Ballard Spahr LLP

# Tax, Transactional, and Regulatory Aspects of Business Transactions in the Health Care Industry

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| Saba Ashraf<br>Partner, Tax<br>Ballard Spahr LLP<br>999 Peachtree Street<br>Atlanta, Georgia 30309-3915<br>678.420.9372<br>AshrafS@BallardSpahr.com | Larkin Ellzey<br>Associate, Healthcare<br>Ballard Spahr LLP<br>999 Peachtree Street<br>Atlanta, GA 30309-3915<br>678.420.9458<br>EllzeyL@BallardSpahr.com | Jennifer T. McFarland<br>Associate, Healthcare<br>Ballard Spahr LLP<br>999 Peachtree Street NE<br>Atlanta, Georgia 30309-3915<br>678.420.9542<br>McFarlandJ@BallardSpahr.com |

# Speaker Bio

**Saba Ashraf**, *Partner*
678.420.9372
ashrafs@ballardspahr.com

Saba Ashraf advises clients worldwide on corporate and partnership taxation matters. Ms. Ashraf has managed the tax aspects of a wide range of complex business transactions, including coordination with internal and external non-tax counsel and financial advisers. She handles the tax-related issues involved in domestic and international mergers, acquisitions, and spin-offs; recapitalizations; leveraged buyouts; going private transactions; joint ventures; fund formations; private equity investments; debt restructurings and loan workouts; securitizations; and the tax aspects of REITs and investments in real estate. She also has experience dealing with the IRS and state tax agencies during state and federal audits.

Ms. Ashraf has represented major financial services institutions and investment concerns, global manufacturing firms, and Fortune 500 companies, and she has managed the tax issues on 10-figure deals, both in the United States and abroad. She has also served as an additional resource to other law firms and accounting firms.
Ms. Ashraf is the author of *Tax Geek Tips You Ought to Know*, a monthly publication of the Ballard Spahr Tax Group (link below).

### *Representative Matters*

- Represented a publicly traded company with respect to structuring and other tax aspects of acquisitions of, and joint ventures with, various companies, including joint ventures with not-for-profit companies
- Represented an equipment finance company regarding the U.S. federal income tax aspects of the cross-border securitization of lease receivables
- Advised on tax aspects relating to the formation and operation of a private equity fund, attracting U.S. and non-U.S. investors, formed to target investments in the Southeast
- Represented a real estate developer in negotiating tax and business aspects of a joint venture agreement with respect to a major development project
- Represented a Canadian gold mining company with significant U.S. shareholders in a three-way business combination, in a deal valued at more than $8 billion
- Advised a national home builder on offerings of Tangible Equity Units, Senior Notes, Common Stock, and Mandatorily Convertible Notes
- Represented an investor in the extraction of equity in real estate on a tax-deferred basis using a leveraged partnership
- Represented several Chinese companies in tax issues concerning investment and expansion in the United States

Ms. Ashraf has been listed in Chambers USA: America's Leading Lawyers for Business in the area of tax law from 2009 through the present. She has also been named a Super Lawyer by Law & Politics magazine for excellence in tax law (2008-present), to Georgia Trend magazine's Legal Elite (2007-present), and one of America's Best Lawyers (2010-present).

### *Publications*

- "So You Want To Issue Profits Interests," Tax Geek Tips You Ought To Know, September 2014
- "Tax Distribution Provisions," Tax Geek Tips You Ought To Know, August 2014
- "Management Fee Waivers: The Current State of Play," Journal of Taxation and Regulation of Financial Institutions, November/December 2013
- "Upcoming U.S. Tax Increases May Accelerate M&A, Property Sales and Dividends to 2012," Financier Worldwide Global Reference Guide Corporate Tax, July 2012
- "Disclosing Confidential Matters Under Recent Tax Shelter Regulations," 4:12 Derivatives Fin. Products Rep. 1, August 2003
- "Tax-Free Corporate Mergers Have Been Redefined for the LLC Era," 30:3 Corporate Taxation 3, May/June 2003; reprinted in PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings, 2004-2009
- Co-author, "Tax-Free Mergers for Disregarded Entities," 2:11 Mergers and Acquisitions 3, March 2002

***Recent Speaking Engagements***

- "Tax Allocation in Partnerships and LLCs - Minimizing Tax Impact Through Strategic Allocation of Income, Gains, Losses and Liabilities," Strafford Webinar, November 2013
- "Tax Allocation in Partnerships and LLCs Minimizing Tax Impact Through Strategic Allocation of Income, Gains, Losses and Liabilities," Strafford Webinar, April and February 2013
- "Tax Planning for Maximum Benefit in Real Estate Transactions," Vermont Bar Association and Atlanta Bar Association Webinar, January 2013
- "LLCs: Latest Developments in Federal and State Tax Treatment," Strafford Webinar, January 2013
- "LLCs: Recent Developments and Current Issues," Lorman Webinar, December and June 2012
- "Buying and Selling Privately Held Businesses: Tax Planning and Considerations," Institute of Continuing Legal Education in Georgia, November 2012

Ms. Ashraf is a graduate of New York University School of Law (LL.M., taxation, 1997) and Hofstra University School of Law (J.D. 1993), where she was a member of the Hofstra Law Review and received the Award for Excellence in Taxation Courses and Constitutional Law Courses. She earned her bachelor's degree in accounting at New York University Stern School of Business (B.S., cum laude, 1990). Ms. Ashraf is fluent in Urdu.

Ms. Ashraf is Corporate Development Chair of Autism Speaks Georgia. Other professional activities include:

- Past Chair, Tax Committee of Business Law Section of the American Bar Association
- Past Charter Member, Atlanta Chapter of TiE (The Indus Entrepreneurs)
- Charter Member, OPEN-Atlanta (Organization of Pakistani Entrepreneurs of North America)
- Co-Chair of Programming, 2010 NASABA (North American South Asian Bar Association) Annual Convention

# Speaker Bio

**Larkin B. Ellzey**, *Associate*
678.420.9458
ellzeyl@ballardspahr.com

Larkin B. Ellzey assists clients in all aspects of mergers and acquisitions, joint ventures, franchise relationships, entity formation and structure, commercial leasing, and general transactional matters. Mr. Ellzey has significant, in-depth experience drafting, reviewing, and negotiating asset purchase agreements, merger agreements, stock purchase agreements, franchise and area development agreements, operating agreements, commercial real estate leases, and services agreements.

Mr. Ellzey has served as lead attorney in the development and ongoing operations of multiple franchisee and franchisor businesses, providing services ranging from corporate structure to negotiation of development agreements to asset acquisitions and sales. He regularly advises on compliance with the Stark law and Anti-Kickback Statute in the context of financial relationships between hospitals and providers of health care services.

*Representative Matters*

*Corporate*

- Served as lead counsel in the development stages and establishment of contractual arrangements for an entity providing consulting services in the food and beverage industry
- Served as lead counsel in the asset acquisition of an insurance agency
- Served as lead associate in the merger of two major insurance companies
- Served as lead associate in the acquisition of two golf and country clubs by an investor group
- Served as lead associate in the acquisition of a golf and country club by a subsidiary of an international industrial company
- Served as lead associate in a series of asset acquisitions representing an electrical wholesaler acquiring competitors
- Advised on the corporate structure and ownership transfers of a regional freight line company and its various subsidiaries and affiliates
- Served as lead counsel in the corporate restructuring of a local restaurant chain
- Assisted in analyzing and documenting the corporate structure and ownership transfers of a tobacco distributor and its subsidiaries and affiliates
- Advised on the corporate structure and ownership transfers of a wholesale meat distributor

*Franchise*

- Served as lead counsel and client contact in the process of establishing a franchise system and corporate structure for a fast casual restaurant chain
- Served as lead counsel in the negotiations and development of a limited liability company structure to serve as the holding company of a new restaurant franchise
- Served as lead counsel in the negotiations and development of a limited liability company structure to serve as the franchising entity of a smart phone repair service provider
- Served as lead counsel for a national pizza chain franchisee in the negotiation of the franchise relationship with the franchisor and the corporate structure of the franchisee
- Served as lead counsel for a national fast casual restaurant chain franchisee in the negotiation of the franchise relationship with the franchisor and the corporate structure of the franchisee
- Served as lead counsel in the asset acquisition of a franchised restaurant unit by a new franchisee
- Served as lead counsel in the asset sale of a franchisee's developed units and its development rights to the franchisor

*Health Care*

- Served as lead associate in the affiliation of two hospital systems
- Served as lead associate on behalf of a hospital client in a controversial acquisition of a local cardiology group
- Served as lead associate on behalf of a hospital client in the acquisition of the largest local cardiology group
- Served as lead associate on behalf of a hospital client in the joint venture with a prominent cardiovascular surgery group
- Served as lead associate on behalf of a hospital client in the acquisition of a general surgery group
- Served as lead associate on behalf of a hospital client in the acquisition of an OB-GYN group
- Served as lead associate on behalf of a hospital client in the acquisition of a family practice group
- Served as lead associate in a series of acquisitions of three nursing homes

Mr. Ellzey is a graduate of the University of South Carolina School of Law (J.D. 2008), where he was a member of Phi Delta Phi, and the University of South Carolina (B.S., cum laude, 2005), where he was recipient of the Life Scholarship for 2001-2005.

*Publications*

- Simsbury-Avon Preservation Society, LLC v. Metacon Gun Club: The Difficult Task of Applying the Supreme Court's Rapanos Analysis, 15 SE. Envtl. L.J. 509-536, 2007

# Speaker Bio

**Jennifer T. McFarland**, *Associate*
678.420.9542
mcfarlandj@ballardspahr.com

Jennifer T. McFarland represents clients in a wide range of corporate matters, including the formation and organization of business entities, corporate governance, mergers and acquisitions, joint ventures, commercial transactions, and dissolution. She advises senior management and corporate directors on governance and strategic planning issues and counsels clients on regulatory compliance and privacy matters.

