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When Nonprofits Look Too Much Like For-Profits



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Introduction

In *Pottstown School District v. Montgomery County Board of Assessment Appeals, Pottstown Hospital, LLC, Pottstown Borough and County of Montgomery* (Pa. Supreme Court, May 30, 2025), Pennsylvania's highest court confronted a question that has dogged nonprofit healthcare for decades: How far can a tax-exempt hospital emulate a for-profit enterprise before it ceases to be a "purely public charity"? At stake in the *Pottstown* case was more than one hospital's tax bill. This was a test of how modern, system-integrated, market-responsive nonprofits fit within a constitutional framework originally designed for 19th-century almshouses.

Background

The facts in this matter are nuanced and the litigation spanned nearly five years. In 2017, Tower Health, LLC (a 501(c)(3)) (Tower) acquired several for-profit hospitals and subsequently created a new LLC to run each of the purchased hospitals, one of which included Pottstown Hospital (the Hospital). The acquired entities were non-profit in form but were closely integrated into the management and financing of Tower.

The Montgomery Board of Assessment Appeals granted the Hospital's application for a property tax exemption as a not-for-profit. Subsequently, the Pottstown School District (the School District) contested the Board's decision in trial court. The lower court ruled in favor of the Hospital, finding that it fulfilled a charitable purpose, provided a substantial percentage of services gratuitously, and provided charity to appropriate recipients (including Medicare and Medicaid). With regard to compensation, the trial court found that despite higher than market salaries and 40% of compensation being tied to financial performance, the compensation did not disqualify the Hospital because total compensation remained below the 90th percentile.

The School District then appealed the lower court's decision to the Commonwealth Court, claiming that while the Hospital was charitable in form, it had a for-profit motive because

Tower Health exercised near-total control, meaning that the Hospital was not free from private motive. The School District also claimed that executive compensation of Pottstown employees was excessive and tied to profit-like metrics. The Commonwealth Court reversed the trial court's decision, finding a private profit motive where a substantial percentage of executive compensation is tied to an entity's financial performance. The case was then appealed to the Pennsylvania Supreme Court.

The Pennsylvania's Supreme Court's Majority Opinion

Chief Justice Debra Todd, writing for a five-justice majority, reversed the Commonwealth Court's decision and reinstated Pottstown Hospital's tax exemption.

The Court held that:

1. Legal Corporate Independence Still Matters. The Hospital and Tower Health were legally distinct entities. Unless there is evidence that the parent and subsidiary function as a "sham" or "alter ego," courts must respect corporate separateness. Tower Health's managerial control and shared finances did not amount to domination or abuse, especially since Tower Health covered the Hospital's losses and invested heavily in its facilities.
2. Executive Pay Can Reflect Market Reality—If It's Reasonable. The Court reaffirmed that executive compensation should be reasonable, and does not need to be artificially low to retain tax-exempt status. It adopted an analytical framework drawn from both a 1985 landmark case, *Hospital Utilization Project v. Commonwealth* and IRS "intermediate sanctions" guidance, including considerations such as:
    - Market comparability
    - The executive's qualifications and scope of responsibility
    - Independent board approval
    - Documentation and rationale for pay decisions

The majority also noted that in this case, it did not appear that the fixing of a salary was a device for securing profits; rather, it was compensation for services rendered.

3. Financial Incentives Are Not Inherently Disqualifying. The Court rejected the Commonwealth Court's suggestion that tying 40% of bonuses to financial results proved a "private profit motive." The Court further asserted that there is *no fixed percentage* of incentive pay that crosses the line. What matters is context, governance, and reasonableness. The Hospital's incentive plan—60% based on non-financial metrics such as quality, patient safety, and staff engagement—passed muster.

    In short, the Court accepted the modern nonprofit hospital as an enterprise that can look and act businesslike, provided it operates with transparency and aligns compensation with mission rather than private gain.

The Dissent: A Warning About “Market Creep”

Justice Mundy, joined by Justice Donohue, dissented. Her opinion reads as a cautionary counterweight to the majority’s pragmatism. The dissent argued that the Court’s decision erodes the constitutional distinction between charities and businesses.

Key themes included:

- Substance over Form: Justice Mundy warned that respecting corporate formality while ignoring financial realities invites abuse. If the parent dictates budgets, collects revenues, and pays eye-popping executive salaries tied to financial outcomes, the subsidiary nonprofit entity risks becoming a shell for profit-driven behavior.
- Executive Pay of Tax-Exempt Entities Should Not Be Tied to Profit Motives, Period: The dissent contended that corporations need to pick a lane, and if they want to be tax-exempt, they must pick the charity lane, operating entirely free from a profit-motive, or tying significant portions of executive pay to financial performance.
- Local Consequences Are Important: Justice Mundy emphasized the practical fallout for communities: when hospitals win exemptions yet behave like for-profits, the tax burden shifts to local residents and school districts.

In essence, while the majority recognized the economic realities of modern healthcare, the dissent warned against normalizing corporate incentives under the banner of charity.

Broader Implications for Tax-Exempt Organizations

The *Pottstown* decision extends beyond healthcare. Every tax-exempt board, including universities and cultural institutions, would be wise to focus on the following concepts to ensure continued tax-exempt status:

Governance and Documentation

- Independent Oversight: Compensation committees must operate independently, supported by professional benchmarking and conflict-free deliberations.
- Transparency: Document every element of the compensation-setting process: rationale, comparability data, performance metrics, and links to mission outcomes.
- Balanced Incentives: Incentive pay should meaningfully incorporate mission metrics – quality, community service, access, education – not merely financial performance.

Corporate Structure

- Maintain clear separation between parent and subsidiary entities.
- Avoid intermingled accounts, undocumented management fees, or shared governance that undermines independence.

Community Accountability

Boards must be ready to demonstrate how tax exemption benefits the public – through uncompensated care, educational outreach, or other quantifiable community benefits. The "trust" concept emphasized by the Court remains central: a tax-exempt entity holds its assets for public use, not private enrichment.

Reflections: The Line Between Charity and Commerce

The Pennsylvania Supreme Court majority accepted that nonprofits must behave like businesses to survive. The dissent reminded us that charities must never forget why they exist. Both are right—and the tension between them defines modern nonprofit governance.

With that background, boards and compensation committees should consider:

- Have we clearly documented the public benefit our tax exemption supports?
- Are our executive incentives balanced between financial stewardship and mission delivery?
- Could our compensation philosophy withstand public or judicial scrutiny?
- Do we understand how our corporate structure might appear to a skeptical assessor or regulator?

The *Pottstown* Ruling Provides Comfort – but Also a Caution

It recognizes that nonprofit hospitals cannot be run like parish infirmaries, yet it implicitly challenges the sector to prove that business sophistication serves, rather than supplants, public purpose. The takeaway for boards is not "we're safe." It's "we'd better be able to prove it."

About the Author

Alexander brings 20+ years of experience advising tax-exempt boards on executive compensation and succession planning, with deep expertise in physician compensation governance for hospitals and integrated health systems.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the

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