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Adverse IRS Determination Sheds Light on Tax Treatment of Accountable Care Organizations Conducting Commercial Activities

By Elizabeth Mills and Don Stuart*

In the previously released Notice 2011-20 and Fact Sheet FS-2011-11 (Notices), the Internal Revenue Service (IRS) addressed some of the tax-exemption issues surrounding accountable care organizations (ACOs), including the tax treatment of an exempt hospital organization participating in an ACO and the availability of Section 501(c)(3) exempt status for an ACO entity. The Notices indicate that an ACO participating in the Medicare Shared Savings Program (MSSP) may be exempt because it lessens the burdens of government and that an ACO caring for Medicaid enrollees may be exempt because it relieves poverty, both recognized charitable purposes. The Notices question, however, whether an ACO that participates in commercial payor programs as well as, or instead of, the MSSP or Medicaid-related programs, has a basis for Section 501(c)(3) tax exemption as a charitable organization.

In a recently released IRS Private Letter Ruling (Number 201145025) (PLR), the IRS denied tax exemption to a hospital-controlled organization that contracted with commercial payors to provide the services of the hospital and its medical staff. The PLR provides some pointers on what to do and not do when developing an application for tax exemption or argument that an ACO with commercial activities is tax-exempt.

PLR Facts

The facts in the PLR describe the stated purposes of the applicant organization as establishing or participating in healthcare delivery networks, encouraging efficiency, enhancing the delivery of care to the public through the exchange of ideas, and providing an opportunity for the improvement of medical practice management, among other items. The facts sound like a fairly typical "messenger model" physician-hospital organization. The organization is controlled by a tax-exempt hospital, and participation is open to members of its medical staff and hospital-based physicians. The organization enters into payor agreements for subscribers of benefit plans and enters into member agreements with participating physicians. Participating physicians maintain their own private practices. For risk-based contracts, the organization establishes risk pools and distributes savings based on formulas approved by its board of directors. The PLR states that the organization holds meetings monthly to discuss opportunities in which providers can improve care, to develop guidelines for care, and to recommend implementation of standards that promote efficiency, and provides a forum and communication vehicle for the discussion of current quality healthcare practices and practice management techniques.
Denial of Exemption

The IRS’ proposed denial of exemption (which was not protested by the organization and became final) stated that the organization was not organized and did not operate exclusively for charitable purposes. The IRS noted that the organization's purposes were not limited to exempt purposes, but were broader than those permitted under Section 501(c)(3), and that its specific purposes (mentioned above) were not per se charitable activities.

With respect to the organization's operations, the IRS stated that the organization's primary activity is to enter into payor agreements on behalf of physician members. The IRS noted that the organization does not provide health services directly, but arranges for the provision of services only to those with whom the organization stands in a contractual relationship, as in Geisinger Health Plan. Such activity was not considered by the IRS as "charitable" for Section 501(c)(3) purposes. The proposed denial also cites Revenue Ruling 86-98, which held that an independent practice association did not qualify for Section 501(c)(4) status because it operated for the primary benefit of its member physicians rather than the community. The IRS also found that the organization did not qualify as a supporting organization under Section 509(a)(3).

Key Thoughts

Several caveats are in order with respect to the PLR. First, as always, a single PLR does not indicate the final position of the IRS and is solely based on the particular facts of the taxpayer. Second, the facts described in the PLR are a summary, so other facts that may be of interest are not necessarily mentioned. Finally, the timeline indicates that this application for exemption made by the organization in the PLR may well have been filed before the enactment of PPACA, and the proposed denial was issued very shortly after Notice 2011-20 came out. The proposed denial letter was dated July 5, 2011, and the organization did not protest the proposed denial. Thus, the application may not have been developed taking the current ACO analysis into account.

Based on the specific facts described in the PLR, the organization's application and denial is not a good test of whether an ACO could qualify for tax-exempt status. Aside from monthly meetings, the facts do not describe any efforts to integrate or become accountable for care. For example, electronic health records and exchange of data are not mentioned. The development of protocols and care standards to which participants must adhere, or patient-centered care efforts, also are not mentioned. Of importance is that the PLR does indicate that when an ACO is seeking tax exemption, it should distinguish itself as strongly as possible from the "traditional" physician-hospital type of organizations.

*We would like to thank Elizabeth Mills, Esquire (Proskauer Rose LLP, Chicago, IL) and Don Stuart, Esquire (Waller Lansden Dortch & Davis LLP, Nashville, TN), for authoring this email alert.

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