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IRS Revokes Hospital's Exempt Status for Failing to Comply with § 501(r)(3)

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For the first time, the Internal Revenue Service (IRS) has revoked the exemption of a hospital for failing to comply with Internal Revenue Code (IRC) § 501(r). Specifically, the hospital failed to timely conduct and implement a Community Health Needs Assessment (CHNA). The hospital received a final adverse determination letter revoking exemption in February 2017, and the redacted letter was posted to the IRS website earlier this month.

The circumstances of this revocation are unusual. The hospital in question was a governmental entity that did not want to continue making the effort necessary to comply with § 501(r) to retain its dual status as a § 501(c)(3) organization. Therefore, the revocation does not suggest that more revocations should be expected. However, it does serve as a reminder that the IRS is monitoring compliance and will audit and take action if it finds a hospital is not meeting the regulatory requirements.

Background of the Legal Requirements

Under § 501(r)(3) and its implementing regulations, a tax-exempt hospital must conduct a CHNA every three years. The process includes assessing the health needs of the community, with input from local leaders and public health experts, and making the CHNA widely available to the public, generally on the hospital's website. The hospital's board or other authorized body must adopt the CHNA and an implementation strategy that explains how the hospital plans to address the health needs identified in the CHNA.

Hospitals that fail to comply with § 501(r)(3) will be subject to a $50,000 excise tax and possibly temporary taxation of income and revocation of tax-exempt status. If disclosed and corrected, failures that are neither willful nor egregious will be excused for purposes of revocation or taxation, but may still result in an excise tax. An "egregious" failure is "only a very serious failure, taking into account the severity of the impact and the number of affected persons."[1] A hospital's omission or error will not be considered a failure if it was minor or inadvertent and the hospital corrects the issue promptly after it was discovered.

The hospital whose status was revoked was a "dual-status" entity, meaning that its income is excluded from tax under § 115 as a governmental unit, regardless of its § 501(c)(3) qualification. Dual-status hospitals are exempt from filing, but they still are required to meet all § 501(r) requirements that do not relate to disclosure on the Form 990.[2]

Background of Affordable Care Act Audits

In assessing compliance with § 501(r), the IRS examines Form 990s, hospital websites, and other public information to identify hospitals that are potentially non-compliant with § 501(r) and refer those facilities to examiners for field audits.[3] In the *IRS Tax Exempt and Government Entities FY17 Work Plan*, the agency reported that as of September 30, 2016, it had completed 968 reviews and referred 363 hospitals for field examinations. Depending on the information obtained from the hospital's website and areas of suspected non-compliance, the IRS will send facilities selected for field

examinations an Information Document Request with specific questions targeting either the CHNA, Financial Assistance Policy (FAP) and Emergency Medical Care Policy under § 501(r)(4), or Billing and Collection Requirements under § 501(r)(6).

Facts of the Adverse Determination

Based on what was reported in the adverse determination letter, the hospital at issue was selected for an Affordable Care Act audit specifically addressing its CHNA. It is likely that in preliminary reviews, the IRS was unable to locate the facility's CHNA on its website. The facility had performed a CHNA to maintain its designation as a "critical care access facility" under Medicare rules, but the CHNA was not timely performed to meet § 501(r) requirements. The hospital's CHNA was not available on its website, although administrators claimed they had paper copies of the CHNA available to the public upon request. The hospital organization's board adopted the CHNA but did not adopt a separate implementation policy. Executives said they may have acted on several of the recommendations made in the implementation strategy report, but the IRS found that any type of implementation strategy did not meet the requirements of Treasury Regulation § 1.501(r)-3(2)(c).

Hospital administrators told the IRS auditor that the hospital did not need or want its tax-exempt status under § 501(c)(3). Moreover, the facility "had neither the will, the financial resources, nor the staff to follow through with the CHNA process." Based on these facts, the IRS concluded that the hospital failed to meet the regulatory requirements by not completing and adopting an implementation strategy and by not making the CHNA widely available to the public. The government categorized these failures as "egregious." Further, because, by its own admission, the hospital did not have the will or the resources to complete the CHNA as required by § 501(r), the failure was considered willful. Therefore, the IRS revoked the hospital's IRC § 501(c)(3) exempt status.

Implications

This adverse determination was unique in that the hospital appeared to freely relinquish its 501(c)(3) status. It is impossible to know whether the IRS would have pushed for revocation had the hospital been willing to correct its errors and commit to establishing a fully compliant CHNA process. Nonetheless, there are some lessons to be learned regarding what the IRS considers "egregious" failures and how it evaluates dual-status entities.

Egregious Failures

The adverse determination demonstrates that the IRS will consider as "egregious" a failure to draft and adopt a compliant implementation strategy combined with the failure to publicly distribute the CHNA. Therefore, even if a hospital has completed a CHNA, without public distribution of the report and an implementation strategy adopted by the governing body, the hospital is at risk.

While most hospitals likely conduct CHNAs every three years, hospitals should take extra care to make sure that these assessments include implementation plans that are adopted and acted upon by the hospital's governing body by the 15th day of the fifth month after the end of the taxable year in which the CHNA was completed. Moreover, to avoid on-site audits, the hospital should confirm that the two most-recently conducted CHNAs are readily available and easy-to-find on the facility's website. IRS auditors have suggested that facilities make the online CHNA and FAP clearly visible and directly available with one click from the hospital's homepage. Auditors also have asked hospital front-desk staff for hard copies of the CHNA and FAP (and relevant translations) during site visits.

Dual-Status Entities

This adverse determination makes clear that the IRS is not willing to let dual-status hospitals ignore their § 501(r) obligations while continuing to enjoy 501(c)(3) status. Dual-status hospitals should evaluate the costs and benefits of maintaining their 501(c)(3) status. Historically, some government-affiliated hospitals have sought 501(c)(3) status because it simplifies the process of qualifying for grants from foundations and other philanthropies and because it may allow the hospital to offer certain kinds of retirement plans that would not otherwise be an option. However, maintaining such status comes with a significant burden to achieve § 501(r) compliance.

In the § 501(r) rulemaking, the IRS noted that "government hospital organizations that have previously been recognized as 501(c)(3) entities who do not wish to comply with 501(r) may submit a request to voluntarily terminate their 501(c)(3) recognition."[4] Hospitals may voluntarily terminate their recognition by requesting a determination letter and paying a $400 user fee.[5] Dual-status entities that do not have the resources to devote to § 501(r) compliance may wish to pursue this option in lieu of the possibility of attracting a time-intensive audit and adverse determination.

[1] Rev. Proc. 2015-21, 2015-13 I.R.B. 817, § 3.02(3)

[2] 79 Fed. Reg. 78954, 78958 (Dec. 31, 2014).

[3] Letter from the Internal Revenue Serv. to Senator Charles Grassley (R-IA) (June 27, 2016).

[4] 78 Fed. Reg. at 78958.

[5] Rev. Proc. 2017-5, 2017-1 I.R.B. 230, § 3.01(12).

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