FEDERAL LAW UPDATE: ANCILLARY

JOINT VENTURES AFTER ***REDLANDS***

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I. Introduction

As consolidation and cost containment initiatives have become more prevalent in the health care market, joint ventures have become a common vehicle for nonprofit health care providers to assure both a continuing community benefit and their own survival. In over a hundred private letter rulings, the IRS has approved of health care joint ventures involving medical office buildings, imaging centers, ambulatory surgical centers, treatment centers, women's health centers, physical therapy centers, hospital home care services, nursing homes, HMOs and the like. These joint ventures generally involve partnerships, although more recent letter rulings utilize limited liability companies. See, e.g., PLR 9517029 (acute care hospital and psychiatric hospital LLC joint venture between an exempt university subsidiary and a for-profit company); PLR 9645018 (outpatient dialysis service LLC joint venture among an exempt hospital, an unrelated exempt health care system and nephrologists); PLRs 9739036 - 9739039 (diagnostic laboratory LLC joint venture among tax-exempt hospitals and for-profit subsidiaries of tax-exempt hospitals).[1] Only a few years ago, the IRS approved what appeared to be various whole hospital joint ventures. See, e.g., PLR 9517029 (Creighton University tax-exempt affiliate and American Medical International LLC joint venture to operate the University's two teaching hospitals). *See also* PLRs 9352030, 9323030, 9319044, 9318033 and 9308034.

In all of the above-referenced rulings issued after Plumstead Theatre Society, Inc. v Commissioner, 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982), the Service has generally applied a two-prong test (as outlined in GCM 39005 (Dec. 17, 1982)) in determining whether or not participation as a general partner in a partnership jeopardizes a nonprofit's 501(c)(3) status. The first prong is whether participation furthers a charitable purpose of the nonprofit, and the second prong was whether the nonprofit's duties to its partners would preclude it from acting exclusively in furtherance of its exempt purposes. As a corollary to the second prong, the IRS has looked at whether there are mechanisms (such as insurance or a provision precluding unlimited capital calls against the exempt organization) in place to protect the assets of the exempt organization from being used to satisfy the obligations of the partnership for the benefit of the proprietary partners. This two-prong test was liberally applied in many cases by the IRS, requiring little more than good charitable intentions, arm's length terms, at least 50/50

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[1] Although Private Letter Rulings ("PLRs"), Technical Advice Memoranda ("TAMs"), General Counsel Memoranda ("GCMs"), Field Service Advice ("FSAs") and IRS CPE Educational Texts are not legally binding precedent, they are often viewed as evidence of administrative practice and current IRS views absent more definitive guidance such as Treasury Regulations that are directly on point. See Code § 6110(j)(3); Internal Revenue Manual – Audit § 424(14).3; Rowan Cos. v United States, 452 U.S. 247, 261 n. 17 (1981); Hanover Bank v Commissioner, 369 U.S. 672, 686-87 (1962); Wolfpaw v Commissioner, 47 F.3d 787 (6th Cir. 1995); PLR 9726021 (March 31, 1997) (citing FY 1995 & 1996 IRS CPE Texts).

control (veto rights) and adequate insurance or other protections against catastrophic liability being unfairly allocated to the exempt organization.

For the last two or three years, however, high-ranking representatives of the IRS in speeches expressed a variety of concerns about whole hospital joint ventures. The concerns previously expressed by IRS officials have culminated in the issuance of Revenue Ruling 98-15, and more recently, the Tax Court's decision in the ***Redlands*** case. These recent developments call into question the conclusions in many of those prior joint venture rulings and likely are of significance for many ancillary services joint ventures as well as whole hospital joint ventures. If it is not a change in the rules, it is at least a change in their application, with a more stringent focus on the nonprofit's right to control the activities of the venture and whether the venture itself acts in a charitable manner. It remains to be seen whether clarifying guidance will be forthcoming from the IRS. One top IRS official indicated that a private letter ruling involving an ancillary services joint venture was put on hold in light of the continuing *Redlands* litigation and concerns that the Service not take a position in the ruling that would impact its position in the *Redlands* case.[2] Those same concerns may apply to the pending appeal of the *Redlands* case.

II. Audit Implications of Joint Ventures

A. Recent Audit Activity. As of March 1998 the average hospital CEP audit was lasting 2-1/2 years and resulting in an assessment or settlement of $1.7 million, often with closing agreements. Over 108 audits have been closed in the CEP program, including at least 53 health care cases. Of the 76 open cases in March 1999, 36 were hospital and health care organization audits. Furthermore, the trend in all areas is upward. According to statistics announced in October 1999, the average CEP audit was lasting 3 years and resulting in an average assessment or settlement of $2.5 million over 63 closed cases (excluding one or two outliers). Of the 83 open cases in March 1999, 40 were hospital and health care organization audits.[3]

As these audits continue, a key area of focus will be nonprofit/for-profit joint ventures (including hospital-physician deals as well as whole hospital joint ventures, all based on the standards of Rev. Rul. 98-15 and including questions such as actual control in the joint venture and potential excess benefit issues such as overvaluing or undervaluing assets and whether compensation arrangements were entered into to assure the transaction would move forward).[4] In audits of nonprofit/for-profit joint ventures to date, the IRS has found that the joint ventures do

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[2] See B. Yuill, "Unwind of Columbia Joint Venture in Virginia A First But Likely Not the Last, Experts Say," Daily Tax Report (BNA), p. J-1 (Feb. 12, 1999).

[3] See Comments of Marcus Owens, Director of the Exempt Organizations Division of the IRS, at the AHLA Tax Issues for Healthcare Organizations seminar on October 28, 1999, *partially reported in*, J. Almeras, "Look for Continued Scrutiny of Joint Ventures, Owens Says," *Tax Notes Today*, 1999 TNT 209-2 (Oct. 29, 1999), and B. Yuill, "Tax Policy: Owens to Leave IRS for Private Sector; Updates Key Tax-exempt Health Care Issues," *Daily Tax Report (BNA)*, p. G-8 (Oct. 29, 1999).

[4] *See* C. Wright, Nonprecedential Guidance, *supra*; B. Yuill, "IRS Official Gives 'Gainsharing' Advice; Intermediate Sanctions Rules 'Imminent,'" Daily Tax Report (BNA), p. G-2 (July 28, 1998); A. Bennett, "Owens Sees New Focus on Internet Issues, Exclusive Marketing Contracts for Exempts," Daily Tax Report (BNA), p. G-4 (May 18, 1998); L. Gold, "Precedential Guidance, Court Actions Are 'Coming Attractions,' IRS Official Says," Daily Tax Report (BNA), p. G-3 (Feb. 26, 1998). For a discussion of other "hot audit issues," see G. Griffith, "What the IRS Is Examining in CEP Audits of Health Care Organizations," Journal of Taxation of Exempt Organizations, p. ___ (March 2000).

not always further the charitable purposes for which were formed. In some cases, actual operations of the joint venture have borne little or no resemblance to the terms of the written agreements. For example, IRS examiners have audited joint venture arrangements where the agreements provide for a certain level of charity care, yet "[t]he agreed-upon levels are never even approached, and the exempt organization never inquired or had any sense that something was amiss."[5] In other audits, the IRS discovered that funds of the joint venture had been used for political campaign intervention and other inappropriate purposes (*i.e.*, activities which a tax-exempt organization could not undertake on its own and remain qualified for Section 501(3)(c) status). Activities of a partnership are, for many though not all tax purposes, attributed back to the partners under an aggregate theory of partnership which treats each partner as having engaged directly in the activity of the partnership. See, e.g., Code § 512(c)(1); PLR 9609012.

One senior IRS official summarized the results of these various audits as supporting the conclusion and position which the IRS took in Rev. Rul. 98-15. Another common theme emerging from the joint venture audits is that all of the joint ventures reviewed by the IRS (at least whole hospital joint ventures) appear to have been entered into without being "run through 'legitimate and rigorous' business investment analyses." Rather, "[t]here seems to be a different dynamic at work in these situations, a dynamic that is governed by secrecy and a lack of competitive bidding."[6]

Pure economics, however, are not the only concern. In addition to the control aspects discussed below in this outline, on audit the IRS considers various community benefit factors to be important:

> . . . such as whether the exempt partner's interests in a joint venture are located in the part of a city that draws a less-profitable clientele, and how the community as a whole fairs under the joint venture. The Service also examines whether decisions are made with the interests of the community in mind, rather than the interests of the for-profit . . ..[7]

Joint ventures with for-profits also may affect tax-exempt bonds. In that regard, the IRS has indicated that one factor which may be considered reflective of abuse of tax-exempt financing would be "a management contract with a for-profit manager to operate the bond financed facility which provides for the sharing of net profits or provides for penalties if the applicant terminates the contract."[8]

In the whole hospital joint venture area, the restrictive position taken by the IRS in Rev. Rul. 98-15 (described below) has led to the unwinding or cancellation of a number of high profile joint ventures. For example, a Columbia/HCA whole hospital joint venture in Northern

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5 F. Stokeld, "New Health Care Trends, Other Developments Preoccupied EOs, 86 Tax Notes 602 (Jan. 31, 2000) (hereafter, "New Health Care Trends").

