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Anne Sheramiaro, Esq., Executive Vice President & General Counsel • Jessamyn Sudhakaran, MLS, Director of Library Services

Healthcare Valuation Series Part IV: Regulatory Issues Related to Exempt Organizations

The four-part *HC Topics Series: Healthcare Valuation* examined the various aspects of valuation related to the healthcare industry, and is excerpted from the book authored by HCC CEO, Bob Cimasi, entitled, "*Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services*," to be published by John Wiley & Sons later this year. The first installment discussed the application of the *Fair Market Value* and *commercial reasonableness* standards utilized by various regulatory bodies in valuing healthcare enterprises, assets, and services. Part II addressed the valuation of intangible assets, and Part III addressed the valuation of physician services. The fourth and final installment of the series examines the regulatory issues present during the valuation of a tax exempt organization.

Market Activity

The increasing government scrutiny of the business activities of healthcare providers over the past several decades has led to tightened restrictions and increased regulatory enforcement of tax exempt organizations. Many types of business arrangements, which would be regarded as typical motivations inherent in commercial relationships between parties in other industries, are perceived as exhibiting the potential for a *significant risk* of fraud in the U.S. healthcare industry. With continued consolidation, integration, and affiliations among various healthcare providers and enterprises, those transactions that involve tax exempt organizations are likely to continue to receive regulatory scrutiny in the coming years. Accordingly, parties to these transactions need to ensure that they are in compliance with IRS standards regarding excess benefit and inurement of benefit, as well as applicable fraud and abuse regulatory requirements related to establishing *Fair Market Value* and *commercial reasonableness*. See part one of the **HC Topics Valuation Series: A Look at Fair Market Value and Commercial Reasonableness**.

The current healthcare industry is focused on the coordination of care and integration among various providers. As healthcare expenditures continue to outpace the general rise in price of most other goods in the U.S. economy, and in light of the fact that the U.S. government is the largest payor of healthcare services, there is a reasonable likelihood of continued consolidation in the healthcare delivery system in an effort to achieve some semblance of *scale economies*.

Consolidation among providers (either through physician employment, mergers, or joint ventures between healthcare enterprises) has already begun to impact the competitive nature of the U.S. healthcare environment. Hospital mergers are one illustration of this consolidation; in 2012, there were 89 transactions among hospitals, as compared to 72 in 2000, and 49 in 2005.[1] Likewise, the number of physicians employed by hospitals has grown by 32 percent since 2002, to 212,000 physicians in 2012, accounting for 20 percent of all practicing physicians.[2] Many of these transactions involved tax exempt organizations.

Legal Issues

Corresponding with the continuing trend of *hospital employment* of physicians, there has been an increase in *regulatory scrutiny* related to the *legal permissibility* of these arrangements under federal and state *fraud and abuse* laws, i.e., Stark, Anti-kickback, and False Claims Act, as well as IRS regulations regarding transactions involving tax exempt organizations. While some IRS regulation of tax exempt organizations mirror the language found in the fraud and abuse prohibitions listed above, one of the main issues for tax exempt entities is the IRS prohibitions against *excess benefit* or *inurement of private benefit.*

A tax exempt organization, such as a non-profit hospital, is generally permitted to sell one or more of its assets to another tax exempt organization or a for-profit entity, so long as *fair market value* consideration is received for the sale.[3] In those circumstances in which the purchaser of the tax exempt organization's assets is an organization created by individuals related to the exempt organization, e.g., physicians practicing at the non-profit hospital or members of the non-profit hospital's board of directors, these individuals will be treated as *insiders* by the IRS and the transaction will receive strict scrutiny by the IRS to ensure that there are no *excess benefit(s)* or *inurement of private benefit(s)* between the tax exempt organizations and *disqualified persons*.[4]

An *excess benefit transaction* can be characterized as a transaction in which, *"…the value of the economic benefit provided exceeds the value of the consideration received for providing the benefit"*[5] Additionally, the

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IRS defines *inurement of private benefit* as when an e*xempt organization* is "*…organized or operated for the benefit of private interests…*" and has explicitly stated that, *"[n]o part of the net earnings of a section 501(c)(3) organization may inure to the benefit of any private shareholder or individual[, whereby] a private shareholder or individual is a person having a personal and private interest in the activities of the organization."*[6] However, prohibitions related to *excess benefits* and *inurement of private benefit* do not *unilaterally* prevent *tax exempt organizations* from paying *financial incentives* (e.g., shared savings related to quality improvements or other *incentive compensation arrangements*) to physicians as part of the compensation package.

