



## **States Should Avoid Sales Taxes on Nonprofit Hospital Purchases**

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### **Six States Tax Nonprofit Hospital Purchases; Only Seven States Exempt All Hospital Purchases**

#### **Summary**

States seeking a neutral, transparent sales tax system should exempt all business-to-business transactions and impose sales tax only on final retail sales of goods and services. Because many states continue to impose sales tax on business-to-business inputs, examining the tax treatment of a variety of such transactions can provide insight into the neutrality and transparency of a state's overall tax system.

While income tax exemptions for nonprofit hospitals may not be justified under the principles of sound tax policy, sales tax exemptions for the purchase of inputs are. Only seven states exempt inputs purchased by all hospitals, and six states do not exempt inputs purchased by nonprofit hospitals. For many states, exempting inputs from the sales tax should be a part of any tax reform effort.

#### **Inputs Should Generally Be Exempt from Sales Tax**

Ideally, a sales tax should be levied on all goods and services sold at retail, and to prevent distortions and hidden taxes, it should be levied only once on each good or service sold at retail. Take the example of bread sold at retail. The bread is the final retail product, coming after the farmer purchased seeds from a store owner, the miller purchased wheat from the farmer, the bakery purchased flour from the miller, and the supermarket purchased the bread from the bakery. If a sales tax is imposed on each of those transactions, the taxes cascade or "pyramid" on top of each other, resulting in taxes on top of taxes.

Tax pyramiding distorts economic decision-making because goods or services provided by one company become artificially favored over those requiring multiple production steps. If the

farmer, the miller, and the baker must pay sales tax on pre-retail steps, those taxes will become embedded in the final retail price. Consumers thus end up paying hidden taxes, and the tax system is less transparent and neutral.

Of those states that impose a state-level sales tax (45, plus the District of Columbia), many impose sales taxes on business-to-business transactions that do not involve a final retail sale. In the Tax Foundation's 2008 *State Business Tax Climate Index*, the tax treatment of ten business-to-business transaction categories was examined. While no state exempted all ten, more than half the states (27 plus D.C.) tax two or more inputs. 14 states and D.C. tax the purchase of manufacturing machinery, an especially distortionary tax, and Hawaii imposes sales tax on all but one examined business-to-business transactions.<sup>1</sup>

### **The Income Tax Exemption for Nonprofit Hospitals May Be Unjustified**

Of the approximately 3,400 hospitals in the United States, 60 percent (2,033) are nonprofit and enjoy tax-exempt status.<sup>2</sup> This exempts nonprofit hospitals from paying income tax on investment earnings or surpluses, and donations to them are deductible.

In *Tax Foundation Special Report No. 137, "Charities and Public Goods: The Case for Reforming the Federal Income Tax Deduction for Charitable Gifts,"* we argued that the justifications for such favorable tax treatment are thin. "[H]ospital services are not economically different from other goods and services such as rock-climbing lessons or auto care. That makes it difficult to see how either is subject to market failure and would be significantly under-provided in the absence of a tax subsidy."<sup>3</sup> IRS Commissioner Mark W. Everson reached the same conclusion in a 2005 report, writing that there was little difference between nonprofit and for-profit hospitals "in their operations, their attention to the benefit of the community or their levels of charity care."<sup>4</sup> Large salaries and a perception that nonprofit hospitals are not providing a *quid pro quo* in return for their favored tax status may lead to increased scrutiny and perhaps congressional action.<sup>5</sup>

### **Nonprofit Hospital Inputs Should Be Exempt from Sales Tax**

A second, more justifiable, tax benefit enjoyed by many nonprofit hospitals is a sales tax exemption on purchased inputs. Just as imposing sales tax on manufacturing inputs leads to hidden taxes and pyramiding on retail consumers, so too would imposing a state sales tax on hospital purchases lead to hidden taxes and pyramiding on patients.

Tennessee provides one illustrative example. Parkridge Hospital in Chattanooga purchased human blood from a commercial blood bank, in turn making it available to patients in need of transfusions.<sup>6</sup> The state ordered the hospital to pay sales tax on the purchase of the blood from the blood banks. The hospital complied under protest and then sued for a refund. Even though Tennessee's sales tax statute specifically limits the sales tax to "selling tangible personal property at retail in this state,"<sup>7</sup> the Tennessee Supreme Court ruled against the hospital and ordered the tax paid on the business-to-business transactions. Tennessee legislators responded by inserting a specific sales tax exemption for blood purchased by charities into the state code.<sup>8</sup> While the "Blood Exemption" is still on the books, other purchases of inputs by hospitals (aside from some equipment) in Tennessee remain subject to sales tax. Patients in Tennessee thus pay hidden taxes embedded in their hospital bills, and Tennessee's tax system is less transparent and neutral.

Of the 45 states that impose a state-level sales tax, 39 exempt all or most purchases by nonprofit hospitals. In 13 states, all purchases of inputs by charities or nonprofits are exempt from the sales tax, and in another 13 states, nonprofit hospital purchases are specifically exempt. Seven states exempt inputs purchased by all hospitals. Arkansas and North Carolina exempt only certain purchases by nonprofit hospitals.

Louisiana, Oklahoma, and West Virginia tax all inputs purchased by nonprofit hospitals, and Tennessee, Washington, and Wyoming tax all but medical equipment purchases. Oklahoma's tax is upside-down: it taxes hospitals' inputs but exempts retail sales. See the tables below for a complete listing.