6 New Health Care Trends, *supra*.

7 Id.

8 C. Gannett & G. Sack, Chapter H: Identifying Abusive Transactions Involving Section 501(c)(3) Organizations and Tax-exempt Bonds, IRS Continuing Professional Education, Exempt Organizations-Technical Instruction Program for FY 1999), pp. 153, 159. For IRS guidance concerning permissible management agreements that will not adversely affect tax-exempt bonds, see Rev. Proc. 97-13, 1997-1 C.B. 632.

Virginia was reportedly unwound due to delays in receiving an IRS ruling. In voting to terminate the joint venture, the board of the nonprofit Arlington Health Foundation reportedly blamed possible loss of its tax-exempt status.[9]

The IRS' restrictive position on joint ventures has also carried over into the area of ancillary joint ventures. As of mid-1999, the IRS had approximately eight ruling requests pending involving joint ventures between tax-exempt hospitals and either physicians or for-profit partners related to ancillary medical services (*e.g.*, laboratory, X-ray, MIR, etc.). That was a decrease in number from approximately 20 in 1998. Despite all these requests, the IRS has not yet issued a favorable final ruling on any ancillary joint venture since issuance of Rev. Rul. 98-15 and the Tax Courts opinion in *Redlands*.[10]

B. Overview of TBOR2. In 1996, Congress enacted the Taxpayer Bill of Rights 2 ("TBOR2") which added Section 4958 to the Internal Revenue Code providing for intermediate sanctions on individuals participating in prohibited private inurement. On July 30, 1998, the IRS issued proposed regulations to implement TBOR2. 63 Fed. Reg. 41,486 (Aug. 4, 1998). Although the regulations are only proposed, the IRS expressly noted in the preamble that "[t]axpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect." 63 Fed. Reg. at 41,494. TBOR2 and these regulations themselves could fill an entire session, so the discussion in this outline is limited to some of the key highlights. For a more detailed review and analysis of the regulations, see G. Griffith, "IRS Intermediate Sanctions Proposal: Guidance on the Eve of Enforcement," Health Law Reporter (BNA), pp. 1558-72 (Oct. 1, 1998).

TBOR2 applies to any transaction in which a disqualified person (someone in a position of substantial influence over the exempt organization plus their family members, if an individual, and 35% controlled entities) receives an excess benefit (*i.e.*, more than fair market value/reasonable compensation or, after regulations are finalized, a revenue sharing payment which results in inurement). Such transactions are defined as excess benefit transaction and are taxed at the two-tier rates of 25% for all such transactions and a second tax of 200% if the transaction is not corrected prior to a formal assessment of the first-tier tax. Organization managers who participate in the excess benefit transaction knowingly and without reasonable cause to believe it is not an excess benefit transaction are taxed at 10% of the excess benefit up to a maximum tax of $10,000 per transaction.

Although the exempt organization itself is not required to pay these penalty taxes, it can indemnify its disqualified persons and organization managers or purchase insurance for them. The value of any such indemnity or insurance, however, must be included in calculating whether or not an excess benefit is received. In the case of indemnity, this likely triggers an upward spiral

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[9] See K. Hallam, "Tax Ruling Delay Kills Columbia VA. Venture," Modern Healthcare, p. 8 (Feb. 1, 1999); C. Reaves & J. Gerzog, "Unwind of Columbia/HCA Whole Hospital Joint Venture in Northern Virginia May Just Be the Writing on the Wall,"" Tax Notes Today, 1999 TNT 66-108 (April 7, 1999); J. Moore, "Virginia Hospital to Close: Troubled 50/50 Venture Involving Columbia Decides to Pull Plug on Pentagon City Hospital," Modern Healthcare, p. 18 (Aug. 30, 1999).

[10] B. Yuill, "Handful of Ancillary Joint Ventures Might Soon Get IRS Nod, Official Tells ABA," 8 Health Law Reporter (BNA) 751 (May 6, 1999).

where each indemnity payment results in more excess benefit, triggering yet another indemnity payment and more excess benefit, etc. For insurance, Moreover, penalty excises taxes are normally, but not necessarily, the only penalty. Exemption still can be revoked in addition to levying these penalty excise taxes; however, the Congressional intent expressed in the legislative history of TBOR2 (House Ways & Means Committee Report) was that generally penalty excise taxes would be the only penalty unless the conduct is so pervasive that it calls into question whether or not the organization as a whole continues to operate for charitable or social welfare purposes.

The legislative history of TBOR2 also contemplated procedural protections for disqualified persons and organization managers where there is an advance review and approval of an arrangement by the exempt organization's independent board or a committee thereof. Such a review will give rise to a rebuttable presumption of fair market value if it is conducted in advance of any legal commitment to the transaction, the board or committee is indeed independent (*i.e.*, any member with a conflict of interest excuses himself or herself from the deliberations and vote on the transaction), and its conclusions are based on appropriate documentation of fair market value. Additional details regarding the rebuttable presumption review process and other aspects of TBOR2's excess benefit provisions were outlined in proposed regulations.

1. Disqualified Persons. The proposed regulations would apply both a bright-line test and a facts and circumstances test to determine who is a disqualified person by virtue of being in a position to exercise substantial influence over the affairs of an exempt organization. In addition, their family members and 35% controlled entities (voting power in corporations, profits interest in partnerships) are deemed to be disqualified persons by statute. Family members would include spouse, brothers and sisters (by the whole or half blood), spouses of brothers and sisters (by the whole or half blood), ancestors, children, grandchildren, great-grandchildren and spouses of children, grandchildren and great-grandchildren. Prop. Reg. §53.4958-3(b)(1)-(2).

a. ***Deemed Disqualified Persons***. Under the bright-line test, the following individuals would be deemed conclusively to be disqualified persons: (1) voting members of the governing board; (2) president, CEO, COO and other persons with the power or responsibility, in whole or in part, for implementing decisions of the board; (3) treasurer, CFO and other persons with similar powers or responsibilities; and (4) anyone with "a material financial interest in a provider-sponsored organization" in which the tax-exempt hospital participates. Prop. Reg. §53.4958-3(c)(1)-(4).

b. ***Safe Harbor***. The following persons would be deemed not to be in a position to exercise substantial influence: (1) any other 501(c)(3) organization (but **not** 501(c)(4)) subject to TBOR2; and (2) any person (individual or entity) who is paid less than a "highly compensated employee" as described in Section 414(q)(1)(B)(i) of the Code (*i.e.*, $80,000 annually plus a cost of living adjustment pursuant to Section 415(d) or, if elected by the employer, the top 20% of employees in compensation excluding certain new hires, part-time and unionized employees). To qualify for the safe harbor, the person also must not be (a) a family member or 35% controlled entity of a disqualified person, (b) one of the four categories of individuals above who are deemed to be disqualified persons, or (c) a substantial contributor to the organization as defined in Section 507(d)(2) (higher of $5,000 or 2% of total annual contributions). Prop. Reg. §53.4958-3(d). Examples in the proposed regulations suggest that receipt of benefits of a type and amount provided to all employees and volunteers of an organization will not disqualify an employee from the safe harbor. The non-highly compensated person exception should be particularly helpful in narrowing the scope of contracts that should be run through a rebuttable presumption review procedure. It also may protect many medical directors if one Treasury Department official's statement is correct that part-time employees' compensation will not be grossed up to a full-time rate for purposes of applying the $80,000 threshold. See C. Wright, "ABA Tax Section Meeting: Treasury Officials Discuss New Intermediate Sanctions Regs," Tax Notes Today, 98 TNT 148-7 (Aug. 3, 1998).

c. ***Facts and Circumstances Test***. In all other cases, a facts and circumstances test applies. Factors indicating that someone may be in a position to exercise substantial influence include: (1) founder of the organization; (2) substantial contributor under Section 507(d)(2) ($5,000/2% of total contributions); (3) compensation based on revenues derived from activities of the organization he/she/it controls; (4) authority to control or determine a significant portion of the organization's capital expenditures, operating budget or employee compensation; (5) managerial authority or serving as a key advisor to a person with managerial authority; and (6) owning a controlling interest (undefined – 35%? 50%? 80%?) in a corporation, partnership or trust that is a disqualified person. These factors, particularly the broadly worded factor (5) for "key advisors" could sweep in a large number of health care executives and consultants. Factors that suggest someone is not a disqualified person include: (1) taking a bona fide vow of poverty as an employee, agent or on behalf of religious organization; (2) independent contractor serving in the capacity of attorney, accountant, or investment manager or advisor, unless the person could economically benefit directly or indirectly from the transaction (other than by payment of fees for professional services rendered); and (3) receiving only the same preferential treatment as is offered to all donors making comparable contributions as part of a fund raising campaign designed to attract a substantial number of contributions. Prop. Reg. §53.4958-3(e)(3).

