

# **Oversight of Nonprofit Hospital Tax-Exempt Status: Background and Key Considerations**

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Prepared for the Subcommittee on Oversight of the Committee on Ways and Means

U.S. House of Representatives

Hearing on

Tax-Exempt Hospitals and the Community Benefit Standard

**April 26, 2023**

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## Introduction

Good afternoon, Chairman Schweikert, Ranking Member Pascrell, and distinguished Members of the Subcommittee. Thank you for inviting me to testify about tax-exempt hospitals and the community benefit standard.

I am Zachary Levinson, the director of a new project at KFF examining the business practices of hospitals and other providers and their impact on costs and affordability. KFF is a non-profit organization providing non-partisan health policy analysis, polling, and journalism (KFF Health News) for policymakers, the media, the health policy community, and the public. We are not associated with Kaiser Permanente.

Over the years, some policymakers have questioned whether nonprofit hospitals provide sufficient benefit to their communities to justify their exemption from federal, state, and local taxes. This issue has been the subject of renewed interest in light of reports of nonprofit hospitals taking aggressive steps to collect unpaid medical bills—such as by suing patients over unpaid medical debt—including from patients who are likely eligible for financial assistance.<sup>1</sup> Given these concerns, several policy ideas have been floated to better align the activities of nonprofit hospitals with the needs of their communities and the value of their tax exemption.

During my testimony, I will describe the value of tax exemption, federal oversight of community benefits, concerns about the adequacy of government requirements, proposed policy solutions, and general tradeoffs of policies that seek to strengthen requirements for tax-exempt status.

## The Value of Tax Exemption

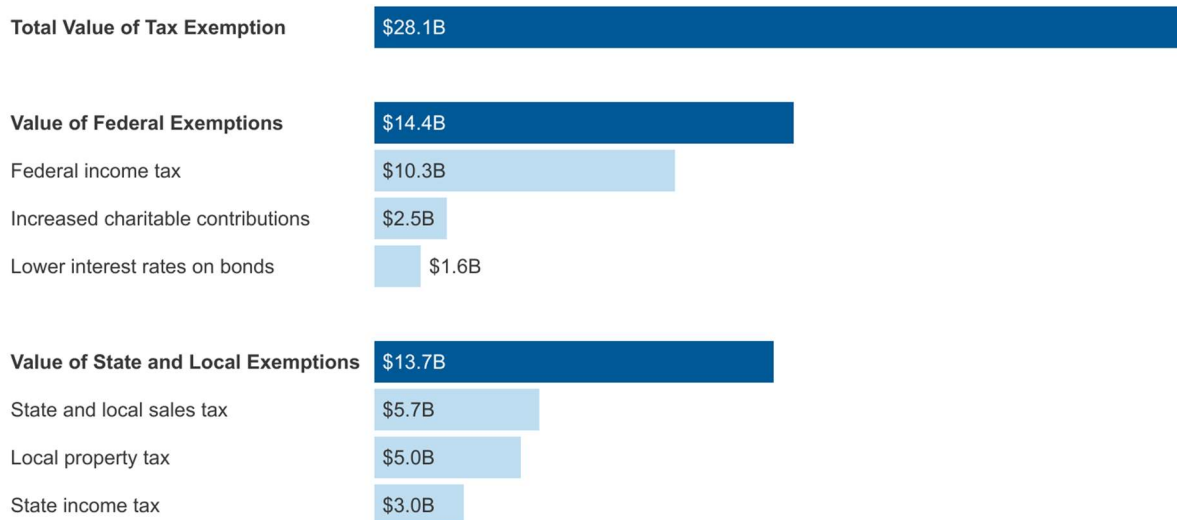
We recently estimated the value of tax exemption for nonprofit hospitals to provide context for debates about the adequacy of community benefits provided by these facilities. One motivation for our work was to update a previous estimate from 2011, which predated large changes to the federal tax code and health insurance coverage expansions under the Affordable Care Act (ACA) of 2010. We relied on a modeling approach based on prior research, using data from hospital cost reports, filings with the Internal Revenue Service (IRS), and the American Hospital Association survey.

