Tax Issues in Joint Ventures and Acquisition for Hospitals and Academic Medical Centers
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Agenda

• Ancillary Joint Ventures – A Refresher
• Reorganizations – Revisited
Ancillary Joint Ventures – A Refresher
Tax Considerations for Ancillary Joint Ventures

- The environment: Health care systems have to provide more services for more people with fewer resources.
- The restrictions: No shareholders to ask for additional funding; national and state health care regulations
- One option: ancillary joint ventures
  - Source of alternative capital
  - Mitigate business risk
Tax Considerations for Ancillary Joint Ventures

• Smaller in size and scope than whole system joint ventures – they also usually have a medical focus
• Types of ancillary JVs (included but not limited to):
  – cardiac
  – pulmonary
  – diagnostic imaging services
  – physical therapy
  – ambulatory surgery
  – durable medical equipment
Tax Considerations for Ancillary Joint Ventures

- Who participates in an ancillary JV?
  – the health system or systems
  – physicians (as individuals or as a group)
  – other business partners

- The Law (Treas. Reg. § 1.501(c)(3)-1(c)(1)): A tax-exempt health care system can participate in a partnership JV if:
  – (1) participation in the partnership furthers its tax-exempt purpose, and
  – (2) no more than an insubstantial amount of the partnership’s activities are not in furtherance of the health system’s tax-exempt purposes.
Test 1: "Control" is Key:

- Does the Tax-Exempt Partner have voting control? (Answer: sometimes but not always!)
- In the absence of voting control, what other mechanisms are in place to give the tax-exempt partner "control"?
  
  - Redlands (9th Cir. 2001): 50/50 Board = no "control"
  
  - St. David's (5th Cir. 2003): 50/50 Board + partnership agreement required the JV promote tax-exempt charitable purposes of hospital, even to the detriment of the partnership = "control" by tax-exempt entity
Tax Considerations for Ancillary Joint Ventures

• What hurt "Redlands"
  – 1) there was no obligation in the partnership document to fulfill a charitable purpose;
  – (2) a lack of formal control;
  – (3) the requirement to go to arbitration in the event of a deadlock between the equally-split Board;
  – (4) the presence of a long-term management contract by which the tax-exempt partner abdicated some authority;
  – (5) the delegation of significant decisions to a medical advisory group which was also split 50/50 with the for-profit partner; and
  – (6) a lack of informal control.
Tax Considerations for Ancillary Joint Ventures

• Why does it matter how the IRS views the joint venture?
  – If there is no control, then the activity could be UBTI
  – If the UBTI is too large, it endangers the tax-exempt status of the health care system

• Strategies to protect the tax-exempt entity partner:
  – Provide the services to "patients" of the hospital
  – Establish that the joint venture furthers the tax-exempt purposes of the health care system
  – Make the documentation strong – use them as a way to establish control by the tax-exempt parent over the joint venture
Joint Venture Strategies

**Tax / Other Considerations**
- Corporate Structure
- Partnership / LLC Structure
- Management Agreements
- Intermediate Sanctions
- Compensation
- Fair Market Value
- Other

**Exempt Partner Considerations**
- Who 'controls' the JV?
  - Ownership (>50%)
  - Voting rights
  - Governance
  - Charitable mission
  - Rights over key decisions
  - Unrelated Business Income
- Risk to Exempt status
  - Political / Lobbying activity
  - Misuse of charitable funds
  - Mismanagement
  - Conflicts of interest
Joint Venture Strategies

Tax / Other Considerations

- Corporate Structure
- Partnership / LLC Structure
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- Fair Market Value
- Other

- RVU Models recommended
- Incentive models recommended, 100% fixed compensation NOT recommended
- Consider FMV of entire package
- Bonuses, Ok as long as total = FMV
- Non-compete agreements
- Deferred compensation (limited, depending on corporate structure)
- Fringe Benefits & Retirement Plans

- Keep compensation models as simple as possible and as clear as possible—the less subjectivity the better
Joint Venture Strategies

Tax / Other Considerations

- Corporate Structure
- Partnership / LLC Structure
- Management Agreements
- Intermediate Sanctions
- Compensation
- Fair Market Value
- Other

- Applies to transactions between tax-exempt organizations and “disqualified persons,” those who have the ability to significantly influence the organization
  - Physicians can be disqualified persons
- "Rebuttable presumption of reasonableness"
  - Transaction must be at fair market value
  - Approved by governing board or committee
  - Approval documented in board minutes
Reorganizations – Revisited
Hospital Reorganizations – A brief history

