Estimates of the federal revenue forgone due to the tax-exemption of non-profit hospitals compared to the community benefit they provide, 2016

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Building a better working world

Estimates of the federal revenue forgone due to the tax-exemption of non-profit hospitals compared to the community benefit they provide

EY was commissioned by the American Hospital Association to analyze the federal revenue forgone due to the tax-exemption of non-profit hospitals as well as the community benefits they provide. This study presents estimates for 2016, the most recent year for which community benefit information is available for non-profit hospitals based on Medicare hospital cost reports for approximately 3,000 non-profit general hospitals. The analysis does not account for other non-profit specialty hospitals, such as psychiatric or long-term acute care.[1]

In 2016, the estimated tax revenue forgone due to the tax-exempt status of non-profit hospitals is $9.0 billion**. In comparison, the benefit tax-exempt hospitals provided to their communities, as reported on the Form 990 Schedule H, is estimated to be $95.0 billion, almost 11 times greater than the value of tax revenue forgone.**

Federal revenue forgone from tax-exempt non-profit hospitals in 2016

Three tax provisions provide a federal exemption for non-profit hospitals:

1) Federal corporate income tax-exemption;
2) Tax-exempt bond financing; and
3) Federal unemployment tax-exemption.

Based on the data and methodology described below for non-profit general hospitals, the value of the federal revenue forgone due to these three tax-exemptions in 2016 is estimated to be $9.0 billion. This estimate reflects the upper bound of the potential value of the federal tax-exemption for two reasons:

1) Some hospitals may be exempt due to their educational or religious nature, rather than their charitable nature. In the absence of a tax-exemption for charitable hospitals, certain institutions could continue to be exempted for other reasons.
2) Certain features of the federal tax code are not reflected in this analysis due to a lack of necessary information, such as potential tax credits and accelerated depreciation. Additionally, potential taxpayer behavioral changes may occur if hospitals were subject to tax. These effects would likely reduce taxable income but have not been reflected in this analysis.

Total community benefit provided by tax-exempt non-profit hospitals in 2016

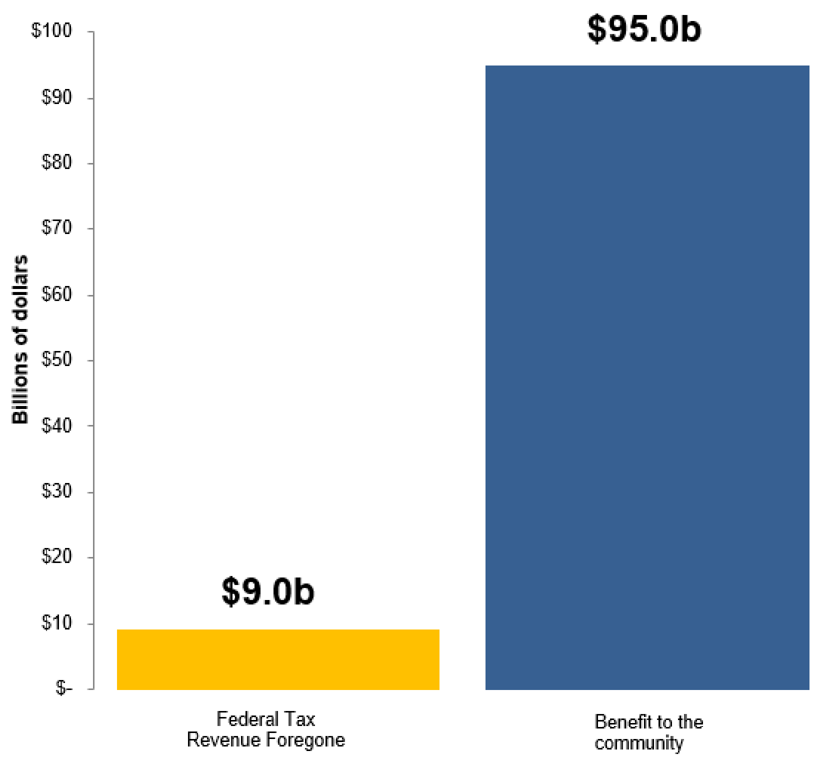
Four items are included in tax-exempt hospitals' total benefit to communities reported on form Schedule H:

