

Community Accountability
**A Study of St. Mary's Hospital: Tax Exemptions
and Charity Care**

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A report prepared by UNITE HERE!
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For highlights of the report and more information, go to:
<http://haveaheartstmarys.info>

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Introduction

There is increasing national attention being paid to whether not-for-profit hospitals are providing the charitable care that communities need in exchange for the tax exemptions these hospitals receive. Given the number of Americans who lack health insurance, not-for-profit hospitals' ability and willingness to provide free or subsidized care to the uninsured has become a pressing issue.¹

This study focuses on St. Mary's Hospital Medical Center in Madison. A comparatively wealthy not-for-profit hospital, St. Mary's non-profit status has saved it approximately \$22 million a year in taxes that a for-profit business would have had to pay (for years 2003-2005 inclusive). St. Mary's provided around \$4 million in charity care in 2006. Of the \$22 million, approximately \$9 million comes from Madison and Dane County in the form of property taxes forgone.

Hospitals frequently claim that they fail to make money from their core business of patient care. Bill Bazan of the Wisconsin Hospital Association thus rebuked critics of hospital profitability, arguing that they had failed to understand that of the \$1 billion "so-called profits" (from all Wisconsin hospitals combined in 2005), "more than half of those numbers are from investment income, philanthropic foundations, gift shop sales and other fund-raisers."²

A close look at St. Mary's reveals a different picture. It has earned, on average, a surplus of \$33.2 million a year from its core operations between 2003 and 2005. Overall operating margins were 14% and 11% in 2003 and 2004 respectively.³ This number does not include investment income, one of the most significant sources of income outside of patient services. (It does include fairly small amounts from such things as gift shop sales and other services related to the running of the hospital.⁴) When income from investment and other sources is added in, St. Mary's averaged a

¹ The issues of charity care, tax exemption and collections practices have led to hearings by federal representatives, been investigated by state politicians and the IRS, campaigned on by grassroots organizations, and fretted over by hospital associations, and individual hospitals. For testimony to the Senate Finance Committee, go to: <http://finance.senate.gov/sitepages/2006hearings.htm> (9/13/06) Minnesota Attorney General Mike Hatch was one state leader who conducted investigations into Minnesota hospital practices, including debt collections and the provision of charity care. See his testimony about his findings, <http://www.senate.gov/~finance/hearings/testimony/2005test/mhtest040505.pdf> The IRS was prompted to respond with a survey that it sent to approximately 500 not for profits, requesting information about charity care and other aspects of community benefits.

<http://www.modernhealthcare.com/apps/pbcs.dll/article?AID=/20070719/REG/307190004>

The news has been widespread, making not only mainstream papers, but also smaller ones that are usually read by those in the charitable giving or philanthropy circles,

<http://www.philanthropy.com/free/update/2006/03/2006032102.htm> and amongst lawyers

<http://www.aaasc.org/documents/OTS--CongressionalScrutinyofHospitalTax-ExemptStatus.doc>.

² Eric Decker, "Wisconsin's Nonprofit Hospitals are Flush with Cash," *Small Business Times* (January 5, 2007) accessed online at <http://www.biztimes.com/news/2007/1/5/wisconsins-nonprofit-hospitals-are-flush-with-cash>.

³ Operating margins and select financial data for St. Mary's and all other Wisconsin hospitals can be found at the Wisconsin Hospital Association website, <http://www.whainfocenter.com/dataresources.htm>, under 2004 and 2003 Reports: Guide to Wisconsin Hospitals.

⁴ If we exclude revenue from "other operations" and focus exclusively on patient revenue, the hospital still earned a healthy average of \$29.9 million annually. This is not an exact figure though. Due to the way in which the data is reported, the hospital's revenue from 'other operating' sources is clear. The expenses related to the operation of these sources (whatever costs are involved in running the gift shop or parking lot, etc) are not broken out from the rest of the operating expenses. Thus, the calculation (net patient service revenue - total operating expenses)

surplus (what an ordinary business would consider “profit”) of \$42 million a year. It is thus well placed to assume greater leadership in providing care to Madison and Dane County’s less well-off and uninsured residents.

Charity Care and Community Benefits: What Matters and How to Count?

