AHLA
connections
January 2013 Volume 17 Issue 1
For the health and life sciences law community

JOAs Are Here Again: A Refresher on Tax Exemption Issues with Joint Operating Agreements
(page 10)

Go Do It – Mentoring
(page 20)

OFFICIAL MAGAZINE OF AMERICAN HEALTH LAWYERS ASSOCIATION

JOAs Are Here Again: A Refresher on Tax Exemption Issues with Joint Operating Agreements

By Elizabeth M. Mills, Proskauer Rose LLP, Chicago, IL

Introduction

Healthcare joint operating agreement (JOA) transactions, or "virtual mergers," became popular in the mid-1990s when the Internal Revenue Service (IRS) provided guidance for tax-exempt health systems participating in JOA transactions.[1] Many JOA transactions were undertaken; some were completed; some continue to exist; some ended with the buyout of one of the participants by the other; and some ended up in litigation.[2] With the current wave of consolidations and acquisitions in the hospital arena, JOA transactions are again attracting interest. This article describes a typical JOA transaction; explains the existing IRS guidance on tax-exemption issues related to JOAs and its analogy with antitrust issues; and describes some important points to consider in deciding upon and implementing a JOA transaction.

Types of JOA Transactions

In the healthcare context, a JOA transaction is an agreement between two (or more) previously unrelated tax-exempt health systems to "virtually merge" part or all of each system. The JOA transaction concept is not unique to the healthcare industry. For example, JOAs have become common in the newspaper industry, as it has become increasingly difficult for two-newspaper towns to support both newspapers.[3] The Newspaper Preservation Act[4] provides antitrust protection to newspaper JOAs, as approved by the Justice Department, to save failing papers. The Act defines a JOA as follows:

> The term "joint newspaper operating arrangement" means any contract, agreement, joint venture (whether or not incorporated), or other arrangement entered into by two or more newspaper owners for the publication of two or more newspaper publications, pursuant to which joint or common production facilities are established or operated and joint or unified action is taken or agreed to be taken with respect to any one or more of the following: printing; time, method, and field of publication; allocation of production facilities; distribution; advertising solicitation; circulation solicitation; business department; establishment of advertising rates; establishment of circulation rates and revenue distribution: Provided, That there is no merger, combination, or amalgamation of editorial or reportorial staffs, and that editorial policies be independently determined.[5]

Thus, the newspapers operate jointly in allocating resources, sharing facilities, and sharing expenses and revenue, but provide separate editorial content. In the healthcare context, the parallel to separate editorial content is that participating healthcare facilities remain in separate entities, retain their own licenses, and bill under their own names and numbers. As in the newspaper JOA, revenues and expenses in healthcare JOAs are shared "virtually" by contract.

For purposes of the examples in this article, it is assumed that the JOA transaction involves two national or regional systems of tax-exempt hospitals, with each system having a separately incorporated local health system (hospital facility and associated health services) in a particular geographic market. The JOA is structured to be a "virtual merger" of the two local health systems. The two large systems enter into a JOA under which the parties create a joint operating company (JOC) to serve as the "parent" of the two local health systems. For example, Parent A is the tax-exempt parent organization of System A, which includes local System Y in Anytown, USA. Division H is an unincorporated division of local System Y. Parent B is the tax-exempt parent organization of System B, which includes local System Z in Anytown, USA. As part of the JOA transaction, Parent A and Parent B agree to form New JOC, a not-for-profit corporation that will apply for tax exemption. These are the types of arrangements that the IRS guidance (discussed later in this article) address.

Many variations on this JOA model are possible. For example:

- System A may be national and System B may operate only in Anytown, USA—the JOA transaction includes local System Y and all of the entities controlled by Parent B.
- Both System A and System B may operate only in Anytown, USA—the JOA transaction includes all of the entities controlled by Parent A and all of the entities controlled by Parent B.
- System A may be national and System B may operate only in Anytown, USA—the JOA includes Division H of local System Y, and all of the entities controlled by Parent B.