Ms. McFarland has significant experience in drafting and negotiating contracts, including asset purchase, stock purchase, shareholder, security, supply, service, equipment lease, employment, software license, outsourcing, confidentiality and non-disclosure, clinical trial, business associate, and affiliation agreements.

*Representative Matters*

- Represented the purchaser in the acquisition of a privately held software company that provides information technology services to the U.S. Department of Veterans Affairs
- Represented a company that provides wastewater treatment services to Caribbean resorts in a successful dissenter's rights transaction that involved a merger and share exchange
- Represented a start-up mobile technology company that specializes in security systems in a private offering to obtain venture capital funding
- Represented a health system in an asset sale and subsequent membership interest transfer of an ambulance service company
- Represented a hospital in the establishment of a joint venture ambulatory surgery center with a physician practice group and advised on health care regulatory requirements, state licensure, and corporate structure
- Represented a multi-state health system in the negotiation of a multimillion-dollar supply agreement for infusion equipment and disposables
- Represented a manufacturing company in the purchase of a corporate jet valued at over $19 million
- Represented a multi-hospital health system in the purchase of an electronic health records system and related information technology services for more than $30 million

Ms. McFarland is a member of the Business Law, Health Law, and Science & Technology Law Sections of the American Bar Association; the Business, Corporate Counsel, Health Law, and Technology Law Sections of the State Bar of Georgia; the Health Information and Technology, Hospitals and Health Systems, and Business Law and Governance Practice Groups of the American Health Lawyers Association; the Georgia Association of Women Lawyers; and the International Technology Law Association.

She is a former Emerging Leaders Committee member (2013-2014) of the Savannah Community Foundation, former Assistant Secretary (2012-2013) of the Savannah Classical Academy, and former Community Council member (2011-2013) of the Savannah Technical College Foundation.

Ms. McFarland graduated from the University of Georgia School of Law (J.D., cum laude, 2010), where she was Conference Editor for the Georgia Journal of Int'l and Comparative Law, Student Representative to the UGA Student Bar Association's Academic Affairs Committee, a member of the Georgia Society for International and Comparative Law, a member of the Women's Law Student Association at UGA, and a mediator in the Athens-Clarke County Magistrate Court. She is also a graduate of the University of Georgia (M.Ed. 2007, and B.B.A., magna cum laude, 2000), where she was elected to Pi Lambda Theta (International Honor Society and Professional Association in Education), Phi Kappa Phi National Honor Society, Beta Gamma Sigma (Business National Honor Society), and the Golden Key National Honor Society. She is proficient in French.

*Publications*

- "Stage 2 Meaningful Use Set to Kick Off in 2014 for Health Care Providers," Business in Savannah, December 18, 2013
- Co-author, "Licensor and Licensee Dealmaking Tips to Reduce Data Privacy and Security Risks," Law Seminars International 22nd Annual Seattle Conference on Technology Law, Seattle, December 12, 2013
- "CEDAW's Flaws: A Critical Analysis of Why CEDAW Is Failing to Protect a Woman's Right to Education in Pakistan," Journal of Law & Education, October 1, 2009

# Table of Contents

# Disclaimer

The topics and issued discussed herein are discussed only at a general level in order to allow for a productive discussion of the relevant issues.

This presentation is intended to be informational and does not constitute legal advice regarding any specific situation.

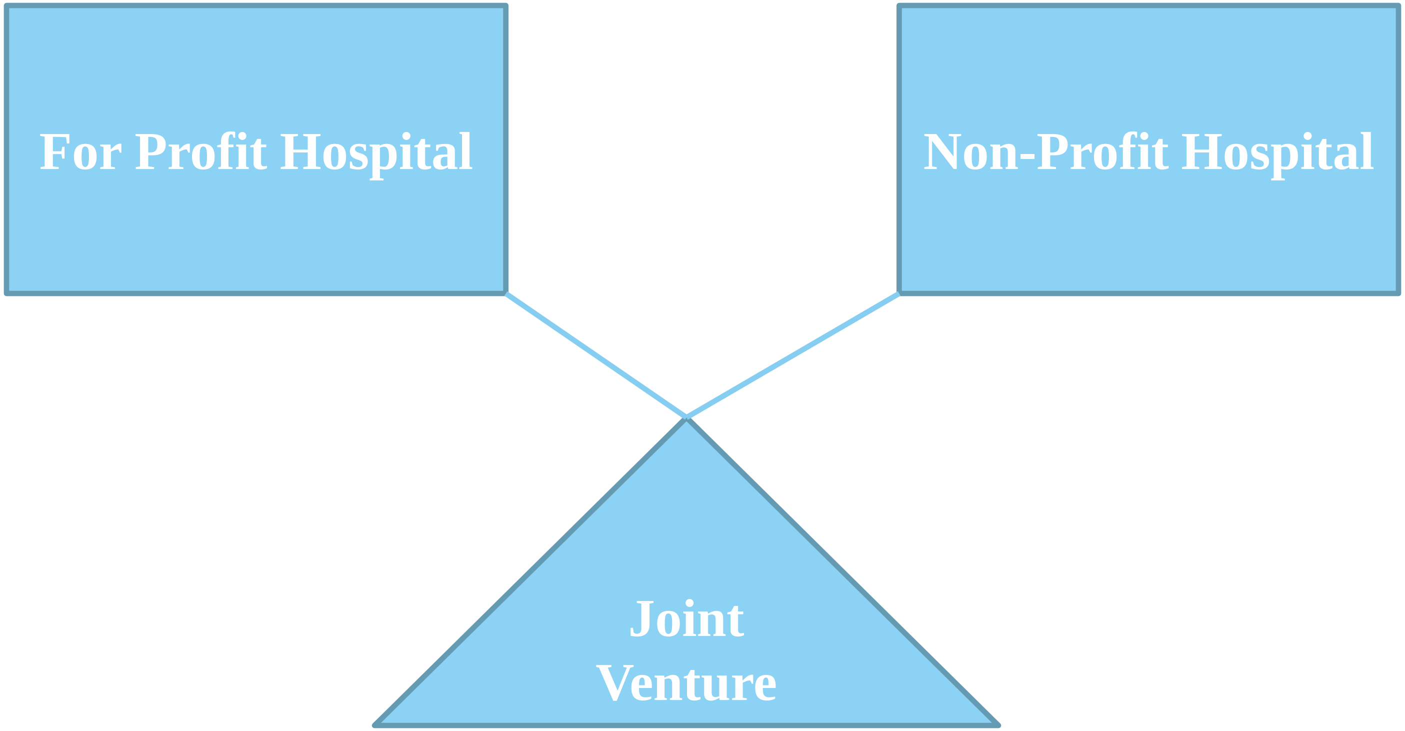
# Healthcare Transaction Trends

- Hospitals and healthcare systems have been consolidating at a feverish pace in recent years.  Perhaps this is in large part because they are under pressure to contain costs while simultaneously delivering higher-quality care.
- Mega-Mergers.  Example: CHS-Health Management Associates, Inc. merger valued at $7.6 billion.
- But also many non-mega unions are taking place among hospitals and healthcare systems.
- Further, hospital acquisitions of physical medical groups continue to take place.

# Healthcare Transactions Models

- As hospitals, health systems and others in the industry undertake business acquisitions and combinations, they can choose to structure deals in a variety of ways depending on objectives.
- In large part, the structure will be driven by business, tax, regulatory and other transactional considerations.
  - A transaction can take the form of a traditional asset or stock purchase transaction.
  - Increasingly, healthcare organizations are adopting a joint venture model, under which the two parties both hold ownership in a new entity.
  - Finally, parties can also pursue various "alternative" transaction models that fall short of a full merger or sale.

# Scenario 1: Joint Venture



# Scenario 1: Joint Venture

- A joint venture is simply two or more parties coming together to jointly undertake an activity and share in the profits and losses derived from such activity.
- The recent economic downturn has caused many tax-exempt health-care organizations and for-profit parties to examine ways to consolidate their operations and expand their reach – with one of the most common approaches being through a joint venture.
- Joint ventures have been particularly useful models as hospitals try to capture more ancillary and out-patient services, and as parties seek alliances – for example between physician group and hospitals, and even between hospitals themselves.

# Scenario 1: Joint Venture

Entity/Choice of entity:

A joint venture may take a variety of forms.

- It may be created as a separate legal entity, such as a general partnership, a limited partnership , a limited liability company ("LLC"), or a corporation.
- In other cases, it may represent merely a contractual relationship, such as a joint operating agreement, service and management contracts or some other type of collaboration agreement.

# Scenario 1: Joint Venture

- In order to ensure that there is limited liability, most parties form an entity.
- Choice of Entity:
  - Corporation –
    - biggest hurdle: highly tax inefficient, especially for the for-profit party.
  - Limited partnership
    - offers limited liability to the limited partners; however, need to have a general partner with unlimited liability; often the general partner is newly formed, single purpose entity.
  - Limited Liability Companies or LLCs
    - by far, the most common entity used to serve as the joint venture vehicle.

# Scenario 1: Joint Venture

## LLC:

- Provides members with limited liability
- Allows them flow-through tax treatment and no entity-level tax
- At least two basic advantages over partnerships (including limited partnerships) :
  - Unlike a general partner who has unlimited liability with respect to the liabilities of a partnership, no member of the LLC has personal liability for the debts and obligations of the LLC; and
  - Unlike a limited partner in a limited partnership, all members are permitted to materially participate in the management of the LLC without risking personal liability for the debts of the LLC.

