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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

SEP 8 - 1975 094912

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The Honorable Herman E. Talmadge
Chairman, Subcommittee on Health
Committee on Finance
United States Senate

Dear Mr. Chairman:

Recently your office requested information pertaining to a proposal of July 1, 1975, by the Federation of American Hospitals for legislation authorizing the recognition of taxes as a reimbursable cost to proprietary health facilities under Medicare.

Because some taxes--such as State and local property taxes and Social Security taxes--are generally reimbursable under Medicare, we understand that the Federation's proposal pertains to the allowability of Federal, State and local income and excess profit taxes which are specifically not allowable for reimbursement under Medicare regulations and related instructions.

Specifically, the information requested by your office was:

--any prior GAO decisions or opinions on including income taxes as an allowable cost under cost reimbursement arrangements;

--precedents for authorizing income tax reimbursement under such arrangements; and

--the consequences of authorizing reimbursement of income taxes under Medicare.

Information on each of these points follows

1. Prior decisions or opinions

We have not had occasion to issue any legal decisions or opinions on permitting Federal income tax payments to be charged as allowable costs under Federal cost reimbursement arrangements.

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2. Precedents under other Federal cost reimbursement arrangements

The two basic sets of regulations under which the Federal Government buys and pays for goods and services are the Federal Procurement Regulations and the Armed Services Procurement Regulations. The portions of these regulations dealing with cost reimbursement arrangements (41 CFR 1-15.205-41 and ASPR 15-205.41, respectively) both specifically prohibit including Federal income and excess profit taxes as costs under cost reimbursement type contracts. However, State and local income taxes are allowable costs under these regulations, whereas such taxes are not allowable under Medicare. Conversely, some costs not allowable under the Federal Procurement Regulations and the Armed Services Procurement Regulations--such as interest expense and return on equity capital for proprietary facilities--are reimbursable under Medicare.

In summary, we do not know of any precedent for permitting Federal income taxes to be an allowable cost under Federal cost reimbursement arrangements.

3. Consequences of authorizing reimbursement of income taxes under Medicare

It is difficult to assess the consequences of authorizing the reimbursement of income taxes under Medicare because of the potential impact of Medicare's cost apportionment system which could minimize the effect of authorizing such reimbursement.

Aside from the precedent setting nature of the Federation's proposal, we believe it would be difficult to implement the proposal for reimbursing income taxes and comply with the provisions of section 1861(v)(1)(A) of the Social Security Act which provides that under the methods for determining reasonable costs for Medicare providers:

> "* * * the necessary costs of efficiently delivering covered services to individuals covered by the insurance programs established by this title will not be borne by individuals not so covered, and the costs with respect to individuals not so covered will not be borne by such insurance programs * * *."
> (emphasis added)

It is under this provision that Medicare's cost reimbursement requirements include various prescribed methods of "apportioning" allowable costs between Medicare and non-Medicare patients. The apportionment of income taxes as a "cost" would present unique problems.

Net taxable income--the basis on which Federal income taxes for a proprietary provider is computed--represents the difference between income and allowable expenses or costs. Since Medicare only reimburses costs for providing covered services, the principal reimbursement by Medicare which would represent a net taxable income is the reimbursement for return on equity capital specifically authorized by section 1861 (v)(1)(B).

Thus, except for the return on equity capital reimbursement by Medicare, the net taxable income of a provider would be generated either by non-Medicare patients or by non-patient-care revenues. Accordingly, under Medicare's cost apportionment system, even if income taxes were recognized as an allowable cost, only that portion of the taxes generated by the Medicare program (e.g., taxes paid on the taxable income representing return on equity capital) could be apportioned to Medicare for reimbursement purposes.

Your proposals for Medicare-Medicaid administrative and reimbursement reform (S 11122, Cong. Rec. June 20, 1975), specifically included a proposal to increase the allowable return on equity capital from 1 1/2 times to twice the rate of return on current Medicare hospital insurance trust fund investments in order to bring the return closer to the after-tax return on competing investments. Thus, it appears to us that the adoption of both a higher rate of return on equity and the recognition of income taxes payable on the return as a reimbursable cost, would represent a duplicate recognition of essentially the same thing.

Other comments

The Federation has pointed out that taxes have historically been recognized as an operating expense by commissions which approve public utility rates and therefore should be part of the definition of reasonable costs under Medicare. Although it is true that income taxes have been recognized as an expense in public utility accounting, public utility rate setting is not necessarily the same as a retrospective cost reimbursement arrangement.

As we understand it, one of the purposes of the rate setting process is to provide the public utility stockholders with a reasonable rate of return on their investment or equity in the utility. Thus, if a return rate of 10 percent on equity was considered appropriate, the revenue rate calculations must necessarily recognize not only the costs of providing the service, but also the payment of corporate income taxes by the utility before the appropriate income could be distributed to the stockholders. Assuming a 50 percent corporate tax rate on net revenue, the same result could be obtained by using a 20 percent return

rate and disregarding the corporate income tax liability. As we understand it, this was essentially the approach you were taking in proposing to increase the allowable rate of return under Medicare.

We trust that the information provided satisfies your needs.

Sincerely yours,

Comptroller General
of the United States