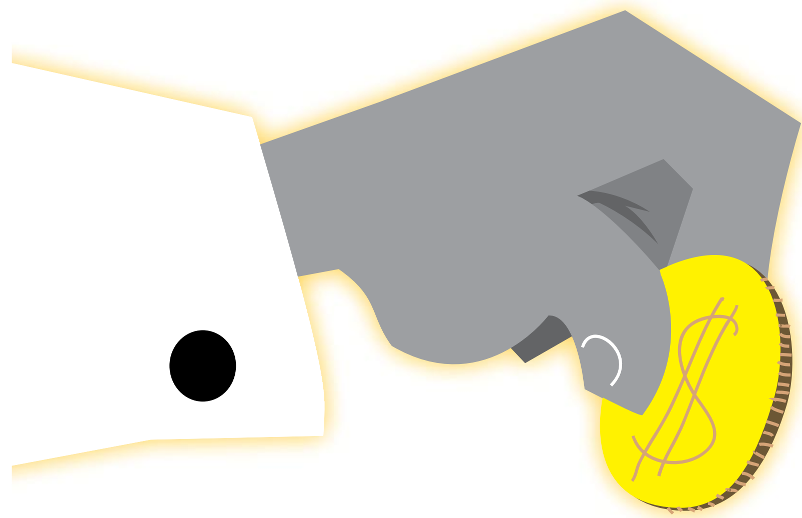
Generally, in an "actual" merger of health systems, the components of the two systems are brought under the common control of a parent of the new system. Even though each system's legal entities may retain their separate legal existence rather than merging under state corporate law, the parent controls the new system's entities through structural controls—typically, the ability to appoint and remove subsidiaries' board directors and to approve subsidiaries' major actions through reserved powers. The transaction is usually effectuated by amendment of the participants' corporate documents to reflect new governance and reserved powers. The subsidiaries in the combined system act together because they are coordinated and supervised by the parent and work together at its direction to allocate resources and carry out strategic initiatives. In a JOA, the JOC may or may not have the ability to appoint and remove subsidiaries' board directors. Rather, some essential elements of a JOA transaction that distinguish it from an "actual" system merger are: a retention of some control over participating entities by the original controlling entities; a prescribed sharing of participating entities' net income; and often an exit strategy of some sort.

WITH THE CURRENT WAVE OF CONSOLIDATIONS AND ACQUISITIONS IN THE HOSPITAL ARENA, JOA TRANSACTIONS ARE AGAIN ATTRACTING INTEREST.

What Are the Tax-Exemption Issues?

The tax-exemption issues for exempt organizations participating in a JOA arise from the IRS' "integral part" doctrine and also the IRS' denial of exemption to "feeder organizations." The IRS has long recognized that when organizations are related (in a parent-subsidiary relationship or as subsidiaries of a common parent), and one organization is operating an exempt charitable activity—such as a hospital—a related organization performing some of the functions of that organization can itself be recognized as a Section 501(c)(3) tax-exempt organization even if the functions (for example, management or investment services) are not inherently charitable. It is operating as an "integral part" of a related exempt organization.[6] If an organization's primary purpose was performing such services for unrelated organizations, it would be classified as a "feeder" organization by the IRS and not entitled to tax exemption.[7] Thus, parent organizations of tax-exempt healthcare systems can be recognized as tax-exempt because they perform management, governance, and oversight services for the controlled organizations that the controlled organizations would otherwise perform for themselves. If the parent were providing some of the same services to organizations that it did not control, that activity could be treated as a taxable unrelated trade or business of the parent, and if such activities make up a substantial part of the parent's activities, the parent might not be eligible for tax exemption.[8]

A JOA does not fall into a "traditional" single-parent/subsidiary type of structure. This can be illustrated by visualizing and comparing the organizational charts of a single parent system and a JOA. The single-parent system is



Because the IRS takes a "facts and circumstances" approach to determining whether the participants are sufficiently related, changes in JOC structure or powers may be requested as part of the IRS determination process.

