Tax Exemption In a Reformed Healthcare System

BY JANE H. WHITE

Private, not-for-profit hospitals face a unique challenge and responsibility as the country pursues healthcare reform. Representing two-thirds of all hospital beds, these organizations are the cornerstone of the delivery system. Yet the very concept of universal health coverage for those Americans now uninsured or underinsured raises questions about the future of not-for-profit hospitals. With universal coverage, how does one redefine charitable mission? Does the community benefit of not-for-profit healthcare facilities justify continued tax-exempt status?

Over the past decade, not-for-profit hospitals have been challenged on many fronts and for many reasons regarding the issue of tax exemption. The healthcare reform debate adds a new wrinkle to the tax question: Hospitals must now do more than simply calculate their current community benefit; they must actively define their future roles as well. This column examines the challenge hospitals face regarding tax exemption and looks at some activities under way to meet that challenge in the future.

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Motivating Factors

A variety of factors have led state and federal policymakers to question the tax-exempt status of not-for-profit hospitals. The recent report of the Catholic Health Association (CHA) task force on tax exemption pointed to three reasons for the heightened debate.[1] First, states and localities are under severe budget pressures. As they search for new sources of revenue, the property tax and other subsidies granted not-for-profit hospitals have come under increased scrutiny, facing court and legislative challenges in almost half the states.

Second, the growing number of uninsured Americans has finally caught the attention of federal policymakers. As they begin to debate methods of expanding coverage to the uninsured and underinsured, legislators are questioning whether the tax subsidies could be better channeled to direct payment for increased access to healthcare.

Third, the CHA report suggests that the commercial and competitive behavior of hospitals "is jeopardizing tax exemption."

"Today's system of price competition in healthcare mitigates against the charitable role traditionally played by the nation's not-for-profit hospitals," according to William J. Cox, CHA's vice president for government services. "Too often it requires them to behave like commercial enterprises in order to survive, especially in areas that have more than enough hospitals. The system itself encourages these hospitals to compete for paying patients and restrict severely the number of charity and Medicaid patients they serve. Today's not-for-profit hospital must make a conscientious and deliberate effort to maintain its community service orientation."

Others agree with Cox's view that, during the 1980s, not-for-profit hospitals found it necessary to act more like businesses to compete with the for-profit market and with each other. "When it came to competition, nonprofits were not patsies," notes Yale sociologist Bradford H. Gray in a recent article.[2] Their competitive success led some to trim their charitable activities, thus raising questions as to how they differed from for-profit facilities. The inevitable comparison of not-for-profit hospitals with the for-profit sector led to a "legitimacy crisis," according to Gray. "Some of the similarities were somewhat misleading, as with comparisons of uncompensated care using national numbers. But the effect was to create the impression that nonprofit hospitals were little different than for-profits, except for their tax exemptions," he adds.

In his article, Gray raises additional factors that fueled the tax debate. "Medicare's capital cost policy made it possible for hospitals to go to the debt market," he notes. "This set up powerful incentives that ran counter to charitable traditions." Also, Medicare's prospective payment system, when first implemented, provided high profit margins for hospitals. These high margins "attracted considerable publicity and helped cre-

ate the atmosphere for multiple challenges to tax exemptions," Gray continues.

Finally, a lack of consensus regarding the rationale for not-for-profit hospitals' right to tax exemptions has stimulated the debate. Economists, policy analysts, and legal scholars have struggled to clarify such a rationale. Gray concludes, however, that "whatever principled bases scholars may find for tax exemptions, governmental decisions seem to be made in a more pragmatic and political way." For instance, "factors that may justify exemptions from federal taxes may not be important at the local level, and vice versa."

Policy Implications

From a pragmatic rather than a theoretical perspective, a number of factors are likely to shape tax-exemption policy in the near future. At the federal level, two bills introduced in 1991 regarding community benefit criteria for tax exemption have not moved forward. Rep. Edward Roybal, D-CA, who introduced H.R. 790, is retiring, as is Rep. Brian Donnelly, D-MA, who introduced H.R. 1374. Further action by Congress appears unlikely at this juncture.

"Federal legislators have ducked the question and will continue to duck it," said economist Gerard Anderson in an interview. Anderson, who directs the Johns Hopkins Center for Hospital Finance and Management, explains that members of Congress "don't like to draw lines, making certain hospitals that used to be exempt no longer eligible" for tax exemption. "They don't like to pick a fight that they don't need to pick," he added.

In addition, federal policymakers may be "unsympathetic with [the concept of] taxing institutions for which Medicare pays half the budget," Gray suggested in an interview. While struggling to control escalating costs, government should be wary of imposing new expenses (taxes) on hospitals from which it is a major purchaser of services.

"Some members of Congress believe that [not-for-profit hospitals] ought to provide some minimum amount of charity care," but they have left the policy making "to the next available format—the courts," said Anderson. "The courts are not a good policy-making body," he added.

Court decisions in a number of states have sought to clarify criteria for granting tax benefits to not-for-profit hospitals and other organizations. Anderson testified on the courts' policy-making role, particularly as it related to the tax-exemption issue, at a June 17 House hearing on the Structure of the Hospital Industry in the Twenty-first Century.[3] He said: "I am sympathetic to the argument that profitable hospitals which provide very little uncompensated care are not deserving of the very valuable tax exemption. My reservation, however, comes from the fact that I do not know how hospitals will respond to an explicit charity care requirement."