# Scenario 1: Joint Venture – Entity

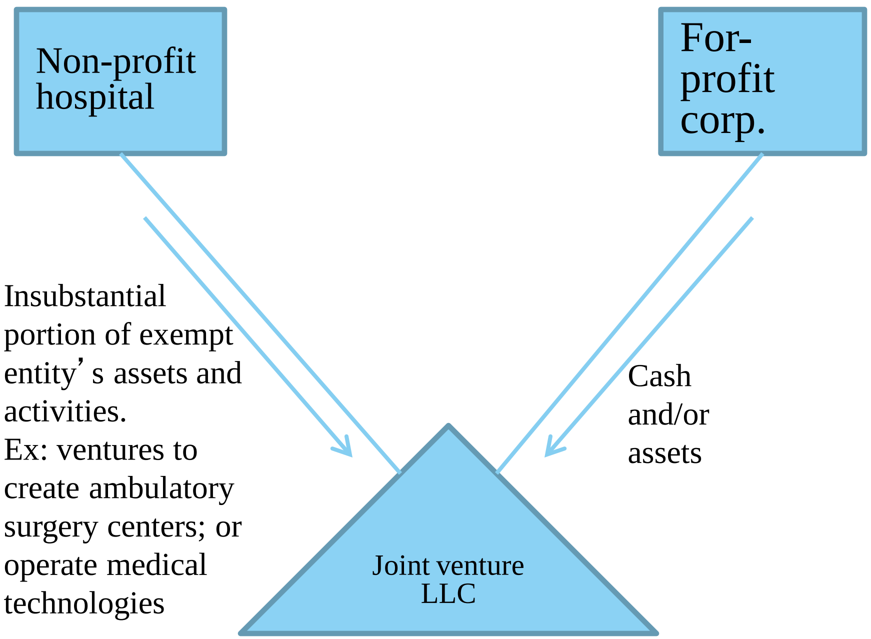
- Generally, LLCs with 2 members are treated as partnerships for U.S. federal income tax purposes.  This means that they are flow-through entities.
- Flow-through tax treatment is generally attractive for both tax-exempt and taxable participants.
- In a flow-through structure, the for-profit's share of joint venture net income is subject to only one level of tax – and only in the hands of the for-profit participant.
- The tax-exempt partner is not taxable on its share of joint venture income, so long as the joint venture's activities further its exempt purpose.

# Scenario 1: Joint Venture – Flow-Through Vehicle

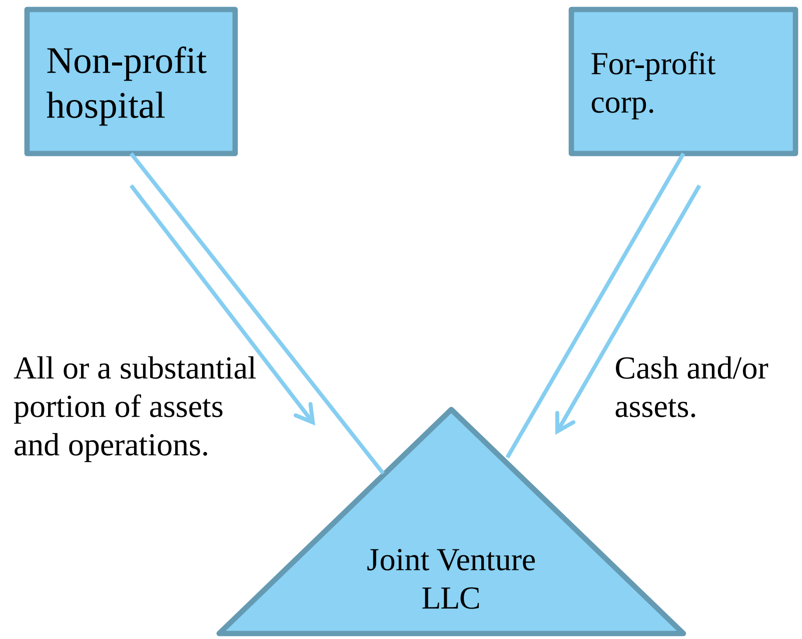
- An exempt organization that participates in a joint venture structured as a flow-through entity will be treated as conducting directly its proportionate share of the joint venture's activities.
- This affects 2 important things:
  - The exempt participant's tax liability on "unrelated business taxable income" or "UBTI"; and
  - Its qualification for tax exemption.

# Scenario 1: Healthcare Joint Ventures – 2 Main Types

## Ancillary Joint Ventures




## Whole-Entity



# Scenario 1: Joint Venture – All Joint Ventures

- Each time an exempt organization participates in a joint venture with a for-profit entity, it must be analyzed for prohibited (1) private inurement and (2) private benefit.
- The presence of any amount of private inurement or more than an incidental amount of private benefit may jeopardize an organization's continuing 501(c)(3) status.

# Scenario 1: Joint Venture – Private Inurement

- As a requirement of tax exemption, Section 501(c)(3) provides, in part, a restriction that "no part of the net earnings [of the organization] of which inures to the benefit of any private shareholder or individual."
- Private inurement occurs when an "insider" with respect to an exempt organization receives a benefit in excess of the fair market value of goods and services provided by the insider.
- The term "insider" is not precisely defined, but includes members of the organization's board, its officers, and their family members, entities owned by them, and likely others who may have a substantial level of influence over the organization (e.g., a key department head, or a medical group responsible for substantial hospital admissions).
- Where the other party to a joint venture is an insider, it becomes particularly important to ensure that any transactions with the co-venturer are at arm's length and at fair market value.

# Scenario 1: Joint Venture – Private Inurement

- Most obvious form of private inurement is excessive salaries.
- Other examples: providing goods or services to members or other insides without adequate consideration.
- Consequence of private inurement: revocation of the organization's tax-exempt status.

# Scenario 1: Joint Venture – Private Inurement – Intermediate Sanctions

- Any transaction that results in private inurement may also result in "intermediate sanctions" on the party that received the undue benefit. Section 4958 of IRC.
- The intermediate sanctions rules do not impose any liability on the tax-exempt organization itself. Rather, the rules were designed as means of addressing private inurement transactions by penalizing the persons who benefit from such transactions, rather than (or in addition to) revoking the organization's exemption.
- The intermediate sanctions rules authorize the IRS to impose an excise tax on any individual or entity who is a "disqualified person" with respect to the exempt organization and who receives a benefit from the organization that exceeds the value of goods or services that the disqualified person provides.

# Scenario 1: Joint Venture – Private Inurement – Intermediate Sanctions

- The tax is initially 25% of the excess amount.
- The IRS may impose an additional tax equal to 200% of the excess amount if the disqualified person fails to correct the transaction by repaying the excess to the exempt organization.
- An exempt organization officer or director who knowingly approves an excess benefit transaction may also be personally liable for a tax of 10% of the excess amount.
- Treasury Regulations provide a procedure for creating a rebuttable presumption that a transaction is reasonable (i.e., not an excess benefit transaction), and therefore does not trigger the excise tax under the intermediate sanctions rules:
  - The arrangement must be approved by the independent members of the exempt organization's board or an authorized committee;
  - The board or committee must rely on "appropriate data" as to the fair market value of the transactions; and
  - The board's or committee's action must be documented concurrently in writing on a timely basis (e.g., in meeting minutes).

# Scenario 1: Joint Venture – Private Benefit

- Section 501(c)(3) requires that an organization be organized and operated exclusively for charitable, religious, or educational purposes. An organization is not organized or operated for one or more of he purposes specified unless it serves a "public" interest, rather than a "private interest.
- A Section 501(c)(3) organization is prohibited from conferring benefits that are more than incidental on private parties (whether or not insiders), except where the benefits are provided to a charitable class of beneficiaries, such as the poor, the sick, or the elderly.
- For benefits to be incidental, and therefore permissible, they must be both quantitatively and qualitatively incidental.

# Scenario 1: Joint Ventures – Distinction Between Private Inurement and Private Benefit

- The private inurement prohibition applies only to insiders.
- Private inurement may result in private benefit, but not the converse.
- As to private inurement, no amount is acceptable.
- As to private benefit, “incidental” private benefit will not jeopardize the organization’s tax-exempt status.

# Scenario 1: Joint Venture – Avoiding Private Inurement and Private Benefit

- All joint ventures must be organized in a manner that ensures that the exempt organization will not effectively subsidize the for-profit participant in the venture, in order to avoid private inurement and/or an impermissible level of private benefit.
- Specifically,
  - Each joint venture party must receive an interest in the joint venture that is proportionate to the value for the party's contributions
  - Payments to participants or their affiliates for goods or services to the joint venture must be at arm's length at fair market value, and
  - The terms of the joint venture agreement must not put the exempt organization's assets at risk to the benefit of any for-profit participant.

# Scenario 1: Joint Venture – Valuation of Assets

- In order to ensure that the parties' interests in the joint venture fairly reflects the value of their contributions, it is critical that assets that either party is contributing to a joint venture be properly valued.
- A third party, independent valuation by a qualified appraiser should be considered.

# Scenario 1: Joint Venture – Other Private Inurement and Private Benefit Issues

- Distributions schemes should reflect arm's length terms.
- All unwinding of the joint venture should be done in such a manner that each member gets assets and other payments in proportion to their interests, and capital accounts.
- Other aspects of the LLC agreement should reflect arm's length terms – for example, the requirements to contribute additional capital.

# Scenario 1: Joint Ventures – Whole-Entity Joint Ventures – IRS Guidance

- In a whole hospital joint venture, the tax-exempt hospital remains in existence and, although it no longer conducts hospital operations directly, it receives allocated income and distributions from its interest in the joint venture entity.
- Key ruling: Rev. Rul. 98-15. Contains 2 examples: one good and one bad.
- Good: Hospital controls the joint venture and is able to ensure that the venture furthers its exempt purposes. Facts include:
  1. Majority hospital representation on the joint venture board,
  2. Governing documents that require the board to satisfy the community benefit standard without regard to maximizing profitability, and
  3. Joint venture management by an independent party.

## Scenario 1: Joint Venture – Whole-Entity Joint Ventures – IRS Guidance

- Bad Facts: the hospital is not able to further its exempt purpose through its participation in the joint venture. Facts include:
  1. 50/50 representation on the joint venture board
  2. No charitable override in the governing documents, and
  3. Joint venture management by an affiliate of the for-profit participant.