The preamble to the proposed regulations also indicates that someone "who has managerial control over a discrete segment of an organization may nonetheless be in a position to exercise substantial influence over the affairs of the entire organization." 63 Fed. Reg. at 41,490. That interpretation is supported in three examples, where the IRS described two department heads (cardiologist and a law school dean) who are in a position to exercise substantial influence and another (radiologist) who is not. Key factors are: (1) importance of the department as a direct and indirect revenue source; and (2) managerial control over the department such as through a key role in hiring and authority to determine a significant portion of its capital and operating budgets and to allocate compensation of department staff; (3) incentive bonuses funded by a portion of organization revenues attributable to the department vs. lack of any revenue-based compensation related to activities he/she controls. Prop. Reg. §53.4958-3(f), *Examples 6-8*.

d. ***Physicians***. Historically, the IRS' bias was toward finding all staff physicians to be insiders.[11] In the legislative history of TBOR2 (H.R. 104-506 at n. 12), Congress rejected that sweeping presumption and indicated that only physicians in a position to exercise substantial influence should be treated as disqualified persons. The examples are helpful in illustrating that not all physicians are disqualified persons, and managerial authority is a key consideration. However, the range of which physicians are disqualified persons is still potentially very broad and the door is open for the IRS to argue that the level of potential referrals can make a physician a disqualified person. In addition, the proposed regulations would consider revenue-based compensation as one factor indicating that the recipient is a disqualified person. Prop. Reg. §53.4958-3(e)(2)(iii). Given the IRS' historical bias in treating all staff physicians as insiders and its suspicion of revenue-sharing arrangements at least since GCM 39862 (Nov. 21, 1991), the result may be that any physician with a revenue based incentive compensation arrangement, even one limited to personal productivity, is a disqualified person.

e. ***No Free "First Bite"?*** The provisions for deeming certain individuals disqualified persons and the examples in the proposed regulations patterned on *United Cancer Council*, 109 T.C. 326 (1997) (fundraiser for charity found by Tax Court to be an insider), rev'd, 165 F.3d 1173 (7th Cir. 1999) and Rev. Rul. 98-15 emphasize the IRS' view that no one should receive a free "first bite" at the apple for their initial contract. Prop. Reg. § 53.4958-3(f), *Examples 3 & 5*; Reg. § 53.4958-5(d), *Example 2*. Even with no prior relationship to the exempt organization, the proposed regulations suggest that a person may be a disqualified person based solely on his/her/its responsibilities under the initial contract. Alternatively, a person also may become a disqualified person during the term of the contract by receiving benefits disproportionate to the value of the services provided in exchange. This extreme position is reminiscent of the IRS' prior view that all staff physicians, even new recruits, were insiders. The Seventh Circuit's sternly worded reversal of the UCC case, however, rejects a facts and circumstances approach and rejects the idea that an initial contract, itself negotiated at arm's length, makes the other party an insider. Those same concerns should lead to a tightening of the definition of "disqualified persons." In light of the Seventh Circuit's recent opinion, the facts and circumstances test should be clearly articulated in the regulations. Although the intent of the meanings of the terms "disqualified person" and "insider" are similar, the legislative history of TBOR2 indicates that the term "disqualified person" is intended to be less inclusive than the IRS' past interpretation of the term "insider" (*see*, *e.g.*, the Ways & Means Committee's disagreement with the Service's prior position that all staff physicians are "insiders" in H.R. 104-506 at n. 12). The UCC case indicates that a facts and circumstances test used in defining who is an "insider" is not clear enough to give exempt organizations a standard to rely on. Accordingly, if the UCC ruling is followed, more detailed guidance should issued for the definition of "disqualified persons" as well.

f. ***Affiliated Groups***. Excess benefits are taxable even if provided indirectly through another entity owned or controlled by or affiliated with an exempt organization, a potentially broad group. The proposed regulations, however, do not define a minimum level of ownership, control or affiliation for this purpose. Although the proposed regulations include somewhat contradictory provisions, the legislative history, the IRS' model conflicts of interest policy (first published in the FY1997 CPE Text) and certain of the proposed

[11] See, e.g., GCM 39498 (Jan. 18, 1986).

regulations strongly suggest that a person who is in a position of substantial influence over a subsidiary by virtue of that relationship also may have substantial influence over the affairs of the parent or a brother-sister corporation. Prop. Reg. §53.4958-4(a)(2) & (b)(3)(ii)(E).

2. Rebuttable Presumption Procedure. The proposed regulations outline, in greater detail, the same procedure for establishing a rebuttable presumption of fair market value as set forth in the legislative history and in instructions to Form 990. By following this procedure, taxpayers can shift the burden of proof to the IRS to establish that a transaction is not at fair market value, rather than the taxpayer being required to prove it is. Although following the procedure could establish a road map for the IRS, other regulators and private parties to use against the hospital, following the procedure in good faith may lead to summary judgment or more importantly it can play prominently in the exercise of "prosecutorial discretion."

To establish the presumption, the following three steps must be taken prior to making any payment to the disqualified person: (1) the arrangement must be reviewed and approved by the exempt organization's governing board or a committee thereof, and none of the members of the board or committee participating in the discussion or vote on the arrangement can have a conflict of interest with respect to that arrangement; (2) the board or committee must rely on appropriate data as to fair market value in comparable arrangements prior to making its determination; and (3) the board or committee must adequately document the basis for its decision concurrently in the minutes. Prop. Reg. §53.4958-6(a) & (b).

a. ***Conflicts of Interest***. One of the key elements of establishing the rebuttable presumption is documenting that all of the board or committee members participating in the deliberation and vote on the arrangement were disinterested as to that arrangement. In that regard, the proposed regulations echo the IRS' model conflicts of interest policy by noting that interested individuals may attend the meeting only to answer questions and then must recluse themselves from the meeting. They can not be present for any debate or voting on the transaction. The proposed regulations also provide a limited safe harbor for avoiding conflicts. A board or committee member does not have a conflict if he or she: (1) is not a party to and does not personally benefit from the transaction and none of his or her family members will participate in or economically benefit from the transaction; (2) is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the transaction; (3) is not receiving compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the transaction; (4) has no material financial interest affected by the transaction; and (5) does not approve a transaction providing economic benefits to any disqualified person participating in the transaction, who in turn has approved or will approve a transaction providing economic benefits to the member (*i.e.*, no vote swapping). Prop. Reg. §53.4958-6(d)(1)(ii)-(iii).

b. ***Comparable Data***. The proposed regulations make it clear that the level of detail necessary in the supporting documentation to establish the rebuttable presumption depends on the level of knowledge and experience of the board or committee members. Relevant information for the board or committee to determine fair market value would include: (1) compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; (2) availability of similar services in the geographic area of the applicable tax-exempt organization; (3) independent compensation surveys compiled by independent firms (suggesting internally compiled statistics are insufficient); (4) actual written offers from similar institutions competing for the services of the disqualified person; and (5) independent appraisals of the value of property that the applicable organization intends to purchase from, or sell or provide to, the disqualified person. Prop. Reg. §53.4958-6(d)(2)(i). Although there is no reference to consideration of community benefit (cost, quality and access to health care) in this process, it should remain a persuasive fact.

The specific examples of comparable (and non-comparable) data in the proposed regulations emphasize the relationship between board or committee members' knowledge and experience and the level of detail required in the comparable data. In compensation matters, for example, based on their knowledge and experience, the board or committee members must be able to reasonably determine that the position they are reviewing and their organization are comparable to the positions and organizations represented in salary survey data. General business experience alone is not sufficient if the board or committee members do not have any particular expertise in compensation matters in the exempt organization's industry. In general, less experience equates to a need for more detailed data. Prop. Reg. §53.4958-6(d)(2)(iv), *Examples 1 & 2*.

