.

73. Utah Code Ann § 59-2-30. *Intermountain Healthcare* reviewed the statutory provisions of sections 59-2-30 and 59-2-31 when it created its six point test for charitable purpose exemptions. The reader should note that these statutes have since been repealed. The Utah Supreme Court, however, did not follow the literal statutory language of these since-repealed sections, but instead created its own six point test for determining whether a hospital would qualify for a charitable exemption.

purposes of the organization.

(3) The property is not used or operated by the organization or other person so as to benefit any officer, trustee, director, shareholder, lessor, member, employee, contributor or any other person through the distribution of profits, payment of excessive charges or compensations.

(4) Upon liquidation, dissolution, or abandonment of the user no part of any proceeds derived from such use will inure to the benefit of any private person.⁷⁴

Section 59-2-31 further provides:

(1) Property used exclusively for religious, hospital, educational, employee representation, or welfare purposes which use complies with the requirements of 59-2-30, shall be deemed to be used for charitable purposes within the exemption for in Section 2 of Article XIII of the Constitution of the State of Utah.⁷⁵

From the above sources, the Utah Supreme Court formulated the following six point test:

(1) Whether the stated purpose of the entity is to provide a significant service to others without immediate expectation of material reward;

(2) Whether the entity is supported, and to what extent, by donations and gifts;

(3) Whether the recipients of the 'charity' are required to pay for the assistance received, in whole or in part;

(4) Whether the income received from all sources (gifts, donations, and payments from recipients) produces a 'profit' to the entity in the sense that the income exceeds operating and long term maintenance expenses;

(5) Whether the beneficiaries of the 'charity' are restricted or unrestricted and, if restricted, whether the restriction bears a reasonable relationship to the entity's charitable objectives;

(6) Whether dividends or some other form of financial benefit, or assets upon dissolution, are available to private interests, and whether the entity is organized and operated so that any commercial activities are subordinate or incidental to charitable ones.⁷⁶

74. *Id.*

75. Utah Code Ann 59-2-31 (The Michie Company 1974) (repealed). The relevant language of section 59-2-31 has been somewhat paralleled in Utah Code Ann section 59-2-1101(2)(d) (The Michie Company 1987) which provides: "The following property is exempt from taxation: . . . property owned by a nonprofit entity which is used exclusively for religious, charitable, or educational purposes." Utah Code Ann § 59-2-1101. The obvious change in this new statute is the replacement of the words "hospital, employee or welfare purposes", found in section 59-2-31, with the words "charitable purposes."

76. *Intermountain Healthcare*, 709 P2d at 269-70. The *Intermountain Healthcare* test did not mirror the repealed statutory language of sections 59-2-30 and 59-2-31. Rather, the Utah Supreme Court created its own standards which were in fact more stringent than the standards found in the legislative statutes. The recent codification of section 59-2-1101 does not legislatively overrule the *Intermountain Healthcare* test. Instead, it is arguable that the legislature intended the this test to be used when determining whether a nonprofit entity has used its property for "exclusively charitable purposes." Utah Code Ann § 59-2-

In this case, the majority held that Intermountain Healthcare ("IHC") had not been clearly supported by gifts or donations.⁷⁷ For example, the court recognized third party payments, such as those from Blue Cross and Medicare, merely as a reciprocal exchange of services for money.⁷⁸

In so determining, the Utah Court heavily scrutinized both the amount of free care provided, which constituted less than 1% of their gross revenues, and IHC's failure to advertise the availability of free care.⁷⁹ The court also concluded that since IHC had not shown that without the tax exemption it would operate at a loss, it was, as a non-profit organization, afforded an unfair competitive advantage over for-profit entities.⁸⁰ As this was evolving in Utah, many local governments in other states had begun to seriously challenge the tax exempt status of their larger hospitals.⁸¹

The Commonwealth Court of Pennsylvania dealt an ominous blow to the tax exempt status of non-profit hospitals in Pennsylvania in *The School District of the City of Erie and the City and County of Erie v Hamot Medical Center of Erie (Hamot)*.⁸² In this case, the Commonwealth Court affirmed the order of the Court of Common Pleas which declared that Hamot was not entitled to retain its tax exempt status for real property taxes.⁸³

Hamot, founded in 1881 by public and private charities, provided healthcare to the Erie community as a non-profit corporation.⁸⁴ As many hospitals did during the 1980's, Hamot underwent a corporate reorganization in 1981 which led to the formation of Hamot Health Systems, Inc., ("HHSI").⁸⁵ HHSI functioned to supervise the operation of a multitude of other entities which included: Hamot Medical Center; Hamot Corporate Services, Inc. (a management and administrative service); Regional Health Services, Inc. (a provider of ambulatory and related healthcare services); Senior Living Services, Inc. (which offered senior citizen care and services); the Center for Personal and Family Growth

1101.