We estimated that the total value of tax exemption for nonprofit hospitals was about \$28 billion in 2020 (Figure 1).<sup>2</sup> This represented over two-fifths (44%) of net income (i.e., revenues minus expenses) earned by nonprofit facilities in that year.

About half of our estimate of the total value of tax exemption reflects the benefit of receiving federal tax-exempt status. The federal component of our estimate includes the value of not having to pay federal corporate income taxes. It also reflects estimated increases in charitable contributions and decreases in bond interest rate payments that might stem from tax-exempt status.

Figure 1

## The Total Estimated Value of Tax Exemption for Nonprofit Hospitals Was About \$28 Billion in 2020



NOTE: Value of tax exemption reflects the estimated benefit of not having to pay federal, state, and local taxes as well as estimated increases in charitable contributions and decreases in bond interest rate payments due to tax-exempt status.

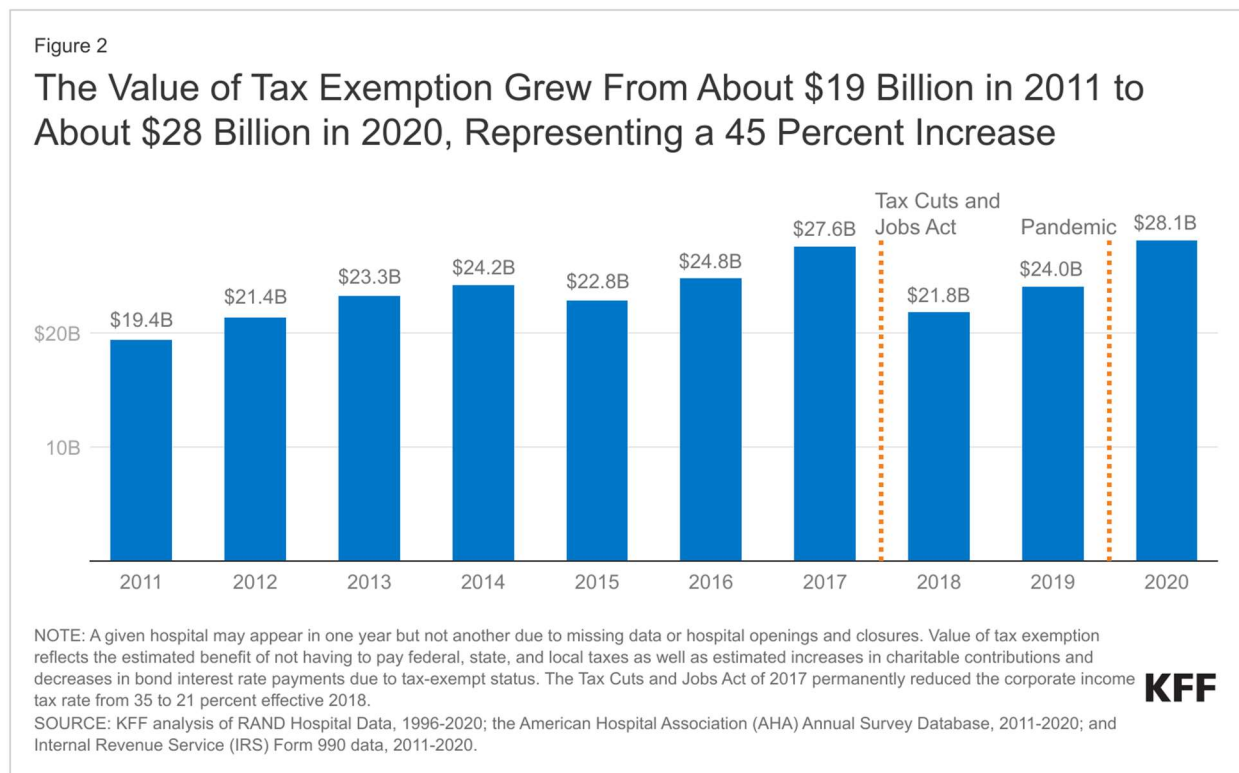
SOURCE: KFF analysis of RAND Hospital Data, 1996-2020; the American Hospital Association (AHA) Annual Survey Database, 2011-2020; and Internal Revenue Service (IRS) Form 990 data, 2011-2020.