There is also a special rule for small organizations, i.e., receipts of less than $1 million, deeming it to be sufficient comparable data if the board or committee has data on compensation paid by five comparable organizations in the same or similar communities for similar services, even if documented only in a summary prepared by a board or committee member (but not by the executive), and an evaluation of the executive's prior salary and performance. Prop. Reg. §53.4958-6(d)(2)(ii) & (iv), *Example 3*. The safe harbor, however, implies that larger organizations (including virtually all tax-exempt health care providers) must have more extensive comparability data to support the reasonableness of a total compensation package.

c. ***Written Documentation***. For adequate documentation, the board or committee minutes should include: (a) terms of the transaction; (b) date it was approved; (c) members of the board or committee present during debate and those who voted on the transaction; (d) comparability data obtained and relied upon by the board or committee and how the data was obtained; (e) actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the board or committee but who had a conflict of interest with respect to the transaction; and (f) if the board or committee determines that fair market value in a specific transaction is higher or lower than the range of comparable data obtained, the minutes must state the basis for that determination (perhaps an implied reference to under-compensation for past service,[12] community benefit considerations or an invitation to admit excess benefit). For a decision to be documented concurrently, the minutes also must be prepared by the next meeting of the board or committee and must be reviewed and approved as reasonable, accurate and complete within a reasonable time period thereafter. Prop. Reg. §53.4958-6(d)(3).

d. ***Future Determinations of Reasonableness***. The rebuttable presumption applies to all payments made or transactions completed in accordance with the

[12] See, e.g., Choate Construction Co. v Commissioner, T.C. Memo. 1997-495 (§162 deductibility case).

contract provided that the three requirements of the rebuttable presumption were met at the time the contract was agreed upon. If reasonableness of compensation cannot be determined based on circumstances existing when the contract was made, then the rebuttable presumption cannot arise until circumstances exist so that reasonableness can be determined, and the three basic requirements for the presumption subsequently are satisfied. Prop. Reg. §53.4958-6(e) & (g).

e. *Rebuttal or Lack of Any Presumption*. The presumption is rebuttable by the IRS. It may be rebutted, for example, by challenging the independence of the reviewing body or challenging the comparability of the data relied on in the review process. Failure to follow the rebuttable presumption procedure, however, does not create an inference of excess benefits. Nor does following the procedure relieve anyone from compliance with other state and federal laws governing health care organization. Prop. Reg. §53.4958-6(c) & (f).

f. *Applicability to Revenue Sharing Arrangements*. As reflected in the legislative history, the proposed regulations and the Instructions to Form 990, the rebuttable presumption procedure only applies to the non-fair market value type of excess benefit. Accordingly, to the extent that a revenue sharing arrangement is challenged as resulting in an excess benefit by virtue of providing for more than fair market value payments to disqualified persons, the rebuttable presumption procedure will apply. That procedure, however, is not presently designed to create any rebuttable presumption that would protect a revenue sharing arrangement which results in excess benefit because it is defectively structured. In other words, once regulations are finalized, a revenue sharing arrangement which results in inurement based on the manner in which the gross or net revenue sharing payments are calculated will be an excess benefit even if the total payments do not exceed fair market value for the items or services provided. It remains to be seen whether those final regulations, when and if issued, will expand the rebuttable presumption procedure to include some protection for the advance independent board or committee approval of the structure of revenue sharing arrangements.

3. Revenue Sharing Arrangements. For transactions occurring after final regulations are issued, "excess benefit transactions" also will include any revenue-sharing arrangement where the disqualified person is paid based on a percentage of the revenues of the organization or any of its activities where the arrangement results in inurement, whether or not total compensation exceeds fair market value. Prop. Reg. §53.4958-5(c). The date of occurrence of a transaction generally would be "the date on which the disqualified person receives the economic benefit . . . for federal income tax purposes." Prop. Reg. §53.4958-1(e). Under that definition, any payment made in a prohibited revenue-sharing arrangement after the publication of the final regulations could be viewed as an excess benefit transaction, even if the arrangement was in place before the regulations are finalized, unless a grandfathering provision is included in the final regulations for pre-existing binding contracts.

a. *Current Fair Market Value Limit*. Even before final regulations are issued, revenue-sharing arrangements may result in prohibited private inurement or excessive private benefit jeopardizing tax-exempt status. They also can be excess benefit transactions if total payments exceed fair market value. Prop. Reg. §53.4958-5(c). After final regulations are issued, a revenue-sharing arrangement can result in both inurement and excess benefit if the arrangement is defectively structured, even if the total payment does not exceed fair market value. The entire amount of the revenue-sharing payment in that case would be a taxable excess benefit. Moreover, the rebuttable presumption procedures do not apply to defectively structured revenue-sharing arrangements. A defectively structured revenue-sharing arrangement would be one that allows the disqualified person to receive additional compensation (*i.e.*, the percentage payments) without providing proportional benefits to the organization that contribute to its exempt purposes. As one Treasury Department official phrased it, the question is "whether the arrangement could cause the interests of the organization and disqualified person to diverge."[13] One example of a defectively structured arrangement would be one that gives the disqualified person the equivalent of an equity interest in the exempt organization.

b. ***Facts and Circumstances Test***. In a significant step back from the specificity of prior guidance, the proposed regulations would adopt a facts and circumstances test for analyzing revenue-sharing arrangements. All relevant factors would be considered, including: (1) whether the disqualified person can receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purpose; (2) relationship between the size of the revenue-sharing benefit and the quality and quantity of services provided by the disqualified person; and (3) ability of the person receiving the revenue-sharing payment to control the activities generating the revenues on which the payment is based. Prop. Reg. §53.4958-5(a). Although the proposed regulations include three examples, they shed little light on the meaning of the revenue sharing provisions.

c. ***Examples***. The proposed regulations include three examples to illustrate the principles used to determine whether a revenue-sharing arrangement constitutes impermissible inurement, none of which deal specifically with joint ventures (though one does address management contracts). Prop. Reg. §53.4958-5(d). In the first example, one of several employed investment managers is paid a base salary plus a bonus that is equal to a percentage of any increase in the value of the organization's portfolio over the year (net of expenses for external investment management). The regulations note that the revenue-based portion of the compensation plan gives the investment manager an incentive to provide the highest quality service in order to maximize benefits and minimize expenses to the exempt organization. The investment manager has a measure of control over the activities generating the revenues on which his bonus is based, but he can increase his own compensation only if the exempt organization also receives a proportional benefit. Under these facts and circumstances, the bonus payment does not constitute an excess benefit transaction.

In the second example, an exempt organization enters into a management contract with a for-profit company to provide all staff and equipment necessary to carry out charitable gaming operations on behalf of the exempt organization, and to pay over a specified percentage of the net profits to the exempt organization. The net profits equal the gross revenues less equipment rental, staff wages, prizes and other specified operating expenses. The manager retains the balance of the proceeds after expenses and after paying the exempt organization its percentage. It also controls the activities generating the revenue on which its compensation is based. In addition, because the manager owns the equipment and employs the staff needed to operate the

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[13] Prop. Reg. §53.4958-5(a); 98 TNT 148-7, *supra*; A. Bennett, "Exempt Organizations: Intermediate Sanctions Rules Praised; Regulations Will Not Be Finalized This Year," Daily Tax Report (BNA), G-1 (Aug. 3, 1998).

charitable gaming activities, it controls what the exempt organization is charged, including the profit the manager makes above the cost of these items. Therefore, the manager can also control the amount of expenses and thereby reduce or increase the net revenues from the gaming activity. The regulations conclude that the compensation plan does not provide the manager with an appropriate incentive to maximize benefits and minimize costs to the exempt organization. The manager can benefit whether expenses are high and net revenues are low or expenses are low and net revenues are high. By contrast, the exempt organization suffers if expenses for gaming operation are high and net revenues are low because the value of its percentage interest declines. All of the gross revenues generated by the charitable gaming operation belong to the exempt organization, yet the contract allows a portion of those revenues to inure to the manager by the manager retaining the residual net profits under the contract. Therefore, this arrangement results in inurement and the entire amount paid to the manager constitutes an excess benefit.

The distinguishing facts as compared to the first example are that in the second example the manager has complete control over the activity whereas in the first example, the individual was only one of several employees with control over investment activities. Given its position of sole control over the activity and the revenue-sharing methodology, the manager in the second example has ability to control the various expenses that go into determining whether or not the activity turns a profit. The manager can profit from providing the staff, equipment and other overhead services and could obtain a windfall since any excess revenues, after paying expenses and the nonprofit’s share, belong to the manager. Given these distinctions, the second example is particularly troubling for hospital ancillary services joint ventures where a for-profit entity or physician group manages the venture. It appears that the IRS would treat the hospital’s partner as a disqualified person, unless the IRS can be persuaded that such characterization is inappropriate where the activities are an insubstantial part of the organization’s overall activities.

The third example involves intellectual property rights. A professor at a tax-exempt university is the principal investigator in charge of certain scientific research which produces an invention. In accordance with an agreement the university entered into with its faculty, the university owns the invention and patents it with the professor’s assistance. Also in accordance with the faculty agreement, the university grants the professor the right to receive a specified percentage of the royalties on the patent, payable semi-annually in addition to her annual salary and benefits. The proposed regulations conclude that the availability of revenue-based compensation under these circumstances does not give the professor any incentive or opportunity to act contrary to the university's interests in accomplishing its exempt purpose. She receives the revenue-based compensation, *i.e.*, the percentage of royalties, as an incentive and a reward for producing work of especially high quality. In addition, any time she benefits by receiving royalties, the university also benefits to a proportionate degree. Finally, because the patent belongs to the university, the professor has no control over how the patent is used nor the stream of revenue it generates. Under these facts and circumstances, the university's payment of revenue-based compensation to the professor does not constitute an excess benefit transaction.

d. ***Gainsharing and Other Affected Transactions***. Without a grandfathering provision, many existing whole hospital and ancillary services joint ventures, contracts including any percentage compensation, and a variety of hospital-physician programs, including the so-called “gainsharing” programs, may need to be restructured.