77. Id at 273. This was a split decision.

78. Id at 274.

79. Id.

80. Id at 278.

81. At the time of (*IHC*), challenges were underway in Tennessee, Vermont, Pennsylvania, inter alia. See Comment, 9 Va Tax Rev at 599 n 9 (1990) (cited in note 2).

82. 144 Pa Commw 668, 602 A2d 407 (1992).

83. *Hamot*, 602 A2d 407-8. Judge Doyle wrote the opinion for the unanimous court.

84. Id at 410.

85. Id.

(which provided psychological and support services); Bayside Pharmacy Services, Inc.; Independent Professional Services, Inc., (a diagnostic imaging center); Joint Patient Services, Inc. (an oncology treatment center); Community Rehabilitation Specialists (a rehabilitative health service); Great Lakes Home Health (which involved in the sales of durable medical equipment); Cardiac Fitness (which provided healthcare for those with cardiac disorders); College Park Properties (owner of real estate in Edinboro, PA); and Great Lakes Manage Care (a health maintenance facility).⁸⁶ Furthermore, HHSI, through another entity, Bayside Development Corporation, owned a substantial amount of real estate in the Erie area which included condominiums and a marina⁸⁷ and participated in the leasing of office space to non-affiliated businesses.⁸⁸ Also, through Hamot, HHSI oversaw a competitive answering service and paging systems company and a competitive local health club.⁸⁹

In its decision, the Commonwealth Court applied the five point *HUP* test.⁹⁰ At the outset, the court made it clear that the entity seeking the exemption in such cases bears the burden of proof to show that it satisfies each prong of the test.⁹¹

The court rejected Hamot's argument that it advanced a charitable purpose.⁹² It held that Hamot's community education programs were promotional in nature and designed to attract additional *paying* patients.⁹³ Furthermore, the judges were not persuaded that Hamot's urban renewal programs promoted a charitable purpose, noting that these ventures were carried out primarily by subsidiaries of HHSI, not Hamot *per se*.⁹⁴ Therefore, Hamot failed to meet the requirements of the first prong.⁹⁵

Next, the court affirmed the trial court's conclusion that Hamot did not donate or render gratuitously a substantial portion of its services; this finding was made on the totality of the circumstances

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 412. See notes 59-68 and accompanying text for a review of the 5 point *HUP* test.

91. *Id.* at 409. See also *Hamot*, 602 A2d at 414, n 7, citing *G.D.L. Plaza*, 132 Pa Commw 134, 572 A2d 51 (1990).

92. *Hamot*, 602 A2d at 413-14.

93. *Id.* at 414. (emphasis added).

94. *Id.*

95. *Id.*

surrounding the organization.⁹⁶ Various factors taken into account in reaching this decision consisted of: revenues generated from paying patients which were utilized to cover Hamot's losses; Hamot's indigent treatment plan which was mandated by statute and not undertaken voluntarily; and fees paid by Medicare and Medicaid which qualified as reimbursement.⁹⁷ The court also mentioned that Hamot had in fact initiated lawsuits against Medicare-Medicaid for increased reimbursement levels.⁹⁸ In addition, as in the *IHC* case, the court noted a large profit margin since Hamot's reorganization.⁹⁹ Thus, for the above reasons, the court concluded that Hamot failed to fulfill the requirements of the second prong.¹⁰⁰

Hamot was unsuccessful in meeting the third prong's criteria essentially because the court found that Hamot operated under a profit motive.¹⁰¹ In the words of the trial court, "[Hamot] accepts defeat only after collection and execution processes fail to yield fruit."¹⁰² According to the court, Hamot qualifies its services as charitable after the debt is determined to be uncollectible, rather than targeting such services as charitable upon admittance.¹⁰³ Quoting the trial court, the commonwealth court stated in part:

Hamot has sued the very patients that it would now have this court deem objects of charity. These cases are numerous as evidenced by the School District's Exhibit, which indicated the number of collection actions filed in the Office of the Prothonotary of Erie County. Hamot's collection agency not only pursues collection of money but takes individual assets by execution.¹⁰⁴

Both the trial court and commonwealth court agreed, however, that Hamot did meet the fourth prong of the test satisfactorily in that it relieved the government of some of its burden.¹⁰⁵ However, as noted *infra*, *all* of the prongs must be met for the entity seeking the exemption to prevail.¹⁰⁶

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.* Since 1981, Hamot had operated with an overall \$58 million profit. *Id.* at 410-

11.

100. *Id.* at 414.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.* at 411-12.

105. *Id.* at 414.

106. *Id.* See note 91.

