HEALTH SERVICES COST REVIEW COMMISSION
TAX BENEFIT ASSESSMENT

July 1, 2020

SB & COMPANY, LLC
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Assumptions Used in Calculating the Tax Benefit

Financial data for the in-scope hospitals was obtained from various schedules included in the HSCRC's Annual Filing (the Schedules). The Schedules[2] as provided by the HSCRC, or the audited financial statements, where applicable, were for the fiscal year ended June 30, 2019, or December 31, 2018, based on the hospital's fiscal year end. Information from the IRS Form 990 - *Return of Organization Exempt from Income Tax*, was not used as many of the June 30, 2019 Form 990s were not yet filed.

Federal Income Tax Exemption

The Federal corporate income tax exemption is the amount of Federal corporate taxes the tax-exempt organization would pay if they were not tax exempt. The Federal income tax exemption was calculated by multiplying net income for the reporting period by the Federal statutory corporate tax rate for the reporting period. Net income was obtained from the Annual Filing Schedule RE – Statement of Revenues and Expenses (Schedule RE)[2] provided by the HSCRC. We assumed taxable income would equal Excess (Deficit) Operating Revenues Over Operating Expenses (column "AL_PROFT" on Schedule RE) for regulated charges (as identified in the "Category" column on Schedule RE). No adjustments were made for those items that are often reflected in tax return filings, such as, but not limited to, accelerated depreciation, nondeductible expenses and credits. The Federal corporate tax rate for the reporting period was 21%[3]. For all hospitals that reported a net loss for the reporting period, no Federal corporate tax was assessed, nor was any consideration given for a refund or net operating loss benefit.

State Income Tax Exemption

The state corporate income tax exemption is the amount of state corporate taxes the tax-exempt organization would pay if it were not tax exempt. The state income tax exemption was calculated by multiplying net income for the reporting period by the corporate tax rate for the State of Maryland (the State) for the reporting period. We assumed taxable income would equal Excess (Deficit) Operating Revenues Over Operating Expenses (column "AL_PROFT" on Schedule RE) for regulated charges (as identified in the "Category" column on Schedule RE). No adjustments were made for those items that are often reflected in tax return filings, such as, but not limited to, accelerated depreciation, nondeductible expenses and credits. The state corporate tax rate for the reporting period was 8.25%[4]. For all hospitals that reported a net loss for the reporting period, no state corporate tax was assessed, nor was any consideration given for a refund or net operating loss benefit.

State Sales Tax Exemption

The state sales tax exemption is the money tax exempt organizations save on purchases of items subject to state sales tax. To calculate this value, we obtained Annual Filing Schedule C – General Service Rate Centers (Schedule C)[2] from the HSCRC, which lists total expenditures for each hospital by service department. For purposes of this assessment we excluded personnel, medical surgical supplies, and medical surgical drugs purchased, as these expenses are exempt from sales tax in Maryland. As such, we utilized the "Other Expense" (column "CD_OEX") for the departments below on the Schedule C[2] to calculate the sales tax benefit. These departments were determined by the HSCRC to have functions which would have more taxable items such as supplies, equipment, etc. The HSCRC excluded many administrative functions such as finance because the "Other Expense" column in these areas likely included non-taxable professional services, although it is likely there are some costs subject to sales tax in these areas.

- Schedule C
    - Line C2 – Laundry and Linen
    - Line C3 – Social Services
    - Line C4 – Purchasing and Stores
    - Line C5 – Plant Operations
    - Line C6 – Housekeeping
    - Line C7 – Central Services and Supply

We then multiplied the amount reported in the "Other Expense" column by the State of Maryland sales tax rate of 6%[5] to calculate the sales tax benefit.

Local Property Tax Exemption

The local property tax exemption is the money tax exempt organizations would have to pay in local property taxes. In the State of Maryland, personal property and real property are taxed at different rates. Additionally, personal property and real property rates vary depending on the city, county, or town in which the property resides. For purposes of this assessment, real property consists of tangible land and buildings owned as well as leasehold improvements used by the hospitals, and personal property consists of all other tangible property (i.e. furniture, equipment, etc.) owned or used by the hospitals.

In Maryland taxable personal property is generally taxed based upon cost less statutory depreciation computed using uniform depreciation rates for specific types of property. Real property is generally taxed based upon fair market value as calculated by the Department of Assessments and Taxation. We did not have enough detail to categorize the tangible personal property into the different asset classes for the majority of the in-scope hospitals, nor did we have the fair market value of the real property.

