

## Tax-Exempt Hospitals and Accountable Care Organizations

April 27, 2011

IRS clears path for tax-exempt organizations to participate in Medicare and Medicaid accountable care organizations (ACOs), but raises potential red flags as to tax-exempt organizations' participation in commercial ACOs.

In Notice 2011-20, 2011-16 I.R.B. 652, the Internal Revenue Service (IRS) indicated that it is considering how existing tax exemption and unrelated business income principles will apply to tax-exempt hospitals described in section 501(c)(3) of the Internal Revenue Code (the Code) that will be participating in the Medicare Shared Savings Program (MSSP) through accountable care organizations (ACOs). The Notice invites comments as to where (if anywhere) additional guidance is needed from the IRS with respect to ACOs and tax-exempt hospitals that participate in them. Perhaps more important, the IRS is also inviting comments concerning tax-exempt hospitals' participation in ACOs outside of the MSSP context and, in the course of requesting such comments, sends clear signals as to its initial thoughts in this area.

### Charitable Purposes of ACOs

In the Notice, the IRS recognizes that the promotion of health has long been recognized as a charitable purpose, but it then goes on to quote several authorities indicating that promotion of health alone does not ensure exemption. This suggests that the IRS is taking the initial position that ACO activities, in and of themselves, do not promote health for the benefit of the community within the meaning of section 501(c)(3) of the Code and, accordingly, a different charitable purpose for such activities must be found. In fact, the Notice states that negotiating with private health insurers is not a charitable activity "regardless of whether the agreement negotiated involves a program aimed at achieving cost savings in health care delivery." However, the Notice leaves open the issue of relatedness when the program also addresses quality improvement issues in a meaningful fashion.

The Notice takes a more favorable view when addressing Medicare and Medicaid ACOs. With respect to a tax-exempt hospital's participation in Medicare ACOs, the IRS believes that such activities could further a charitable purpose—specifically, "lessening

the burdens of government.” As a general rule, in order to demonstrate that activities lessen the burdens of government, the tax-exempt organization must demonstrate that the activities it conducts are a burden of government and that the tax-exempt organization’s conduct of such activities does, in fact, lessen such burden. Accordingly, when structuring Medicare ACOs and when documenting the basis for the tax-exempt hospital’s participation in a Medicare ACO, the tax-exempt hospital should clearly articulate lessening the burdens of government as one of the purposes for which it is entering into such activities. Consideration should also be given to clarifying that the tax-exempt hospital’s charitable purposes include lessening the burdens of government as one of its core charitable purposes.

The IRS also indicated that a tax-exempt organization’s participation in Medicaid ACOs could further an additional charitable purpose—specifically “relief of the poor.” Presumably, Medicaid ACOs could also be found to lessen the burdens of government like Medicare ACOs, and the IRS inclusion of the “relief of the poor” standard in the Notice was simply to identify an alternative basis for exempt purposes, not an exclusive basis for Medicaid ACOs. This approach is similar to the approach taken by the IRS with Medicaid HMOs. Nonetheless, tax-exempt hospitals participating in Medicaid ACOs would be best advised to clarify and document that their intended purpose in entering into such activities includes relief of the poor.

Many hospitals and health systems planning the development of commercial, Medicare and Medicaid ACOs have structured the entity as a nonprofit membership corporation in hopes of obtaining tax-exempt status for the corporation at some time in the future. While the Notice could be interpreted as casting doubt on whether the IRS would recognize the exempt status of a predominately commercial ACO, the Notice clearly offers hope that exempt status will be available for a predominately Medicare or Medicaid ACO if the ACO satisfies other organizational and operational requirements.

### **Private Benefit/Inurement Concerns**

Key for any section 501(c)(3) health care entity participating in an ACO, whether such ACO is a Medicare ACO, a Medicaid ACO or a commercial ACO, is ensuring that its participation in the ACO does not result in proscribed inurement of net earnings or more than incidental private benefit for the private parties, including physicians, who also participate in the ACO. Private benefit or inurement can result if the tax-exempt hospital

provides a disproportionate of capital or operating support relative to its share of financial benefit derived from the ACO. Private benefit and inurement also can occur if the tax-exempt hospital provides facilities, services or other items for less than fair market value compensation or subsidizes operating losses without expectation of repayment.

With respect to Medicare ACOs, the Notice states that because of U.S. Centers for Medicare & Medicaid Services (CMS) regulation and oversight of Medicare ACOs, the IRS will not consider a tax-exempt hospital's participation in the Medicare ACO to result in inurement or impermissible private benefit to private party ACO participants where:

- The terms of the tax-exempt organization's participation in the Medicare ACO (including its share of shared savings payments or losses and expenses) are set forth in advance in a written agreement negotiated at arm's length
- CMS has accepted the ACO into, and has not terminated the ACO from the MSSP
- The tax-exempt organization's share of economic benefits derived from the ACO (including its share of shared savings payments) is proportional to the benefits or contributions the tax-exempt hospital provides to the ACO and, if the tax-exempt hospital receives an ownership interest in the ACO, the ownership interest received is proportional and equal in value to its capital contributions to the ACO and all ACO returns of capital, allocations and distributions are made in proportion to ownership interests
- The tax-exempt hospital's share of the ACO's losses (including its share of shared savings program losses) does not exceed the share of ACO economic benefits to which the tax-exempt hospital is entitled
- All contracts and transactions entered into by the tax-exempt organization with the ACO and the ACO's participants, and by the ACO with the ACO's participants and any other parties, are at fair market value

These same basic principles should be followed in developing and operating a commercial ACO.

## Open Issues

The bigger question, left mostly unanswered by the IRS in the Notice, is whether or under what circumstances a tax-exempt hospital's participation in "private payor" ACOs can further exempt purposes or be treated as a related trade or business when meaningful care management and quality improvement activities are undertaken by the ACO along with cost reduction activities. In short, without releasing any meaningful guidance, the IRS has suggested by negative implication that its initial position on ACOs is that a tax-exempt organization's participation in Medicare and Medicaid ACOs, if structured properly, may be considered substantially related to charitable purposes, but that participation in private payor ACOs, in and of itself, is not a charitable activity. It is hoped that comments provided to the IRS in response to the Notice will enable the IRS to become more comfortable that ACO formation in the private payor setting should be encouraged by the IRS for the same reasons that the U.S. Department of Health and Human Services believes such activities improve the quality of care and reduce the costs of such care for participants in Medicare and Medicaid ACOs.

To view the full Notice, please [click here](#).

## The McDermott Difference

McDermott Will & Emery's health care lawyers can assist in the submission of comments regarding the proposed waivers or any of the above topics.

Please contact your regular McDermott attorney or either author.

McDermott will be distributing additional newsletters on other issues related to the new accountable care organization regulations. Additionally, we will be releasing a White Paper that will serve as a key resource and reference document about the proposed regulations. Access our five-part webcast series, '[Accountable Care: Strategy & Structure](#)'.

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