Hamot, according to the court, dismally failed the fifth prong of the test.¹⁰⁷ Failure was predicated upon the fact that Hamot, since its reorganization in 1981, had showed a large profit margin.¹⁰⁸ Moreover, the salaries paid to executives of Hamot were described by the court as being "copious."¹⁰⁹ Having failed to carry its burden of showing satisfaction of four of the five prongs, Hamot's tax exempt status was revoked.¹¹⁰

Approximately one month after the commonwealth court of Pennsylvania handed down its decision in *Hamot*, the commonwealth court reversed a decision of the Court of Common Pleas of Allegheny County, rejecting the application by a nursing home for an exemption from real property taxes in *St. Margaret Seneca Place v Municipality of Penn Hills and the Penn Hills School District of Allegheny County*.¹¹¹ The commonwealth court utilized the five part HUP test in determining whether the nursing home deserved tax exempt status.¹¹²

As to the first and second prongs of the test, the commonwealth court held that although care for the elderly is a charitable purpose and although the elderly are legitimate objects of charity, in this case, the residents of the nursing home were required to pay for its services.¹¹³ The court also cited testimony of an executive vice president of the hospital who, when asked if a non-paying resident would ever be admitted over a paying resident, responded:

We would really be forced I would think to take..we don't have a hard and fast rule to answer that question, but we would be prudent to take the person who could afford to pay for the care.¹¹⁴

The court thus concluded that the hospital failed to make a bona fide effort to provide service to those who cannot afford its usual fees.¹¹⁵

107. *Hamot*, 602 A2d at 414.

108. *Id.* See note 99.

109. *Id.* at 411. The court noted that Hamot executives salaries plus retirement benefit packages were worth \$250,000 - \$300,000 per year. Furthermore, additional perks such as payment of membership dues to the Erie Yacht Club were offered to corporate executives. *Id.*

110. *Id.* at 414.

111. Pa Commw , 604 A2d 1119 (1992).

112. *St. Margaret Seneca Place*, 604 A2d at 1122-23.

113. *Id.* at 1123-25. Virtually all of the residents pay for the services rendered via insurance or private payment. A breakdown of a sampling of the nursing home's patients revealed that 48.5% were covered by medicaid, 10.7% by Medicare, 10.2% by Blue Cross and 30.6% paid privately. *Id.* at 1122.

114. *Id.* citing Notes of Testimony at 185a.

115. *Id.* at 1125.

Although the court conceded that the elderly per se are legitimate objects of charity, the court nevertheless held that in order to satisfy the third prong, the class must be indefinite.¹¹⁶ Based on the testimony of the executive vice president, the court concluded that the class, being comprised of only those elderly who could pay, was not indefinite.¹¹⁷ Consequently, the hospital failed to meet the requirements of the third prong.¹¹⁸

As to the fourth prong, in contrast to *Hamot*, the commonwealth court in *St. Margaret's* applied a broader standard in finding that since 59.2% of its revenues were generated from government subsidized programs, the hospital did not relieve the government of some of its burden.¹¹⁹

In addressing the fifth prong, the court rejected *St. Margaret's* contention that they operated free from a private profit motive.¹²⁰ *St. Margaret's* claimed that their assertions were supported by the fact that they had an open admissions policy which accepted Medicare recipients whom the for-profit nursing homes would not accept.¹²¹ The court countered this argument by claiming that the policy, in actuality, was not open as the home considered the prospective resident's ability to pay in determining whether or not to admit the patient.¹²²

The court made further reference to the nursing home's statement of direction and purpose which provided:

The health system shall utilize the organizational structure that strives to achieve optimal volumes of patient services and maintain a financially competitive and viable position.¹²³

Furthermore, the court noted that the nursing home's operating budget revealed that it expected to make a profit of \$199,100 for the 1991 tax year.¹²⁴ Consequently, as *St. Margaret's Seneca Valley Nursing Home* failed to meet any of the criteria under Pennsylvania law warranting a charitable tax exemption, its application for such exemption was denied.¹²⁵

116. Id.

117. Id.

118. Id.

119. Id at 1125-26.

120. Id at 1126.

121. Id.

122. Id.

123. Id.

124. Id.

125. Id.

Given the *HUP* criteria and the recently refined application of this test by the common pleas and commonwealth courts of Pennsylvania, avoiding the tax problem will be difficult. Based on the stern language and strict scrutiny applied by these courts, a direct judicial challenge by the hospital will prove costly and probably yield little gain.