# Scenario 1: Joint Ventures – Whole-Entity Joint Venture – Control Required

- An ideal joint venture governance structure would allow the exempt organization to appoint a majority of the joint venture's board members, and require a majority of the exempt organization's board members for a quorum, or supermajority voting for certain actions.
- Though highly preferred that it exist, majority control of joint venture governance by the exempt organization may not be *absolutely* required. (Though it will make it harder to show that the joint venture will further the exempt partner's charitable purposes.)
- Key is establishing that profit motives do not subvert the exempt organization's charitable mission.
  - For example, the LLC operating agreement should specifically provide that the joint venture was formed for charitable purposes and that charitable purposes will take precedence over profit maximization.

# Scenario 1: Joint Ventures – Whole-Entity Joint Ventures – Control in 50/50 Ventures

- Where formal voting control  of the board is lacking, there must be another mechanism to ensure that the joint venture will operate to further the exempt organization's charitable purposes.
- Informal control may exist if the exempt organization retains certain powers over major actions and has unilateral initiation rights with respect to certain actions of the joint venture.
- Can be demonstrated if there is for profit manager who is under the control and subject to the authority of management committee that is comprised of a majority of the tax-exempt's representatives.
- Can be demonstrated by reserving certain powers for the review and approval of such exempt organization's board of directors.

# Scenario 1: Joint Ventures – Whole-Entity Joint Ventures – Control in 50/50 Joint Ventures

- An exempt organization might also consider reserving for itself unilateral decision making power over certain actions. These would be actions most relevant to ensuring that the hospital is operated in furtherance of its exempt purpose:
  - The scope of services offered by the joint venture and locations where they are offered
  - The ability to enter into new managed care contracts for the joint venture
  - The ability to implement community benefit activities (e.g., new services, publication of charity care policy, increase in charity care, and removal of barriers to Medicare/Medicaid access)
  - The ability to terminate joint venture management agreements for cause or after a reasonable initial term without cause
  - Open staff policies that allow the joint venture facilities to be utilized by non-investor physicians
  - The ability to dissolve the joint venture if continued participation jeopardizes the organization's exempt status. The hospital should be able to exit the joint venture and receive fair market value for its interest.
- The IRS has recognized exemption in a few cases where the tax-exempt entity's share of the control was as low as 50%. But none where it was lower.

# Scenario 1: Joint Ventures – Whole-Entity joint Ventures – Recognition of Charitable Purposes

- The LLC agreement and other documents should include a clear statement of purpose or philosophy that indicates that the joint venture will be operated in a manner that is consistent with the exempt organization's charitable purposes.
- The LLC agreement and other documents. should also include express language to reflect the for-profit partners' recognition and understanding of the fact that the operations of the joint venture will not be conducted in a manner solely designed to maximize profits. This will supersede the general duty that partners in a partnership or members of an LLC have to maximize profits of the joint venture.
- The LLC agreement should have a dispute resolution provision that would cause the joint venture to satisfy charitable purposes, without regard to profitability, when a disagreement arises between the board and the members over the joint venture's policies or actions.

# Scenario 1: Joint Ventures – Whole-Entity Joint Ventures – Right to Enforce

- The joint venture documents should give the exempt organization the right to bring suit to enforce the provisions regarding charitable activities under the laws of the state where the joint venture is formed.

# Scenario 1: Joint Ventures – Whole-Entity Joint Ventures – Actual Operations

- Actual operations are as important as the joint venture's formal documentation.
- Simply stating in the joint venture documents that that exempt purposes should prevail will not be sufficient to demonstrate that the joint venture arrangement furthers exempt purposes.
- It is important that the exempt participant be able to exercise control over key aspects of the joint venture in actual practice.  The actions must be consistent with the documentation.

# Scenario 1: Joint Venture – Ancillary Joint Ventures

- A joint venture with a for-profit partner that comprises only an insubstantial part of the exempt health care organization's overall assets and activities.
- Typically formed to operate a particular service – such as diagnostic imaging services, ambulatory surgical centers, durable medical equipment.

# Scenario 1: Joint Venture - Ancillary Joint Ventures

- As with all joint ventures, the 2 main issues raised are:
  - Whether the income from the LLC is UBTI; and
  - Doe the income/activities of the LLC affect the participant's tax-exempt status?
- So long as the assets and activities of the joint venture are "insubstantial" – then a tax-exempt member may enter into an ancillary joint venture without jeopardizing its tax-exempt status (assuming all elements of the arrangement are at arm's length and for fair market value – so no private benefit or private inurement issues).
- Whether an activity is "substantial" may be determined on a number of factors, including time devoted by the exempt partner to carry on the joint venture activities; assets, revenues and personnel involved.
- PLR 20061022 – where a 501(c)(3) organization sold ½ its interest in a scholarly journal to a for-profit publisher, the IRS found that the activities under the arrangement with the for-profit publisher constitute an "substantial" part of the activities of the exempt organization
- Unfortunately, no clearer guidance.

# Scenario 1: Joint Venture - Ancillary Joint Ventures – Tax Exempt Status

- Key governing ruling: Rev. Rul. 2004-51.
- Tax-exempt university entered into a joint venture structured as an LLC with an unrelated for-profit company to offer teacher training seminars at off-campus locations using interactive video technology.
- Each member owned 50% of the LLC, proportionate to the value of their capital contributions.
- Under LLC governing documents, all returns of capital, allocations, and distributions were proportionate to the ownership interests.
- LLC was managed by a 6 person board, with 3 persons chosen by the university and 3 persons chose by the for-profit.
- Under the governing documents, the university had the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars.
- The for-profit was responsible for arranging and conducting all of the seminars, including advertising, enrolling participants, arranging for facilities, distributing course materials and broadcasting the seminar to various locations. It also had the exclusive right (1) to select the locations where participants could receive a video link and (2) to approve other personnel, such as camera operators.

# Scenario 1: Joint Venture – Ancillary Joint Ventures – Tax Exempt Status

- IRS ruled that the university's contribution to and operation of an insubstantial part of its activities through the LLC did not jeopardize the university's tax-exempt status.
- The IRS relied on the fact that the university's activities were insubstantial. If an activity is insubstantial, then it will not, taken alone, affect the organization's tax-exempt status. See also Treas. Reg. Section 1.501(c)(3)-1(c)(1); Section 513.
- The activities were insubstantial in proportion to the university's overall exempt status, and therefore it did not matter whether or not they furthered exempt purposes.

# Scenario 1: Joint Venture – Ancillary Joint Ventures – Unrelated Trade or Business

- The IRS concluded that the university's activities conducted through the joint venture were NOT an unrelated trade or business.
- Reason: The exempt organization controlled those aspects of the joint venture's activities – specifically, the programmatic content, selection of teaching staff and standards for successful completion of the seminars – that were central to fulfilling the university's educational mission.
- This is despite the fact that under the 50/50 structure, the exempt organization did not have formal majority control over the joint venture, and the for-profit had certain exclusive rights with respect to the day-to-day management of certain of the joint venture's activities.

# Scenario 1: Joint Venture – Ancillary Trade or Business – Unrelated Trade or Business

- In the health care context, the exempt participant should ensure control of those aspects of the joint venture that are relevant to the organization's satisfaction of the "community benefit" standard.
- The IRS adopted the "community benefit" standard in Rev. Rul. 69-545. Indicators of community benefit, as listed in the ruling, include:
  - Having a governing board that consists of individuals who represent a broad cross-section of the community;
  - Reinvesting net profits in the organization's facilities;
  - Training and patient care;
  - Accepting and treating Medicare and Medicaid patients;
  - Operating a full-time emergency room that is open to all, regardless of their ability to pay;
  - And an open medical staff policy.

# Scenario 1: Joint Venture – Ancillary Trade or Business – Unrelated Trade or Business

- Note that if an activity of the joint venture is considered unrelated, then if it is substantial in relation to the exempt organization's charitable activities, the activity could be subject to the unrelated business income tax, **and** would require the organization to withdraw from the activity in order to protect its exempt status.
- There is no bright-line quantitative test for determining when an unrelated activity is substantial in relation to an exempt organization's charitable activities. Any final determination will take into the consideration the amount of the unrelated business income, as well as the amount of efforts devoted by the organization's personnel on the unrelated business activities.
- The Chief Counsel's Office suggested that where more than 50% of the exempt organization's income is unrelated business income, the IRS will deny or revoke the organization's tax-exempt status.

# Regulatory Overview

## Stark Law

1. Prohibits a physician from making referrals for certain designated health services payable by Medicare to an entity with which he or she (or an immediate family member) has a direct or indirect financial relationship, <u>unless an exception applies</u>
2. Prohibits the entity from presenting or causing to be presented claims to Medicare (or billing another individual, entity or third-party payor) for those referred services

# Regulatory Overview (continued)

"Designated Health Services" (or "DHS"):

- Clinical laboratory services
- Physical therapy services
- Occupational therapy services
- Outpatient speech-language pathology services
- Radiology and certain other imaging services
- Radiation therapy services and supplies
- Durable medical equipment and supplies
- Parenteral and enteral nutrients, equipment, and supplies
- Prosthetics, orthotics, and prosthetic devices and supplies
- Home health services
- Outpatient prescription drugs
- Inpatient and outpatient hospital services

# Regulatory Overview (continued)

"Financial relationship":

- A direct or indirect ownership or investment interest in any entity that furnishes DHS; or
- A direct or indirect compensation arrangement with an entity that furnishes DHS

Exceptions

- General Exceptions Related to Both Ownership or Investment Interests and Compensation (e.g., Physician Services, In-Office Ancillary Services)
- Exceptions Related to Ownership or Investment Interests (e.g., Publicly-traded Securities, Mutual Funds, Specific Providers)
- Exceptions Related to Compensation Interests (e.g., Rental of Office Space, Bona Fide Employment Relationships, Personal Service Arrangements)

