December 18, 2015

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative (A.G. File No. 15-0102) that would require certain nonprofit hospitals to provide a minimum amount of charity care—generally defined as the provision of health care services or items, or other specified community benefits, without reimbursement—to maintain their nonprofit status and exemption from the state corporate income tax.

BACKGROUND

Two Types of Private Hospitals: For-Profit and Nonprofit. There are two main types of privately controlled hospitals operating in California: 84 for-profit hospitals and 206 nonprofit hospitals. Collectively, the state's for-profit hospitals pay tens of millions of dollars annually in the state corporate income tax. The state's nonprofit hospitals are generally exempt from the state corporate income tax and local property taxes.

Specially Designated Hospitals. Some hospitals receive specific designations under federal or state law. For example, state law designates children's hospitals that specialize in providing care to patients under the age of 18, while critical access hospitals are federally certified hospitals that meet certain size and geographic criteria.

Current Requirements for Nonprofit Hospitals. Under current law, the state exempts nonprofit hospitals from corporate income taxes based on certain requirements. (For example, a hospital may qualify for tax-exempt status only if none of its net earnings benefit any private shareholder.) Current law also requires most nonprofit hospitals to develop community benefit plans that identify the hospitals' activities to address community needs—such as providing community health programs and uncompensated care—and to submit these plans to the Office of Statewide Health Planning and Development (OSHPD) annually.

Current Law Requires All Hospitals to Offer Financial Assistance to Uninsured . . . Current law requires all hospitals (both for-profit and nonprofit) to *offer* financial assistance in the form of free medical care (for which payment is not expected and patients are not billed) or discounted payment policies to uninsured or underinsured patients who have low or moderate incomes. Specifically, the law requires most hospitals to—at a minimum—offer financial assistance eligibility

to uninsured patients at or below 350 percent of the federal poverty level (FPL) (currently about $85,000 for a family of four). Beyond this minimum requirement, financial assistance policies vary from hospital to hospital. To varying degrees, some hospitals grant eligibility for financial assistance to patients with incomes *above* 350 percent of the FPL. Hospitals also vary in the degree of discounts they offer to patients at different income levels.

. . . But Does Not Require Nonprofit Hospitals to Provide Minimum Amount of Financial Assistance or Other Community Benefits. There are currently no federal, state, or local requirements on the amount of free or discounted care—or the type or amount of other community benefits—that nonprofit California hospitals must *provide* to maintain their nonprofit and tax-exempt status.

PROPOSAL

This measure would require certain nonprofit hospitals to provide a minimum amount of charity care as defined by the measure to maintain their nonprofit and tax-exempt status, and gives the Attorney General (AG) authority to oversee and enforce the provisions of the measure. The measure goes into effect January 1, 2017, and is repealed on December 31, 2021, unless extended by future statute.

Measure Defines Charity Care

This measure defines charity care as the unreimbursed cost to a nonprofit hospital for performing any of the following activities:

- Directly providing health care services or items to needy patients, defined as those with no medical coverage or high medical expenses whose family income is at or below 350 percent of the FPL. (If a hospital grants eligibility for financial assistance to patients with incomes *above* 350 percent of the FPL, then these higher-income patients also count as needy patients under the measure's definition.)
- Indirectly providing health care services or items to needy patients through other nonprofit or public outpatient clinics, hospitals, or health care organizations.
- Directly providing specific community benefits for low-income families (defined as families with income no more than 200 percent of the FPL—currently about $48,500 for a family of four), including vaccination programs or chronic illness prevention programs, that reduce community health care costs.

Within the above definition, the measure requires cost to be calculated based on certain federal reporting requirements for hospitals. The measure also excludes bad debt—amounts billed to patients but later determined to be uncollectible due to the patients' unwillingness to pay—from the definition of charity care. In other words, a hospital's unreimbursed cost of care for an uninsured patient would qualify as charity care only if the hospital furnished that service for free (or at a discount) under its financial assistance program, without expectation of payment.