**Table 1**  
**Sales Tax on Nonprofit Hospital Purchases by Category**

<b>Category</b>	<b>Number of States in Category</b>
<b>MOSTLY TAXED</b>	
Taxed	2
Some medical equipment exempt	3
Hospital inputs taxed, but retail sales exempt	1
<b>SOME EXEMPT</b>	
Nonprofit hospitals specifically exempt, except for some major items	1
<b>MOSTLY EXEMPT</b>	
Items "ordinary and necessary" for operation of nonprofit hospitals exempt	1
Most purchases of medicine and equipment exempt	2
Charities exempt, except for some items	2
Services and materials to hospital exempt, but not building materials	1
<b>EXEMPT</b>	
Nonprofit hospitals specifically exempt	13
Hospitals specifically exempt	7
Sales to nonprofits or charities exempt or generally exempt	13
No Sales Tax	5

Source: Tax Foundation

**Table 2**  
**Sales Tax on Nonprofit Hospital Purchases by State**

<b>State</b>	<b>Taxed/Exempt</b>	<b>Notes</b>
Alabama	Exempt	Nonprofit hospitals specifically exempt
Alaska	<i><b>No Sales Tax</b></i>	
Arizona	Exempt	Nonprofit hospitals specifically exempt
Arkansas	Mostly Exempt	Services and materials to hospital exempt, but not building materials
California	Exempt	Nonprofit hospitals specifically exempt
Colorado	Exempt	Charities exempt
Connecticut	Exempt	Nonprofit hospitals specifically exempt
Delaware	<i><b>No Sales Tax</b></i>	
Florida	Mostly Exempt	Most purchases of medicine and equipment exempt
Georgia	Exempt	Nonprofit hospitals specifically exempt
Hawaii	Exempt	Hospitals specifically exempt
Idaho	Exempt	Hospitals specifically exempt
Illinois	Exempt	Charities exempt
Indiana	Exempt	Nonprofits exempt
Iowa	Exempt	Nonprofit hospitals specifically exempt
Kansas	Exempt	Hospitals specifically exempt
Kentucky	Exempt	Sales to charities exempt
Louisiana	<b>Taxed</b>	
Maine	Exempt	Hospitals specifically exempt
Maryland	Exempt	Nonprofits exempt
Massachusetts	Mostly Exempt	Most purchases of medicine and equipment exempt
Michigan	Exempt	Nonprofit hospitals specifically exempt
Minnesota	Exempt	Nonprofit hospitals specifically exempt
Mississippi	Mostly Exempt	Items "ordinary and necessary" for operation of nonprofit hospitals exempt
Missouri	Exempt	Charities exempt
Montana	<i><b>No Sales Tax</b></i>	
Nebraska	Exempt	Hospitals specifically exempt
Nevada	Exempt	Nonprofits exempt
New Hampshire	<i><b>No Sales Tax</b></i>	
New Jersey	Mostly Exempt	Charities exempt, except for some items
New Mexico	Exempt	Nonprofits exempt
New York	Mostly Exempt	Charities exempt, except for some items
North Carolina	Some Exempt	Nonprofit hospitals specifically exempt, except for some major items
North Dakota	Exempt	Hospitals specifically exempt

Ohio	Exempt	Nonprofit hospitals specifically exempt
Oklahoma	<b>Taxed</b>	Hospital inputs taxed, but retail sales exempt
Oregon	<i>No Sales Tax</i>	
Pennsylvania	Exempt	Nonprofit hospitals specifically exempt
Rhode Island	Exempt	Nonprofit hospitals specifically exempt
South Carolina	Exempt	Nonprofit hospitals specifically exempt
South Dakota	Exempt	Hospitals specifically exempt
Tennessee	<b>Mostly Taxed</b>	Some medical equipment exempt
Texas	Exempt	Nonprofits exempt
Utah	Exempt	Charities exempt
Vermont	Exempt	Nonprofits exempt
Virginia	Exempt	Nonprofits generally exempt
W. Virginia	<b>Taxed</b>	
Washington	<b>Mostly Taxed</b>	Some medical equipment exempt
Wisconsin	Exempt	Nonprofit charities exempt
Wyoming	<b>Mostly Taxed</b>	Some medical equipment exempt
Dist. of Columbia	Exempt	Nonprofit hospitals specifically exempt

Source: Tax Foundation

## Notes

1. See also Federation of Tax Administrators, *2004 Survey on State Taxation of Services* (May 2005), at <http://www.taxadmin.org/fta/pub/services/services04.html>.
2. See John Carreyrou and Barbara Martinez, "Nonprofit hospitals, once for the poor, hit gold," *the Wall Street Journal* (Apr. 6, 2008).
3. Andrew Chamberlain and Mark Sussman, *Tax Foundation Special Report*, No. 137 "Charities and Public Goods: The Case for Reforming the Federal Income Tax Deduction for Charitable Gifts" (Nov. 2005), at <http://www.taxfoundation.org/news/show/1191.html>.
4. See Robert Pear, "Nonprofit Hospitals Face Scrutiny Over Practices," *New York Times* (Mar. 19, 2006), at <http://www.nytimes.com/2006/03/19/politics/19health.html>.
5. See, e.g., Carreyrou and Martinez, *supra* note 1.
6. See *Parkridge Hospital, Inc. v. Woods*, 561 S.W.2d 754 (Tenn. 1978).
7. Tenn. Code Ann. § 67-6-201 (then Tenn. Code Ann. § 67-3003).

8. See Tenn. Code Ann. § 67-6-304.

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