# Regulatory Overview (continued)

## Anti-Kickback Statute

- Prohibits the offer, solicitation, payment, or receipt of any remuneration (including any kickback, bribe or rebate) directly or indirectly, overtly or covertly, in cash or in kind, in return for, or to induce:
  - (i) the referral of a patient for any item or service for which payment may be made under Medicare; or
  - (ii) the purchase, lease or order of any good, facility, service or item for which payment may be made under Medicare
- Intent requirement - "knowingly and willfully"
- Safe Harbors

# Regulatory Overview (continued)

- HIPAA & State Privacy Laws
- Antitrust Laws
- FDA Regulations
- EMTALA
- Federal and State False Claims Acts
- Medicare / Medicaid Billing and Reimbursement Requirements
- State Licensing Requirements / Certificate of Need
    - Preference for Stock Purchase Deals when State Licensure is at Issue
    - Example of Ambulance Service Company
- State Prohibition on the Corporate Practice of Medicine

# Scenario 1: Joint Venture – Regulatory Due Diligence

- Physician Employment Agreements of Joint Venture Partner
  - Valuation
  - Components met
- Other contractual relationships with referral sources
  - Leases
  - Medical Director Agreements
- Resolutions
  - Self Disclosure
  - Reduction in price

# Scenario 1: Joint Venture – Regulatory Aspects

Anti-Kickback Safe Harbor for Investment Interests in Ambulatory Surgical Centers (ASCs)

- 4 Kinds of ASCs are Covered:
  - Surgeon-Owned
  - Single-Specialty
  - Multi-Specialty
  - Hospital/Physician
- Specific Requirements for Each Type of ASC Setting
- No Equivalent Exception under Stark – <u>but</u> ASC services are not DHS

# Scenario 2: Non-Ownership Collaboration

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# Scenario 2: Non-Ownership Collaboration — Joint Operating Agreements

- Joint Operating Agreements ("JOA"s) are contracts between two independent organizations that provide for the transfer of control over the assets and activities of the organizations to a central governing authority. The central governing body may be organized as a separate legal entity (e.g., nonprofit corporation, LLC etc.) or simply be a contractual arrangement created pursuant to the terms of the JOA.
- JOAs have been employed mostly in the healthcare industry between two formerly unrelated hospitals or health systems.
- The hallmark of a JOA affiliation is that participating hospitals or entities retain their separate identities, boards of directors, and a certain amount of autonomy, even though considerable management and financial authority is shifted to the governing body of the JOA.
- The key difference between a JOA and a traditional joint venture (e.g., LLC) is that, in a JOA, there is no change in ownership of assets; each party to the JOA retains ownership in their respective assets and agrees to undertake certain obligations contractually within the purview of the JOA.

# Scenario 2: Non-Ownership Collaboration –Joint Operating Agreements

- Healthcare organizations or entities may find a JOA arrangement attractive because it offers many of the advantages of a merger (i.e., economies of scale, access to new markets, a broad service offering) without the complete loss of a separate legal identity and ownership over its assets.
- From a tax standpoint, absent a formal corporate structure, the JOA will be treated as a partnership for federal income tax purposes. Thus, the resulting deemed entity would be exempt with a for-profit partner and the relevant inquiry would be to determine the effect on the exempt partner's tax-exempt status and whether or not the income derived from the JOA is subject to UBIT.

# Scenario 2: Non-Ownership Collaboration – Contractual/Agency Relationships

- Contractual relationships should be analyzed to determine whether the contracts create an agency relationship. Examples: leases and management contracts.
- Key issue: Whether an individual or entity is an agent of an exempt organization. The IRS's concern is that an exempt organization should not be conducting an unrelated trade or business through an agent.
- If there is an agency relationship, the IRS may attempt to attribute the activities of the service provider (for example, the management company) to the exempt organization. This would convert income that would otherwise be exempt from income into unrelated business taxable income.

# Scenario 2: Non-Ownership Collaboration – Contractual/Agency Relationships

- Tax exemption: If agent's activities are attributed to the exempt organization, and those activities are ones that are otherwise prohibited (for example, political campaign activities or legislative lobbying), the exempt organization may be at risk of losing its tax-exempt status. Similarly, if the activities of the agent attributed to the exempt organization are "substantial" in relation to the organization's overall activities, the organization could jeopardize its tax exemption since it would no longer be considered organized and operated exclusively for charitable purposes.
- UBIT: If the activities of the agent constitute an unrelated trade or business, the organization will be subject to UBIT.

# Scenario 2: Non-Ownership Collaboration – Contractual/Agency Relationships

- A significant factor distinguishing an agency relationship from other legal relationships is that a principal has the right to control the conduct of the agent with respect to certain matters.
- Important factors in analyzing include:
  - The agent is designated as such in a written agreement.
  - The agent conducts business in the name of the principal.
  - The agent has the authority to bind the principal.
  - The agent transfers funds received to the principal, or uses them as directed by the principal.
  - All or part of the agent's activity is subject to the principal's right to approve or control
  - The principal actually exercises control or supervision over part or all of the agent's activity.
  - The principal rather than the agent bears the risk of loss in the transaction.

# Scenario 2: Non-Ownership Collaboration –Regulatory Aspects

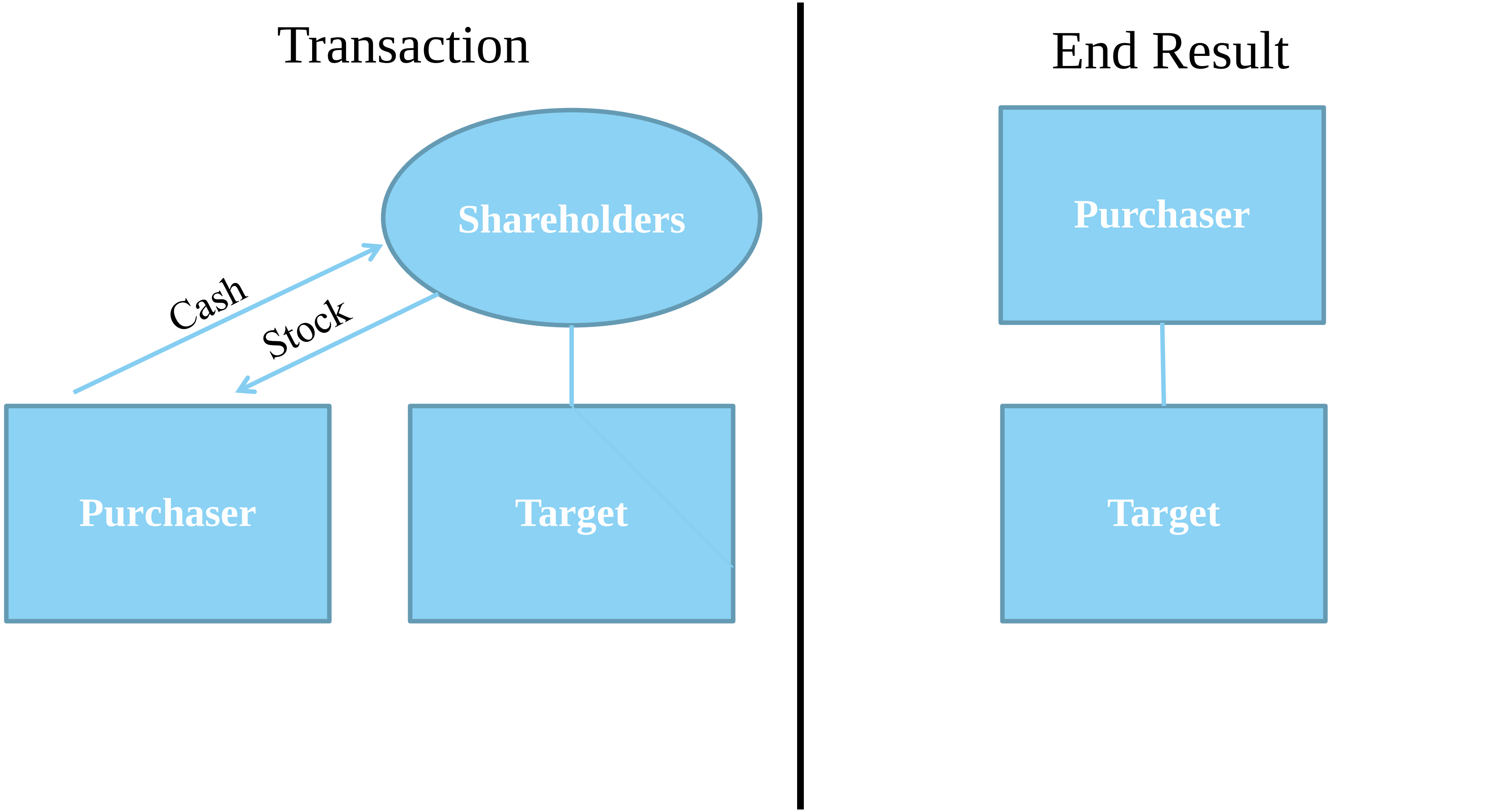
- Affiliation transaction = a contractual relationship between health care providers that will increase efficiencies with a minimal loss in control; sometimes a prelude to an acquisition
- Typically, a larger entity agrees to make services and professionals available to a smaller entity "at cost"; provides smaller entities with access to resources that would otherwise be unavailable
- Gives rise to Stark and Anti-Kickback issues
- Several exceptions and safe harbors may apply

# Scenario 2: Non-Ownership Collaboration – Regulatory Aspects (continued)

<u>Stark Exceptions & Anti-Kickback Safe Harbors</u>

- Personal Services and Management Contracts
  - E.g., medical director services, on-call services and medical education services
- Fair Market Value Compensation (No Anti-Kickback Safe Harbor)
- Equipment Leases
- Space Leases
- Electronic Health Records
  - 85-15 Rule
  - Sunset Date Extended

