



Federal Tax Reform and its Implications for Hospitals

Background

Reforming the nation's federal tax code is a high priority for both President Obama and congressional leaders. The House Ways and Means Committee held 20 hearings on comprehensive tax reform during the last Congress and released a financial products discussion draft in January 2013. In February, Chairman Dave Camp (R-MI) and Ranking Member Sander Levin (D-MI) announced the formation of 11 separate Ways and Means Committee Tax Reform Working Groups. Also during the last Congress, the Senate Finance Committee began a comprehensive review of America's tax system and held numerous roundtable discussions and hearings to study the specifics. They are now working on a detailed tax reform proposal intended to attract bipartisan support.

Proposals from some in both parties recommend the limitation or replacement of tax-exempt bonds. In addition, the Bowles-Simpson Commission recommended that tax-exempt bonds be replaced with direct-pay bonds. Tax changes also have figured prominently in the debate over the federal budget. In particular, under recent presidential and congressional proposals, investors with adjusted gross income exceeding certain income thresholds would no longer receive the full benefit of various tax deductions, adjustments and exemptions. This includes limiting the current full tax-exemption on interest earned from tax-exempt hospital bonds. One proposal, originally included in the president's 2012 budget, would place a 28 percent cap on the exemption, which would effectively impose an 11.6 percent tax on otherwise tax-exempt interest for investors in the 39.6 percent tax bracket.

Proposals to limit the deduction for charitable contributions also have appeared in recent years, in some cases as part of broader tax reform proposals that lower rates, and in other cases for the purpose of raising taxes to fund specified levels of government spending. Examples of these restrictions include: limiting the tax rate against which contributions may be deducted; a dollar cap on total itemized deductions; a floor below which contributions may not be deducted; and the replacement of the deduction with a tax credit available regardless of whether the taxpayer itemizes. Different types of limitations could have varying effects on giving.

AHA View

Tax-exempt Financing. It is essential that America's hospitals have access to needed capital to improve community health, increase jobs and support the local economy. Better access to capital helps hospitals upgrade facilities, meet growing patient needs and invest in clinical and information technology. But, many hospitals struggle to obtain adequate capital financing.

Moody's Investors Service is maintaining its negative outlook for the "US Not-for-Profit Healthcare Sector" for 2013. The negative outlook reflects

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Moody's view that revenue growth will remain positive, but will continue to decelerate as a result of federal cuts to health care spending, limited reimbursement increases from commercial health care insurers, and a tepid economy that dampens demand for health care services. Moody's outlook has been negative since 2008 as the recession has left a lasting impact on patient volumes, and hospitals confront significant challenges stemming from changes in how they are paid. It finds that hospitals face heightened pressure from all levels of government, as well as businesses, to lower the cost of health care services.

Non-profit hospitals and health systems would bear much of the burden of proposals that would significantly raise borrowing costs for non-profit organizations and hamper their ability to meet our country's health and infrastructure needs.

The president proposes to place a cap on the amount of certain tax deductions and exclusions, including interest on otherwise tax-exempt bonds, that is intended to ensure that higher income taxpayers pay at least a 28 percent tax rate. Under this retroactive proposal, investors with adjusted gross incomes exceeding the thresholds set by the proposal would no longer be able to receive the full benefit of the tax-exempt interest they paid for when they purchased the bonds. This amounts to an effective 11.6 percent tax on otherwise tax-exempt interest for many taxpayers who would be in the top tax bracket. In the case of newly issued tax-exempt bonds, investors would likely demand higher interest rates to make up for this new tax.

The proposal would have a direct and negative impact on hospitals and the communities they serve. The outcome would be higher borrowing costs, fewer services, less investment in infrastructure and fewer jobs. The federal tax-exemption on municipal bond interest has been in place since the enactment of the very first federal tax code in 1913. As a result, non-profit hospital borrowers save, on average, an estimated two percentage points on their borrowing to finance investment in non-profit and public health infrastructure.

The proposed de facto tax increase would be retroactive. That is, the proposal would apply to interest on bonds hospitals already have issued, and investors, in good faith and in reasonable reliance, already have purchased. The effect would be to substantially erode the value of bonds already in investors' portfolios. This would violate the basic assumption of investors that Congress will not change the terms governing the taxability of interest for bonds already outstanding. In the nearly 100-year history of the tax-exemption, Congress has never applied a retroactive tax to bonds already held by investors.

This new tax risk would result in higher borrowing costs for hospitals and higher health costs for the communities they serve. It is estimated that

borrowing rates could rise by at least a full percentage point if the proposal is enacted. Hospitals will have to pay these additional costs on every bond they issue even though the tax is intended to affect those considered “wealthy.”

Proposals to eliminate entirely the tax-exemption would impose even greater costs. Proposed substitutes for tax-exempt bonds are unproven or are not financially practical for thousands of small clinics and hospitals.

Deduction of Charitable Contributions. Hospitals do more to assist the poor, sick, elderly and infirm than any other entity in health care. Since 2000, hospitals of all types have provided more than \$367 billion in uncompensated care to their patients. In 2011 alone, hospitals delivered more than \$41.1 billion (in costs) in uncompensated care to patients and uncounted billions more in value to their communities through services, programs and other activities designed to promote and protect health and well-being. This broad array of benefits includes basic research, medical education and unprofitable services such as burn intensive care, emergency department care, high-level trauma care and labor and delivery services.

America’s communities receive a positive return on their investment from the tax-exemption of hospitals. Federal revenue forgone because of hospital tax-exemption is an estimated 2.3 percent of hospital expenses compared to the 9.3 percent of expenses hospitals provide in community benefit.

Hospitals recognize the responsibilities that come with tax-exemption and fully appreciate the benefits. One important benefit is the ability to attract community investment through tax-deductible giving. Hospitals are the backbone of the communities they serve, and people in those communities recognize their importance through generous philanthropic giving. In fiscal year 2011, philanthropic support for nonprofit hospitals and health care organizations reached \$8.9 billion, according to the Association of Healthcare Philanthropy (AHP). Needed construction and renovation projects receive almost a quarter of philanthropic dollars, but many hospitals rely on funds raised from community partners simply to meet operating expenses, allocating on average more than 15 percent of the funds they raise to general operations.

Philanthropic giving also is increasingly important as a source of capital financing as hospitals prepare to meet the health care needs of the future. Hospitals that are under significant financial strain – not profitable, not liquid and with a significant debt burden – often are shut out of traditional capital markets. They have a limited number of capital sources and incur higher costs than hospitals with a brighter financial picture. For these financially challenged hospitals, philanthropy is essential to finance the necessary facility upgrades and investments in information technology required if they are to continue to provide high-quality health care services in their communities.

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Community support for hospitals is strong, but incentives are necessary to retain this critical support. The AHA is concerned that, in an environment where hospitals rely increasingly on charitable giving, limiting or eliminating the current charitable contribution deduction would reduce the availability of resources that are critical to fund hospital operations. The most recent AHP survey of hospital and health care development professionals found that nine out of 10 agreed that proposed limits on charitable deductions would result in significant reductions in giving to their organizations. About 40 percent estimate that giving would decrease between 10 and 30 percent if significant changes are made to the current tax incentives for charitable donations, which conservatively could amount to a decrease of more than a \$1.07 billion in total annual giving to nonprofit hospitals and health care providers, based on AHP's FY 2009 giving statistics.