Forty-nine of the fifty-two in-scope hospitals are part of larger hospital systems, and as such, their property information is presented as part of consolidated totals in the hospital systems' audited financial statements. For those forty-nine hospitals, we applied the ratio of each asset class reported in the consolidated audited financial statements to the total net book value of the individual hospitals' property and equipment. In most cases, the net book value for each hospital was included in the supplemental consolidating schedules in the audited financial statements.

The property and equipment amounts by asset class for the consolidated hospital system from the audited statements were used to calculate the ratio of each asset class to the total property and equipment for the consolidated hospital system. Those ratios were then applied to the respective hospitals' total net book value for property and equipment to determine the asset classification for the calculation. Those values were then grouped into personal and real property, and taxed based upon each hospital's location / taxing jurisdiction as established by the Maryland Department of Assessments and Taxation[6]. Without specific location information for the property, we assumed all of the property was situated in one primary taxing jurisdiction. For the three stand-alone hospitals, we were able to obtain the asset classifications directly from the audited financial statements without any adjustment to those amounts. We did not include construction in process in our calculation as those assets have not yet been placed in service.

Tax-Exempt Bonds

Maryland tax-exempt hospitals are able to issue debt through the Maryland Health and Higher Education Facilities Authority (MHHEFA). As tax exempt entities, the Maryland not for profit hospitals are able to issue tax exempt debt to the debt holders, which results in the holder paying no Federal income tax on their interest income. We obtained the calculation of the hospitals' tax-exempt bond interest from MHHEFA. MHHEFA provided the amount of interest paid to corporate financial institutions and to individual investors for the fiscal year ended June 30, 2019. Consistent with the methodology MHHEFA uses in calculating the tax benefits, we assumed the corporate debt holders would be taxed at 21% and the individual bond holders would pay tax at the marginal tax rate of 35% (the rate used by MHEFFA in its analysis). We recalculated the interest the hospitals would have paid if the holders, demanding the same "after Federal tax" return on their investment, had to pay tax on the interest. This additional interest is the savings the hospitals were able to achieve due to their tax-exempt status. No benefit was calculated for state income tax benefits as we do not know the state nexus of the bond holders nor was it considered by MHEFFA.