In *General Counsel Memorandum (GCM) 35638*, published on January 28, 1974, the IRS noted that even compensation arrangements that involved *shared savings* related to quality improvements could be acceptable if they were at arm's length and were *"…a means of providing reasonable compensation to employees without any potential for reducing the charitable services or benefits otherwise provided…*" [emphasis added].[7]

In the past, *excess benefit transactions* were considered together with other *private benefit inurement's*, and violations were subject to total revocation of the organizations tax exempt status as the sole remedy.[8] In 1996, the *Taxpayer Bill of Rights 2* authorized the IRS to impose *intermediate excise taxes* (a penalty short of *exempt status* revocation) against the *disqualified person* who received the *excess benefit* and on the organizational manager who *knowingly* participated in the transaction.[9]

In the final regulations published on March 28, 2008, the IRS identified five factors to be considered when determining whether the organization should be subject to an *intermediate excise tax* or whether the organization's exempt status should be revoked in the event that an exempt organization is found to have participated in an excess benefit transaction: (1) the size and scope of the organization's *ongoing activities*; (2) the size and scope of the *excess benefit transaction* in relation to regular activities; (3) whether *excess benefit transactions* happened in the past; (4) whether the organization has implemented *safeguards* against this type of transaction; and, (5) whether the *excess benefit transaction* has been corrected, or there has been a *good faith effort* to do so.[10] These last two factors are given a greater weight when considering whether to allow an exempt organization to maintain its *tax-exempt status* in those cases in which the exempt organization has taken steps to remedy the situation.[11]

SERIES CONCLUSION

Valuation analysts whose healthcare engagements have been focused on appraising historically *"traditional"* provider organizations, e.g., physicians in solo and small group practices, are seeing a decline in their client base as the healthcare industry consolidates, and greater numbers of providers form new and larger *emerging healthcare organizations* (EHOs). These EHOs are driven by the need to develop new affiliations, capital structures, and governance configurations, in order to align the interests of various healthcare industry subsectors, e.g., inpatient and outpatient providers, suppliers and vendors, payors, and consumers, in such a manner as to address the rise of *Accountable Care Organizations* and other *value-based* reimbursement initiatives. As the U.S. healthcare delivery system continues to navigate the tumultuous transactional landscape, it will be central for healthcare enterprise and providers to obtain a certified opinion of value as to whether the proposed transaction is both at *Fair Market Value* and *commercially reasonable* in order to ensure that the proposed arrangement is in compliance with applicable regulatory requirements.

Healthcare Valuation Series Part III: The Valuation of Physician Services

Healthcare Valuation Series Part II: The Valuation of Intangible Assets

Healthcare Valuation Series Part I: A Look at Fair Market Value and Commercial Reasonableness

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1 "M&A Transactions in the Hospital Sector" Irving Levin Associates, Inc. https://www.levinassociates.com/dealsearch (Accessed 1/2/2013).

2 "AHA" Hospital Statistics" American Hospital Association, 2012 ed., Health Forum LLC, 2011, p. vii.

3 "The Law of Tax-Exempt Organizations, By: Bruce R. Hopkins, 10th edition; John Wiley & Sons, Inc. Hoboken, NJ (2011), p. 958-959.

4 A disqualified person is any person in a position to exercise substantial influence over the affairs of the organization at any time in the Lookback Period [five years] or family members of the disqualified person. To be a disqualified person, it is not necessary that the person actually exercise substantial influence, only that the person be in a position to exercise substantial influence." *Ibid*.; "An Introduction to I.R.C. 4958 (Intermediate Sanctions)" By Lawrence M. Brauer, et al., 2002 Exempt Organization CPE Text, 2002; "Taxes on Excess Benefit Transactions" 26 U.S.C.A Section 4958 (March 23, 2010).

5 "Excess Benefit Transaction" 26 C.F.R. . §53.4958-4(a)(1) (2012).

6 "Inurement/Private Benefit - Charitable Organizations" Internal Revenue Services, February 2, 2012, http://www.irs.gov/charities/charitable/article/0,,id=123297,00.html (Accessed 8/7/2012); "Exemption from tax on corporations, certain trusts, etc." 26 U.S.C. §501(c)(3) (2012).

7 "Section 4958 Update" By Lawrence M. Brauer and Marvin Friedlander" in "2000 Exempt Organization (EO) CPE Text" Internal Revenue Service, 2000, p. 29.

8 "IRS Policing of Tax-Exempt Organizations" By Charles R. Brodbeck and Mark R.Stabile, Physician's News Digest, February 1997, Accessed at http://www.physiciansnews.com/finance/297.html (Accessed 9/24/12).

9 "Taxpayer Bill of Rights, Sec. 1311" Pub. Law 104-168, 110 Stat. 1452 (July 30, 1996), p. 1475-1479.

10 "Standards for Recognition of Tax-Exempt Status if Private Benefit Exists of if an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transaction(s)" Federal Register, Vol. 73, No. 61 (March 28, 2008), p. 16522.