a pyramid, with the parent alone at the top and the second-, third- or fourth-tier subsidiary organizations across the bottom of the pyramid. A JOA chart may instead look like an "X." The existing system parents (Parent A and Parent B, in our example above) are at the top of the X, New JOC is in the middle of the X, and the heads of local System Y and System Z are at the bottom of the X (with their subsidiaries below them). If Parent A and Parent B reserve some powers directly over System Y and System Z, the chart may look like an X with an H superimposed on it. It is more difficult to analyze whether New JOC, System Y and System Z are "related" for integral part purposes and thus whether New JOC is entitled to recognition of tax exemption.

Having sufficient "relatedness" and obtaining recognition of the JOC as a Section 501(c)(3) tax-exempt organization can be important for several reasons. Tax-exempt systems may be reluctant to enter into transactions in which they are subject to the control of a taxable organization, even if there is no private ownership. Also, the JOC may in the future wish to conduct operations directly, enhancing the permanence of the integration, and will want to conduct those on a tax-exempt basis. More significantly from a legal point of view, System Y and System Z are sharing their bottom line through the JOA. If System Y and System Z actually transfer their bottom lines to New JOC for pooling, then arguably an entity that is not tax exempt has an equity-type interest in the exempt organizations. Whether or not funds are actually transferred to New JOC, each of System Y and System Z is sharing its bottom line with the other and the two are not related for tax purposes. Arguably System Y's and System Z's operations may be deemed unrelated trades or businesses because each is operating its business for the other, or the other is "using" its facilities. This can raise questions both for tax-exempt bonds and for maintaining tax exemption.

IRS Guidance

In 1996, the IRS reached a decision on how to approach JOAs for tax-exemption purposes. It began issuing private letter rulings to exempt organizations with favorable rulings that participation in a JOA would not endanger their tax-exempt status or create an unrelated trade or business and would not endanger their outstanding tax-exempt bonds.[9] The IRS' position and analysis on JOAs was first set forth in July, 1996 letters to taxpayers with pending JOA exemption applications or ruling requests.[10] It is stated in more detail in a chapter in its Exempt Organizations Continuing Professional Education Text that was issued in the fall of 1996.[11] The analysis looks at the facts and circumstances of the JOA to determine whether the JOA establishes the equivalent of a parent-subsidiary relationship between the JOC and participating entities. The facts and circumstances must demonstrate that significant control over management and financial decisions have been ceded by participating hospitals or systems to a governing body (the JOC) created under the JOA.

The IRS' facts and circumstances analysis for JOAs falls into the following four categories:

1. **Delegation of Significant Authority**. The JOC board should have, and actually exercise through frequent meetings, day-to-day and long-range management authority over the participating entities. Elements of management authority include: establishing budgets; approving major contracts; approving debt; approving major or capital expenditures; monitoring and auditing participating entities' compliance with JOC board directives; binding participating entities to managed care and other contracts; granting staff privileges; approving prices; buying and selling assets of participating entities; and reallocating income among the participating entities to assure financial integration and achieve mutual objectives.

2. **Permanence.** The more permanent the JOA, the more the JOA establishes the equivalent of a parent-subsidiary relationship. Automatic termination, or an option to renew, after a term of a few years does not spell permanence. Rather, the IRS is looking for, first, whether there are mechanisms to hold the parties together through disputes, such as negotiation procedures and arbitration, and second, whether there are disincentives to terminating the arrangement, such as significant penalties.

3. **Absence of Veto Powers.** If the JOA has only the power to veto actions of participants, rather than initiating action, this suggests that the equivalent of a parent-subsidiary relationship does not exist. Similarly, if the members of the JOC (Parent A and Parent B in the examples above) can veto actions of the JOC board, the JOC board does not appear to have the power of a parent, but rather is the subsidiary of two unrelated entities.