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We also found that the value of tax exemption grew over time from about \$19 billion in 2011 to about \$28 billion in 2020 (Figure 2). One notable exception to this trend was a large decrease in the value of tax exemption in 2018 following the implementation of the Tax Cuts and Jobs Act of 2017, which reduced corporate income tax rates and therefore decreased the value of being exempt from federal income taxes for nonprofit hospitals.<sup>3</sup> Conversely, there was a large increase in the value of tax exemption in 2020, which overlapped with the start of the COVID-19 pandemic. This primarily reflects a large increase in aggregate net income for nonprofit hospitals in 2020. Although there were disruptions in hospital operations in 2020, hospitals received substantial amounts of government relief,<sup>4</sup> and it is possible that other sources of revenue, such as from investment income, may have also led to increases in taxable income. Increases in the estimated value of tax exemption over time also reflect trends that preceded the pandemic, such as the growth of supply expenses and net income, both of which would carry tax implications if hospitals lost their tax-exempt status.

The value of the tax exemption may have decreased since 2020 given the more recent financial challenges facing the hospital sector. These challenges include the erosion of government pandemic relief funds, costs associated with labor shortages, and broader economic trends that have led to rising prices and investment losses.<sup>5</sup> The recent unwinding of the Medicaid continuous enrollment provision—which was introduced at the start of pandemic—may also have implications for hospital finances. A KFF analysis estimated that millions of people could lose Medicaid enrollment as a result, which may increase

hospitals' charity care and other uncompensated care costs.<sup>6</sup> We were unable to evaluate the value of tax exemption in the context of recent trends given lags in the availability of our data.



While our analysis focused on the total value of tax exemption, the benefit to a specific hospital or health system will vary based on its finances and the state and local policy where it operates. It is possible that tax exemption may tend to provide greater value to nonprofit hospitals or health systems with greater resources that are serving wealthier patients. For example, hospitals operating in wealthier areas of a given region may receive greater value from local property tax exemption than hospitals in areas where property values are lower. Similarly, hospitals with low versus high safety-net indices tend to earn higher margins<sup>7</sup> and may therefore receive greater value from income tax exemption, all else equal. In sum, there may be a mismatch between the benefit of tax exemption and the needs of the patients and community that a given hospital serves.

As is the case with previous work, we were unable to capture the effects of all nuances of the tax code, nor the various actions that nonprofit hospitals might take to reduce their tax burden if they lost tax-exempt status, such as by changing how they operate or how they account for revenues and expenses. In general, evaluating the value of tax exemption is challenging given the limitations of available data and uncertainty about how hospitals would respond to losing their tax-exempt status.

## Federal Oversight of Community Benefits

The IRS evaluates community benefits in determining whether a hospital is considered “charitable” and thus tax-exempt. The IRS identifies six factors that demonstrate community benefits:

1. “Operating an emergency room open to all, regardless of ability to pay
2. Maintaining a board of directors drawn from the community
3. Maintaining an open medical staff policy
4. Providing hospital care for all patients able to pay, including those who pay their bills through public programs such as Medicaid and Medicare
5. Using surplus funds to improve facilities, equipment, and patient care; and
6. Using surplus funds to advance medical training, education, and research.”<sup>8</sup>

The IRS requires hospitals to document community benefit activities through Schedule H of Form 990 on an annual basis.<sup>9</sup> Part I of Schedule H asks hospitals to report net expenses for each of a set of specified community benefits. This list includes expenses that are directly related to patient care, such as unreimbursed Medicaid costs, charity care costs, and losses on certain unprofitable services (e.g., that are necessary to meet community need). The list also includes other net expenses, such as for unreimbursed medical education, unfunded research, and community health improvement activities. Hospitals may report additional community benefits in other parts of Schedule H. For instance, while the IRS does not allow hospitals to report unreimbursed Medicare costs or bad debt as a community benefit under Part I, it does allow them to report these expenses elsewhere and explain why some, if any, of these costs should be considered a community benefit.