C. <u>UCC Case: One Free Bite</u>. In apparent recognition of its victory in the <u>United Cancer Council</u> case in the Tax Court, the IRS included two examples in the proposed regulations where a company managing a charity's bingo operation was a disqualified person. The bingo games were the charity's principal source of income and the manager was also compensated based on the revenues generated from the bingo games (retaining all the proceeds after paying a percentage to the charity). Prop. Reg. §53.4958-3(f), *Example 3* & §53.4958-5(d), *Example 2*. That same approach could be applied to a for-profit company managing a health care organization's principal revenue producing activity (*e.g.,* managing a subsidiary's ambulatory surgery facility).

The provisions in the proposed regulations for deeming certain individuals disqualified persons and the examples patterned on <u>United Cancer Council</u> and Rev. Rul. 98-15 emphasize the IRS' view that no one should receive a free "first bite" at the apple for their initial contract. Even with no prior relationship to the exempt organization, a person may be a disqualified person based solely on his/her/its responsibilities under the initial contract. Alternatively, a person also may become a disqualified person during the term of the contract by receiving benefits disproportionate to the value of the services provided in exchange. This extreme position is reminiscent of the IRS' prior view that all staff physicians, even new recruits, were insiders. It also has now been discredited by the Seventh Circuit Court of Appeals in a blistering reversal of the Tax Court decision in the <u>UCC</u> case.

The <u>UCC</u> case involved a splinter organization that split off from the American Cancer Society. The focus of the United Cancer Council was on encouraging preventive and ameliorative approaches to cancer rather than finding a cure. In 1984, the Council had an annual operating budget of only $35,000 and was on the verge of bankruptcy following the defection of several of its larger member societies to the American Cancer Society. It was at this point that the Council (through a board committee) selected Watson & Hughey Co. ("W&H") to be its exclusive fundraiser under a five-year agreement. In view of the Council's dire financial straits, W&H agreed to front the initial expenses for the fundraising campaign. Of the $28.8 million raised by W&H, $26.5 went toward W&H's expenses under the agreement and only $2.3 was spent by the Council on services for cancer patients. (The solicitations, however, did include some educational materials that may have accounted for $12.2 million of the fundraising expenses.)

The Tax Court, had essentially found that the fundraiser, W&H, was an insider based on its favorable contract terms and its control of the fundraising activity and the donor list of United Cancer Council. No other reported court decision has concluded that a person's first contract with an exempt organization can ever make him/her/it an insider (at least absent other circumstances like a relative on the board). The Seventh Circuit soundly rejected the IRS' arguments and the Tax Court's analysis, refusing to turn what it described as a bad business decision, negotiated at arm's length (as the IRS admitted) and made when the charity was in desperate straits and on the brink of bankruptcy, into a case of private inurement. In reaching that conclusion, the Seventh Circuit noted that there were no allegations that any UCC board member or his/her relatives or friends were owners, managers or employees of W&H, no allegations that W&H was involved in the establishment of UCC or the selection of its charitable goals (*i.e.,* it was not a founder of UCC). In short, the court noted that to be an insider, one must be "the equivalent of an owner or manager."

UCC admittedly paid out approximately 90% of the $28.8 million of donations in costs and fees to W&H and the contract was an exclusive, no-cut contract for five years. Essentially, the IRS argued that the contract was so one-sided that W&H must have been an insider to get such a sweetheart deal, an argument that the IRS frequently makes in hospital-physician transactions. The Seventh Circuit refused to go that far, but did acknowledge that "The test [for insider status] is functional. It looks to the reality of control rather than to the insider's place in a formal table of organization. The insider could be a 'mere' employee – or even a nominal outsider, such as a physician with hospital privileges in a charitable hospital." (Citing Harding Hospital, Inc. v U.S., 505 F.2d 1068, 1078 (6th Cir. 1974)). In UCC's case, the contract that the IRS argued made W&H an insider was a fundraising contract, a type of contract common to many charities. It was negotiated at arm's length and it was an exclusive contract, in the court's view, to protect W&H's risk from fronting the initial fundraising expenses. The exclusivity prevented another fundraiser from reaping the benefits of W&H's work and capital. Moreover, if W&H was not performing, as a matter of contract law UCC could terminate the contract and hire a new fundraiser. As for the use of the donor list, UCC retained the rights to use it for the only purpose for which it had value to the charity, to raise additional funds for its activities.

It is important to note, however, that the Seventh Circuit's opinion is only one decision. The case has been remanded to the Tax Court for further proceedings on the IRS' alternative basis for revocation, namely a finding (by the IRS) of excessive private benefit. The IRS may prevail with the same control arguments on private benefit grounds, and at a minimum the case should provide new insight as to the practical difference, if any, between the restrictions of the inurement prohibition (which only applies to insiders) versus the private benefit standard (which applies to everyone). In the interim, it is unlikely that the IRS will simply acquiesce in the decision, and it is not binding precedent outside of the Seventh Circuit. It is a significant decision and, as an appellate decision, it is persuasive authority. There can be no assurances, however, that the IRS will adopt the same approach to determining who is a disqualified person. Whereas insider status, as interpreted by the Seventh Circuit, rests on a finding of "control," disqualified person status rests on being in a position to exercise substantial influence over the affairs of an organization. Although the definition of insider in the regulations (actually the term is private shareholder or individual) does not use the term "control," adopting a higher standard for who is an insider and thereby reducing the number of transactions subject to the inurement prohibition while maintaining a broader definition of "disqualified person" would be consistent with the Congressional intent of TBOR2. Specifically, the legislative history (House Ways & Means Committee Report) indicates Congress' intent that the penalty excise tax on excess benefit transactions generally should be the only sanction and revocation of exemption should be reserved for extreme cases where there is a pattern of activity indicating that the organization, as a whole, is not operated exclusively for charitable purposes.

D. ***<u>Current TBOR2 Litigation</u>***. There has been some uncertainty as to what effect, if any, intermediate sanctions provisions in TBOR2 will have on the frequency of revocations of tax-exempt status. The legislative history of TBOR2 noted that intermediate sanctions may be imposed by the IRS either in lieu of or in addition to revocation of exemption. It also noted, however, that in practice revocation would occur only when the excess benefit "rise[s] to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization."[14] Litigation currently pending in the Tax Court may clarify just when that level of excess benefit is reached.

In September and November, 1999, six nonprofit corporations and five individuals (the founders and their children) filed petitions in the Tax Court challenging the IRS action in levying substantial penalty excise taxes (approximately $42 million in filings to date) on disqualified persons and revoking exemption retroactively.[15] From one of the petitions, it appears that the IRS action relates to the sale of substantially all of the assets of a group of nonprofit home health agencies to corporations owned by the founders or their children in return for an assumption of the associated liabilities and no other consideration (a transaction which the petitions unadvisedly describe as "conversion of the family businesses"). Even though the organization had a history of losses, the IRS apparently disregarded a supporting appraisal and the parties assertions that industry risk factors affected value. Its reasons for doing so are not yet clear.[16]

III. Current IRS Position on Joint Ventures

A. Rev. Rul. 98-15. Perhaps the most significant recent development in the joint venture area is Rev. Rul. 98-15, 1998-12 I.R.B. 6.[17] Although the ruling involves a whole hospital joint venture, the principles in the ruling seemingly are applicable to all joint venture situations. One key IRS official and a number of practitioners (though not all) agree that Rev. Rul. 98-15 applies to all joint ventures not just whole hospital joint ventures.[18] The ruling presents two factual situations, each of which involves a tax-exempt hospital that forms a LLC with a for-profit corporation and contributes its hospital and all of its other operating assets to the LLC, which then operates the hospital. Under both fact patterns, the for-profit corporation also contributes assets to the LLC and the tax-exempt hospital and for-profit corporation receive an ownership interest in the LLC proportional and equal in value to their respective contributions. All returns of capital and distributions of earnings to the two owners in each case are to be proportional to their ownership interests. In both cases, the tax-exempt hospital intended to use any distributions it received from the LLC to provide grants to promote the health of the community and help the indigent obtain health care. Thus, the sole activities of the tax-exempt hospital in each instance would be its participation in the LLC and its grant-making program.

The control, governance and management in the two factual situations varied significantly. In *Situation 1*, where the IRS found that the tax-exempt hospital would be

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[14] House Ways & Means Committee Report (H. Rept. 104-506) on HR 2337, p. 59, n. 15, reprinted in, 14 The Exempt Organization Tax Review, 423, 430 n. 15 (Sept. 1996).

[15] See C. Wright, "Intermediate Sanctions Petitions Now Available," Tax Notes Today, 1999 TNT 232-3 (Dec. 3, 1999).

[16] Sta-Home Home Health Agency, Inc. of Grenada, Miss. v Commissioner, No. 14711-99 (Tax Ct., Sept. 7, 1999).