4. **Few Reserved Powers.** The participating entities and JOC members may need to reserve some powers to act or to make decisions. JOC members likely need to be able to participate in JOC board director selection and to approve organic changes in the JOC (such as amendment of its corporate documents, merger, or dissolution). However, if many JOC actions must be approved by the JOA members, then power has not been delegated by the JOA members and participants to the JOC. A member reserved power may be direct (the JOC cannot act unless its members approve) or indirect (each JOC member appoints a class of JOC directors and both classes of JOC directors must approve the action before the JOC can take action.) The IRS recognizes that, particularly with respect to religious hospitals but also with respect to governmental and other hospitals, hospitals or JOC members may be required to exercise authority or have reserved powers over some decisions. These may involve adherence to religious practice, laws limiting a governmental hospital's ability to delegate certain powers, or property deeds restricting transfer or lease restrictions of the property that cannot be removed. Nonetheless, given all the facts and circumstances, the IRS will want to see reserved powers of JOC members and of JOA participants over the JOC board kept to a minimum.

Note that the members of the JOC may also control organizations that do not participate in the JOA. For example, in our fact pattern, both Parent A and Parent B control hospital systems other than the JOC participants (local Systems Y and Z). Entities in Systems A and B that do not participate in the JOA will, according to the IRS' CPE text, not be viewed as "related" to the JOC or the participating local systems. Accordingly, if the JOC provides management or similar services to them, this may be viewed by the IRS as an unrelated trade or business generating taxable income.

In the healthcare context, a JOA transaction is an agreement between two (or more) previously unrelated tax-exempt health systems to "virtually merge" part or all of each system.

Antitrust: Analysis Is Parallel

Antitrust concerns will of course arise when a JOA involves competitors. The antitrust analysis, not covered in detail here, looks for the facts showing a unity of economic interest between former competitors, looking at such factors as control over assets and clinical programs, bottom-line sharing, and difficulty of exit;[12] these are very similar to the integration facts and circumstances being sought by the IRS.

Conclusion

A JOA may be an attractive alternative to a "traditional" affiliation of health systems. For example, if one of the healthcare facilities that will participate in the JOA is an unincorporated division of an entity operating other facilities elsewhere, a JOA may be the only acceptable alternative. It is important to note that JOAs are implemented by contract rather than by transfer of assets. This does not mean, however, that such implementation will always go quickly. In most cases the JOC will need to apply to the IRS for recognition of its tax exemption, a process that can take a year or more. Because the IRS takes a "facts and circumstances" approach to determining whether the participants are sufficiently related, changes in JOC structure or powers may be requested as part of the IRS determination process. Thus, the tax-exemption issues described here should be addressed at the beginning of and throughout the JOA negotiation process and submission of a tax-exemption application to the IRS should be an early priority. C

About the Author

Elizabeth M. Mills (emills@proskauer.com) is a Senior Counsel in the Chicago, IL, office of Proskauer Rose LLP, and a member of the firm's Healthcare Department. Her practice is focused both on healthcare organizations and tax exemption issues for not-for-profit organizations. She addresses regulatory and transactional issues for all types of healthcare providers, including hospitals, academic medical centers, large physician group practices, retirement facilities, and health maintenance organizations. Ms. Mills advises these organizations as changes to their particular tax exemption standards are proposed, implemented, and litigated. In addition, she assists tax-exempt organizations in addressing tax compliance and governance issues such as Form 990 reporting, executive compensation, payroll taxes, compliance with supporting organization and private foundation restrictions and use of tax-exempt bond-financed property.

Endnotes

1 *See* R. Darling and M. Friedlander, "Virtual Mergers: Hospital Joint Operating Agreement Affiliations," 1996 (for FY 1997) Exempt Organizations CPE Technical Instruction Program Textbook, Chapter J (Spt. 1996), *available at* www.irs.gov/pub/irs-tege/eotopicj97.pdf.