The federal government has revised its standards for tax-exempt hospitals over time, including by introducing new requirements under the ACA. The ACA requires nonprofit hospitals to meet the following four criteria:<sup>10</sup>

- **Establish a financial assistance policy (FAP).** The FAP must describe who is eligible for We relied on charity care, the level of assistance provided, and how patients can apply. A hospital must make its FAP easily accessible to patients and ensure that the FAP is translated into the languages commonly spoken in the community served by the hospital.
- **Cap charges to patients eligible for charity care based on amounts generally billed to other payers.** Federal regulation defines approaches for calculating the amount generally billed based on fee-for-service Medicare rates, Medicaid rates, and/or commercial plan payment rates.
- **Conduct a community health needs assessment (CHNA) every three years and adopt an implementation strategy to address those needs.** The CHNA must define the community that the hospital serves and evaluate the health needs of that community, taking into account input from local stakeholders. Community health needs could include, for example, lowering financial barriers to health care or addressing social determinants of health.

- **Make reasonable efforts to determine if a patient is eligible for charity care before engaging in certain debt collection practices**, including selling the patient’s debt to third parties, reporting the debt to credit agencies, and taking legal action to control a patient’s financial assets. A “reasonable effort” could entail, for example, notifying the patient of the FAP and giving them at least four months to apply following their first bill after being discharged from the hospital.

## Adequacy of Federal Oversight

The Government Accountability Office (GAO) and others have questioned whether current federal standards provide adequate oversight of community benefits. Concerns include the following:

- **There are no statutory or regulatory requirements for specific community benefits.** The IRS uses the six broad factors described above when evaluating a hospital’s community benefits. However, the GAO has noted that there is no guidance on what constitutes a sufficient level of these benefits or how the IRS weighs different factors when evaluating hospitals’ community benefits.<sup>11</sup>
- **There are limited standards for financial assistance programs.** Although the ACA requires that hospitals establish a financial assistance program, there are no requirements about who must be eligible or how much assistance must be provided.<sup>12</sup>
- **The IRS does not require standardized reporting for all community benefits.** The GAO has noted that, while Schedule H of IRS Form 990 includes specific, detailed, and standardized questions about some community benefits, it does not require other community benefits to be reported in a standardized way.<sup>13</sup> For example, hospitals are instructed to report details about the “use of surplus funds to improve facilities, equipment, and patient care” in an open-ended, narrative section.
- **Some community benefits acknowledged by the IRS may not be aligned with local needs.** For example, “using surplus funds to improve facilities, equipment, and patient care” may include some activities that are not targeted towards the greatest needs in the community, such as instances where a hospital opens a new facility in a wealthy neighborhood.<sup>14</sup>

The GAO reported in 2020 that the IRS had not revoked a hospital’s nonprofit status on the basis of community benefits over the prior ten years.<sup>15</sup>

States fill in some of the gaps in federal standards for tax-exempt status and community benefits but have varying approaches. For example, about half of states require all or a subset of hospitals to offer charity care to certain eligibility groups.<sup>16</sup> These state regulations vary in terms of which hospitals they cover, the eligibility criteria, and the level of assistance that must be provided. For example, Nevada requires a subset of hospitals to provide free care to uninsured patients with very low incomes (about 40% of the federal poverty level [FPL] in 2022 depending on household size), while Maryland requires every acute and chronic care hospital to provide free care to both insured and uninsured patients at or below 200% of the FPL and to provide discounted care to patients with higher incomes. There is little information about the effectiveness of state regulations or the extent to which they are enforced.

