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CLIENT ADVISORY

December 19, 2011

Tax-Exemption for Your ACO? Watch Out for PHO and IPA Pitfalls

Shortly after the Centers for Medicare & Medicaid Services ("CMS") released proposed regulations on March 31, 2011 describing the Medicare Shared Savings Program ("Shared Savings Program") and accountable care organizations ("ACOs"), the Internal Revenue Service ("IRS") released Notice 2011-20 to discuss how tax-exempt organizations may participate in an ACO.[1] Based upon CMS's issuance of the final Shared Savings Program regulations, the IRS released Fact Sheet FS-2011-11 on October 20, 2011 to provide additional information for tax-exempt organizations participating in an ACO and to confirm that an ACO may qualify for tax-exemption under Section 501(c)(3) of the Internal Revenue Code ("IRC") in certain situations. Organizations concerned about tax-exemption issues that have formed or are planning to form an ACO should ensure that the ACO is not organized and operated in a manner similar to many physician-hospital organizations ("PHOs") or individual practice associations ("IPAs"), as those organizations are typically focused on network delivery systems that benefit their participants. A tax-exempt ACO needs to be organized and operated exclusively for exempt purposes that benefit the community rather than individual interests within a provider network.

Prior IRS guidance from Revenue Rulings 2004-51 and 98-15 provide a "control test" that applies when an exempt organization participates in a joint venture with private parties. The joint venture would need to be organized and operated for charitable purposes and the exempt organization would need to demonstrate exclusive control over the joint venture's exempt functions. Several different factors that include ownership or management control are often considered in making this determination. Depending upon how substantial the activities of the joint venture are to the participating exempt organization, these rules may impact the exempt organization's ability to continue to qualify for exemption in addition to the taxable nature of any distributions it receives from the joint venture.

In FS-2011-11, the IRS explained that an exempt organization may participate in an ACO joint venture with private parties. Specifically, if an ACO joint venture is engaged exclusively in the Shared Savings Program, the tax-exempt participant's income from the ACO joint venture would generally not be subject to the tax on unrelated business income, *even if the exempt organization does not meet the "control test."* The IRS indicated that CMS's regulation and oversight of the ACO would be sufficient "control" to ensure that the ACO furthers the charitable purpose of lessening the burdens of government. However, if the ACO decided to participate in any other activities, the "control test" would apply.

If an ACO is engaged exclusively in Shared Savings Program activities, the IRS has indicated that the ACO will qualify for tax-exempt status if it meets all of the requirements of IRC Section 501(c)(3) status. This does not apply to joint venture ACOs subject to taxation as a partnership or ACOs owned by private interests. The ACO may participate in other non-Shared Savings Program activities and still qualify for tax exemption so long as the ACO "engages exclusively" in

[1] Please see HDJN's Client Advisory dated April 19, 2011, which discusses the proposed regulation and Notice 2011-20 in greater detail. The Client Advisory may be found at http://www.hdjn.com/pdfs/advisories/2011/ClientAdvisory-CMSAnnouncesACOProposedRules4.19.11.pdf.

one or more activities that accomplish one or more charitable purposes. The IRS mentioned that other activities may include serving Medicaid or indigent populations, which would relieve the poor and distressed or the underprivileged. "Other activities" would not include an ACO's participation in accountable care programs offered by commercial payors.

The IRS has raised concerns about the ability to a PHO or an IPA to qualify for tax-exempt status under IRC Section 501(c)(3), as they are often not organized and operated for a charitable purpose but to benefit the interests of the network participants. A recent example involves a private letter ruling released by the IRS on November 10, 2011 PLR 201145025 where the IRS refused to grant tax-exempt status to an applicant. In that scenario, the applicant's sole member was a hospital that was recognized as exempt under IRC Section 501(c)(3). The IRS explained that applicant was not organized for charitable purposes, as required under Section 501(c)(3), because the applicant's purposes involved operating a healthcare delivery network that benefited private parties. The IRS also noted that the applicant operated primarily for non-charitable purposes since it arranged for the provision of medical services through contracted entities.

In sum, an ACO seeking exemption pursuant to FS-2011-11 should be mindful that it must be organized and operated exclusively for charitable purposes. Additional activities undertaken by an ACO that participates in the Shared Savings Program may have an impact on the ACO's ability to qualify for tax-exempt status. If the ACO is a joint venture that undertakes additional activities, its exempt owners would be subject additional "control test" requirements related to the tax status of their distributions.

For further guidance on tax-exemption issues for ACOs and other healthcare organizations, please contact Michael R. Newby (mnewby@hdjn.com) or James M. Daniel, Jr. (jdaniel@hdjn.com). Each may also be reached at 804-967-9604.

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