2 *E.g.*, Ken O'Brien, *St. Joseph, Morris Hospitals Create Alliance to Trim Costs*, Chicago Tribune (Mar. 16, 1999); Mark Taylor, *Caught in the Crossfire: Hospital CEO who Opposed Merger that Divides Alabama Communities is Fired*, Modern Healthcare (Aug. 23, 1999) (public rejects proposed JOA); Ed Lovern, *Church's ruling seals deal's fate*, Modern Healthcare (Oct. 15, 2001); Julie Piotrowski, "A difference of mission: Saint Luke's parts ways amicably with Shawnee," Modern Healthcare (Oct. 14, 2002); *Vista Health says FTC won't pursue action*, Modern Healthcare (July 9, 2003) (indicates breakup of Vista Health JOA); Gregg Blesch, *Haven't we met before?*, Modern Healthcare (July 16, 2007); *Ohio Appeals Court Says Hospitals May Withdraw From Health Alliance*, AHLA Health Law Weekly, vol. 7, no. 39 (Oct. 10, 2008); *Columbia St. Mary's, Froedtert put plans on ice*, Modern Healthcare (Dec. 22, 2008); Melanie Evans, *Poudre Valley, university hospital set JOA*, Modern Healthcare (Jan. 31, 2012); Regional News/ Midwest, Modern Healthcare (Feb. 11, 2012) (Ministry Health Care buys out JOA interest of Wheaton Franciscan Healthcare in Affinity Health System).

3 *See, e.g.*, Sanders, *Market Definition, Merger Review, and Media Monopolization: Congressional Approval of the Corporate Voice Through the Newspaper Preservation Act*, 59 Fed. Comm. L.J. 403 (2006-2007).

4 15 U.S.C. §1801 et seq.

5 15 U.S.C. § 1802(2).

6 *See, e.g.*, Rev. Rul. 78-41, 1978-1 C.B. 148 (hospital malpractice trust fund controlled by hospital is exempt).

7 Treas. Reg. § 1.502-1(b); B.S.W. *Group v. Comm'r*, 70 T.C. 352, 356-57 (1978).

8 The IRS explained this reasoning in Chapter C, Health Care Organizations, of its 1983 Exempt Organizations Continuing Professional Education Text, *available at* www.irs.gov/pub/irs-tege/eotopicc83.pdf.

9 IRS Private Letter Rulings 9714011 (4/4/1997); 9738046 (9/19/1997); 9814039 (4/3/1998); 9819049 (5/8/1998); 9842030 (10/16/1998); 9847033 (11/20/1998); 199918066 (5/10/1999); 199924065 (6/21/1999); 199929041 (7/26/1999); 200108045 (2/23/2001); 200245057 (11/8/2002); 200324047 (6/13/2003).

10 A sample letter was made public by Tax Analysts (96 TNT 149-42).

11 R. Darling and M. Friedlander, "Virtual Mergers: Hospital Joint Operating Agreement Affiliations," 1996 (for FY 1997) Exempt Organizations CPE Technical Instruction Program Textbook, Chapter J (Sept 1996), *available at* www.irs.gov/pub/irs-tege/eotopicj97.pdf.

12 *See* Busey, *Antitrust Aspects of Joint Operating Agreements and Other Affiliations*, AHLA 2001 Annual Meeting seminar material.

Thanks go to the leadership of the Tax and Finance Practice Group for sponsoring this month's feature: Elizabeth M. Mills, Proskauer Rose LLP, Chicago, IL (Chair); **Travis F. Jackson**, Jones Day, Columbus, OH (Vice Chair of Research and Website); **Lauren K. Mack**, Polsinelli Shughart PC, Chicago, IL (Vice Chair of Membership); **Donald B. Stuart**, Waller Lansden Dortch & Davis LLP, Nashville, TN (Vice Chair of Publications); and **Stephanie N. Switzer**, Cleveland Clinic Foundation, Beachwood, OH (Vice Chair of Educational Programs).

For more information about AHLA's Tax and Finance Practice Group, visit www.healthlawyers.org/Members/PracticeGroups/TF or follow them on Twitter, @ahla_tax.