Certain Nonprofit Hospitals Required to Provide Minimum Amount of Charity Care

Required Minimum Charity Care Amount Set at 5 Percent of Net Revenues. This measure requires nonprofit hospitals, unless exempted by the measure, to provide an amount of charity care (as defined by the measure) equal to at least 5 percent of their net patient revenues. (Net patient

revenues are the actual payment amounts received by hospitals for providing patient care, as opposed to the gross amounts billed by hospitals for providing that care.) Hospitals subject to the measure must meet this requirement to continue to qualify as nonprofit corporations and to maintain their tax-exempt status within the state.

Certain Nonprofit Hospitals Exempted From Charity Care Requirement. This measure exempts certain categories of nonprofit hospitals from the charity care requirement. Specifically, the measure does not apply to nonprofit hospitals that are part of an integrated nonprofit health system or a safety-net nonprofit health system as defined by the measure. Additionally, children's hospitals, critical access hospitals, and certain other designated hospitals are exempted. Altogether, the measure would exempt 79 (or 38 percent) of the state's current nonprofit hospitals from its charity care requirement.

Nonprofit Hospitals Must Report Annual Amounts of Charity Care. This measure requires nonexempt hospitals to file an annual report to the AG that includes the amount of charity care provided in the previous fiscal year. In lieu of this report, a nonprofit hospital can elect to include this information in its community benefit plan currently required by state law.

Enforcement of Charity Care Requirement. The AG may bring any action available under the law against a nonprofit hospital for violating the measure's charity care requirement. Civil actions may include, but are not limited to, assessing a civil penalty or revoking a hospital's status as a nonprofit corporation.

FISCAL EFFECTS

Currently, Most Hospitals Subject to Measure Likely Fall Short of Measure's Charity Care Requirement . . . In an effort to understand nonprofit hospitals' current cost of providing financial assistance to needy patients, we examined hospital annual financial data reported to and published by OSHPD in 2014. Our analysis of this data suggests the vast majority of nonprofit hospitals subject to the measure provided financial assistance at a cost of less than 5 percent of their net patient revenues (the measure's minimum requirement for charity care). (Nearly 80 percent of these hospitals provided financial assistance at a cost of less than 2 percent of their net patient revenues.) Outside of financial assistance, it is unknown what amount of additional charity care these hospitals provided in the way of other community benefits meeting the measure's definition (such as vaccination and disease prevention programs). However, we believe it is unlikely that including these additional benefits would bring most hospitals' current level of charity care up to the 5 percent threshold required by the measure.

. . . Suggesting Potential Responses by Hospitals, Some With Fiscal Effects. The above analysis suggests most hospitals would have to increase the amount of charity care they currently provide, and/or reduce their net patient revenues, to meet the measure's requirements for maintaining nonprofit and tax-exempt status. Alternatively, it is possible some hospitals could opt to convert to for-profit status, if they are unable or unwilling to meet the measure's requirements. Below, we discuss each of these potential responses, factors that could limit the extent of the responses, and the potential range of associated fiscal effects (if any) on state and local governments. Although we consider this the most plausible set of responses available to hospitals, the actual choice and degree of responses among individual hospitals would vary to an unknown extent, and depend on each hospital's operations, financial position, and other unique characteristics and situation. We are unable

to determine which responses—across all impacted hospitals—would be more likely to occur and/or outweigh the others, making the measure's overall fiscal effect on state and local governments highly uncertain.

Response 1: Increase Reported Cost of Charity Care. It is likely some hospitals, in an effort to maintain their tax-exempt status, would increase their reported cost of providing free or discounted care. Hospitals could possibly accomplish this in various ways, including (1) expanding income eligibility for their financial assistance policies (so more of their existing patients qualify), (2) increasing the generosity of discounts offered under their policies (to incur more unreimbursed cost per charity case), and/or (3) more widely advertising these policies within their communities (to attract additional patients likely to obtain free or discounted care). Even without formally changing their policies, some hospitals may—through better screening or informing practices—more frequently identify patients who are eligible for financial assistance, rather than billing such patients and making unsuccessful attempts to collect payment. In other words, these hospitals may become more likely to record cases of uncompensated care as charity care rather than bad debt.