Charitable Contribution Subsidization

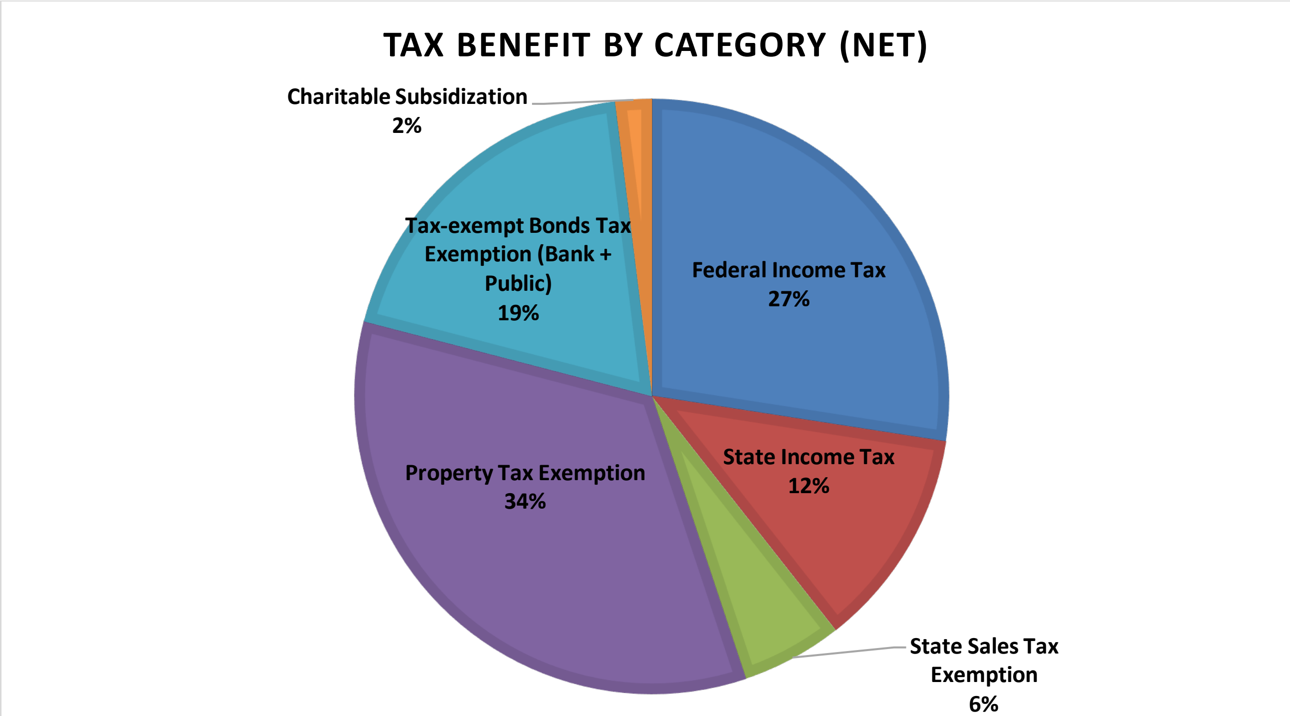
The charitable contribution subsidization equals the extra charitable contributions tax exempt organizations receive because of the Federal personal income tax deduction for charitable giving. We were not able to obtain charitable contribution information from the annual filing schedules provided by the HSCRC or the hospital's audited financial statements as this information is not separately presented. In the alternative, we utilized the average national charitable donation amount of $826,080 received by U.S. hospitals, which was the 2012 amount used in the Herring article. We did not inflate the annual contribution to 2019 dollars due to immateriality. The Herring article assumed an average tax rate of charitable donors to be 32%. The assumption is that absent the tax deduction to a donor of 32%, their donations would be reduced accordingly. Although recent studies have questioned whether the tax deduction elimination would have a significant impact on charitable giving, we kept this perceived benefit in our assessment to be consistent with the Herring article. The impact to the overall study is immaterial, therefore, we did not revise the reported taxable income numbers for the state and Federal income tax calculations to reflect the reduction in income resulting from reduced charitable contributions.

Results of Assessment

The following table reports the net tax benefit for the various tax exemptions available to Maryland tax-exempt hospitals. State sales tax, property taxes and additional interest expense would be tax deductible, so we reduced the gross state taxable income by these deductions, resulting in a lower net state tax. Additionally, the state sales tax, property taxes additional interest expense, and the state income taxes reduced the gross Federal taxable income, resulting in a lower net Federal tax.

The net amount includes reductions to the Federal and state income tax based on taxes that would be paid for state and local tax purposes. Our assessment calculated an overall net tax benefit of $703,604,270. The following calculation is based on hospital data for the year ended June 30, 2019, and for three hospitals data for the year ended December 31, 2018 was utilized.

Tax Category	Net
Federal Income Tax (21%)	$ 193,133,200
State Income Tax (8.25%)	84,023,498
State Sales Tax Exemption (6%)	38,623,786
Property Tax Exemption	240,463,563
Tax-exempt Bonds Tax Exemption (Bank + Public)	133,614,252
Charitable Subsidization	13,745,971
Total Value of Tax Benefit	**$ 703,604,270**
Total Operating Revenue per Schedule RE	$ 15,253,815,000
Tax Benefit as % of Operating Revenue	4.6%



Hospital Specific Estimates

As part of the assessment the HSCRC requested that we assess whether they should pursue requiring hospitals to develop and provide a hospital specific estimate of the value of the tax exemption to their institution. Although possible, a more accurate analysis could be very time consuming due to the following factors:

Federal and State Corporate Income Taxes

In order to calculate a more accurate hospital specific Federal and State tax benefit each hospital would need to calculate its own effective tax rate, factoring in differences in calculating taxable income versus Schedule RE income. This would necessitate re-calculating depreciation, tax deductible reserves and accruals, nondeductible items and allowable tax credits.

State Sales Tax

Each hospital would need to analyze all of its purchases to determine which items would be subject to Maryland sales tax. This would require a detailed analysis of each trial balance account to determine which items would be taxable.

Personal Property Tax Exemption

To calculate the impact of a hospital's personal property tax exemption each hospital would need to reformat its fixed asset listing so as to categorize all taxable personal property additions by year acquired and according to Maryland's personal property categories subject to tax. In addition, fully depreciated assets or assets expensed would need to be included.

