

Covenant v. Wauwatosa: Wisconsin Supreme Court Addresses the Nonprofit Hospital Exemption

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The Wisconsin Supreme Court yesterday released a landmark decision involving the availability of a property tax exemption for freestanding outpatient facilities. In the case, *Covenant Healthcare System, Inc. v. City of Wauwatosa*, the Supreme Court determined that the exemption under section 70.11 (4m) of the Wisconsin Statutes applied to the St. Joseph Outpatient Center in the City of Wauwatosa (the "SJOC"). In reaching this decision, the Supreme Court rejected the Court of Appeals' characterization of the SJOC as a non-exempt "doctor's office" and also determined that the SJOC met other legal requirements for the exemption.

The Non-Profit Hospital Exemption

Section 70.11 (4m) of the Wisconsin Statutes provides an exemption from property taxes for nonprofit hospitals. There are a number of restrictions on this exemption, however, both as to the nature of the hospital and as to how the property is used. As to the former, the exemption is available to a "hospital of ten beds or more devoted primarily to the diagnosis, treatment or care of the sick, injured or disabled, ... no part of the earnings of which inures to the benefit of any... member." The property must be "used exclusively" for the purposes of the nonprofit hospital, but the property may not be used as a "doctor's office" or for "commercial purposes". Each of these restrictions was in play in the *Covenant* case, but the most significant debate centered on whether the SJOC was a "doctor's office" within the meaning of the statute.

With the increase in freestanding outpatient departments, the line between a traditional doctor's office and traditional hospital operations has become increasingly difficult to define. Two Wisconsin appellate decisions have provided conflicting guidance on this grey line. See *St. Elizabeth Hospital, Inc. v. City of Appleton* (1987), and *St. Clare Hosp. of Monroe, Wis., Inc. v. City of Monroe* (1997). In the wake of this uncertainty, municipal assessors have increased their scrutiny of outpatient departments as potential "doctors' offices." Until yesterday's decision, the Wisconsin Supreme Court had yet to address the "doctor's office" language in the nonprofit hospital exemption.

Background

SJOC is an off-campus hospital-based outpatient department of St. Joseph Regional Medical Center, Inc., a Wisconsin nonprofit corporation. Covenant Healthcare System, Inc. is the sole member of St. Joseph. Covenant requested a property tax exemption for the SJOC from the City of Wauwatosa each year from 2003 to 2006 (the tax years in dispute). The city assessor denied the property tax exemption for each of those years; Covenant paid the assessed tax and brought an action to recover the assessments.

In March 2009, a Milwaukee County trial court judge found that the SJOC was exempt from property taxes under the nonprofit hospital exemption. In August 2010, the Court of Appeals reversed the trial court's decision, holding that the SJOC was a doctor's office and therefore not eligible for the property tax exemption. The Court of Appeals ultimately focused on a simple distinction:

- A doctor's office is a place where doctors see patients, mostly by appointment, during scheduled business hours, and have their offices.
- A hospital is a place that offers inpatient, overnight care.

The Court of Appeals held that the SJOC was a "doctor's office." As a result of this decision, many assessors assumed that freestanding hospital outpatient departments would be treated as the functional equivalent of a doctor's office for property tax exemption purposes.

Covenant sought review by the Supreme Court. von Briesen & Roper filed two briefs on behalf of the Wisconsin Hospital Association (WHA), and the Supreme Court heard oral arguments in April of this year.

Supreme Court Decision

In yesterday's decision, the Supreme Court ruled 6-1 in favor of Covenant that the SJOC is exempt from property taxes. Reversing the Court of Appeals, the Supreme Court concluded that the SJOC met the criteria for exemption under § 70.11(4m) insofar as it was: (1) used for the primary purpose of a nonprofit hospital, (2) not a doctor's office, and (c) not used for a commercial purpose. The Court also concluded that although earnings of the SJOC might inure to the benefit of Covenant, this did not violate prohibitions in § 70.11(4m) against earnings inuring to the benefit of a "member" because the term "member" was not intended to apply to a nonprofit entity such as Covenant.

A. The SJOC is used for the "primary purpose" of a hospital

The majority opinion, authored by Justice Gableman, held that the SJOC is used for the primary purposes of a hospital, and therefore qualifies for the property tax exemption under § 70.11(4m). Affirming the findings of the circuit court, the Supreme Court determined that the SJOC effectively serves as a department of St. Joseph's.

The Court found that the SJOC fulfilled the primary purpose of St. Joseph's in a number of ways. For example, the SJOC was constructed in order to alleviate some of the limitations confronting St. Joseph's in its delivery of medical services. One purpose of the construction of SJOC was to re-route less serious emergencies to SJOC, reducing the strain on St. Joseph's emergency room and allowing the hospital to accept more ambulances, thus significantly decreasing the number of diversion hours at St. Joseph's. The Court also cited a variety of additional factors in support of its "primary purpose" analysis, including integrated medical records and billing systems and common licensure and accreditation.

B. The SJOC is not a "doctor's office"

The Supreme Court reviewed the factors that had been identified in the *St. Clare* and *St. Elizabeth* cases for whether a facility is properly considered a "doctor's office" for purposes of the exemption. The Court ultimately concluded that whether property is used as a doctor's office is a fact-specific analysis, emphasizing that the facts in *St. Clare* and *St. Elizabeth* are not prongs of a test that must be met or even considered in every case."

