# Establishing the Value of Tax Exempt Status (7/06)

*Prepared for the Catholic Health Association by*
*Keith Hearle, Verité Healthcare Consulting (Keith.Hearle@VeriteConsulting.com)*

Many not-for-profit healthcare organizations agree that the dollar value of community benefits provided should equal or exceed the value of the taxes that would be paid if the organization were no longer exempt. This belief is based in part on why governments grant exemptions. In granting them exempt status, governments expect that not-for-profit organizations will provide services that otherwise would be the direct or indirect responsibility of government.

Establishing the amount of taxes that would be paid is a complicated undertaking. This is because for-profit and not-for-profit healthcare organizations operate under different incentives, the formulae used vary from one location to the next, and because organizations would incur a variety of different taxes if their exemptions were lost.

The amount of taxes that would be paid is only one component of the "value of tax exempt status." Tax exempt organizations enjoy lower (pre-tax) interest costs, philanthropic contributions, and in some cases significant savings on supply costs compared to their for-profit, taxable counterparts.

One framework for establishing the value of taxes that would be paid and the value of exempt status is described below.

To determine the value of tax exempt status, first calculate the following:

- **Payroll Tax.** Payroll tax represents federal and state unemployment tax (SUTA/FUTA) that the organization would be required to pay if it was not an IRC Section 501(c)(3) charitable organization. Sec. 501(c)(3) organizations are exempt from FUTA.
- **Sales Tax.** Sales tax would be incurred on supplies and equipment at rates prevailing in your state and local jurisdiction.
- **Real Estate Tax.** Real estate tax would be paid based on the current valuation of all real estate owned by the organization and the applicable property tax rates.
- **Personal Property Tax.** Personal property tax is assessed on tangible personal property (fixed assets and inventory) used in a trade or business. Each taxing district has its own tax rate.
- **Income Tax.** Federal, state, and local income taxes should be estimated based on the organization's excess of revenue over expenses ("book" net income) after adjusting for the effect of the loss of tax-exempt status (elimination of contributions, changes to interest expense, and additional taxes).
- **Higher Interest Costs.** The interest rate differential between tax-exempt debt and taxable corporate debt would increase interest costs.
- **Incremental Depreciation Expense.** The hospital would incur higher depreciation expense on equipment since sales tax would be added to equipment and other capital purchases.

The table below shows one approach to calculating tax liability if exempt status were lost. For each category of taxation, a tax rate is applied to a "taxable basis" which can be income, or taxable wages, equipment, or other items.

| Summary | | Average Rate | Basis | |
|---|---|---|---|---|
| | | | | |
| **Income Tax** | | | | |
| Local Income Tax | $ 130,568 | 2.50% | $ 5,224,125 | Taxable Income |
| State Income Tax | 223,778 | 5.00% | $ 4,475,557 | Taxable Income |
| Federal Income Tax | 1,488,123 | 35.00% | $ 4,251,779 | Taxable Income |
| | | | | |
| **Unemployment Tax** | | | | |
| State Unemployment Compensation Tax (SUTA) | 288,000 | 0.80% | $ 36,000,000 | Taxable Wages |
| Federal Unemployment Tax Act (FUTA) | 720,000 | 2.00% | $ 36,000,000 | Taxable Wages |
| | | | | |
| **Other Taxes** | | | | |
| Sales Tax | 5,701,500 | 7.00% | $ 81,450,000 | Taxable Goods and Services |
| Real Estate Tax | 3,171,875 | 4.77% | $ 66,500,000 | Value of Exempt Real Estate |
| Personal Property Tax | 637,500 | 7.50% | $ 8,500,000 | Adjusted Personal Property Value |
| Provider/Gross Receipt Tax | 1,250,000 | 0.25% | $ 500,000,000 | Gross receipts |
| | | | | |
| **Estimated Additional Taxes** | 13,611,344 | | | |
| | | | | |
| **Additional Expenses** | | | | |
| Interest Expense | 1,125,000 | 1.50% | $ 75,000,000 | Tax-Exempt Debt |
| Depreciation Expense | 1,000,000 | 14.3% | $ 7,000,000 | Sales Tax on PP&E Purchases |
| | | | | |
| **Donations Received** | 5,000,000 | | | |
| | | | | |
| **Estimated Value of Tax Exemption** | $ 20,736,344 | | | |

The total financial effect of losing one's tax exempt status is greater than the taxes that would be paid, because exempt organizations have lower interest and depreciation costs while also receiving charitable donations.

Separate worksheets and analyses are needed to calculate taxable income, taxable wages, the changed basis for depreciable assets, and other metrics. For example, here is a schedule for calculating state and federal income tax liability:

| **Income Tax** | **State** | **Federal** |
|---|---|---|
| Tax-Exempt Net Income | $ 22,500,000 | $ 22,500,000 |
| Charitable Donations Received | $ 5,000,000 | $ 5,000,000 |
| Subtotal | 17,500,000 | 17,500,000 |
| Less: Additional Interest | 1,125,000 | 1,125,000 |
| Less: Unemployment Taxes (FUTA & SUTA) | 1,008,000 | 1,008,000 |
| Less: Sales Taxes | 5,701,500 | 5,701,500 |
| Less: Real Estate Taxes | 3,171,875 | 3,171,875 |
| Less: Personal Property Taxes | 637,500 | 637,500 |
| Less: Provider/Gross Receipts Taxes | 1,250,000 | 1,250,000 |
| Less: Local Income Taxes | 130,568 | 130,568 |
| Less: State Income Taxes | [redacted] | 223,778 |
| Less: Other Adjustments | - | - |
| Add: Non-deductible Losses | - | - |
| Taxable Income | 4,475,557 | 4,251,779 |
| Income Tax Rate | 5.00% | 35.00% |
| Estimated Income Tax | $ 223,778 | $ 1,488,123 |