[17] See G. Griffith, "Revenue Ruling 98-15: Dimming the Future of All Nonprofit Joint Ventures?," 20 The Exempt Organization Tax Review 405 (June 1998).

[18] See J. Holmes, "IRS Issues Guidelines for Whole Hospital Joint Ventures; Concern Among Practitioners," Daily Tax Report (BNA) pp. GG-1 - GG-3 (March 5, 1998); F. Stokeld, "Owens Expects Joint Ventures to Get More Attention in CEP Exams," Tax Notes Today 98 TNT 59-5 (March 27, 1998).

furthering charitable purposes and therefore continues to qualify for exemption, the tax-exempt hospital chooses three of the five members of the LLC governing board and intends to choose community leaders who have experience with hospital matters but who are not on the hospital staff and who do not otherwise engage in business transactions with the hospital. Major decisions must be approved by a majority of the governing board members. The LLC governing documents require the LLC to operate the hospital in a manner that furthers charitable purposes by promoting health for a broad cross-section of the community. The LLC governing documents also explicitly provide that the duty of the members of the governing board to operate the LLC for charitable purposes overrides any duty they may have to operate the LLC for the financial benefit of its owners. The LLC contracted with an unrelated third party to serve as manager of the LLC pursuant to a five-year management contract that was renewable for additional five-year periods by mutual consent and was terminable for cause. The terms, including fees, were deemed reasonable and comparable. Finally, none of the hospital's officers, directors or key employees had any interest in the for-profit co-owner of the LLC or its related entities and none of the officers, directors or key employees of the tax-exempt hospital involved in the decision to form the LLC were promised employment or other inducements by the LLC, the for-profit co-owner of the LLC or their related entities.

In *Situation 2*, where the IRS found that the tax-exempt hospital would not be engaging primarily in activities that further an exempt purpose and therefore no longer would continue to qualify for exemption, the tax-exempt hospital chooses three of six members of the LLC governing board members and intends to choose community leaders who have experience with hospital matters but who are not on the hospital staff and who do not otherwise engage in business transactions with the hospital. Major decisions must be approved by a majority of the governing board members, which could result in deadlock (in addition, major decisions requiring approval are a somewhat narrower class in *Situation 2*, for example, approval is not required for distributions below certain minimum levels, acquisition or disposition of health care facilities, changes to the type of services offered by the hospital or renewal or termination of management agreement). There was no provision in the LLC governing documents requiring the LLC to operate the hospital in a charitable manner or subordinating any duty of the governing board members to maximize profits to their obligation to operate the LLC for charitable purposes. The LLC contracted with a subsidiary of the for-profit co-owner of the LLC to serve as manager of the LLC pursuant to a five-year management contract that was renewable indefinitely for additional five-year periods at the discretion of the manager, but terminable for cause. The terms, including fees, were deemed reasonable and comparable to management contracts at similar hospitals, other than the renewal provision. Finally, As part of the agreement to form the LLC, the tax-exempt hospital agreed to approve two individuals as the LLC's CEO and CFO. These individuals previously worked in hospital management for the for-profit co-owner. Their compensation was deemed comparable to comparable executives at similar hospitals.

In *Situation 2*, the IRS focused principally on the fact that the organization had not established that it would further exempt purposes. In this regard, the IRS noted that there was no assurance that the LLC would serve charitable purposes or give priority to the health care needs of the community over profits, pointing to the shared control by the tax-exempt hospital, the absence of a binding obligation in the LLC's governing documents to serve charitable purposes, the broad discretion of the management company, which is an affiliate of the for-profit co-owner, and the two executives of the LLC, who had a prior relationship with the for-profit co-owner. The IRS also found that the organization had not established that it was neither organized nor operated for the benefit of private interests. The two fact situations in Rev. Rul. 98-15 represent opposite ends of the spectrum and to date, the IRS has not issued a single private letter ruling interpreting exactly where the line may fall in between those two extremes. A top IRS official has commented, however, that "virtually all the fact patterns we have seen to date have met the bad example" of *Situation 2* in Rev. Rul. 98-15. B. Yuill, "Unwind of Columbia Joint Venture in Virginia A First But Likely Not the Last, Experts Say," Daily Tax Report (BNA), p. J-1 (Feb. 12, 1999) (hereafter "Unwind").

B. ***Ancillary Services***. The standards of Rev. Rul. 98-15 on their face would apply to any nonprofit hospital joint venture, not just whole hospital joint ventures. Even ancillary services joint ventures with for-profits and physicians are potentially affected. Informal comments from IRS officials have suggested that in joint ventures involving less than an entire hospital, the consequence of failing to pass muster under Rev. Rul. 98-15 may be unrelated business income rather than inurement (or excess benefit). Absent further binding guidance from the IRS, however, it is difficult to support such a conclusion.

In GCM 39862, the IRS adopted what is essentially a per se inurement approach to net revenue stream joint ventures. One potential, restrictive reading of Rev. Rul. 98-15 would be that it is yet another form of per se inurement. Although it has been labeled as a facts and circumstances approach, the facts and circumstances examined are those indicating control of the venture and continuing ability of the nonprofit to continue to use its assets (contributed to the joint venture) exclusively in furtherance of its tax-exempt purposes. Once a certain set of facts have been shown to demonstrate that the nonprofit is no longer in control, one would expect the result to be loss of exemption. If the reason the hospital in *Situation 2* did not qualify for exemption is that it did not retain control over how its assets were used, the same could be said of any 50/50 joint venture with a physician or physician group. By allowing its assets to be used to turn a profit for the proprietary hospital chain and its management affiliate in *Situation 2*, the nonprofit was serving a substantial nonexempt purpose. Moreover, the liberalization of the control test in the UCC case may not apply to hospital-physician joint ventures. In that regard, even the Seventh Circuit in UCC noted "even a nominal outsider, such as a physician with hospital privileges in a charitable hospital" could be an insider triggering the inurement prohibition.

It is true that not all hospital-physician joint ventures may be considered a substantial activity in that sense. It is difficult, however, to distinguish Rev. Rul. 98-15 from a smaller scale joint venture on any basis other than the amount of the nonprofit's assets that are committed to the joint venture. In light of the IRS' historical view of staff physicians as insiders (even though tempered by Congress in the legislative history of TBOR2, see H.R. 104-506 at n. 12), it may be argued that virtually all 50/50 hospital-physician joint ventures will jeopardize the hospital's tax-exempt status unless the IRS is willing to either (1) redefine who is an "insider," (2) acknowledge a generous allowance for levels of inurement that will not jeopardize exemption, or (3) acknowledge that the result in Situation 2 of Rev. Rul. 98-15 could be different if one or more of the negative factors were reversed and provide guidance through additional rulings or more informal means as to how that balance is struck. It is this last possibility which is the most realistic, and the most likely. However, TBOR2 suggests that the first two approaches also may be possible given Congress' disagreement with whether all physicians are insiders (and the Seventh Circuit's insistence in UCC in looking for real control, despite an offhand reference to staff physicians as insiders) and given the expectation, reflected in the legislative history, that "[i]n general, the intermediate sanctions are the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization." (H.R. 104-506 at nn. 12 & 15) Of course even the legislative history of TBOR2 does not provide guidance as to what minimum level of activity in a joint venture may be substantial enough to affect exemption. The IRS may be tempted, however, to simply label hospital-physician joint ventures unrelated trades or businesses and not challenge exemption, rationalizing the distinction as one of degree, a justification often floated by IRS officials to explain why prior rulings on hospital joint ventures with for-profits were favorable – *i.e.*, that they only involved a portion and not substantially all of the nonprofits' activities (which was true in most but not all of the prior private letter rulings but not, for example, in the UBI ruling PLR 9517029).

One IRS official indicated at the 1998 AHLA Nonprofit Tax Seminar that a private letter ruling involving an ancillary services joint venture had been issued and would be publicly released around the end of December or early January. As of the date this outline was completed, however, no such ruling had been released nor had any been leaked to the press. More recently, a top IRS official indicated that the private letter ruling was put on hold in light of the continuing Redlands litigation and concerns that the IRS not take a position in the ruling that would impact its position in the Redlands case. *See* B. Yuill, "Unwind," *supra*.