## Value of Community Benefits Relative to Tax Exemption

The extent to which nonprofit hospitals provide sufficient benefit to their communities to justify tax exemption is a matter of ongoing debate. Answering this question may be challenging and likely depends on at least a few considerations, such as: (1) what counts as a community benefit, (2) whether comparisons consider the total value of community benefits provided by nonprofit hospitals or only the *additional* value they provide relative to for-profit hospitals, and (3) whether certain business practices—such as instances where nonprofit hospitals have engaged in anticompetitive behavior, charged high commercial prices, and engaged in aggressive debt collection practices<sup>17</sup>—affect assessments of the value that nonprofit hospitals provide to their communities.

Whether the value of community benefits exceeds the value of tax exemption, or vice versa, may vary across hospitals and health systems. For instance, one study estimated that the value of community benefits exceeded the value of tax exemption for about three-fifths (62%) of nonprofit hospitals during 2011-2018 (when focusing on the additional benefits provided relative to for-profit hospitals), while the reverse was true for the remaining hospitals (38%).<sup>18</sup> That study also estimated that the value of community benefits was more likely to exceed the value of tax exemption in counties with higher poverty rates, among other findings.

## Hospital Charity Care

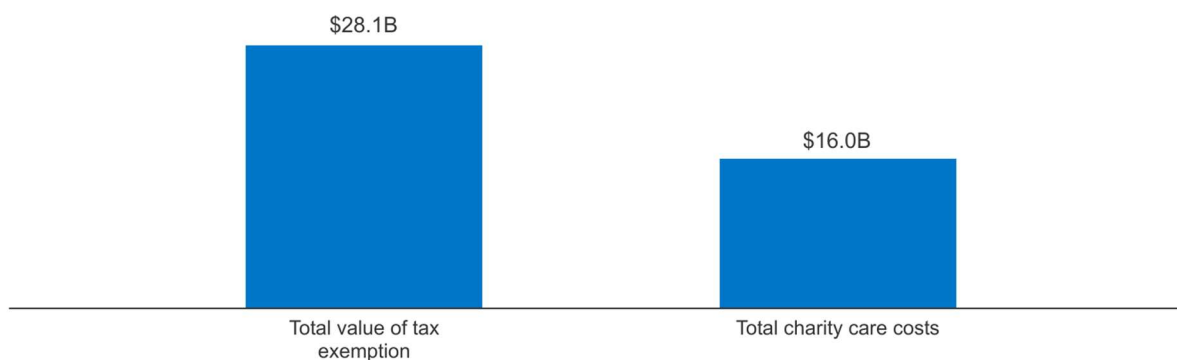
Hospital charity care—which is one type of community benefit—has received renewed scrutiny amid national discussions about medical debt. About four in ten adults (41%)—and about six in ten (57%) of those with household incomes below \$40,000—reported some level of medical debt in a 2022 survey.<sup>19</sup> A large share of adults who reported medical debt cited costs associated with hospitalizations (35%) and emergency care (50%) as sources of unpaid bills. Estimates based on survey data also suggest that medical debt totaled at least \$195 billion in 2019.<sup>20</sup>

Hospital charity care programs provide free or discounted services for eligible patients who are unable to afford their care. These programs could help fill in gaps in coverage for uninsured patients, as well as insured patients, whose plans may have large cost-sharing requirements. However, eligibility criteria vary across hospitals, and news reports have documented instances where eligible patients have fallen through the cracks. Policymakers have explored options to strengthen the oversight of hospital charity care programs in response to concerns about medical debt and the affordability of care more generally.

Our estimate of the value of tax exemption exceeded estimated charity care costs among nonprofit hospitals in 2020, a difference of \$28 billion versus \$16 billion (Figure 3). This result highlights that the charity care provided by nonprofit hospitals—one core component of community benefit—may not on its own justify tax exemption, though nonprofit hospitals also provide many other benefits to the communities they serve and the public at large.