• 1980s: Hospitals began to reorganize into a multi-organizational structure for various reasons
  – increased third party reimbursement by spinning off hospital's charitable endowment
  – mitigate legal and business risk
  – desire to engage in new ventures which were placed in new controlled, for-profit subsidiaries
Hospital Reorganizations – A brief history

- 1980s (cont'd):
  - Trying to create different sphere of business activities to ensure the focus of Board and Management
    - Hospital – healthcare
    - Foundation – endowment and development
    - For-profit entity – new ventures
Hospital Reorganizations – A brief history

- 1990s to Current: Hospital Consolidations
  - cost reimbursement no longer in place – need for separate organizations no longer exists
  - need for cost savings and economies of scale are now the focus
  - joint ventures – how to structure (within exempt organization, partnership, or for-profit "C" corporation)
Hospital Reorganizations – A brief history

- 1990s to Current: Hospital Consolidations (cont'd)
  - tax-exempt healthcare systems focus on aligning healthcare "tax related" activities back to a tax-exempt hospital or a related exempt org
    - IRC § 337(d) issues
      - focus on acquiring physical practices
        - what is the best way to do it?
Case Study: Meritus Health System (formerly Washington County Health System)
Case Study: Meritus Health System

Washington County Health System, Inc.
Corporate Relationship Structure

Washington County Health System, Inc.

Washington County Hospital Association
- Acute care hospital
- Home Health of WCH
- Behavioral Health Services
- EAP
- Psychiatry Practice
- Robinwood Endocrinology/Diabetes Education Center/Nutrition Education Center
- John R. Marsh Cancer Center
- Professional Court Imaging
- Total Rehab Care at Robinwood

Antietam Insurance Company, LTD

Washington County Hospital Endowment Fund, Inc.

Antietam Health Services, Inc.
- AHS Proper
- Home Care Pharmacies
- Equipped for Life
- Managed Services Organization
- The Learning Center (TLC)
- Hagerstown Medical Laboratory, Inc.
- Medical Practices of Antietam, LLC
- Health @ Work, LLC
- Antietam Urgent Care, LLC

Washington County Hospital Auxiliary, Inc.

Antietam Healthcare Foundation, Inc.

Antietam Health Services, Inc.
Joint Ventures
- Robinwood Diagnostic Imaging, LLC d/b/a Diagnostic Imaging Services
- GI Real Estate Company, LLC
- Robinwood Surgery Center, LLC
- Endoscopy Center at Robinwood, LLC
- Endoscopy Real Estate Development, LLC
- Western Maryland Medical Supply, LLC

Washington County Health System, Inc.
Joint Venture
- Colonial Regional Alliance, LLC

Washington County Hospital Joint Ventures
- Maryland Care, Inc. (MCO) d/b/a Maryland Physicians Care
- TriState Health Partners (PHO)
- Maryland eCare, LLC

LEGEND
- BOLD indicates legal corporate members
- Regular type indicates subsidiary departments or business units
Case Study: Meritus Health System

Facts

• A product of the 1980s Hospital Reorganization process
  – cost based third party reimbursement
  – mitigate legal and business risk
  – create difference business entities to focus on specific business areas
  • Healthcare – Washington Co Hospital Association
  • Endowment – Wash Co Hospital Endowment Fund
  • Development – Antietam Healthcare Foundation
  • New Ventures – Antietam Health System, Inc. (for-profit entity)
Case Study: Meritus Health System
Facts

- Activities that furthered Meritus Health System's tax-exempt status were also placed in a for-profit subsidiary:
  - lab operations
  - urgent care
  - physician practices
  - other
Case Study: Meritus Health System

Action Plan

1. GT and Attorneys recommendation to Meritus was:
   - governance efficiencies and continuity
   - long-term tax reduction
   - short-term cost to implement transaction (including one time transaction cost related to IRC § 337(d))
   - avoid disruption to existing business arrangements

2. Meritus created Meritus Holdings LLC (a disregarded entity to the Hospital) to hold:
   - "related operations" being transferred from for-profit sub
   - hold stock of for-profit sub, Meritus Enterprises, Inc. (formerly Antietam Health Services, Inc.)
Case Study: Meritus Health System
Action Plan