- Financial assistance and means tested government programs and other benefits (Part I, line 7k of the Form 990 Schedule H)
- Community building activities (Part II of the Form 990 Schedule H)
- Medicare shortfall (Part III, line 7 of the Form 990 Schedule H)
- Bad debt attributable to charity care (Part III, line 3 of the Form 990 Schedule H).

The total community benefit provided by tax-exempt hospitals is estimated to be $95.0 billion in 2016.

Estimates of the federal revenue forgone due to the tax exemption of non-profit hospitals compared to the community benefit they provide, 2016

Figure 1. Federal tax revenue forgone compared to non-profit hospital community benefits provided by hospitals, 2016



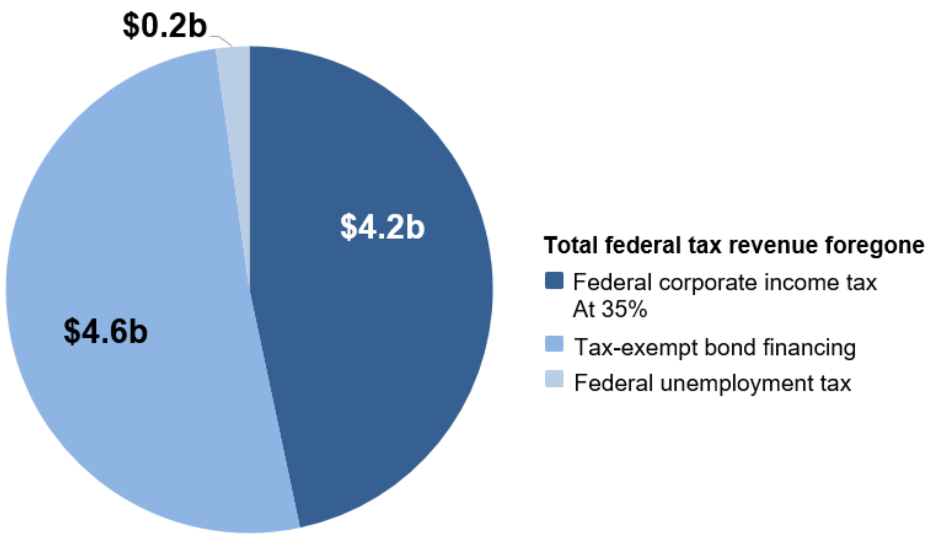
SOURCE: Ernst & Young LLP calculations. Community Benefit from 'Results from 2016 Tax-Exempt Hospitals' Schedule H Community Benefit Reporting' American Hospital Association, May 2019

Numbers may not sum due to rounding

Figure 1 offers a comparison of the federal tax revenue forgone due to the tax benefits available to tax-exempt hospitals with the value of hospital-provided financial assistance and other community benefits. Total community benefits are calculated at cost for private non-profit hospitals from the IRS Form 990 Schedule H.[2]

Estimates of the federal revenue forgone due to the tax exemption of non-profit hospitals compared to the community benefit they provide, 2016

Figure 2. Breakdown of federal tax revenue forgone from tax-exempt non-profit hospitals, 2016



