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Health Care Law

Tax Exemption For Captive-Physician Entities

How 501(c)(3) nonprofit status may be achieved for a medical practice

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In New Jersey, physician practices must be formed as for-profit entities pursuant to N.J.A.C. 13:35-6.16. This regulation, which implements the corporate practice of medicine doctrine (CPOM Doctrine) mandates that the owner of the professional practice must be a New Jersey licensed physician, as must all members of the governing board of the practice.

Consequently, health-care entities that wish to establish physician practices will often enter into agreements with a physician to serve as the sole shareholder of a professional service entity. The physician will be the sole owner of what is known as a "captive-physician practice entity." Often, this physician is employed by the "parent entity."

Commonly, a restricted stock agreement is entered into among the physician, the captive-physician practice entity and the parent entity. The agreement, in part, typically prohibits the physician from transferring any portion, or all, of the stock without the consent of the parent entity and also may require the physician to transfer his or her stock to any New Jersey licensed physician chosen by the parent entity. The relationship among the parent entity, the captive-physician practice entity and the physician may be further tightened through several other agreements, including a management services agreement. This structure is often utilized by hospitals and affiliated physician practices. Although this article may use terms associated with corporations, the same structure can be established with limited liability companies.

As many parent entities are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (IRC), they may seek to also obtain tax-exempt status for their captive-physician practice entities. This is not an easy goal to achieve, as there is the inherent belief that physician practices are established primarily to carry on a business for profit from the professional practice of medicine. Nonetheless, if the captive-physician entity is organized appropriately to obtain this status, and the right arguments are made, it is possible (although the likelihood, of course, cannot be guaranteed) to obtain tax-exempt status for a captive-physician practice entity.

Charitable Purpose

Section 501(c)(3) of the IRC provides tax exemption for an entity that is organized and operated exclusively for an exempt purpose. The organization of the entity and its operations are examined separately, and both must satisfy the requirement. There must, therefore, be clear language in the description of the purpose of the captive-physician practice entity mimicking the charitable purpose of the parent entity.

The Internal Revenue Service (IRS) has issued guidance over the years with respect to captive-physician practice entities seeking tax-exempt status, which sheds some light on the factors the IRS focuses on when reviewing such applications.

In 1998, the IRS issued a favorable determination letter to a New Jersey professional corporation seeking tax-exempt status based substantially on its serving as an extension of an affiliated nonprofit hospital's charitable purpose. Alliance Medical Group (AMG) had incorporated as a New Jersey for-profit professional corporation. As noted, the CPOM Doctrine prevented Memorial Health Alliance (MHA), a 501(c)(3) entity and the sole member of a community health-care sys-

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tem, from owning the professional corporation and from serving as a shareholder of the professional corporation. However, as discussed in the determination letter, clear language in AMG's certificate of incorporation ensured that MHA controlled AMG and explicitly limited AMG's activities to operate in furtherance of MHA's charitable purpose. Additionally, AMG's bylaws provided a restriction on the transfer of shares, as well as assurance that a shareholder's legal title to the shares was "solely for the benefit of MHA." The determination letter found that, because of the appropriate provisions in the certificate of incorporation, bylaws, shareholder agreement and management agreement, MHA effectively controlled AMG. Therefore, under these circumstances, the for-profit organization earned tax-exempt status by operating solely in furtherance of MHA's charitable interests. *Alliance Medical Group,* 1998 WL 34304310 (I.R.S. Dec. 10, 1998).

Additionally, in *Marietta Health Care Physicians*, the IRS, in determining that Marietta qualified for 501(c)(3) exempt status, highlighted additional factors, such as the tax-exempt parent entity establishing the fee schedule with Marietta for Marietta's employed physicians, the fee schedule being based upon usual, customary and reasonable charges for medical services in Marietta's community, the adoption by Marietta of a charity care policy, and the intended provision by Marietta physicians of services to Medicare and Medicaid patients. 1995 WL 594915 (I.R.S. Oct. 3, 1995).

Conversely, the IRS issued a Private Letter Ruling in 2007 where the captive-physician practice entities in question did not, in fact, act to further the charitable interests of their parent entities. While this Private Letter Ruling focused on applying federal Unrelated Business Income Tax principles to a tax-exempt hospital, its analysis is instructive for identifying factors in the relationship between tax-exempt parent entities and their captive-physician practice entities. Although the IRS found that the hospital did control the six captive professional corporations at issue, it found that their provision of medical services did not have a substantial causal relationship to the hospital's charitable purpose, as required by Income Tax Regulation 1.513-1(d)(2). In the absence of an organizational and operational intent to further the hospital's charitable purpose, the captive professional corporations were not tax-exempt and instead produced taxable "net unrelated income." While these professional corporations may have qualified for 501(c)(3) status in appropriate circumstances, they wholly operated as for-profit entities, but for their obligation to deliver their profits to the exempt hospital. Section 502 of the IRC provides that "an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation." The IRS therefore found that these professional corporations did not meet tax-exempt status. I.R.S. P.L.R. 200716034 (Apr. 20, 2007).

Physician Compensation

Favorable IRS determination letters, though sparse, universally take note of the physician salaries and employment agreements in captive physician practice entity settings. In *Marietta*, the IRS reviewed the compensation arrangement set forth in the agreement. The IRS found that the salaries were comparable to other physicians practicing in the community and this was established by third-party surveys to determine the average range in each specialty. 1995 WL 594915 (I.R.S. Oct. 3, 1995).

Likewise, the determination for *North Shore Medical Specialists* echoed this sentiment, but the IRS also noted that physician bonuses "are a direct function of the physicians' productivity and time devoted to providing medical care to their patients. These bonuses are determined regardless of the nature of the patient, the ultimate payor, or whether payment is ultimately received." 1996 WL 688398 (I.R.S. Nov. 22, 1996).

Furthermore, in the case of *C.H. Wilkinson Physician Network*, the IRS wrote a letter specifically noting that the compensation arrangement would not "penalize physicians who perform charitable services that generate little or no revenues." 1996 WL 343384 (I.R.S. Jun. 19, 1996).

A physician compensation arrangement may aid in establishing the charitable purpose of a captive-physician practice entity; however, the arrangement may alternatively provide the IRS with evidence of physician benefit that would defeat the charitable purpose and result in the denial of exemption.

Conclusion

Despite the CPOM Doctrine's prohibition on a direct ownership relationship between parent entities and physician practices, the use of the captive-physician practice entity model can aid in achieving a similar outcome. In developing and structuring these arrangements, it is critical to create the appropriate provisions within the articles of incorporation, bylaws, shareholder agreements and management agreements that give the 501(c)(3) parent entity full, explicit control and aid in furthering its charitable interest. Most importantly, the foundation of each agreement must be the extension of an entity's exempt purpose.

While the IRS rulings and determinations described in this article provide guidance for use in establishing the relationship between the parent entity and the captive-physician practice entity, the safeguards must be carefully observed and utilized correctly in crafting the structure. Additionally, the rulings and determinations do not address other health-care laws and regulations that require attention designing and implementing such a relationship. ■