American Hospital Association®

Hospital Tax Exemption

Background

Reforming the nation's federal tax code is a high priority for both President Obama and congressional leaders. President's Obama fiscal year (FY) 2015 budget proposed capping the value of the tax exemption for municipal bond interest at 28 percent. Once again, he proposed an America Fast Forward Bond (AFF) program, which would build on the Build America Bond (BAB) program. AFF bonds would be direct-pay bonds with a 28 percent subsidy rate that could be used for the same kinds of projects financed by BABs but also for projects that could be financed with tax-exempt hospital bonds. The Senate Finance and House Ways and Means Committees have held more than 50 hearings combined, examining every aspect of tax reform.

In February, Rep. Dave Camp (R-MI), chairman of the House Ways and Means Committee, unveiled comprehensive draft legislation to overhaul the nation's tax code. The draft is the product of more than 30 separate congressional hearings and 11 separate bipartisan tax reform working groups over the past three years. Under Camp's proposal the tax exemption for interest on tax-exempt 501(c)(3) hospital bonds would be repealed and advance refundings eliminated, effective for bonds issued after 2014. Investors would have to pay taxes on bond income, which would have a dramatic effect on the cost and attractiveness of hospital bonds. In addition, an individual's charitable contributions could be deducted only to the extent they exceed 2 percent of the individual's adjusted gross income. The income-based percentage limit for certain charitable contributions to public charities and certain other organizations would be reduced from 50 percent to 40 percent. Charitable contributions are excluded from the definition of income subject to the 10 percent surtax on high income individuals. While the bill is unlikely to pass the Congress this year, it is the beginning of a conversation about reforming the tax code.

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 2014. The negative outlook reflects Moody's view that hospitals face a "challenging operating landscape over the next 12-18 months as patient volumes shrink and revenue growth slows." The negative outlook also reflects the struggle for hospitals to reduce costs while "making investment necessary to adjust to changing reimbursement methodologies brought on by the Affordable Care Act (ACA) and the demands of other industry participants such as insurers and employers." 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 has proposed 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. One important benefit of hospital tax exemption 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.

Federal Tax Reform and its Implications for Hospitals. 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 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.

Hospital Tax Exemption. 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 2012 alone, hospitals delivered more than $45.9 billion (based on 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 wellness programs, community outreach, basic research, medical education and unprofitable services such as burn intensive care, emergency department care, high-level trauma care and neonatal intensive care services. The ability to obtain tax-exempt financing and to accept tax-deductible charitable contributions are two key benefits of hospital tax-exemption that work to make access to hospital services available where needed. The current exemption for hospital services, governed and guided by the community benefit standard, allows the community in which the hospital operates to determine the needs of its residents and the hospital to tailor its activities accordingly. That approach continues to work well for communities across the nation.

America's communities receive a positive return on their investment from the tax-exemption of non-profit hospitals. For two consecutive years, the AHA has collected the community benefit information that tax-exempt hospitals file with the IRS in a form called "Schedule H" and asked Ernst & Young to analyze and report on it. Schedule H forms were obtained directly from hospitals that filed them with the IRS. Data from more than 900 hospitals around the nation show that tax-exempt hospitals consistently provided benefits to the community valued at more than 11 percent of their total expenses, averaging 11.6 percent in 2010 and 11.3 percent in 2009. Direct benefits to patients, which include free care, financial assistance and spending to fill gaps in Medicaid underpayments, averaged 5.7 percent of expenses in both 2010 and 2009. In contrast, federal revenue forgone because of non-profit hospital tax-exemption represents an estimated 2.3 percent of hospital expenses in 2009.

As the IRS plays a more active role in oversight of hospital activities in this area, it has assumed a regulatory role. However, the IRS frequently claims that its guidance is exempt from the notice and hearing requirement of the Administrative Procedures Act (APA), and the agency has failed in the past to comply with the Paperwork Reduction Act. The AHA has drafted a proposal to assure hospitals have the protection of these laws.