C. Redlands Surgical Services. The most recent guidance available in the ancillary services joint venture area is the Tax Court opinion upholding an exemption denial in Redlands Surgical Services v Commissioner (113 T.C. No. 3 (1999), app. pending (9th Cir., No. 99-71253)). In Redlands, the IRS denied exemption to RSS, a wholly-owned nonprofit subsidiary (Redlands Surgical Services or "RSS") of a hospital parent organization whose sole purpose and activity is to hold a partnership interest in a General Partnership that in turn owns and operates (through another second-tier partnership, the "Operating Partnership") a freestanding ambulatory surgery center ("ASC") located within two blocks of the Redlands Community Hospital ("RCH"). The other partner in the General Partnership is a for-profit company, Redlands-SCA Surgery Centers, Inc. or "SCA," and SCA's subsidiary, SCA Management Co., manages the ASC under a long-term contract described below. In denying exemption, the IRS had determined that RSS held only a minority interest in the ASC (as explained below) and had no control over the ASC partnership and its operations. Because RSS did not have the control necessary to assure that its income and assets would be used to carry out its charitable purposes, the IRS found that RSS violated the private benefit prohibition. Of interest is the fact that the IRS found that RSS had no real control even though it had 50-50 control of the ASC partnership, with a binding arbitration clause in the event of a dispute. The IRS also found that RSS could not qualify for exemption as an integral part of its parent or sister hospital because the ASC did not further charitable purposes (*e.g.*, the ASC provided no charity care, had no Medi-Cal provider agreement and did not treat only patients from RSS's brother-sister hospital, RCH).[19]

In the Redlands case, the nonprofit had at least some control and was an active participant in certain decisions through its 50% representation on the venture's management committee. The IRS' conclusion, as expressed in the revised denial letter of April 1, 1996, was that the limited partnership retained its original character from prior to nonprofit's involvement, *i.e.*, an ASC operated for the financial benefit of its investors (including the for-profit management company), and that it served no charitable purpose. There was insufficient control in the nonprofit, in the IRS' view, for the patients of the ASC to be the nonprofit's patients; therefore, the return on investment in the ASC was unrelated business income ("UBI"). The Tax Court ruled in favor of the IRS, adopting a control analysis similar to the one applied by the IRS. The ***Redlands*** case is currently on appeal to the Ninth Circuit (Case No. 99-71253),[20] the Circuit which decided two of the leading partnership cases relied on by the Tax Court (***Plumstead Theatre*** and ***Housing Pioneers***).[21] Given the delays inherent in the appellate process, it could be another two or three years before a decision is issued (hopefully) clarifying guidance in the joint venture area. In the meantime, however, tax-exempt hospitals planning future joint ventures or reviewing current ones must give serious consideration to the Tax Court's analysis in ***Redlands***.

1. Factual Background of Redlands Transaction. RSS is essentially a shell corporation with no employees or paid officers, and the president of RCH (a brother-sister corporation) also serves as president of RSS. The common parent of RCH and RSS is Redlands Health System ("RHS"), a 501(c)(3) organization. RHS itself originally held the interest in the General Partnership but assigned it to RSS so as to insulate the hospital's and foundation's assets from liability for activities of the ASC and to keep the ASC's activities free of the restrictions of RCH's debt covenants. The partnerships were RSS' sole source of revenue (other than investment income), and RSS estimated that between 50-80% of its annual income would be used to support RCH and RHS.

RSS owns a 46% profits interest and controls 50% of the board vote in the General Partnership, despite contributing only 37% of the equity. The remaining 54% profits interest and 50% board voting rights are owned and controlled by SCA, the wholly owned subsidiary of Surgical Care Affiliates, Inc. ("SCAI"), a company that owns and operates ASCs nationwide. The General Partnership in turn owns 59% of the profits interest in the Operating Partnership, with the remaining 41% owned by physicians on the medical staff of RCH. Accordingly, RSS owns (indirectly) a 27% interest in the Operating Partnership (46% of 59%).

The ASC was already in existence and had been operating profitably before the General Partnership acquired an interest in it. In exchange for the acquisition of the General Partnership's interest in the Operating Partnership, the limited partners (except for a medical group) all

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19 The interim exemption denial letter and opening briefs in the *Redlands* case are available through Tax Notes Today at 97 TNT 213-27 (April 1, 1996 denial letter); 98 TNT 70-73 (IRS); 98 TNT 85-124 (taxpayer); see also G. Griffith, "Bumps in Rocky Road to Joint Ventures for Ancillary Services Being Illuminated," 6 Health Law Reporter (BNA) 1723 (Nov. 6, 1997).

20 The government's reply brief on appeal is reprinted in Tax Notes Today, 2000 TNT 31-7 (Feb. 15, 2000).

21 Both of those earlier decisions affirmed Tax Court rulings. See Plumstead Theatre Society, Inc. v Commissioner, 675 F.2d 244 (9th Cir. 1982); Housing Pioneers, Inc. v Commissioner, 49 F.3d 1395 (9th Cir. 1995).

received common stock in SCAI as part of the purchase price. The amount paid for an interest in the ASC was determined by SCA's formula (4 – 5 times annual earnings) without an independent valuation, and it was less than a competing offer (6 times annual earnings). The limited partners allegedly accepted the lower offer because they valued establishing an affiliation with RCH for quality control and other reasons.

SCA Management Co. was hired to manage the ASC pursuant to a 15-year management contract (or longer depending on whether SCA or an affiliate guaranteed debt of the Operating Partnership), renewable for two successive 5-year terms at SCA Management's sole option and terminable only for breach (following 90 days prior notice and a 90 day cure period). The management fee is 6% of gross revenues (defined as the net collectable portion of fees or charges billed in relation to operation of the ASC, with no deduction for bad debts), plus reimbursement of related expenses. SCA Management also employs all nonphysician personnel at the ASC.

SCA Management was delegated broad day-to-day management authority over the ASC, with two exceptions: (1) significant matters reserved to the governing board of the General Partnership; and (2) clinical matters which were reserved to the Medical Advisory Group (comprised entirely of limited partner physicians, half appointed by the General Partnership and half appointed by the limited partners' group practice). The powers of the General Partnership's governing board include the power to: (a) approve budgets; (b) approve partnership distributions; (c) hire and fire the manager; (d) review the ASC's financial results; (e) review proposed capital equipment purchases; (f) appoint 50% of the Medical Advisory Group; (g) facilitate equipment leasing from RCH; (h) review utilization of nursing staff at the ASC; (i) coordinate training and mentoring opportunities between RCH and the ASC; (j) approve long-term debt; (k) approve obligations for repairs, equipment, additions and improvements to the ASC; (l) approve leases and contracts with aggregate payments in excess of $50,000 in any 12-month period; and (m) approve obligations to a related party in excess of $5,000 (including expense reimbursement for SCA Management). The General Partnership's governing board also makes the final determination as to what constitutes clinical matters within the purview of the Medical Advisory Group. The General Partnership further has the right to repurchase the limited partners' interests in the Operating Partnership (at five times the limited partner's allocable share of the prior year's taxable income of the Operating Partnership) in the event that an opinion of counsel to the Operating Partnership concludes that any referrals to the ASC by the limited partners would be illegal. There appears to be no similar buy-out right for RSS to buy out SCA's interest in the General Partnership if RSS' tax-exempt status is threatened by the current structure or operations of the partnerships. There were also no initiation rights allowing RSS to take any action on its own on behalf of the ASC.

SCA and RCH also agreed to a noncompete which included an agreement not to promote or expand RCH's existing hospital-based outpatient surgery program. The ASC provided no charity care and less than 1% of its revenues were from Medi-Cal patients (California's version of Medicaid). Its payor mix and profit levels were comparable to other ASCs; however, it derived approximately 12% of its revenues from Medicare.

2. <u>IRS Denial of Exemption</u>. In its review of RSS' exemption application, the IRS essentially determined that through the two partnerships RSS held only a minority

interest (59% of 46% = 27%) in, and had no control over, the ASC and its operations. Accordingly, RSS was not exempt based on the activities of the two partnerships because it could not compel either partnership to act in a charitable manner either through its ownership or voting interests or other contractual rights.

The IRS also rejected exemption for RSS under the integral part theory, a theory under which a nonprofit to derive its exemption from a close relationship with another exempt organization for which it provides essential services in furtherance of the other entity's exempt purposes (and which would not be an unrelated trade or business if carried on directly by the other entity). The Service found that RSS could not qualify for exemption as an integral part of RCH or RHS because the ASC did not further charitable purposes of any related exempt organization (*e.g.*, the ASC provided no charity care, had no Medi-Cal provider agreement and did not treat only patients from RCH).[22] RSS had at least veto-type control through its 50% representation on the General Partnership's governing board. Although RSS also contracted to provide certain quality assurance services for the ASC, the agreement was terminated at the end of the first year with no replacement contract, and no fee was paid since the first year of services was to be provided gratis). The ASC, however, apparently was utilized in RCH's surgical residency and nurse training programs.

The IRS concluded that the Operating Partnership retained its original proprietary character from before RSS' involvement, *i.e.*, an ASC operated for the financial benefit of its investors (including the for-profit management company), and it served no charitable purpose. In its appellate brief, the Service stresses the lack of any true charity care, lack of any direct Medi-Cal contract and the *de minimis* amount (8/10ths of 1% of total invoiced charges) of Medi-Cal business at the ASC as reflecting a lack of any charitable purpose or activity at the ASC. There was insufficient control vested in RSS, in the Service's view, for the patients of the ASC to be the nonprofit's patients, and, therefore, the return on investment in the ASC also would have been UBI for RCH (which also would disqualify RSS from integral part exemption).