# Scenario 3: Stock Purchase

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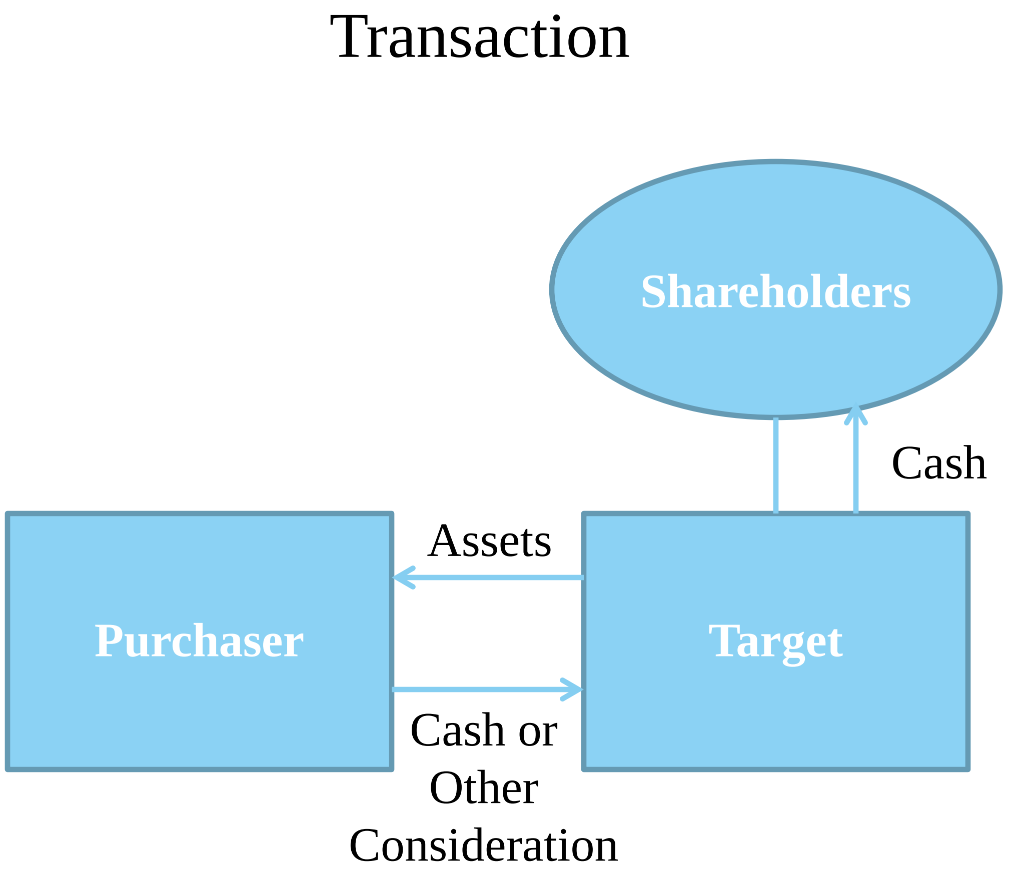
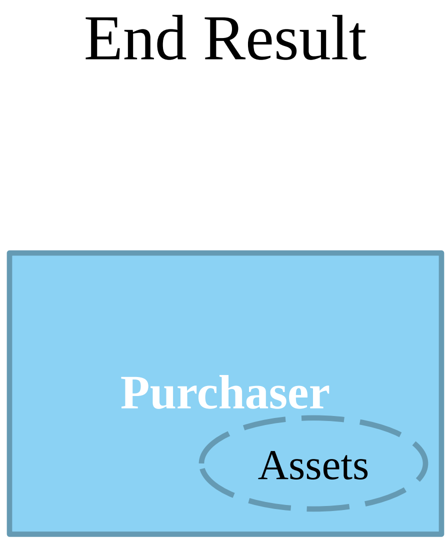
# Scenario 3: Structural Considerations

- **Benefits of Stock Purchase** - Lack of interruption in various relationships
  - Payors
  - Providers
  - Licensing
  - Other
- **Concerns of Stock Purchase** - Lingering liability
  - Overpayments
  - Fraud and Abuse laws
  - Contractual Disputes

# Scenario 4: Asset Purchase Deal



# Scenarios 3 & 4: Tax Aspects – Goals – If You Are Seller

- If a person receives *something*, first question they should ask themselves is why is this not income for tax purposes? It probably is.
- If you can’t exclude it from income:
  - Try to at least make sure it is taxed at a lower tax rate. For example, capital gains are taxed at a lower tax rate than other types of income.
  - Try to see if there is a way to defer paying tax on it until a later date. Taxes paid later are better than taxes paid today.

# Scenarios 3 & 4: Tax Aspects – Goals – If You Are Seller

- Even if you cannot plan to exclude income or defer income, then you still want to be sure you plan to avoid the following:
  - Having the same income be subject to tax more than once (so called "double-taxation of income.")

## Scenarios 3 & 4: Tax Aspects – Goals – If you are a Buyer

- You may not have to worry about having current taxable income. However, you still want to be sure your that the money you spent to buy or invest in something is invested in such as way so as to give rise to tax deductions so that they can reduce your overall income and lower your taxes:
  - Depreciation and amortization deductions

# Scenarios 3 & 4: Tax Aspects – Tax Rates - Individuals

| **Type of Income:** | **Current U.S. Federal Income Tax Rate:*** |
|---|---|
| Ordinary Income | 39.6% |
| Long-Term Capital Gains | 23.8% |
| Short-Term Capital Gains | 43.4% |
| Dividends | 23.8% |
| Interest, Rents, Royalties | 43.4% |

*These rates include the new Medicare tax of 3.8% on investment income of individuals that have adjusted gross income of over $200,000, and $250,000 for married taxpayers filing jointly.

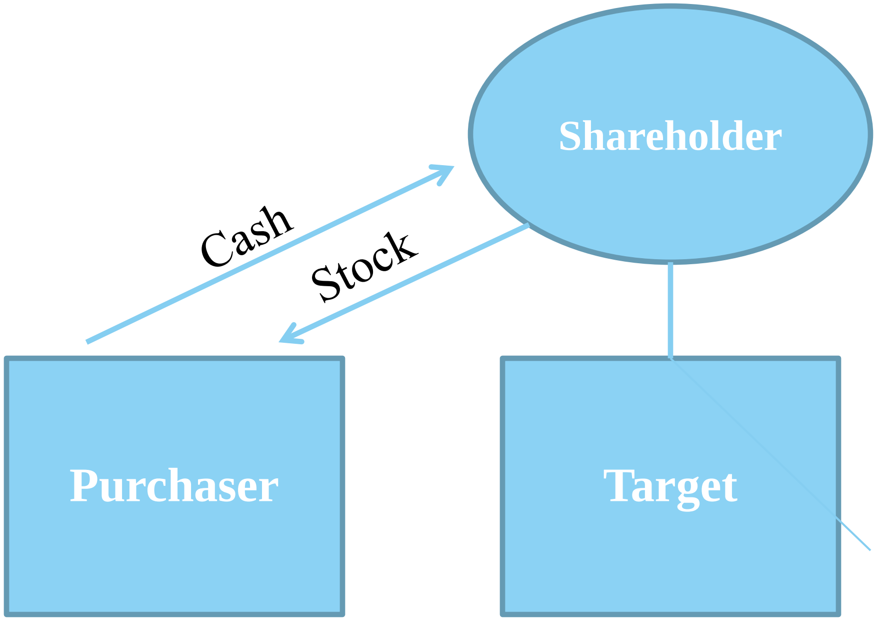
The 3.8% tax does not apply to capital gains, dividends, interest, royalties, rents and other investment income that is derived from a trade or business in which the taxpayer is a not a passive investor. In other words, capital gains, dividends, interest, royalties, rents and other investment income derived from a trade or business in which the taxpayer materially participates (i.e. generally is involved in the operations of the activity on a basis which is regular, continuous and substantial) are not subject to the tax increase.

# Scenarios 3 & 4: Tax Aspects – Tax Rates - Corporations

| Type of Income: | Current U.S. Federal Income Tax Rate: |
|---|---|
| Ordinary Income | 35% |
| Capital Gains | 35% |
| Dividends | 35% (unless qualify for dividends received deduction) |

# Scenarios 3 & 4: Tax Aspects – Consequences to Parties of Stock Sale

Transaction




Tax consequences to parties:

- Shareholder(s): Gain taxed at long term capital gain rate.
  - Ex: Sales price of $100.
  - Shareholder has 0 basis in stock.
  - Taxable gain = $100.
  - U.S. Federal Tax = $23.8
  - After-tax proceeds = $76.2
- Purchaser: Obtains stepped up tax-basis of $100 in stock of Target.
  - Unfortunately, you cannot depreciate stock for tax-purposes, so the stepped-up tax basis is not particularly useful.

