

## **Tax-Exempt Status: IRS Denies Commercial ACO Tax-Exempt Status Under Section 501(c)(3) (Part Two of a Two-Part Series)**

On April 8, 2016, the *Internal Revenue Service* (IRS) publicly released its Private Ruling 201615022, dated January 15, 2016, which denied granting tax-exempt status under Section 501(c)(3) of the *Internal Revenue Code* (IRC) to an *accountable care organization* (ACO) not participating in the *Medicare Shared Savings Program* (MSSP).<sup>1</sup> The IRS found that a substantial portion of the activities of the ACO, in particular negotiating agreements with third-party payors on behalf of member physicians, benefitted private individuals to such a degree that the IRS deemed the ACO to have a “*substantial nonexempt purpose* [that] *destroys the exemption under § 501(c)(3).*”<sup>2</sup> The ruling provides a further example of regulatory scrutiny related to tax-exempt status of healthcare enterprises, in conjunction with recent tax rulings in New Jersey and Illinois. This *Health Capital Topics* article, the second and final installment of the two-part series examining the increasing regulatory scrutiny regarding tax-exempt status of healthcare enterprises, will detail this IRS ruling, as well as how the ruling continues the recent regulatory trend scrutinizing tax-exempt status and the potential implications of this trend for health systems.

The ACO subject to the IRS’s ruling was formed by an existing tax-exempt healthcare system (System) to create and manage a clinically integrated network.<sup>3</sup> The ACO did not directly provide health services to the general public; rather, the ACO negotiated and executed agreements with third-party payors on behalf of System’s physicians.<sup>4</sup> In addition, the ACO collected, aggregated, and analyzed data regarding patient satisfaction and provider performance, and implemented financial incentives for the participating physicians in order to accomplish the ACO’s goals of reducing healthcare costs; increasing patient access to, and quality of, care; and improving population health.<sup>5</sup> The physicians providing services for System fell into three general groups: (i) those employed by System, (ii) those from independent practice groups with medical staff privileges at System, and (iii) those practicing at hospitals unaffiliated with System.<sup>6</sup> The IRS noted that approximately half of the physician members of the ACO fell into categories (ii) and (iii).<sup>7</sup>

In its ruling, the IRS opined that the ACO at issue failed to qualify for tax exemptions because the ACO: (1) did not operate exclusively for exempt purposes; and, (2) did not operate primarily for a public purpose, under

IRC § 501(c)(3).<sup>8</sup> Taking into consideration the facts and circumstances surrounding the ACO, the IRS stated that the tax exemption requirements under IRC § 501(c)(3) were not met.<sup>9</sup> Under § 501(c)(3) of the IRC, a tax-exempt organization is required to be “*organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes...*,” among other purposes.<sup>10</sup> According to its letter ruling, the IRS found that the ACO failed to operate exclusively for charitable purposes, as a substantial activity of the ACO was negotiating payor agreements on behalf of System’s participating physicians.<sup>11</sup> As half of the physicians were independent or unaffiliated with System, the IRS mentioned its finding from Notice 2011-20 that “*negotiating with private health insurers on behalf of unrelated parties generally is not a charitable activity, regardless of whether the agreement negotiated involves a program aimed at achieving cost savings in health care delivery.*”<sup>12</sup> The ACO at issue operated in a similar manner as the healthcare entity subject to IRS Revenue Ruling 86-98, in which the subject entity negotiated with various HMOs on behalf of its member providers, and then administered and distributed claims received from its physician members.<sup>13</sup> These functions provided an available pool of physicians for the HMO subscribers, while also providing a pool of patients for its member physicians.<sup>14</sup> The IRS found that the entity’s primary activities were “*to serve as a bargaining agent for its members... and to perform the administrative claims services.*”<sup>15</sup> These findings were reflected in the IRS’s April 2016 ruling, which found that the ACO’s primary beneficiary was not the public, but rather the ACO’s member physicians.<sup>16</sup>

Next, the IRS determined that the ACO also failed to qualify for an exemption due to charitable activities through “*lessening of the burdens of Government*”<sup>17</sup> as a non-MSSP participating ACO.<sup>18</sup> For an organization’s activity to lessen government burden, there must be an objective manifestation that the government considers that activity its burden.<sup>19</sup> The IRS noted that “*...Congress established the MSSP to be conducted through ACOs in order to promote quality improvements and cost savings in health care. Therefore, participation in the MSSP by an ACO will generally further the charitable purpose of lessening the burdens of government...*”<sup>20</sup> In its 2011-20 Notice, the