Figure 3

The Total Estimated Value of Tax Exemption (About \$28 Billion) Exceeded Total Estimated Charity Care Costs (\$16 Billion) Among Nonprofit Hospitals in 2020, Though Charity Care Represents Only a Portion of the Community Benefits Reported by These Facilities



NOTE: Value of tax exemption reflects the estimated benefit of not having to pay federal, state, and local taxes as well as estimated increases in charitable contributions and decreases in bond interest rate payments due to tax-exempt status.  
SOURCE: KFF analysis of RAND Hospital Data, 1996-2020; the American Hospital Association (AHA) Annual Survey Database, 2011-2020; and Internal Revenue Service (IRS) Form 990 data, 2011-2020.

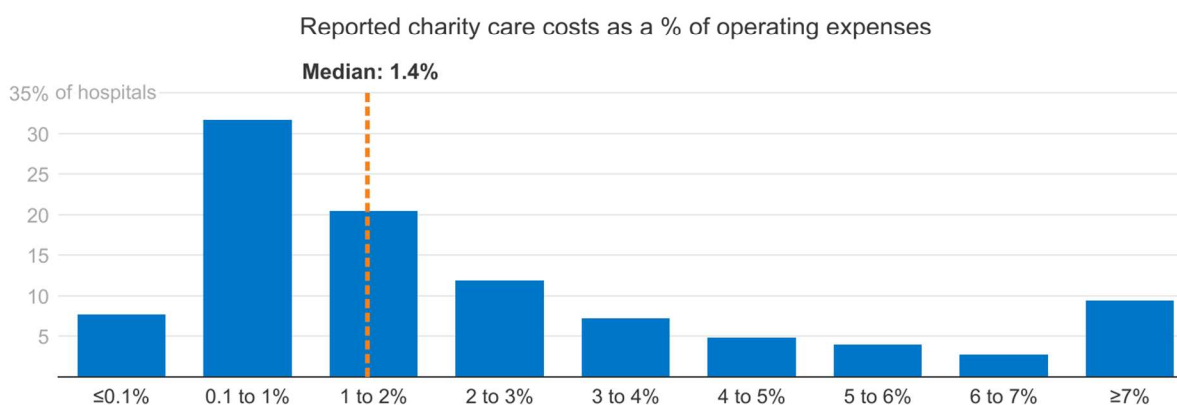
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Hospitals vary substantially in the amount of charity care that they provide (Figure 4). For example, while charity care costs represented 0.1 percent of operating expenses or less on the lower end of the spectrum, it represented 7 percent of operating expenses or more among a similar share of hospitals.<sup>21</sup>



Figure 4

## Half of All Hospitals Reported That Charity Care Costs Represented 1.4% Or Less of Their Operating Expenses in 2020, Though the Level of Charity Care Varied Substantially Across Facilities



NOTE: Includes 4,279 hospitals in 50 states plus DC. Missing charity care costs recoded as \$0 if hospital reported total unreimbursed and uncompensated care costs but left as missing otherwise. Excludes hospitals with incomplete data for the calendar year, missing or negative operating expenses or charity care costs, or outlier amounts of charity care as a percent of operating expenses ( $\geq 38.0\%$ ).  
SOURCE: KFF analysis of RAND Hospital Data, 2020

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Differences across hospitals in part reflect the extent to which their patients need financial assistance. Indeed, research indicates that hospitals provide much more charity care in counties with high versus low uninsurance rates.<sup>22</sup> Additionally, hospitals provide much more uncompensated care (charity care plus bad debt) in states that have not expanded Medicaid, where uninsurance rates tend to be high.<sup>23</sup>

Differences in charity care could also reflect eligibility criteria, the level of assistance provided, and application procedures, which vary across hospitals.

To our knowledge, it is unknown what share of low-income patients are eligible for hospital charity care, let alone what share of eligible patients end up benefiting from these programs, or what share of their costs are covered.