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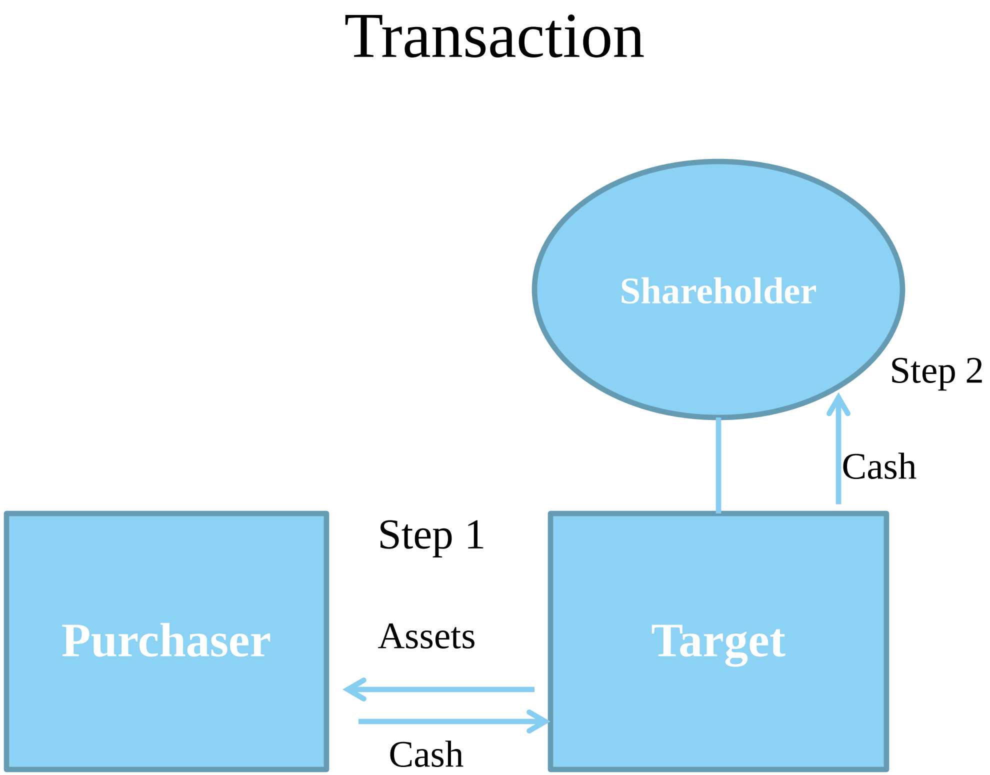
# Scenarios 3 & 4: Tax Aspects – Consequences to Parties of Asset Sale




- Purchaser gets a $100 tax basis in the assets purchased. Unlike stock, the acquired assets are depreciable or amortizable assets. This means that over the useful tax life of the assets, Purchaser will get $100 of tax deductions that it can use to reduce its taxable income.
  - If Purchaser's tax rate = 35%, then tax benefit over life of assets = $35.
  - PV of $35 over 15 years at 8% discount rate = approx. $20
- Shareholder doesn't do as well as with a stock sale.
  - Target's taxable gain = $100
  - Tax = $35
  - Proceeds remaining for distribution = $65
  - Shareholder's tax on distribution = $15.47 (23.8% x $65)
  - Shareholder's net proceeds = $49.53

# Scenarios 3 & 4: Tax Aspects – Breaking a Deadlock: Asset Sale with Shareholder-Level Sale of Goodwill

- Same facts as in previous example, but of the $100 purchase price, $90 is attributable to goodwill owned individually by Shareholder, and $10 is attributable to the assets of Target.
- Goodwill is a capital asset. Its sale should generate capital gain.
- Goodwill acquired in connection with the acquisition of a trade or business is an amortizable asset. A stepped-up basis in goodwill should generate tax deductions.
- Tax consequences:
  - Sale of goodwill:
    - Shareholder - $90 sales proceeds – 0 tax basis = $90 taxable gain.
    - Tax – 20% x $90 = $19
    - After-tax proceeds from sale of goodwill - $71
  - Sale of assets:
    - Target - $10 sales proceeds – 0 tax basis = $10 gain
    - Tax – 35% x $10 = $3.5
    - Proceeds remaining for distribution = $6.5
    - Shareholder - $6.5 – 0 tax basis
    - Tax – 23.8% x $6.5 = $1.55
    - After-tax proceeds from assets sale = $4.95
  - Total after tax proceeds to Shareholder = $75.95

# Scenarios 3 & 4: Tax Aspects – Sale of Personal Goodwill

- Personal goodwill exists when the shareholder's reputation, expertise, or contacts contribute significantly to the company's value and future income stream.
- The goodwill belongs to the shareholder, and not to the Target.

# Scenarios 3 & 4: Tax Aspects – Sale of Personal Goodwill

In every case where the Tax Court has found shareholder personal goodwill to exist, there has been (i) no non-compete in existence, and (ii) no employment agreement.

Martin Ice Cream, 110 TC 189 (1998). Tax Court said:

> Ownership of these intangibles cannot be attributed to [the corporation] because [the shareholder] never entered into a covenant not to compete with [the corporation] or any other agreement – not even an employment agreement – by which any of [shareholder's] distribution agreements, and his relationships with the supermarkets, and his ice cream distribution expertise became the property of [the corporation]. . . . In the case at hand . . . [the corporation] never obtained exclusive rights to either [the shareholder's] future services or a continuing call on the business generated by [the shareholder's] personal relationships with the supermarket owners and the rights under his agreement with Mr. Mattus; [the corporation] never had an agreement that would have caused those relationships and rights to become [the corporation's] property.

Howard v. U.S., 106 AFTR 2d 2010-5533 (E.D. of Was. 2010) (court found no personal goodwill where dentists had non-compete with corporation). U.S. District Court said:

> In this case, Dr. Howard was a Howard Corporation employee with a covenant not to compete with Howard Corporation from 1980 through 2003, plus 3 years, or 2005. Therefore, any goodwill generated during that time period was Howard Corporation goodwill. . . . In a professional services corporation that employs a service-providing employee, such as Dr. Howard, a two-part test is used to determine whether the corporation or the employee is considered to be the controller of the income. . . . The first prong is whether the individual is an employee of the corporation; and the second prong is whether there is a contract showing that the individual recognizes the corporation's control.

Kennedy, TC Memo 2010-206. Tax Court said:

> Portion of payments that employee benefits consulting business owner/pres. received on sale of business were taxable not as capital gains on sale of capital asset/goodwill as he claimed, but rather as ordinary income/consideration for services to be performed or for noncompete agreement. Although operative contracts allocated 75% of payments to goodwill, such allocation lacked economic reality where it was effected late in negotiations as tax-motivated afterthought and didn't reflect value of goodwill in relation to other valuable aspects of transaction. Taxpayer's position/capital characterization was also belied by facts that he had promised to work for purchaser for 5 years until his planned retirement and to not compete. Moreover, he subsequently worked for purchase for period of time without compensation.

# Scenarios 3 & 4: Tax Aspects – Factors Supporting Personal Goodwill

- No noncompete agreement exists between the selling shareholder and the company
- Business is highly dependent on individual's personal relationships, reputation, skills, know-how
- Individual's service is important to the sales process
- Operations in which shareholders are highly involved
- Companies that are highly technical, specialized, or engaged in professional services
- Companies that have contracts that are terminable at will
- More common in companies with higher portion of intangible assets
- Loss of key individual would negatively impact the revenue and/or profitability of the company

# Scenarios 3 & 4: Tax Aspects – Factors Supporting Target Goodwill

- Noncompete agreement exists between the selling shareholder and the company
- Larger business with formal organizational structure, processes, and controls
- Sales are generated from company brand name recognition or company sales team
- Manufacturing businesses or companies that are asset intensive (as opposed to personal service business)
- Selling shareholder is not intimately involved with the business
- Companies that have deep management teams
- Companies that have long-term contracts with customers
- Loss of shareholder or person claiming to be owner of goodwill would not materially impact the revenue and/or profitability of the company, or the individual could be replaced easily

# Scenarios 3 & 4: Tax Aspects – Breaking a Deadlock: Asset Sale with Shareholder-Level Noncompete

- Same facts as in previous example, except that $90 is for a covenant not to compete entered into by Shareholder. Remaining $10 is for assets of Target.
- Sale of noncompete gives rise to ordinary income.
- A noncompete acquired in connection with the acquisition of a trade or business is an amortizable asset. A basis in a noncompete should generate tax deductions for Purchaser
- Tax consequences:
  - Sale of noncompete:
    - Shareholder - $90 sales proceeds – 0 tax basis = $90 taxable income.
    - Tax – 39.6% x $90 = $35.64
    - After-tax proceeds from sale of goodwill - $54.36
  - Sale of assets:
    - Target - $10 sales proceeds – 0 tax basis = $10 gain
    - Tax – 35% x $10 = $3.5
    - Proceeds remaining for distribution = $6.5
    - Shareholder - $6.5 – 0 tax basis
    - Tax – 23.8% x $6.5 = $1.55
    - After-tax proceeds from assets sale = $4.95
  - Total after tax proceeds to Shareholder = $59.31

# Scenario 4: Tax Aspects – Sale of Assets Where Target is an S Corporation or an LLC

- Much more flexibility than where Target is a C corporation.
- Both an S corporation and an LLC are generally flow-through entities or disregarded entities. This means that they generally do not pay an entity level income tax. Accordingly, where Target is an S corporation or an LLC, the seller should have similar consequences depending on whether the sale is structured as an asset sale or a stock sale.
- Generally, the sale should generate capital gain, except to the extent the gain is attributable to non-capital assets held by the Target (appreciated inventory, accounts receivable, depreciation recapture).
- Caution: In the case of the sale of stock of an S corporation, Purchaser will have to ensure that a Section 338(h)(10) election must be made.

# Scenario 3 and 4: Minimizing Employment Taxes For Owners

- A shareholder of a C corporation or an S corporation may also be an employee of the corporation.
- A sole-proprietor or a partner in a partnership cannot be an employee of the entity.  However, a sole proprietor or a non-limited partner is subject to self-employment tax.
- Wages v. Self-Employment  Income
  - Imposed on a different base.
  - Employment tax (FICA) is imposed on an individual's wages.
  - Self-employment tax (SECA) is imposed on an individual's net earnings from a trade or business.
    - The amount of income treated as "net earnings from a trade or business" for self-employment tax purposes does not depend on the amount of the partner's time or involvement in the business.

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# Scenario 3 and 4: Minimizing Employment Taxes For Owners

- **Employment Tax on Employee Wages**
  - FICA is imposed on all wages received as remuneration for employment. Wages are defined to include the cash value of all benefits, including bonuses, deferred compensation, commissions and fringe benefits.
  - Liability for employment taxes is divided equally between the employer and the employee.
  - **Old Age, Survivors, and Disability Insurance component ("OASDI")** - tax on wages of an individual at 6.2% on the taxable wage base (capped at $117,000 for 2014).
  - **Hospital Insurance/Medicare component** – tax on uncapped wage base at 1.45%. Beginning in 2013, an additional 0.9% Medicare tax is imposed on wages above $200,000 ($250,000 for a joint return). The employee is responsible for this 0.9% tax; there is no employer match for this additional component.
    - The employer should withhold the additional .9% Medicare tax from wages it pays to an individual in excess of $200,000, without regard to filing status or wages paid by another employer. An individual may owe more than the amount withheld by the employer, depending on filing status, wages, compensation or self-employment income. In that case, the individual can make estimated tax payments and/or request additional income tax withholding.