Charity Care vs. Community Benefits

Hospitals and hospital associations often argue that charity care should not be the most important measure for determining whether their contribution to the community is proportionate to their tax exemptions. In fact, some hospital associations have responded to the outcry about low charity care funding and the over-billing of the uninsured by urging members to enhance their media savvy about community-benefits stories.⁵ Hospitals do provide other benefits to the community, such as free clinics, health education, immunizations for low-income children, etc.

However, the notion of ‘community benefits’ is nebulous. It can include everything from a heart education fair that primarily attracts insured patients, to brochures and hotlines, or to other health-related education that does not necessarily benefit low income people more than any other member of the community. Many community benefits are thus extremely difficult to assess: does the heart fair at the hospital, or the brochure, or classes really help the poor and uninsured who cannot afford the hospital’s main services? Do these benefits count as charitable care, or as advertising?

Reporting of charity care and community benefits is not necessarily transparent, making it very difficult to determine what a hospital does provide to those who are the most in need of assistance. This was the point made in the just-released preliminary report from the IRS, which had sent questionnaires to nearly 500 not-for-profit hospitals to inquire into their charity care and community benefits practices.⁶

For-Profits Also Give

Community benefits, and specifically, uncompensated care, are also offered by many for-profit hospitals that do not receive general tax exemptions. A study by the Congressional Budget Office found little difference between private not-for-profit hospitals, and private for-profit hospitals in terms of the uncompensated care that they provide. Rather, government-owned hospitals provide a higher percentage of their expenses in uncompensated care than do private non-profits:

The average “uncompensated-care share”—the cost of uncompensated care (bad debt and charity care) as a share of hospitals’ operating expenses—was much higher at government hospitals (13.0 percent) than at either nonprofit hospitals (4.7 percent) or for-profit hospitals (4.2 percent).⁷

excludes the revenue from these sources but still includes the costs associated with operating them.

⁵ Thus the WHA appears to have concluded that the real issue is better communication about what the hospitals do provide. <http://www.wha.org/communityBenefits/articles.aspx>

⁶ See initial news coverage at

<http://www.modernhealthcare.com/apps/pbcs.dll/article?AID=/20070719/REG/307190004>

⁷ Congressional Budget Office, *Nonprofit Hospitals and the Provision of Community Benefits*, (December 2006), p 2.

Why Focus on Charity Care

Charity care was the original rationale for granting hospitals tax-exempt status. Prior to 1969, hospitals seeking tax-exempt status not only had to show that they were organized and operated for a charitable purpose, but specifically, a tax exempt hospital had to “be operated to the extent of its financial ability for those not able to pay for the services rendered.”⁸ That is, tax-exempt hospitals had to provide charity care “to the extent of [their] financial ability.”

But in 1969, in part due to the erroneous belief that Medicaid and Medicare would render charity care unnecessary, the IRS replaced the requirement of charity care with that of vaguely defined ‘community benefits’.⁹

As insurance rates have increased, however, and the number of uninsured Americans continues to rise, the need for hospitals to fulfill the original mandate of charity care has become more pressing.

Reporting Charity Care: From Full Charge to At Cost

As with many aspects of not-for-profit financial reporting, charity care numbers may be confusing. Some hospitals combine ‘bad debt’ with ‘charity care’ to produce an ‘uncompensated care’ figure. Until this year, St. Mary’s Hospital, like many others, reported its charity care numbers at “full” or “undiscounted charge” rather than the actual cost to the hospital. Full charge is like a “list price”—the amount that a hospital ideally wants to charge for a procedure or set of procedures. In fact, hospitals rarely receive full charge unless the patient is uninsured. Instead, they reach agreements with HMOs and other private insurers to offer discounted rates for services—rates that still are above cost.

Reporting charity care at full charge rather than at cost, or what the hospital actually spent on providing the care, however, allows the hospital to increase the face value of its contributions. It thereby appears to be doing more than it actually is. This accounting device has had the approval of the Wisconsin Hospital Association, which instructs hospitals to report charity care at “full established rates.” (Hospital Fiscal Survey Manual, Fiscal Year 2005.)

In 2007 though, St. Mary’s reported its charity care at cost, announcing on its website that it had provided \$4.2 million in charity care in 2006. The number it reported to the WHA in 2005 was \$6.6 million. The actual cost to the hospital for 2005 (and years previous) can be estimated by applying a “cost to charge ratio” as calculated by the Center for Medicare and Medicaid Services (CMS) in 2004. The overall RCC for St. Mary’s in 2004 was .52. The actual cost to the hospital then, was probably closer to \$3.5 million—in keeping with the 2006 self-reported amount by the hospital.