For example, Hamot Medical Center has already spent approximately \$586,000.00 in attorneys' fees and has yet to prevail in any court thus far.¹²⁶ In the meantime, they are now liable for a total of 4 million dollars in taxes to the City of Erie, the Erie School District and Erie County.¹²⁷

If Pennsylvania Courts continue to follow the trend evidenced by their decisions in *Hamot* and *St. Margaret's*, it is certainly possible that very few, if any, hospitals could survive like challenges by local taxing authorities. Noting the tremendous cost in litigating these issues, described *supra*, and the blow such litigation can deal to a hospital's image, the healthcare attorney must at least consider alternative methods of maintaining tax exempt status.

Most local taxing authorities, prior to entering a formal challenge to the hospitals' tax exempt status, have sought to procure an annual payment in lieu of taxes.¹²⁸ Despite a challenge as to the legality of these settlements by the Hospital Council of Western Pennsylvania in the United States District Court of Pennsylvania, many institutions in Allegheny County have entered into such agreements.¹²⁹ It appears that at least in Western Pennsylvania, the taxing authorities are amenable to entering into these agreements and also prefer this method over litigation.

Hospitals may also make an attempt to reorganize their corporate structure so as to conform to the better defined *HUP* criteria. This method would encompass the divestment of hospitals from their non-medical profit making activities. This would certainly reduce profit margins which seemed to be a key area of scrutiny by the courts.

126. *The Erie Daily Times*, 1 (January 15, 1992).

127. *Id.*

128. Allegheny General Hospital and Presbyterian University Hospital of Pittsburgh, *inter alia*, have reached payment agreements with the City of Pittsburgh and Allegheny County in lieu of taxes. Although the exact details of these settlements are confidential, their existence has been confirmed by the Allegheny County Law Office and the Allegheny General Hospital Legal Department.

129. See *Hospital Council of Western Pennsylvania v City of Pittsburgh, County of Allegheny, City of Erie and City of Johnstown*, Civil Action No 90-621 (Memorandum Opinion of December 19, 1990).

Hospitals must also be quite circumspect as to the status of their indigent care services. Since the commonwealth court found the aggressive collection techniques of Hamot extremely distasteful, hospital billing and collection activities must be closely monitored by hospital administration so as to avoid the harsh perception the court had of such practices in *Hamot*.

Another alternative, recently chosen by a Pittsburgh area hospital, is to simply transform into a for-profit entity.¹³⁰ This allows the institution great latitude in organizing its corporate structure; however, the feasibility of this method has yet to be shown.

In summary, healthcare institutions have been caught in a catch twenty-two regarding non-profit status and charitable tax exemptions. As they were primarily supported by public and private donations through the eighteenth and nineteenth centuries, the technological advancements of this century, coupled with the public's demand to have access to this technology, has forced hospitals to reorganize to subsidize these costs. Most of this reorganization was done in the late 1970's and early 1980's.¹³¹

Unfortunately, once hospitals were able to sustain themselves by revenues generated internally, the socio-economic climate began to change around them. Local governments experienced a shrinking tax base partially as a result of unemployment. Adding to the problem, or possibly as a result of it, was the necessity of providing access to healthcare for an expanding number of indigent patients.

Although tradition was temporarily enough to shelter hospitals from taxation, this era has come to an end after such decisions as *Intermountain Healthcare*.¹³²

With regards to which avenue hospitals should pursue, it appears that the courts have set a course consistent with extracting local tax revenues from hospitals. Judicial challenges will prove costly and yield little fruit. Corporate reorganization, in order to meet certain criteria described by the courts would be logistically difficult, time consuming and by their design significantly decrease and/or eliminate any profit margin; perhaps to the point where the institution may be forced to cease operations. The feasibility of the non-profit to profit transition has yet to be proven and could obvi-

130. Braddock Hospital, outside of Pittsburgh, Pennsylvania has recently commenced operations as a for profit entity. This is the only institution of its kind in Pennsylvania to date.

131. See Horowitz, 13 American Journal of Law and Medicine at 527-59 (1982) (cited in note 14).

132. 709 P2d 269 (Utah 1985).

ously lead to massive tax liabilities as tax laws are changed by nature in what some may argue as an arbitrary and capricious fashion.

Perhaps the most pragmatic approach at this point would be for hospitals to maintain an open line of communication with local taxing bodies and reach an equitable agreement for in lieu payments. Although the ability of taxing authorities to enter into such negotiations while threatening challenges to an institution's tax status has come under constitutional attacks from certain hospital organizations,¹³³ both the hospitals and taxing authorities have ostensibly deemed this method satisfactory. By agreeing to set in lieu payments for a definite period of time, preferably as long as possible, hospitals may avoid unforeseen tax liabilities and easily budget for the payments. This approach may afford hospitals the most protection from this unstable situation which, in general, seems to reflect the uncertainty of the future of healthcare across the United States.

G. J. Simon, Jr.

133. See note 128 and accompanying text.