HEAL THYSELF: A LOOK AT AUDITS OF HOSPITAL ORGANIZATIONS UNDER SECTION 501(R)

Posted on **October 30, 2017** by **Jim Malone**

Love it or loathe it, the Affordable Care Act brought big changes to health care.

One of those changes has not received the attention it deserves. The act amended section 501 of the Internal Revenue Code to impose certain specific requirements on "hospital organizations," which are exempt organizations that operate one or more facilities that are "required by a State to be licensed, registered, or similarly recognized as a hospital." I.R.C. § 501(r)(2)(A)(i).

The fact that these requirements are included in section 501 of the Code is significant, as it means that a hospital organization needs to comply to maintain tax-exempt status. Section 501(r) imposes four basic requirements:

- Hospital organizations must conduct a community health needs assessment;
- Hospital organizations must establish a financial assistance policy;
- Hospital organizations must impose limits on their charges for those receiving subsidized care;
- Hospital organizations must restrict their billing and collection practices so that extraordinary collection activity does not take place until a reasonable effort has been made to determine whether the individual is entitled to financial assistance under its policy.

I.R.C. § 501(r)(1), (3)-(6).

While these requirements have been in place for some time, 2016 was the first tax year that the formal Treasury Regulations were in effect; previously, compliance was measured by a standard of reasonableness. Now, the IRS will expect hospital organizations to comply fully with each and every requirement of the regulations, which are quite detailed; as an example, the regulation governing the community health needs assessment contains 3,629 words.

And it's watching: An uncodified provision in the Affordable Care Act requires that the IRS review every hospital organization periodically. Earlier this month, representatives of the IRS TEGE unit explained the process at the American Health Lawyers Association's (AHLA) annual conference on tax issues facing health care organizations. What happens is that a team conducts a review based on the Form 990, the organization's website, its state filings, and other publicly available material. To the extent that the review highlights potential problems, those cases get referred to the field for examination, and the organization will receive a notification that the IRS would like to visit.

When the IRS conducts an audit, these are the potential outcomes:

- No change;
- Execution of a closing agreement specifying remedial requirements;
- Imposition of the section 4959 excise tax for failure to comply with the community health needs assessment requirement, which is $50,000 per year;
- A hospital organization that has more than one facility can be subject to income tax on all income for a non-compliant facility; and
- A hospital organization can have its exemption revoked.

Generally, the IRS tries to revoke as of the first date an exempt organization is non-compliant; as a consequence, it is possible that an organization might face multiple years of tax liability. Presumably, the non-compliant facility tax would apply the same way.

At the AHLA conference, the IRS representatives indicated that 400 cases had been referred to the field for examination, and 200 of those have been closed. While there has only been one revocation, it would be a mistake to take too much comfort in that, since the vast bulk of the audits have been conducted under a reasonable interpretation standard in which the organization merely had to show a plausible interpretation of the statute. Now that organizations will be held to technical requirements of the regulations, it is reasonable to expect an increase in revocations.

Since hospital organizations face a range of outcomes ranging from a major headache (an examination) to a disaster (loss of exempt status), they should be proactive. The starting point would be to carefully review the organization's Schedule H and its website to make sure that they are in order. For example, hospital organizations are required to make the community health needs assessment available on its website, "at least until the date the hospital facility has made widely available on a Web site its two subsequent CHNA reports." Treas. Reg. § 1.501(r)-3(b)(7). There are similar requirements that the hospital's financial assistance policy is available on its website. Treas. Reg. § 1.501(r)-4(b)(5)(i)(A). If they are not there, that can trigger an examination.

Next, the organization should take a hard look at its compliance with the requirements to determine whether they meet each and every regulatory requirement. The regulations under section 501(r) give hospital organizations a strong incentive to identify problems and fix them by excusing certain violations. Specifically, the regulations create tiers for violations:

- Minor errors and omissions will not be considered a violation of section 501(r) if they are inadvertent or based on reasonable cause and are promptly corrected;
- Compliance failures that are not egregious or willful will be excused if they are promptly corrected and are disclosed on the Form 990; and
- Other violations can trigger revocation under a multi-factor test of facts and circumstances. The first factor is whether there were prior failures.

See Treas. Reg. § 1.501(r)-2. In light of this structure, it is apparent that small problems that go uncorrected can become very serious issues.

Since the regulations place a premium on corrective action, hospital organizations need to create systems to flag violations of the section 501(r) requirements and record their disposition:

- Minor errors and omissions must be corrected promptly to avoid becoming more serious problems that may require disclosure.
- Remediation here includes establishing (or reviewing and revising as needed) formal or informal operating procedures to promote compliance with section 501(r). Treas. Reg. § 1.501(r)-2(b)(1)(ii).
- Hospital organizations will need to capture data on violations, why they were considered minor, and how they were resolved.

The IRS has offered some guidance on the dividing line between minor errors and non-egregious/non-willful failures. Minor errors include the following:

- The fact that the hospital organization's website does not include its community health needs assessment or its financial assistance policy for a short period of time due to an inadvertent technical malfunction.
- The signs concerning the hospital's financial assistance policy are not displayed for a short period of time because they fell down or were obstructed.

Rev. Proc. 2015-21, 2015-13 I.R.B. 817, § 5.03 (Mar. 10, 2015).

Examples of non-egregious/non-willful failures include the following:

- A hospital's community health needs assessment does not address all of the requirements set forth in the governing regulation;
- A hospital's financial assistance policy does not contain all of the items set forth in the relevant regulation;
- A hospital's financial assistance policy is not available on its website (or any other website) for several months;
- A hospital charges patients who were eligible for financial assistance under its policy more than it should due to a processing error.

Rev. Proc. 2015-21, 2015-13 I.R.B. 817, § 6.02.

Any failures that fall into this category not only need to be corrected, they need to be disclosed on the 990 in the year that they are discovered. The IRS expects that the hospital organization will, as part of its correction, either establish policies and procedures that promote compliance with section 501(r) or review its existing procedures and revise them if appropriate. Rev. Proc. 2015-21, 2015-13 I.R.B. 817, § 6.01(4). In this context, the review and revision of policies and procedures should be done formally, and it probably should involve senior management. Implementation of the policies and procedures should also be documented.

Hospital organizations should also review their records relating to the adoption of a community health needs assessment and related implementation strategy, the financial assistance policy, the billing and collection policy, and similar items. In examination, the IRS is requesting board minutes or resolutions reflecting the adoption of these items. If the formalities were not observed, it probably makes sense to fix the problem and to consider disclosing it.

Since violations of section 501(r) create a risk that a hospital organization will lose its tax exemption, exempt organizations operating hospitals should evaluate their compliance before the IRS does.

By: Jim Malone

Jim Malone is a tax attorney in Philadelphia. A Principal at Post & Schell, he focuses his practice on federal, state and local tax controversies. Learn more about Post & Schell's Tax Controversy Practice >>

This entry was posted in **Blog** and tagged **Affordable Care Act**, **hospital organization**, **non-compliant facility tax**, **revocation**, **section 501(r)**, **tax-exempt** by **Jim Malone**. Bookmark the **permalink [http://taxcontroversyposts.postschell.com/heal-thyself-a-look-at-audits-of-hospital-organizations/]** .