Calculating the Value of St. Mary’s Tax Exemptions

On Methodology

To arrive at an estimate of the hospital’s tax exemption values, this study followed the method outlined by the non-partisan Center for Tax and Budget Accountability (CTBA) in their study, “An Analysis of the Tax Exemptions Granted to Cook County Non-Profit Hospitals and the Charity Care Provided in Return.”¹⁰ In this landmark study, the CTBA generated an estimated tax burden

⁸ IRS Rev. Rul. 56-185, 1956-1 C.B. 202

⁹ IRS Rev. Rul. 69-545, 1969-2 C.B. 117

¹⁰ Center for Tax and Budget Accountability, “An Analysis of the Tax Exemptions Granted to Cook County Non-Profit Hospitals and the Charity Care Provided in Return,” prepared by Heather O’Donnell and Ralph Martire (May 2006).

for Cook County not-for-profit hospitals by calculating the value of federal and state corporate tax exemptions, property tax exemptions and sales tax exemptions.

Calculating the value of tax exemptions for a not-for-profit hospital can be very difficult given the lack of transparency in hospital financial data. As Kane and Magnus show,¹¹ there are no consistent standards for reporting of key aspects of nonprofit hospital finances. A lack of detailed reporting obviously affects how complex and exact the data analysis can be.

Sources

Data for the calculations were drawn from fiscal surveys submitted by St. Mary's Hospital to the Wisconsin Hospital Association. The data, according to the survey instructions, are to come from "final audited financial statements" or from "Medicare Cost Reports, notes to the financial statements or other internal hospital financial records."¹² At the time of our research the most recent three years available were 2003-2005 inclusive.

The financial surveys provided more useful information than did the IRS Form 990, since St. Mary's Hospital does not report as a stand-alone. Rather, its corporate owner, SSM Health Care of Wisconsin (a subsidiary of SSM Health Care of St Louis, MO) files a Form 990 in which it aggregates information for all its Wisconsin institutions (two hospitals and two nursing homes).

Property Tax

Establishing Property Value Using EBITDA

The first step in estimating a property tax for a not-for-profit is to determine the property value. The Madison Assessor's Office has not established an assessed value for the property in question because it is tax-exempt. Our first step, then, was to calculate, based on available data, a fair value for the hospital. There are three approaches used by assessors to appraise the value of commercial property: comparison, replacement or cost, and income. The comparison approach relies on the sales price of comparable properties. The cost or replacement approach is based on the depreciated reproduction or replacement cost of the improvements plus the market value of the site. Finally, the income approach appraises the real estate based on anticipated future income.¹³

While appraisers, where possible, typically use a combination of approaches, this research was limited by the available data. Since there are no similar for-profit hospitals operating within the City of Madison, there was no basis for comparison. Similarly, there is inadequate data supplied to use a cost or replacement approach. Thus, the estimate is based on an income approach.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is an appropriate metric for assessing the overall profitability of the hospital's core business (given the lack of more detailed data). EBITDA excludes expenses related to investment, financing decisions, and depreciation of tangible assets. In order to focus on the core business, we also excluded investment income and 'other operating revenue' from the total revenue of the hospital, starting

¹¹ For a detailed explanation of the problems that they encountered finding properly reported, audited financial data, see Nancy M. Kane and Stephen A. Magnus, "The Medicare Cost Report and the Limits of Hospital Accountability: Improving Financial Accounting Data" *Journal of Health Politics, Policy and Law*, 26:1, 2001

¹² "Hospital Fiscal Survey Manual, Fiscal Year 2005," WHA Information Center, (April, 2005), p 4.

¹³ See Jack C. Harris, Jack P. Friedman, *Real Estate Handbook* fourth edition, (Hauppauge, NY: 1997), pp 200, 287, 326.

instead with the hospital's net revenue from services to patients (NPSR). Total expenses were deducted from this figure, with the cost of interest, depreciation and amortization added back in. In order to ensure that we were not calculating income based on a single unusual year, we followed the CTBA method of averaging EBITDA over three years. Using data from 2003-2005, we calculated an average EBITDA of about \$52.5 million.