# Scenario 3 and 4: Minimizing Employment Taxes For Owners

- **Self-employment Tax on Net Earnings (SECA)**
  - Generally, self-employment tax is imposed at the same rates as FICA. However, SECA is imposed on a different base amount.
  - SECA is imposed on net earnings from a trade or business. Unless there is an exception (such as for some investment income or most income received as a limited partner), net income from self-employment means the gross income derived from a trade or business carried on by the individual, less attributable deductions, and the individual's distributive share of income of a partnership that carries on a trade or business.
    - SECA is imposed on the net earnings from a trade or business, which may or may not reflect the fair value to the business of the owner's personal services. Therefore, for a sole proprietor or non-limited partner, the amount of income treated as net earnings from self-employment does not depend on the time spent or involvement in the business.
    - Therefore, the amount of earnings subject to SECA may go far beyond what would be deemed reasonable compensation for an employee of a corporation, or, if the business is not particularly profitable, earnings subject to SECA may understate what would be reasonable compensation in the corporate context.
  - The employee can deduct the employer-equivalent portion of self-employment tax in calculating adjusted gross income. This deduction only affects income tax. It does not affect either net earnings from self-employment or self-employment tax. No amount of the additional 0.9% Medicare tax can be deducted for income tax purposes because the employee, rather than the employer, is responsible for this tax.

# Scenario 3 and 4: Minimizing Employment Taxes For Owners

- **S Corporations – Generally**
  - Shareholders of an S corporation often serve as officers and employees of the corporation. Such employee shareholders can receive both wages and distributions from the S Corporation. A determination must be made about how much cash to withdraw from the corporation as compensation and how much to withdraw as distributions. There are tax consequences to these choices.
  - From a practical perspective, if not all of the corporation's shareholders are employees of the corporation, the economic considerations may outweigh the tax consequences because an unrelated shareholder who does not work for the business will resist the payment of an unreasonable salary to an employed shareholder. Further, if the S corporation was formerly a C corporation, the S corporation may find itself somewhat limited by the historic compensation paid by the C corporation. The IRS may question a drastic fluctuation in compensation that coincides with an entity conversion.
  - The limitation of the imposition of employment taxes to "wages" (as opposed to the "net earnings from a trade or business") is one reason that S corporations remain popular.

# Scenarios 3 and 4: Minimizing Employment Taxes For Owners

- **S Corporations – Determining Reasonable Compensation**
  - Facts and circumstances analysis.
  - Factors to be considered:
    - Training and experience
    - Duties and responsibilities
    - Time and effort devoted to the business
    - Dividend history
    - Payments to non-shareholder employees
    - Timing and manner of paying bonuses to key people
    - What comparable businesses pay for similar services
    - Compensation agreements
    - The use of a formula to determine compensation

# Scenarios 3 and 4: Minimizing Employment Taxes For Owners

- **Entities Taxed as Partnerships – Generally**
  - A limited partner's distributive share of income or loss (other than guaranteed payments to the partner for services actually rendered to or on behalf of the partnership) is <u>not</u> subject to self-employment tax. Therefore, being a "limited partner" as opposed to "general partner" of an entity taxed as a partnership can have significant tax consequences.
    - By way of example, a partner that has paid the maximum OASDI portion of self-employment tax must pay the unlimited Medicare tax component if taxed as a "general partner." However, if that partner is classified as a "limited partner" he may avoid the self-employment tax on his allocable share of partnership income.
  - "Limited partner" is not a defined term for purposes of self-employment tax. However, the legislative history suggests that that the exclusion of a limited partner's distributive share of income from self-employment was created for those individuals who merely invested in a partnership and were not actively participating in the partnership's business operations.
  - The first generation of limited liability entities included limited partnerships, in which passive limited partners had limited liability as the quid pro quo for not participating in management or control of the partnership's business. Although the activities that limited partners could participate in increased over time, the general partners of limited partnerships remain personally liable for the debts and obligations of the partnership.
  - An LLC generally provides liability protection to all of its members, even those who participate in the LLC's management and operations. With the advent of entities such as LLCs, in which all members have limited liability, the question of whether members are limited or general partners for tax purposes is critical.
  - Treasury and the IRS have attempted to define the term "limited partner" for self-employment tax purposes on two occasions. IRS issued the first Proposed Regulations in 1994. The IRS withdrew the 1994 Proposed Regulations in response to comments received and issued the second set of Proposed Regulations in 1997.

# Scenario 3 and 4: Minimizing Employment Taxes For Owners

- **Entities Taxed as Partnerships – The 1997 Proposed Regulations**
  - In 1997, the IRS issued Proposed Regulation 1.1402(a)-2, which attempted to define which partners are "limited partners" for purposes of self-employment taxes. The Proposed Regulations would apply to all entities classified as partnerships for federal tax purposes.
  - Under the Proposed Regulations, a person is treated as a "limited partner" for self-employment tax purposes, <u>unless</u>:
    - He has personal liability for the debts of the entity by reason of being a partner;
    - He has statutory authority to contract on behalf of the entity;
    - He participates for more than 500 hours in the entity's trade or business.
  - A special rule applicable to service partnerships provides that any rendition of services for the entity precludes the member from having limited partner status. A service partnership is one in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science and consulting.
  - The Proposed Regulations also allow for the bifurcation of interests where a partner holds more than one class of interest. For example, a partner can be treated as both a limited partner and a general partner in the same partnership. This allows the partner to exclude from self-employment tax those amounts of the partner's allocable share of income that are "demonstrably returns on capital invested in the partnership."
  - The 1997 Proposed Regulations caused controversy and Congress placed a moratorium on their adoption shortly after issuance. The moratorium has expired; however, the regulations have not been adopted and remain outstanding.

# Scenario 4: Sale of Assets – Regulatory Aspects

Stark Exceptions & Anti-Kickback Safe Harbors

- Isolated Transactions (No Anti-Kickback Safe Harbor)
  - Fair Market Value (without considering volume or value of referrals)
  - Commercially Reasonable (even if no referrals)
  - No additional transactions between the parties for 6 months after the isolated transaction, except for (i) transactions which are specifically excepted under other Stark provisions and (ii) commercially reasonable post-closing adjustments that do not take into account (directly or indirectly) the volume or value of referrals or other business generated by the referring physician

# Scenario 4: Sale of Assets – Regulatory Aspects

<u>Stark Exceptions & Anti-Kickback Safe Harbors</u>

- Bona Fide Employment Relationship
  - Employment is for identifiable services
  - Amount of remuneration (i) is consistent with the fair market value of the services, and (ii) is not determined in a manner that takes into account (directly or indirectly) the volume or value of referrals by the referring physician (<u>but</u>, a productivity bonus is okay if it is based on services performed personally by the physician)
  - Remuneration is commercially reasonable even if no referrals were made to the employer

# Scenario 4:  Sale of Assets – Regulatory Aspects

Stark Exceptions & Anti-Kickback Safe Harbors

- Office Space Lease
  - Agreement must be in writing, be signed by the parties, and specify the premises it covers
  - Term of agreement must be at least 1 year
  - Rental charge must be set in advance and be consistent with fair market value
  - Rental charge may not be determined (i) in a manner that takes into account the volume or value of referrals or other business generated between the parties, or (ii) using a formula based on a percentage of revenue earned, billed, collected, etc. or per-unit of service rental charges
  - Space rented may not exceed that which is reasonable and necessary for the legitimate business purposes of the lease and be used exclusively by the lessee, except that lessee may make payments for the use of space consisting of common areas on a pro rata basis
  - Agreement must be commercially reasonable even if no referrals were made between the lessee and the lessor

# Scenario 4: Sale of Assets – Transactional Aspects

- Traditional Components
  - Employment of Physicians
  - Acquisition of Assets
  - Leasing of Real Estate
- Common Themes
  - Valuations and appraisals
  - Control related to business going forward
  - Real Estate

# Scenario 4: Sale of Assets – Transactional Aspects

- Employment of Physicians
  - Employment Agreement Components
    - Non-compete
    - Term and Termination
    - Severance
  - Compensation Structure
    - Commercially reasonable even if no referrals made
    - Does not take into account volume or value of referrals
    - Productivity and other bonuses

# Scenario 4: Sale of Assets – Transactional Aspects

- Office Space Leases
  - Options
    - New space
    - Available space at hospital owned or lease locations
    - Space owned directly or indirectly by physician group
  - Concerns
    - Physician group being locked in to space associated with competing hospital
    - Space being too expensive
    - Space being too large

# Scenario 4: Sale of Assets – Transactional Aspects

- Acquisition of Assets
  - Valuation methodology and valuation company
    - Competing interests financially
    - Aligned interests from a compliance perspective
  - Due Diligence and Contracts
  - Deal Components
    - Individual physicians being named as parties
    - Representations and warranties
    - Indemnification
    - Holdback

# Conclusion

Thank you!

Please feel free to email us any questions that you were not able to ask during the presentation today.


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| Saba Ashraf<br>Partner, Tax<br>Ballard Spahr LLP<br>999 Peachtree Street<br>Atlanta, Georgia 30309-3915<br>678.420.9372<br>AshrafS@BallardSpahr.com | Larkin Ellzey<br>Associate, Healthcare<br>Ballard Spahr LLP<br>999 Peachtree Street<br>Atlanta, GA 30309-3915<br>678.420.9458<br>EllzeyL@BallardSpahr.com | Jennifer T. McFarland<br>Associate, Healthcare<br>Ballard Spahr LLP<br>999 Peachtree Street NE<br>Atlanta, Georgia 30309-3915<br>678.420.9542<br>McFarlandJ@BallardSpahr.com |