11 *Ibid*.

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Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, serves as Chief Executive Officer of **HEALTH CAPITAL CONSULTANTS** (HCC), a nationally recognized healthcare financial and economic consulting firm headquartered in St. Louis, MO, serving clients in 49 states since 1993. Mr. Cimasi has over thirty years of experience in serving clients, with a professional focus on the financial and economic aspects of healthcare service sector entities including: valuation consulting and capital formation services; healthcare industry transactions including joint ventures, mergers, acquisitions, and divestitures; litigation support & expert testimony; and, certificate-of-need and other regulatory and policy planning consulting.

Mr. Cimasi holds a Masters in Health Administration from the University of Maryland, as well as several professional designations: Accredited Senior Appraiser (ASA – American Society of Appraisers); Fellow Royal Intuition of Chartered Surveyors (FRICS – Royal Institute of Chartered Surveyors); Master Certified Business Appraiser (MCBA – Institute of Business Appraisers); Accredited Valuation Analyst (AVA – National Association of Certified Valuators and Analysts); and, Certified Merger & Acquisition Advisor (CM&AA – Alliance of Merger & Acquisition Advisors). He has served as an expert witness on cases in numerous courts, and has provided testimony before federal and state legislative committees. He is a nationally known speaker on healthcare industry topics, the author of several books, the latest of which include: "*Accountable Care Organizations: Value Metrics and Capital Formation*" [2013 - Taylor & Francis, a division of CRC Press], "*The Adviser's Guide to Healthcare*" – Vols. I, II & III [2010 – AICPA], and "*The U.S. Healthcare Certificate of Need Sourcebook*" [2005 - Beard Books]. His most recent book, entitled "*Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services*" will be published by John Wiley & Sons in the Fall of 2013.

Mr. Cimasi is the author of numerous additional chapters in anthologies; books, and legal treatises; published articles in peer reviewed and industry trade journals; research papers and case studies; and, is often quoted by healthcare industry press. In 2006, Mr. Cimasi was honored with the prestigious "*Shannon Pratt Award in Business Valuation*" conferred by the Institute of Business Appraisers. Mr. Cimasi serves on the Editorial Board of the Business Appraisals Practice of the Institute of Business Appraisers, of which he is a member of the College of Fellows. In 2011, he was named a Fellow of the Royal Institution of Chartered Surveyors (RICS).

Todd A. Zigrang, MBA, MHA, ASA, FACHE, is the President of **HEALTH CAPITAL CONSULTANTS** (HCC), where he focuses on the areas valuation and financial analysis for hospitals and other healthcare enterprises. Mr. Zigrang has significant physician integration and financial analysis experience, and has participated in the development of a physician-owned multi-specialty MSO and networks involving a wide range of specialties; physician-owned hospitals, as well as several limited liability companies for the purpose of acquiring acute care and specialty hospitals, ASCs and other ancillary facilities; participated in the evaluation and negotiation of managed care contracts, performed and assisted in the valuation of various healthcare entities and related litigation support engagements; created pro-forma financials; written business plans; conducted a range of industry research; completed due diligence practice analysis; overseen the selection process for vendors, contractors, and architects; and, worked on the arrangement of financing.

Mr. Zigrang holds a Master of Science in Health Administration and a Masters in Business Administration from the University of Missouri at Columbia. He is a Fellow of the American College of Healthcare Executives, and serves as President of the St. Louis Chapter of the American Society of Appraisers (ASA). He has co-authored *"Research and Financial Benchmarking in the Healthcare Industry"* (STP Financial Management) and *"Healthcare Industry Research and its Application in Financial Consulting"* (Aspen Publishers). He has additionally taught before the Institute of Business Appraisers and CPA Leadership Institute, and has presented healthcare industry valuation related research papers before the Healthcare Financial Management Association; the National CPA Health Care Adviser's Association; Association for Corporate Growth; Infocast Executive Education Series; the St. Louis Business Valuation Roundtable; and, Physician Hospitals of America.

Anne P. Sharamitaro, Esq., is the Executive Vice President & General Counsel of **HEALTH CAPITAL CONSULTANTS** (HCC), where she focuses on the areas of Certificate of Need (CON); regulatory compliance, managed care, and antitrust consulting. Ms. Sharamitaro is a member of the Missouri Bar and holds a J.D. and Health Law Certificate from Saint Louis University School of Law, where she served as an editor for the Journal of Health Law, published by the American Health Lawyers Association. Ms. Sharamitaro has presented healthcare industry related research papers before Physician Hospitals of America and the National Association of Certified Valuation Analysts and co-authored chapters in "*Healthcare Organizations: Financial Management Strategies*," published in 2008.