Capitalization Rate

A capitalization rate had to be applied to project future income. Discussions with the assessor's office in Madison revealed that capitalization rates for general commercial properties tended to vary between a low of 5%, with the most conservative capitalization rate being 9%. Again, given that there is no historical record from which to draw, or agreed upon capitalization rate for hospitals, we selected the most conservative figure of 9% and added in the tax rate of 1.97%. (This 1.97% includes taxes for school district and county share.)

Property Value: \$477 million

This produced an estimated property value of \$477,478, 275. According to the Assessor's Office, they assess properties at, or close to, full market value. We therefore applied the property tax rate of 1.9% to the \$477 million assessed value, and came up with a property tax rate of \$9,406,322.

Missing Data: Sales Tax

We have not included any estimate for the value of sales tax that St. Mary's would have paid but for its non-profit status. Calculating a state sales tax proved to be too difficult for several reasons. First, since St. Mary's supplies are reported combined with other SSM Health Care of Wisconsin institutions on the Form 990, we could not use the figure for supplies provided on Line 33 of Form 990. The method used to report supplies to the WHA, however, is clearly different from that used by the IRS: the amount reported by St. Mary's for supplies on the WHA form was approximately twice the amount as that reported on the Form 990 for the entire SSM Health Care of Wisconsin. This is because the WHA survey instructs hospitals to report a combined figure for supplies, services, licensing fees, property insurance, etc.¹⁴ We decided against using the number reported by a similarly sized and situated hospital because of concerns about different supply costs due to hospital participation in Group Purchasing Organizations.

Compounding these problems is the fact that the State of Wisconsin exempts a number of medical supplies from taxes, including pharmaceuticals, crutches, insulin supplies, etc. There would be no way of determining what percentage of the hospital's medical supplies would in fact, continue to be tax-exempt, and what percentage would be subjected to taxes if the hospital itself were a for-profit non-exempt corporation..

As a result of not calculating a sales tax estimate (along with other local taxes and fees), and therefore not deducting it from state and federal taxable income or taxes owed, we have likely underestimated the total value of the hospital's tax exemptions, but may have overestimated the value of federal and state corporate tax exemptions.

¹⁴Instructions for Line 22 of the Survey reads, "Enter all other operating expenses. Report all other expenses not included in the above categories; for example, utility expenses, supplies, purchased services, property insurance, general liability insurance, license fees, operating losses, etc." Hospital Fiscal Survey Manual, Fiscal Year 2005 (WHA Information Center, April 2005)

State and Federal Corporate Taxes

The corporate taxable income was reached by taking the hospital's reported net income and deducting any charitable contributions. It reported no charitable contributions on its WHA survey for the three years in question. The net earnings were averaged over the three years, giving us a figure of approximately \$42 million. Property taxes were then subtracted from the averaged net earning to come up with a taxable amount (\$32.6 million) to which the state corporate tax rate was applied. The hospital's approximate state tax exemption came to about \$2.5 million.

For the federal tax amount, a taxable income was produced by taking the taxable amount from above, and further subtracting the state income tax. When the federal corporate tax rate was applied, the value of the federal corporate tax exemption came to just over \$10 million.

Conclusion

This study found that St. Mary's saves a significant amount in tax exemptions as a result of its non-profit status. Based on the methodology outlined above, we estimate that St. Mary's non-profits status results in about \$22 million in annual tax subsidies. Of that \$22 million, Madison and Dane County residents provide a significant subsidy to the hospital: approximately 42% of the value of the tax exemption came from the local communities in the form of property taxes forgone.

The \$22 million may, however, be an underestimate. As Keith Hearle explained, the value to a not-for-profit hospital of the tax exemption actually goes beyond the total tax bill itself:

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.¹⁵

While it saved an estimated \$22 million a year, it gave back approximately \$4 million or less a year in charity care, the most important source of direct assistance to the poor and uninsured members of the community. In light of St. Mary's significant operating margins and overall earnings of about \$42 million a year on average, much of it from patient care, this hospital is in an excellent position to assume greater leadership in providing immediate care to those who are in greatest need.

¹⁵ Keith Hearle, "Establishing the Value of Tax Exempt Status" Prepared for the Catholic Health Association, (July 2006)