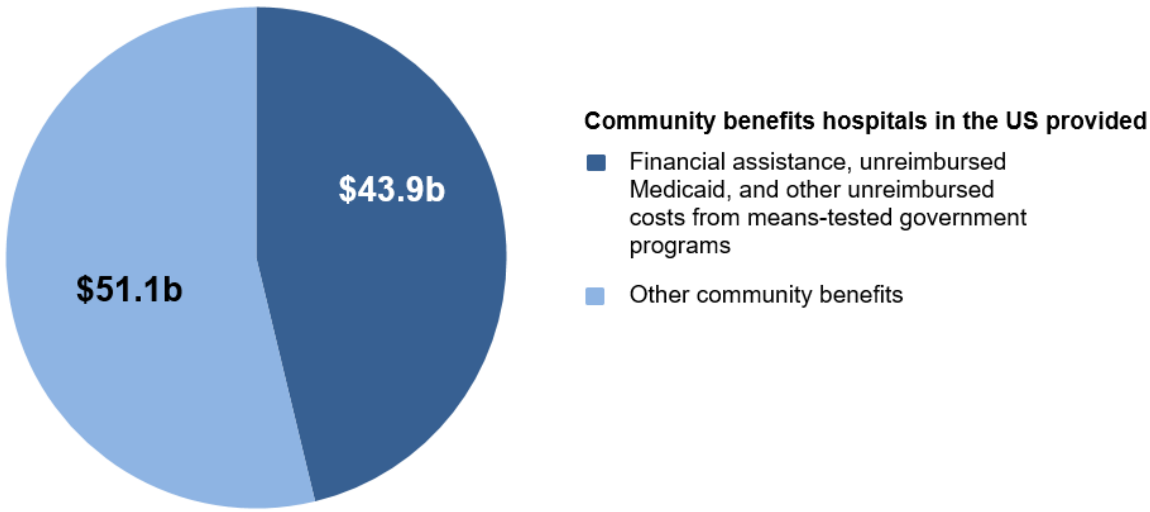
SOURCE: Ernst & Young LLP calculations. Community Benefit from 'Results from 2016 Tax-Exempt Hospitals' Schedule H Community Benefit Reporting' American Hospital Association, May 2019

Numbers may not sum due to rounding

Figure 2 shows the makeup of the federal tax revenue forgone for 2016. Of the $9.0 billion of federal revenue forgone, $4.2 billion reflects federal corporate income taxes. $4.6 billion reflects the reduced cost of tax-exempt financing, the direct benefits of which accrue to tax-exempt bond holders. In return, these holders provide financing to the tax-exempt hospitals at a reduced interest rate. The revenue forgone due to federal unemployment tax-exemption is $0.2 billion.

Estimates of the federal revenue forgone due to the tax exemption of non-profit hospitals compared to the community benefit they provide, 2016

Figure 3. Breakdown of community benefits provided by non-profit hospitals, 2016



SOURCE: Ernst & Young LLP calculations. Community Benefit from 'Results from 2016 Tax-Exempt Hospitals' Schedule H Community Benefit Reporting' American Hospital Association, May 2019

Numbers may not sum due to rounding

Figure 3 shows the makeup of the community benefits provided by tax-exempt hospitals in 2016. Of the $95.0 billion of community benefits, $43.9 billion reflects financial assistance, unreimbursed Medicaid, and other unreimbursed costs from means-tested government programs. $51.1 billion reflects all other community benefits provided.

Overview of approach for estimating federal tax revenue forgone

This analysis estimates federal tax revenue forgone as a result of three federal tax provisions, relying on data from the Medicare hospital cost reports filed by hospitals that receive Medicare reimbursements. The hospital cost reports are not audited financial reports, but are filed by hospitals with the federal government. In 2016 – the year on which this analysis is based – 2,184 private, non-profit, general hospitals filed Medicare hospital cost reports.[3] The results are then grossed up to the entire industry using data from the 2017 AHA Survey of Hospitals and from the AHA Schedule H Community Benefit Reporting study.

In this analysis, we apply the general federal tax rules to the levels of tax-exempt activities reported by non-profit hospitals. Not all aspects of the detailed federal tax rules can be applied to the available financial data in the hospital cost reports, however, so certain estimates of revenue forgone require additional data and/or assumptions, which are described below.