Real Property Tax Exemption

Real property tax is based on fair market value. Real property assessments would need to be made by the State of Maryland / qualified appraisers in order to calculate the real property tax. Due to the unique nature of hospital property, this could be costly and time consuming. In valuing property, Maryland generally looks at similar recent sales transactions, reproduction costs, or a value based on the earning stream of the property, determining which methods should be given more or less weight.

Tax-Exempt Bonds

The total amount of tax-exempt interest paid is readily available from MHHEFA. Calculating the taxable equivalent interest rate for each bond would be subject to each hospital's credit rating, the bondholders' tax rate, and/or changing market conditions.

Charitable Contribution Subsidization

Hospitals could accumulate their charitable contribution data. As done in this assessment, an assumption of donors' effective tax rates would need to be made as well to estimate the benefit. Additionally, consideration would need to be given to whether the hospital has a separate fundraising entity and where those contributions are captured.

Qualitative Discussion

As this is a hypothetical analysis, there are many assumptions that have been made. Some of the data needed to make a more accurate calculation was not readily available and therefore alternative procedures were applied. Outlined below is a discussion of the alternative assumptions that could have been made and the possible impact of those assumptions.

Federal and State Income Tax

The build-up of the tax benefit for the Federal and State Income tax exemption is based on the assumption that the Federal and State government would agree in tandem to remove their respective tax exemptions and hospitals would continue to operate and report their financial information in the same manner they currently report to the HSCRC. Additionally, with the 100% bonus depreciation, and possible large non-deductible accruals it is not possible to determine whether hospitals would indeed pay taxes at 21%. The hospitals' effective tax rate (the amount paid in cash each year) could be higher or lower every year based upon these differences. Note, timing items like accelerated depreciation or non-deductible reserves reverse over time.

State Sales Tax

The sales tax assumptions used blanket categories for each asset class which could possibly overstate or understate the impact of the sales tax exemption. The bulk of the sales tax would probably relate to office and maintenance supplies which would be lower than the amounts used in this analysis. This analysis selected the "other expense" line item for 6 departments that could include professional services in those amounts which are not taxable. The study may have excluded taxable purchases in other departments that would have been taxable.

Property Taxes

The personal and real property tax exemptions are perhaps the hardest to quantify with the data available. Real property taxes are based on locally assessed property values. In this analysis, this information was not available therefore, the net book value was used for property. Original cost could have been used assuming that the value of hospital real property remains constant over time. Regarding personal property taxes, the analysis also used net book value. However, the current Maryland personal property tax calculation considers different classes and useful lives for types of personal property. This level of detail was not available therefore a high-level assumption was made that land, buildings, building improvements, and leasehold improvements were real property and other property and equipment reported in the audited financial statements were considered personal property. It should also be noted that if leasehold improvements were subjected to a cost segmentation study, certain of those assets may actually be subjected to personal property tax instead of real property tax as they were classified in this assessment.

Tax Exempt Bonds

The tax-exempt bond build-up is based directly on data and input from MHEEFA. MHHEFA assumes the corporate debt holders would be taxed at 21% and the individual debt holders would pay tax at the marginal tax rate of 35%. Without tax-exempt bonds, not-for-profit hospitals would raise capital in the taxable market, and/or seek out other financing structures. Alternatively, the analysis could have used an overall rate of 28% applied to total interest on tax exempt bonds which was the methodology used in the Herring article. Lastly, consideration was not given to whether the bondholder would still expect the same after Federal tax return currently or the impact of state income tax exemptions.

Charitable Contribution Subsidization

The charitable deduction subsidization estimate was borrowed directly from the Herring article and applied to the 52 hospitals in our study. With additional analysis, the study could have inflated the 2012 charitable contribution amount to 2019 amounts, based upon actual overall charitable contribution trends or based upon annual inflation rates. In addition, no doubt some hospitals would receive significantly more or less than $826,080 per year. It is also possible that donors would potentially direct their contributions to affiliated entities if no deduction was allowed to Maryland not-for-profit hospitals. Charitable contributions could not be separately identified as many hospital's financial reporting and the Federal Form 990 generally combines grants with charitable contributions for reporting purposes. Additionally, some hospitals receive charitable contributions through foundations or other affiliated entities. Therefore, the assessment did not use a Maryland specific state-wide hospital benefit but instead used a national average. While people generally do not donate to for-profit entities, many charitable donations to hospitals are made to expand services, to combat a specific disease, or to contribute to medical research. It is therefore unlikely donations would stop, or are not entirely due to, a hospital's nonprofit status. Finally, it should be noted that the donations benefit hospitals, however, the tax benefit inures to the donor, which is different from the other elements included in this assessment.

