

A Question of Benefits: Reforming the Tax Treatment of Nonprofit Hospitals in North Carolina

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Executive Summary¹

Policy Question (p.2)

The North Carolina Department of Revenue (NCDOR) has asked us to address the appropriate scheme for taxing nonprofit organizations in North Carolina. To ensure a thorough and timely final analysis, we narrowed our research to nonprofit hospitals – the largest revenue-generating industry within North Carolina’s nonprofit sector, and the focus of much of the recent debate over suitable taxation policy. We addressed the following policy question: *What is the appropriate tax treatment of nonprofit hospitals for sales and use, income, and property taxation in North Carolina?*

Recommendation (p.18)

Based on our analysis, we recommend the North Carolina Department of Revenue pursue a comprehensive strategy that focuses on both procedural reforms and changes to the taxation scheme. In the procedural realm, we recommend that the NCDOR implement stricter reporting and accountability requirements to standardize the measurement of community benefits and the process for local property tax assessments. We additionally recommend that the State clarify statutory language pertaining to the taxation of nonprofit organizations, particularly the definition of community benefits. To be wholly effective, we also recommend that the NCDOR adopt clear minimum standards for charity care that hospitals must comply with in order to retain their tax exempt status.

In terms of reforming the process of taxation, we recommend that the NCDOR alter the process of granting exemptions by requiring nonprofit hospitals to submit documentation to renew their tax-exempt status at regular intervals. Rather than existing in perpetuity, nonprofit hospitals’ tax exempt status would automatically expire after a fixed period of time. The requirement to periodically renew their tax exempt status would give nonprofit hospitals the opportunity to: a) thoroughly reevaluate their activities in a rigorous, quantitative, and consistent fashion, and b) report to the NCDOR on the specific benefits they are generating in order to demonstrate the necessity of their preferential tax treatment.

¹ DISCLAIMER: This student paper was prepared in 2007 in partial completion of the requirements for PPS 304, a course in the Masters of Public Policy Program at the Terry Sanford Institute of Public Policy at Duke University. The research, analysis, and policy alternatives and recommendations contained in this paper are the work of the student team who authored the document, and do not represent the official or unofficial views of the Terry Sanford Institute of Public Policy or of Duke University. Without the specific permission of its authors, this paper may not be used or cited for any purpose other than to inform the client organization about the subject matter. The authors relied in many instances on data provided to them by the client and related organizations and make no independent representations as to the accuracy of the data.

Problem (p.2)

Currently, the NCDOR cannot be confident that nonprofit hospitals in the State merit their exemption from state and local taxes. A number of factors contribute to this problem:

1. The State defers to federal criteria in determining eligibility for exemptions, which are based on the vague and inconsistently quantified concept of “community benefits.”
2. NCDOR grants sales and use tax refunds to nonprofit hospitals without regular review or oversight of the hospitals’ activities.
3. NCDOR has no procedure for determining if nonprofit hospitals engage in levels of “unrelated business activity” that are excessive.

Background (p.3)

Nonprofits dominate the hospital industry in North Carolina, comprising 65% of community hospitals with over \$10 billion in annual expenses. By our estimates, North Carolina currently foregoes roughly \$315 million annually in state income and state and local sales and use taxes, not including local property taxes. These foregone revenues are justified by nonprofit hospitals’ provision of benefits to the community—particularly indigent care—and replacement of government-provided medical services. Nonprofit hospitals provide open access to patients, locate themselves in lower-income areas, and provide services specifically targeted to low-income and uninsured residents.

However, changes in the medical care industry have increasingly blurred the distinction between services offered by nonprofit and for-profit hospitals. The situation is exacerbated by the fact that NCDOR defers to federal definitions of nonprofit status to determine tax-exempt status as well as by the lack of substantive reporting requirements once nonprofit status has been granted.

Several states, including California, Texas, and Maryland, have either enacted regulatory reforms that address the processes for granting tax exempt status or have altered the tax treatment of nonprofit hospitals more generally. These reforms intend to link the actual community benefits provided by hospitals to the level of exemptions they receive.

Criteria (p.7)

Our criteria for analysis were intended to ensure greater transparency, accountability, and oversight in the process for certifying nonprofit hospitals’ tax-exempt status. We evaluated our policy options against four criteria:

1. Ensure that benefits from hospitals meet or exceed the cost to taxpayers of exemptions.

2. Ensure the provision of medical service to low income, underinsured and uninsured community members.
3. Ensure administrative feasibility for NCDOR.
4. Maximize political feasibility.

Policy Options (p.8)

The policy options we evaluated address the process for certification of nonprofit status as well as the specific tax treatment of nonprofit hospitals. We explore the following eight policy options:

1. Implement stricter annual reporting and accountability procedures.
2. Clarify statutory language pertaining to nonprofit organizations and their taxation.
3. Adopt clear minimum standards for charity care in order to retain the tax exempt status.
4. Remove tax exemption for nonprofit hospitals.
5. Impose a cap on the amount of sales and use tax refunds that nonprofit hospitals receive.
6. Require regular reauthorization of tax-exempt status subject to automatic expiry after a fixed period of time.
7. Appropriate funds to provide direct subsidies to hospitals and other medical care providers for the provision of medical services meeting the definition of community benefits.
8. Maintain status quo of exemption of nonprofit hospitals.