Adjustments to reported income incorporated in estimate of revenue forgone from corporate income tax-exemption

The estimate of corporate taxable income starts with the positive net income before adjustments of each hospital as reported in the Medicare hospital cost reports. The cost reports, similar to financial reports, do not include the entire income and expense detail necessary to reconstruct a corporate income tax return. Adjustments for positive and negative differences between book and tax accounting are not made due to insufficient detail in the Medicare hospital cost reports.

For example, the provision for bad debt is likely to reduce financial statement income as compared with taxable income, while accelerated tax depreciation is likely to reduce taxable income as compared with financial statement income.

Bonus depreciation not reflected

In 2016, federal tax law allowed bonus depreciation that provided additional first-year tax write-offs of capital investments as part of fiscal stimulus. Bonus depreciation applied to only certain qualifying property, and some state tax systems did not conform to this provision. Due to this complexity and data constraints, bonus depreciation was not considered in this analysis. Had bonus depreciation been reflected in the estimates, it would have reduced the federal corporate income tax forgone in 2016.

Consolidation with affiliates

The analysis assumes that non-profit hospitals would take advantage of tax consolidation rules with affiliated hospitals if they were subject to tax. Thus, a hospital with a taxable loss could offset positive taxable income of a consolidated hospital in the current year.[4] Using an affiliation listing provided by the American Hospital Association, consolidated taxable income of all non-profit hospitals can be estimated. On net, consolidation of hospitals reduces overall taxable income.

Contributions excluded from income

The analysis reduces hospitals' taxable income by the amount of contributions received. If contributions constitute gifts for federal income tax purposes, such gifts are not included in taxable income, but may be subject to gift tax. Restricted gifts used for capital improvements may not be included in taxable income if certain conditions are met, in which case they would reduce the taxable basis of the capital improvements. Further, if contributions to hospitals are not eligible for a tax deduction, it is assumed most donors would choose other qualified organizations. For these reasons, the contributions are excluded from the estimate of corporate taxable income.

State and local taxes

Many hospitals would automatically pay higher state and local taxes if the federal tax-exemption was eliminated. Thus, estimates on a state-by-state basis of the potential sales tax on business inputs and of potential property taxes on non-profit hospitals were incorporated in the federal tax calculations.[5] Increased state corporate income taxes would be deductible against federal taxable income, and this factor is reflected in the analysis.

Prior year losses

Finally, the federal corporate income tax does not tax businesses only on their net positive income in each year, but instead allows for taxable net operating losses to offset taxable income in certain prior years and for any remaining tax loss to be carried forward offsetting positive taxable income in future years.[6] The analysis incorporates a one-year net operating loss carry back with any remaining tax loss carried forward against future taxable income. For tax loss carry forwards, losses from 2009 through 2015 were applied against positive taxable income for each year, with any remaining losses applied to positive income from 2016. The tax loss carryover rules, similar to the tax consolidation rules, result in taxable income being lower than positive financial net income in all years analyzed.

Items not considered for analysis

The actual federal revenue forgone is likely to be less than the estimate above for the following reasons:

- Potential federal tax credits, such as enterprise zone and work opportunity tax credits, and special deductions, such as accelerated depreciation, are not included in this analysis due to lack of necessary information.
- Routine tax planning could also result in hospitals retaining less earnings and thus earning less future investment income.
- Tax net operating losses that remained at the end of 2016 could be used by some hospitals to offset future taxable income.
- Some non-profit hospitals pay unrelated business income tax already on a portion of their income.[7] These amounts are not reflected in these estimates.

Estimate of federal revenue forgone from tax-exempt bond financing

The analysis calculates the revenue forgone from tax-exempt bond financing to non-profit hospitals. The estimate assumes the total amount of notes payable and other long-term liabilities outstanding as reported in the Medicare cost reports were issued as federally tax-exempt bonds. The analysis assumes that the average marginal tax rate applicable to investors in tax-exempt bonds is approximately 30 percent[8]. Applying this tax rate to the ten-year average taxable yields of Aaa and Baa corporate bonds and tax-exempt debt outstanding in each of the years, the revenue forgone from tax-exempt bonds of non-profit hospitals was $4.6 billion in 2016. To the extent that non-profit hospitals are using short-term financing with lower yields, the revenue forgone would be lower.