The Court concluded that Covenant had met its burden of demonstrating that the SJOC is not a doctor's office for purpose of the exemption. The Court rejected the City's approach that would have limited the exemption to 24/7 inpatient facilities. The Court noted that technological advances have made it possible for more complex procedures to be conducted on an outpatient basis, and that most services performed at St. Joseph's (and other large hospitals) are performed by appointment during business hours. Furthermore, most of the services that are performed in the outpatient center at St. Joseph's are also performed in the same manner, during the same hours as performed at the SJOC. The Court chose to not penalize the SJOC merely because it had moved these operations to a different physical location.

As suggested in the WHA amicus brief, the Court assessed the level of integration between the hospital and the SJOC, such as the fact that the two facilities use the same billing system and patients receive a single bill. In addition, although physicians at SJOC have shared cubicle space to make notes, they do not have their own offices – another factor militating against characterizing the SJOC as a "doctor's office." The Court also found persuasive that the physicians at SJOC do not own or lease the building or equipment. Instead, the building and all equipment are the exclusive property of the hospital.

Finding no one factor determinative, the Court reviewed the factors and factual context of the SJOC and ultimately held that the SJOC was not a "doctor's office" for purposes of the exemption stated in § 70.11 (4m)(a).

C. The SJOC is not used for a "commercial purpose"

The City argued that the SJOC was used for a commercial purpose, and therefore was not exempt, since the predominant purpose allegedly was to generate profit in direct competition with other outpatient clinics. The Court noted that Wisconsin case law states that nonprofit entities may operate in such a fashion that generates revenues in excess of expenses. Otherwise, qualification for the nonprofit tax exemption would require hospitals to continually operate at a loss or generate precisely enough revenue to cover costs. Consequently, the Court held that for a nonprofit to be used for a "commercial purpose," it must have profit as the primary aim. The SJOC's primary purpose of diagnosis, treatment, and care of its patients could easily be identified. In a straightforward analysis, the Court dismissed the City's arguments and determined that the SJOC was not used for a commercial purpose.

D. The benefit to Covenant did not disqualify SJOC from exemption

As noted above, one of the eligibility requirements under the nonprofit hospital exemption is that no part of the hospital's net earnings inures to the benefit of any member. Since Covenant, a nonprofit corporation, is the sole member of St. Joseph, the issue turned on whether Covenant qualifies as a "member" under § 70.11 (4m)(a). The Court declined to classify nonprofit corporations as "members" for purposes of the exemption, reasoning that to do so would be an unreasonable construction of the statute resulting in all nonprofit corporate members being excluded from any distribution of assets upon dissolution. Consequently, although earnings of St. Joseph's might inure to the benefit of Covenant, the prohibition in § 70.11 (4m)(a) was not triggered because Covenant is not considered a "member" under that statute.

Dissent – Definition of "property used as a doctor's office"

Justice Abrahamson dissented, disagreeing with the majority's definition of "property used as a doctor's office." The dissent argued that "property used as a doctor's office" should be simply defined as what a patient (or legislature) would consider to be a "doctor's office." This assessment should be based on the nature of services provided and the manner in which the services are delivered to the patient. Noting that the SJOC may be capable of hospital-like care, Justice Abrahamson based her dissent on the fact that the SJOC is used to treat conditions similar to those generally treated in a doctor's office.

Justice Abrahamson's approach in her dissent echoes some of the questions addressed during oral argument, including whether the application of the exemption in § 70.11 (4m) (a) to outpatient clinics owned and operated by nonprofit hospitals is a public policy question best left to the legislature instead of the courts. Justice Abrahamson argued that until the legislature acts on the public policy question, the tax exemption should be construed strictly to disqualify freestanding outpatient departments from exemption.

Practical Implications

The Supreme Court's decision will have a far-reaching impact on Wisconsin nonprofit hospitals. In light of the decision, hospitals should review the exemption status of their existing outpatient departments, particularly freestanding outpatient departments.

Hospitals and healthcare systems *Covenant* decision is not a blank check for exemption, however. While the Court rejected the notion that off-campus outpatient facilities are automatically disqualified from exemption, the Court did not go to the opposite extreme that all such facilities are automatically exempt. Rather, the Court adopted a facts and circumstances test that will require an analysis that is tailored to each facility. Indeed, this analysis may be more challenging since the Supreme Court not only declined to articulate a defined set of criteria, but also stated that the factors previously identified by the Court of Appeals in *St. Clare* and *St. Elizabeth* need not necessarily even be considered in every case.

In addition to hospitals, assessors have been waiting for the *Covenant* decision. Some assessors have been holding off on taxing similar facilities until the release of this decision, while their decisions to deny exemptions in other cases may be the subject of current legal challenges. The *Covenant* case will force assessors to reconsider previous denials, but the case promises to complicate the assessors' task due to the absence of clear guidelines as mentioned above. What is clear, though, is that a freestanding facility can be exempt even though it serves only outpatients, by appointment, and during normal business hours; exemption denials that were based solely on a facility's outpatient status will no longer be sustainable after *Covenant*.

In situations where assessments have been on hold pending a decision in *Covenant*, hospitals should have assessors confirm the availability of exemptions for their off-campus facilities. Hospitals that have been taxed should also contact assessors before tax bills are released in December 2011. It is likely that assessors will reverse incorrect tax exemption denials made for the current year. However, the process may be time-consuming and hospitals should begin this process in a timely manner.

Hospitals must also remember that eligibility for exemption is not automatic: hospitals must file property tax exemption requests with the municipality by the appropriate deadlines when a facility is first constructed or when there is a change in use that may qualify for exemption. Despite the *Covenant* decision, the tax exemption may not be available for the 2011 tax year if a hospital has not previously filed an exemption request relating to that property. In such situations, hospitals should calendar the March 1, 2012 filing deadline in order to preserve the right to an exemption for the 2012 tax year.

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