APPENDIX A – LIST OF HOSPITALS*

ADVENTIST REHAB OF MARYLAND
ADVENTIST WHITE OAK HOSPITAL
ANNE ARUNDEL MEDICAL CENTER
ATLANTIC GENERAL HOSPITAL
CALVERT HEALTH MEDICAL CENTER
CARROLL HOSPITAL CENTER
DOCTORS COMMUNITY MEDICAL CENTER
FORT WASHINGTON MEDICAL CENTER
FREDERICK HEALTH HOSPITAL, INC
GARRETT COUNTY MEMORIAL HOSPITAL
GRACE MEDICAL CENTER
GREATER BALTIMORE MEDICAL CENTER
HOLY CROSS HOSPITAL
HOLY CROSS HOSPITAL-GERMANTOWN
HOWARD COUNTY GENERAL HOSPITAL
JOHNS HOPKINS BAYVIEW MEDICAL CENTER
JOHNS HOPKINS HOSPITAL
LEVINDALE
MCCREADY MEMORIAL HOSPITAL
MEDSTAR FRANKLIN SQUARE
MEDSTAR GOOD SAMARITAN
MEDSTAR HARBOR HOSPITAL CENTER
MEDSTAR MONTGOMERY MEDICAL CENTER
MEDSTAR SOUTHERN MARYLAND HOSPITAL CENTER
MEDSTAR ST. MARY'S HOSPITAL
MEDSTAR UNION MEMORIAL HOSPITAL
MERCY MEDICAL CENTER
MERITUS MEDICAL CENTER
MT. WASHINGTON PEDIATRIC HOSPITAL
NORTHWEST HOSPITAL CENTER
PENINSULA REGIONAL MEDICAL CENTER
SHADY GROVE ADVENTIST HOSPITAL
SHEPPARD & ENOCH PRATT HOSPITAL
SINAI HOSPITAL
ST. AGNES HOSPITAL
SUBURBAN HOSPITAL
UM-BALTIMORE WASHINGTON MEDICAL CENTER
UM-CHARLES REGIONAL MEDICAL CENTER
UM-HARFORD MEMORIAL HOSPITAL
UM-LAUREL Medical Center
UMMC MIDTOWN CAMPUS
UM-PRINCE GEORGE'S HOSPITAL CENTER
UM-REHABILITATION & ORTHOPAEDIC INSTITUTE
UM-SHOCK TRAUMA
UM-SHORE REGIONAL HEALTH AT CHESTERTOWN
UM-SHORE REGIONAL HEALTH AT DORCHESTER
UM-SHORE REGIONAL HEALTH AT EASTON
UM-ST. JOSEPH MEDICAL CENTER
UM-UPPER CHESAPEAKE MEDICAL CENTER
UNION HOSPITAL OF CECIL COUNTY
UNIVERSITY OF MARYLAND MEDICAL CENTER
WESTERN MARYLAND REGIONAL MEDICAL CENTER

* Provided by HSCRC

APPENDIX B – REFERENCES

1. Herring, B., Gaskin, D., Zare, H., & Anderson, G. (2018). Comparing the Value of Nonprofit Hospitals' Tax Exemption to Their Community Benefits.

2. Information Provided by the HSCRC
    a. Annual Filing Schedule RE – Statement of Revenues and Expenses
    b. Annual Filing Schedule C – General Service Rate Centers

3. Federal Corporate Income Tax Rate – Internal Revenue Service (IRS)
    https://www.irs.gov/

4. Maryland State Corporate Income Tax Rate – Comptroller of Maryland
    https://www.marylandtaxes.gov/business/income/tax-information.php

5. Maryland State Sales Tax Rate – Comptroller of Maryland
    https://www.marylandtaxes.gov/business/sales-use/index.php

6. Maryland Personal and Real Property Tax Rates – Maryland Department of Assessments and Taxation
    https://dat.maryland.gov/Documents/statistics/Taxrates_2019.pdf