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In a conversation Anderson further explained the problems inherent in mandating an explicit standard of care. "If the standard is set high enough, many hospitals would say it is not in their self-interest" to meet it and qualify for tax-exemption. "They may end up providing less charity care than they do now. We could have two distinct types of hospitals"—a smaller group dedicated to providing charity care, and all the rest, he concluded.

From a policy-making point of view, leaving this debate to the courts raises a number of problems, according to Anderson. These include:

- A focus on the litigants' concerns rather than on the broader policy context
- The courts' lack of technical expertise or experience in health policy
- The inability of multiple, independent courts to generate a consistent policy position
- The courts' limited ability to recognize the long-term consequences of their decisions
- Lack of a procedure for discovering or correcting the unintended consequences of the courts' decisions

Hospitals' Response

With the states and courts setting a hodgepodge of tax-exemption criteria and Congress sitting on the sidelines, several hospital groups are attempting to address the issue head-on. They are framing the debate in terms of the community benefits that not-for-profit facilities can offer.

CHA got involved early on—first, with its social accountability budget[4] and now with its task force report setting out voluntary community benefit standards. These standards include ensuring that a hospital's mission statement and philosophy reflect a commitment to benefit the community; implementing a community benefit plan; providing benefits to the poor and the broader community that improve health status, promote access, and contain healthcare costs; and disseminating an annual community benefit report. The voluntary standards adopted by hos-

pitals should center on a hospital's accountability to its community and should allow for flexibility, given the differing needs of each locality.

CHA is undertaking an educational campaign to call for the adoption of voluntary community benefits standards. It is also collaborating with other hospital groups to develop consensus on the need for such standards.

One such collaboration includes CHA, the American Hospital Association (AHA), United Hospital Fund, and the Voluntary Hospitals of America. These organizations have begun working together on the community benefit issue to avoid duplication of effort and to agree on a common direction. AHA's Senior Vice President for Policy James Bentley says the group will focus on hospital mission. "This is not necessarily an issue of taxes," he told me. "Yes, the tax issue jolted some people," he acknowledged, but defining community benefits "is the right thing for hospitals to do. We believe there is a benefit to having not-for-profit institutions be outward oriented to the community."

Anderson questions, however, whether hospitals will be able to come up with an explicit community benefit standard that makes sense. "Not-for-profit hospitals and their associations are in a definite bind," he said. "If they design a standard that all of their members could meet, it will be a nonstandard. If it has teeth to it, they could lose members and lose dues."

Future Reform

Beyond defining community benefits, not-for-profit hospitals need to examine their role in a reformed healthcare system. Although immediate tax threats from court decisions or state policy changes may seem pressing, it is also important to keep an eye on the bigger reform picture. The Hospital Association of Pennsylvania is one group that is taking specific steps to this end.

In the past three years, some 38 not-for-profit Pennsylvania hospitals have faced challenges to their tax status. Broad criteria from a 1985 court case regarding public charities are being used in all the hospital cases. In spring 1992 the association drafted model legislation to provide guidance in interpreting and applying the criteria to hospitals. "We were guilty of taking our tax status for granted and, as a result, have been living with a three-year nightmare to retain our tax exemption," commented association President John A. Russell.[5]

The association also launched a wide-ranging project to convene town meetings, focus groups, and leadership meetings and to distribute questionnaires to determine the community's perception of hospitals and interest in healthcare reform. The association's Pennsylvania Health Care Vision 2000 project, now almost two years old, has three major initiatives, according to Russell. The first is to develop a statewide leadership vision on healthcare reform, as well as a set of values and a reform plan. A second aim is for hospitals to demonstrate they can become important allies with the private and public sectors in solving reform problems. Third, the association is seeking foundation support to develop and test new community-wide organization and delivery models. Concludes Russell: "It is necessary to reinvent the nonprofit community institution as the cornerstone of the emerging healthcare system."

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Not-for-profit, tax-exempt healthcare facilities are not necessarily at odds with a reformed system that ensures universal healthcare coverage. Such institutions exist in Canada. It is important, however, for U.S. not-for-profits to become actively involved in defining what their role could and should be in providing healthcare and community benefit in a uniquely American system. Gray urges not-for-profit hospitals to face this challenge:

> The outcome, I believe, is still in the hands of nonprofit hospitals. Should they fail to meet the challenge, we will all pay the price. Should they succeed, we may find ourselves with a system that both meets our needs and that provides theoretical advantages of a private delivery system. The responsibilities of the leaders of the nation's nonprofit hospitals have perhaps never been more significant. □

NOTES

1. "Criteria to Counter Tax-Exemption Threats," *Health Progress*, September 1992, pp. 50-55.
2. Bradford H. Gray, "Why Nonprofits? Hospitals and the Future of American Health Care," *Frontiers of Health Services Management*, Summer 1992, pp. 3-32.
3. Also see Gerard Anderson, "The Courts and Health Policy," *Health Affairs*, Winter 1992 (in press).
4. Catholic Health Association, *Social Accountability Budget: A Process for Planning and Reporting Community Benefits in a Time of Fiscal Constraint*, St. Louis, 1989.
5. John A. Russell, "A Wake-Up Call for Nonprofit Hospitals in America," *Frontiers of Health Services Management*, Summer 1992, pp. 34-37.