3. The following "related" activities from Meritus Enterprises, Inc. were transferred to Meritus Holdings LLC
   - lab operations
   - urgent care operations
   - Health at Work operations
4. Due to "Physician Political" and other Business/Tax Issues, the following "possibly related" operations did not transfer from Meritus Enterprises, Inc. to Meritus Holdings LLC

- physician practices
- diagnostic services
- other operations

**On-going discussion are being pursued in regard to the transfer of these operations (including due diligence)**
Case Study: Meritus Health System

Meritus Health, Inc. Org Chart

- Meritus Health, Inc.
  - Meritus Medical Center Endowment Fund, Inc.
  - Meritus Medical Center Endowment Development Co, Inc.
  - Meritus Medical Center, Inc.
  - Meritus Holdings, LLC
    - Health At Work, LLC
    - Meritus Urgent Care, LLC
  - Meritus Insurance Company, LTD
    - Downtown Urgent Care, LLC
    - Hagerstown Medical Laboratory, Inc.
  - Meritus Healthcare Foundation, Inc.

Meritus Enterprises, Inc.
- Medical Practices of Antietam, LLC
- Diagnostic Imaging Services LLC
- Home Care Pharmacies
- Western Maryland Medical Supply, LLC
- MSO/Practice Systems Operations
- Robinwood Surgery Center, LLC
- GI Real Estate LLC
- Equipped for Life
- The Learning Center

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Case Study: Meritus Health System
Four Steps to the Decision and Reorganization

A. Tax and legal review/due diligence

B. Formal valuation study to determine value including tangible and intangible assets) related to determining the FMV of the business operations being transferred

C. Tax planning related to the IRC § 337(d) gain determined

D. Tax planning to deal with tax-exempt UBTI planning issues and other ancillary tax issues such as payroll, etc.
Case Study: West Penn Allegheny Health System, Inc.
Case Study: West Penn Allegheny Health System, Inc.

Former Structure

West Penn Allegheny Health System, Inc.

Includes three Hospitals:
- Allegheny General Hospital
- The Western Pennsylvania Hospital
- Forbes Regional Hospital

Canonsburg General Hospital
Alle-Kiski Medical Center
Physician Organizations
Fund Raising Organizations
Allegheny-Singer Research Institute

All are tax-exempt under IRC § 501(c)(3)
1. Made application for IRC § 501(c)(3) status and not a private foundation under IRC § 509(a)(3) Type III
2. Highmark, Inc. is a PA non-profit corporation but is taxable under IRC § 833 as an insurance company. It provides insurance coverage and is a Blue Cross / Blue Shield licensee.
Case Study: West Penn Allegheny Health System, Inc. (WPAHS)
WPAHS/Highmark Affiliation

Background:

1. Two major health providers in Western PA
   1. WPAHS
   2. University of Pittsburgh Medical Center and System (UPMC)

2. Two major health insurers in Western PA
   1. Highmark – Blue Cross/Blue Shield
   2. UPMC Health Plan

3. WPAHS' operations near bankruptcy – 2010 and forward
Background (cont'd):

4. Highmark provided WPAHS $500 million in charitable funding under affiliation agreement
5. Since 2009, UPMC and Highmark cannot come to an agreement for rates for Highmark insured served at UPMC
6. At issue: affordable health care - alternatives needed for the people of Western PA, Eastern Ohio and West Virginia
Case Study: West Penn Allegheny Health System, Inc. (WPAHS)

WPAHS/Highmark Timeline:

1. 2009: Financial difficulties continue for WPAHS
2. 2009: Highmark/UPMC in conflict regarding continued business arrangement to provide for the healthcare needs of Highmark insured
   
   UPMC Health Plan – continues to gain market share against Highmark
3. 2010: Highmark provides financial assistance to WPAHS
4. October 31, 2011: Highmark, WPAHS, UPE (new Parent) & UPE Provider Sub sign affiliation agreement
Case Study: West Penn Allegheny Health System, Inc. (WPAHS)

WPAHS/Highmark Timeline:

5. November 1, 2011: UPE and UPE Provider Sub apply for tax-exempt status under IRC §§ 501(c)(3)/509(a)(3) Type III with IRS

6. 2012: Highmark provides WPAHS $500 million charitable contribution

7. June 2012: IRS grants tax-exempt status to UPE (Parent) and UPE Provider Sub

8. April 2013: Formal affiliation is being held up by PA Insurance Commission approval
Thank you!

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