## Federal and State Policy Proposals Intended to Improve Community Benefits

Several federal and state policy proposals have been floated to increase the provision of community benefits and better align these activities with local needs, some of which have already been implemented among a subset of states:

- **Expand charity care eligibility**, by creating or expanding requirements that hospitals extend charity care to certain groups of patients. For example, the state of Washington requires a group

of large hospitals and health systems to provide free hospital care to patients with incomes below 300% of FPL and discounted care to patients with incomes from 300% to 400% of FPL (while allowing hospitals to impose asset tests for the latter group), and it has similar but less extensive requirements for all remaining hospitals.<sup>24</sup>

- **Improve uptake of charity care among eligible patients**, such as by requiring that hospitals screen patients for eligibility and notify patients of potential eligibility throughout billing and collections processes.<sup>25</sup>
- **Establish quantitative standards** by requiring that a given hospital spend a minimum amount on certain community benefits (e.g., charity care).<sup>26</sup> A market-based alternative would be to create a floor-and-trade system for charity care where hospitals would be required to either provide a minimum amount of charity care for certain eligibility groups or buy credits from other hospitals that do so.<sup>27</sup> This is intended to account for the fact that the need for charity care varies across communities. Quantitative standards could take hospitals' financial health into account. For example, Oregon has established a minimum community benefit spending floor that increases with hospitals' operating margins.<sup>28</sup>
- **Require greater community involvement in hospital decision-making**, such as by requiring more extensive involvement from certain community members in the development of community health needs assessments or by specifying that boards of directors are more representative of the community that a given hospital serves.<sup>29</sup>
- **Revise IRS community benefit standards to better align with community need**, for example, by more clearly recognizing investments in the social determinants of health (e.g., housing) as a community benefit given the growing attention that these initiatives have received as a means for addressing local health needs.<sup>30</sup> Some have also recommended that the IRS narrow its standards to exclude activities that may do little to address community needs (e.g., opening new facilities in wealthy areas).<sup>31</sup>
- **Increase oversight**, such as by requiring that hospitals provide more detailed information about their community benefits and report the estimated value of certain tax exemptions (e.g., sales and property tax exemptions).<sup>32</sup> The GAO has also recommended that Congress consider specifying what it considers adequate community benefits, leading to clearer standards for tax-exempt status.<sup>33</sup>

Policies that seek to strengthen the regulation of nonprofit status would inevitably involve tradeoffs. For example, some of the policies discussed above would require new spending from some nonprofit hospitals on specific types of community benefits. While hospitals may be able to respond by operating more efficiently in order to devote more resources to community benefit, it is possible that some would cut costs in ways that are harmful to patients or the broader community, such as by discontinuing certain services or laying off staff. It may be especially challenging for some nonprofit hospitals to implement new community benefit activities given recent financial challenges, such as the erosion of government pandemic relief, labor shortages, and broader economic trends that have led to rising prices and investment losses.

At the same time, these policies could increase the provision of benefits that are important to patients and communities and better align these activities with local needs and priorities, as intended. For example, this could include extending free or discounted services to more patients who would otherwise have difficulty affording needed care. In the context of recent financial challenges facing hospitals, strengthening community benefit regulations could protect prioritized services and activities from hospitals' attempts to cut costs.

One consideration for these policies is how they might affect hospitals differently depending on the communities they serve, the amount and type of benefits that they already provide, and their ability to absorb new costs, as well as the increase in the demand for charity care that could result from the unwinding of Medicaid continuous enrollment.

## Conclusion

Tax exemption plays a significant role in the financial health of nonprofit hospitals, with an estimated value of \$28 billion in 2020 or over 40 percent of net income earned in that year. In exchange for receiving tax exemption, nonprofit hospitals are expected to provide benefits to the communities that they serve, though there is ongoing debate about how the value of these activities stack up against the tax benefits that nonprofit hospitals receive. Some scrutiny has focused on the provision of charity care, which helps patients afford needed care and varies substantially across facilities.

Several federal and state policy proposals have been floated to increase the provision of community benefits and better align these activities with local needs. These policies would inevitably involve tradeoffs, such as possibly leading to new costs during a period when some hospitals are facing financial challenges while potentially expanding the provision of valuable services to patients and communities.

## Endnotes

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