It should be noted that the benefit received by the hospital issuer is likely smaller than the federal revenue forgone, as the amount of revenue forgone is dependent on all the marginal tax brackets of the investors, whereas the market-clearing interest rate may be for a lower marginal tax bracket than many of the other bondholders. Investors may not convert the entire tax benefit they receive into a lower cost of financing for the hospital.

Estimate of the revenue forgone from federal unemployment tax

The value of the revenue forgone from the federal unemployment tax is calculated assuming an effective federal unemployment tax rate of 0.5 percent and a maximum wage base of $7,000 per employee. Based on the 4.5 million employees of private non-profit hospitals, the value of the exemption from federal unemployment tax is estimated to be $158 million in 2016.[9]

[1] AHA's 2017 Annual Hospital Statistics Survey indicates there are 6,210 registered hospitals in the US. This includes community, federal government, psychiatric, long term care, and other hospitals. There are 5,262 community hospitals, which include non-governmental non-profit (2,668 hospitals), investor-owned for-profit (1,322 hospitals), and state and local government (972 hospitals). The remaining 740 hospitals are made up of the federal government, psychiatric, long-term care, and other hospitals (e.g., prison hospitals).

[2] Community Benefit from 'Results from 2016 Tax-Exempt Hospitals' Schedule H Community Benefit Reporting' American Hospital Association, April 2019.

[3] Hospitals were identified based on AHA's 2014 Annual Hospital Statistics Survey. The Survey defines a general medical hospital as follows: "Provides acute care to patients in medical and surgical units on the basis of physicians'

orders and approved nursing care plans." In terms of the hospitals used for this analysis, there were 2,184 hospitals in the 2016 Medicare hospital cost reports.

[4] For example, two independent hospitals, one with a net operating loss (NOL) of $10M and one with a taxable income of $10M, have an aggregate taxable income of $10M in that year, since the hospital with the NOL has a taxable income of zero, with a potential carryover of the loss against the hospital's future taxable income. If these two hospitals joined together into a system that files a federal consolidated return, the net operating loss from the first hospital would offset the taxable income of the second, leading to a consolidated taxable income of $0, $10M less than if the two hospitals were separate.

[5] Council on State Taxation, Total State and Local Business Taxes: Nationally 1980-2004 and by State 2000-2004, April 12, 2005. The methodology used by Ernst & Young in this study was used for the state-by-state hospital estimates of sales tax on business inputs and property taxes.

[6] For 2016, a taxpayer could carry back net operating losses two prior years and could carry forward up to twenty years. Net operating loss carry back and carry forward rules vary by state.

[7] For example, in 2009, there were 373 tax returns that paid a total of $45 million in unrelated business income classified as "Healthcare and social assistance". This may not account for all unrelated business income taxes paid by hospitals, as taxes paid may have been classified under a different category, such as "retail trade" for gift shop sales. Internal Revenue Service Statistics of Income Tax Stats – Exempt Organizations' Unrelated Business Income (UBI) Tax Statistics, October 2012.

[8] The analysis uses an average marginal rate applicable to investors in tax exempt bonds as 30 percent. This number is likely far higher than the actual average (CBO estimates for 2007 ran as low as 21 percent). This analysis assumes the higher percentage in order to provide a more conservative estimate, as a lower average marginal tax rate would lead to a lower amount of federal revenue forgone for tax-exempt financing.

[9] The U.S. Census Bureau's *County Business Patterns* reports approximately 5.8 million employees for all "non-profit hospitals" for 2016. This definition of non-profit hospitals includes public facilities. Another Census Bureau program, the 2016 *Annual Survey of Public Employment & Payroll*, reports approximately 1.3 million employees for public hospitals for the same periods. The number of employees of private, non-profit hospitals is calculated as total non-profit employment less government hospital employment.