IRS expected that, “...absent inurement or impermissible private benefit, any MSSP payments... would derive from activities that are substantially related to the performance of the charitable purpose of lessening the burdens of government...”<sup>21</sup> While the ACO’s general goals of promoting health may be recognized as a charitable activity, the IRS noted that “not every activity that generally promotes health furthers charitable purposes under IRC § 501(c)(3).”<sup>22</sup> The IRS opined that even if the ACO conducted numerous activities which may further charitable purpose, the existence of a single substantial nonexempt purpose “destroys the exemption regardless of the number or importance of exempt purposes.”<sup>23</sup> The IRS held that the ACO’s activities of promoting health through its clinical integration were more akin to a pharmacy’s activities of promoting health through selling prescriptions, which, considered alone, fails to qualify for an exemption under IRC § 501(c)(3).<sup>24</sup>

The IRS letter ruling serves as another example of increasing regulatory scrutiny regarding tax-exempt status for healthcare enterprises. This decision follows the IRS’ guidance regarding tax exemptions for ACOs in IRS’ Notice 2011-20,<sup>25</sup> which noted that ACOs participating in the MSSP may qualify for tax-exempt status, but that many non-MSSP activities by ACOs are less likely to satisfy the regulatory thresholds necessary to receive tax-exempt status.<sup>26</sup> Additionally, as discussed in the first installment of this *Health Capital Topics* two-part series, regulatory scrutiny regarding the tax-exempt status of healthcare providers has amplified over the past two years. In addition to the IRS denial of tax-exempt status to the ACO at issue in its exemption request ruling from January 2016,<sup>27</sup> Carle Foundation Hospital’s revocation of its state property tax exemption was upheld in early 2016 in Illinois, and Morristown Memorial Hospital’s revocation of its state property tax exemption was upheld in 2015 in New Jersey. In addition to this increased scrutiny of tax-exempt status for healthcare providers generally, the ruling demonstrates this trend has broadened to include ACOs, a central component of the ACA.<sup>28</sup> Although this IRS ruling is non-precedential, and another non-MSSP related ACO may attempt to persuade the IRS that it

qualifies for tax exemptions, the ruling adds to the IRS’s body of regulatory literature regarding tax-exempt status and ACOs. It may be prudent for non-MSSP ACOs to consider the IRS’s position in its Private Ruling 201615022 and determine whether its activities further IRC § 501(c)(3) charitable purposes.<sup>29</sup>

- 1 “Private Letter Ruling No. 201615022” Internal Revenue Service, April 8, 2016, <https://www.irs.gov/pub/irs-wd/201615022.pdf> (Accessed 4/28/16).
- 2 *Ibid.*
- 3 *Ibid.*
- 4 *Ibid.*
- 5 *Ibid.*
- 6 *Ibid.*
- 7 *Ibid.*
- 8 *Ibid.*
- 9 *Ibid.*
- 10 “Exemption from tax on corporations, certain trusts, etc.” 26 U.S.C. § 501(c)(3) (2006).
- 11 IRS, Private Letter Ruling No. 201615022, April 8, 2016.
- 12 *Ibid.*
- 13 “Revenue Ruling 86-98” Internal Revenue Service, <https://www.irs.gov/pub/irs-tege/rr86-098.pdf> (Accessed 5/19/2016).
- 14 *Ibid.*
- 15 *Ibid.*
- 16 IRS, Private Letter Ruling No. 201615022, April 8, 2016.
- 17 “Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals” 26 C.F.R. § 1.501(c)(3)-1(d)(2) (2012).
- 18 IRS, Private Letter Ruling No. 201615022, April 8, 2016.
- 19 *Ibid.*
- 20 *Ibid.*
- 21 “Notice 2011-20” Internal Revenue Service, 2011, <https://www.irs.gov/pub/irs-drop/n-11-20.pdf> (Accessed 5/13/2016), p. 8.
- 22 *Ibid.*
- 23 *Ibid.*
- 24 *Ibid.*; “Federation Pharmacy Services, Inc. v. Commissioner” 72 T.C. 687, 696 (1979).
- 25 “IRS Denial of Section 501(c)(3) Status for a Commercial ACO” By Tamar Rosenberg and Jay Gerzog, Sheppard Mullin, May 9, 2016, <http://www.sheppardhealthlaw.com/2016/05/articles/accountable-care-organization-aco/irs-denial-of-section-501c3-status-for-a-commercial-aco/> (Accessed 5/13/2016).
- 26 IRS, Notice 2011-20, 2011, p. 7-9.
- 27 IRS, Private Letter Ruling No. 201615022, April 8, 2016.
- 28 “Patient Protection and Affordable Care Act” Pub. L. No. 111-148, 124 Stat. 119, 325 (March 23, 2010).
- 29 Rosenberg and Gerzog, May 9, 2016.







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