The success of these strategies would partly depend on certain factors beyond hospitals' immediate control, such as the underlying demographics of their patient populations. For example, a hospital *offering* a generous financial assistance policy could still face difficulty *providing* enough free or discounted care to satisfy the measure's requirement, if there are relatively few uninsured or low-income patients residing in that hospital's service area.

To the extent hospitals successfully pursue such strategies to increase their reported cost of free or discounted care and preserve their tax-exempt status, the measure is unlikely to have significant effects on state and local finances. This is because these strategies involve hospitals' treatment of uncompensated care, and do not directly affect the level of reimbursement hospitals receive for care covered and paid for by government programs and health insurers.

Some hospitals may also be able to provide greater amounts of other qualifying community benefits, such as disease prevention programs, to meet the measure's requirements for the provision of charity care. Their ability to do so would depend on their capacity and resources to implement such programs. To the extent hospitals successfully pursue such strategies to increase their community benefits and preserve their tax-exempt status, the measure is unlikely to have significant effects on state and local finances. This is because these strategies do not involve direct patient care that is covered and paid for by government programs and health insurers.

Response 2: Convert to For-Profit Status. As described earlier, some nonprofit hospitals could face practical limitations to increasing their charity care. Other hospitals—even if able to make changes necessary to comply with the requirement—may determine their cost of doing so would exceed their benefit from preserving their tax-exempt status. Under either scenario, some nonprofit hospitals may opt to convert to for-profit status in response to the measure. Such conversions would newly subject these hospitals to the state's corporate income tax and possibly local property taxes, thereby potentially increasing state and local revenues.

The potential increase in government revenues from nonprofit hospitals converting to for-profit status is highly uncertain. Based on hospitals' reported net earnings in the OSHPD financial data, we estimate the potential state corporate income tax liability across *all* hospitals subject to the measure to be up to the low hundreds of millions of dollars annually. However, any actual amount of additional revenue that could result from the measure would likely be lower—perhaps substantially

so—than the total potential tax liability across impacted hospitals, since (1) it is very unlikely all hospitals would convert to for-profit status; (2) it is highly uncertain whether many, some, several, or no hospitals would choose to convert; and (3) those that do convert would likely pursue strategies to minimize their tax liability. (We note that data are not available to estimate the potential increase in property tax revenues should some nonprofit hospitals convert to for-profit status as a result of the measure.)

Response 3: Reduce Net Patient Revenue. Because this measure defines each hospital's minimum charity care requirement as a percentage of net patient revenue, rather than a fixed dollar amount, another potential way a hospital could meet the requirement—without increasing its charity care—would be to reduce its net patient revenue. In effect, the hospital would provide fewer services and/or accept lower payments from health insurers and other payers. To the extent hospitals pursue this strategy, it could result in some unknown savings to state and local governments, by lowering the cost of employee health benefits purchased from health insurers.

Whether, and to what extent, any hospital would intentionally reduce its net revenue in response to this measure is highly uncertain, as doing so conflicts with its normal business incentive to maximize revenues. We assume in most cases, an individual hospital would adopt whichever approach minimizes its total financial losses under the measure. This means a hospital would choose to reduce its net revenues only if that hospital stood to lose more by converting to for-profit status and paying state income tax. Therefore, any state and local government savings from hospitals reducing their net revenues are likely to be less than the amount these hospitals would potentially owe in state tax if they instead converted to for-profit status.

Summary of Fiscal Effects. This measure would have the following potential fiscal effects:

- To the extent nonprofit hospitals subject to the measure comply by increasing their reported cost of charity care, the measure would not have a significant impact on state and local finances.
- Potential increased state and local revenues and/or state and local savings of an unknown amount, if hospitals comply with the measure by converting to for-profit status and/or decreasing their net patient revenues.

Sincerely,

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Mac Taylor
Legislative Analyst

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Michael Cohen
Director of Finance