3. Tax Court Opinion. The Tax Court's opinion is largely consistent with the reasoning in Rev. Rul. 98-15 and the IRS' denial letters issued to RSS. In short, the Tax Court found that RSS does not qualify for exemption as a 501(c)(3) organization because it has ceded effective control over its activities to a for-profit party. As a result of the inability to control the activities of the ASC itself, the court held that RSS provided SCA with more than an incidental private benefit and failed to show that it (RSS) was operated exclusively for charitable purposes.[23] The Tax Court decision in *Redlands* also sheds some light on ways to mitigate the tax status risks of 50/50 control in these joint ventures. Certain other questions, however, remain unanswered – such as the tax impact of a 50/50 control arrangement in ancillary services joint ventures that do not involve substantially all of a nonprofit organization's charitable activities.

[22] The interim exemption denial letter and opening briefs in the *Redlands* case are available through Tax Notes Today at 97 TNT 213-27 (interim denial letter); 98 TNT 70-73 (IRS brief); 98 TNT 85-124 (RSS brief).

[23] See Treas. Reg. §1.501(c)(3)-1(c) (operational test). To be incidental, private benefit must be both quantitatively incidental (insubstantial in amount) and qualitatively incidental (indirect or unintentional) when compared to the public benefit of the activity. See GCM 37789 (Dec. 18, 1978).

a. *501(c)(3) Operational Test*. In outlining the applicable legal principles, the Tax Court noted that the operational test for 501(c)(3) status focuses on the purposes that are furthered by an organization's activities and not merely on the purposes recited in its articles. The court also noted (and the IRS echoes on appeal) that it is the taxpayer's burden to prove that it meets the operational test and that it is not disqualified from exemption by a substantial nonexempt purpose (or by providing more than incidental private benefit). Relevant factors for that inquiry include "the particular manner in which an organization's activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits,"[24] and whether the organization serves a broad enough cross section of the community to assure that health care services are actually delivered to persons in the community in need of those services.

b. *Facts and Circumstances Approach*. As the Tax Court noted, merely participating in a partnership with a for-profit entity does not necessarily result in more than incidental private benefit – all relevant facts and circumstances must be considered and no one factor is determinative. The relevant facts in *Redlands* were (1) lack of a voting majority for RSS on the General Partnership's governing board, (2) lack of an affirmative duty for SCA and SCA Management to put charitable objectives ahead of economic ones, (3) the duration and scope of delegation in the management contract, which granted broad authority to SCA Management over day-to-day operations of the ASC, (4) the compensation formula for the manager that encouraged it to maximize profits (or at least maximize gross revenues from paying patients), (5) market advantages flowing to SCA from the noncompete and from RCH's relationship with the physicians, and (6) lack of any other formal rights or informal indicia of control sufficient to allow RSS to assure that the two partnerships acted in a charitable manner (*e.g.*, lack of any initiation rights to override a veto by SCA at the board level, lack of any clear charitable performance standards, lack of any significant informal influence over operations, etc.). Considering these factors in particular, the Tax Court held that the totality of the facts and circumstances, reflected substantial nonexempt purposes.

c. *Tantamount to Control of RSS*. Under the aggregate theory of partnership taxation (reflected, for example, in Section 512(c)(1) of the Code), the activities of a partnership are attributed to its partners. Because the activities of the ASC (attributed to RSS as a general partner in the General Partnership) constituted substantially all of RSS' allegedly charitable activities, the Tax Court viewed control over the ASC as tantamount to control over RSS itself.[25] In the process, the Tax Court rejected RSS' contention that under the operational test, control of the partnerships was irrelevant if the ASC actually engaged in charitable activities and none of RSS' share of partnership income was applied to benefit any for-profit partners or their affiliates. Instead, the court sided with the IRS, finding that the control ceded to SCA and SCA Management was indicative of a substantial nonexempt purpose, thereby disqualifying RSS from 501(c)(3) status.[26] The partnership agreements did not recite any charitable purpose for the partnerships themselves, nor did the agreements impose any duty on SCA to give priority to

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24 Redlands, Slip op. at 41 (quoting B.S.W. Group, Inc. v Commissioner, 70 T.C. 352, 358 (1978)).

25 This is a distinct difference from the UCC case where the Seventh Circuit Court of Appeals focused on control of the entity as opposed to control of one of its functions – fundraising. United Cancer Council v Commissioner, 83 AFTR2d ¶99-416 (7th Cir., Feb. 10, 1999).

26 See Better Business Bureau v U.S., 326 U.S. 279, 283 (1945).

charitable activities. Only the recitals even suggested that RHS had a community benefit purpose in entering into the arrangements.

The Tax Court noted that the logical extension of RSS' position would be that mere passive investment in a for-profit health care enterprise would be a charitable activity, contrary to established precedent. Yet the Tax Court's reasoning is poorly stated. In supporting its conclusion, the Tax Court suggested that because the partnership's income was "applied to the profit of petitioner's co-general partner and the numerous limited partners," the partnership's activities were not inherently charitable. Therefore, if those activities had been carried on directly by RSS they also would not be charitable. It is obvious that any private individual or entity stands to (or at least expects to) receive some profit from participating in a partnership to run a health care facility. The court even conceded that not all such partnerships jeopardize tax-exempt status. What the Tax Court seems to be saying, however, is that when profit interests drive a partnership's activities and the proprietary company can cause the partnership to be operated in furtherance of its independent economic interests with no duty to follow charitable purposes first, then the partnership's activities can not be charitable and any community benefit is merely incidental to the private benefit. SCA arguably had that effective control in ***Redlands*** by virtue of its veto rights at the General Partnership board level and the one-sided management contract.

d. *Veto Rights Insufficient*. RSS argued that its veto powers (from 50/50 board representation in the General Partnership) did give it effective control over the activities of the ASC. In that regard, RSS noted it had used its veto power to block various actions including a request that RCH transfer all of its outpatient surgery volume to the ASC. The Tax Court rejected this argument, noting that these actions only show the ability to prevent certain activities but not the power for RSS, acting alone or over the objection of SCA, to initiate and compel any charitable activity at the ASC. In other words, SCA also had a veto which it could exercise to protect its economic interests regardless of the impact on the community. Specific initiation rights which the Tax Court mentioned as being missing were the power to cause the ASC "to respond to community needs for new health services, modify the delivery or cost structure of its present health services to serve the community better, or . . . terminate SCA Management, if SCA Management were determined to be managing the Surgery Center in a manner inconsistent with charitable objectives."[27] In fact, although the court did not so note, exercising veto rights to prevent expansion of health care services may be contrary to community benefit principles which generally contemplate expanding, not limiting, services that are needed in the community.

Although the profitability of the ASC was touted by RSS as a means of support of charitable activities, the Tax Court took a different view, noting that the high rate of return that the for-profit parties (SCA and the physicians) earned on their investments bolstered the conclusion that there was "a significant profit-making objective" underlying the ASC's operations. The court did acknowledge, however, that "other specific powers or rights conferred upon [RSS] might mitigate or compensate for its lack of majority control."[28] Although the court did not find any of those other factors actually existing in *Redlands*, this statement at least

[27] Redlands, Slip op. at 53.
[28] Id. at 55.

confirms that a 50/50 sharing of board control in a joint venture does not per se jeopardize exemption.

e. ***Arbitration*****.** The legal community as a whole has mixed views about arbitration. The same can be said for how the tax law views arbitration. In the context of joint operating agreements among nonprofit hospitals, the Service favors use of arbitration to resolve disputes.[29] In *Redlands*, however, the Tax Court found that the binding arbitration required in the various agreements was a negative because it provided no assurance that charitable objectives would govern the arbitrators' decision (as opposed to economic considerations).

f. ***One-sided Management Contract*****.** The Tax Court found the length and scope of delegation under the management contract to be significant. Under the contract, SCA Management had broad powers over day-to-day management of the ASC, including the power to enter into contracts, negotiate with third party payors and set fees (except physician charges). The contract effectively locked in management of the ASC for at least 25 years (longer if SCA or an affiliate guaranteed debt for the ASC). There was no realistic opportunity for RSS to terminate the agreement, even for cause, because there were liberal cure provisions and termination requires a majority vote of the board of the General Partnership (allowing SCA to block termination through its 50% board representation). The management contract also did not obligate SCA Management to pursue charitable objectives. Rather, that the percentage of gross revenues compensation formula gave the manager a clear incentive to manage the ASC in a manner "so as to maximize profits."

RSS argued that the compensation formula includes the chargeable amount of any charity care services provided at the ASC. Accordingly, RSS argued there would be no disincentive to treating charity care patients since the "charges" would count equally in the compensation formula. The contract, however, was at best ambiguous on this point, and the Tax Court disagreed with this interpretation of the contract, noting that it referred to "net collectable . . . revenues" and that there would be no collectable revenues in true charity care. What is less clear, however, is why the court went on to note that even if RSS' interpretation is correct, it fails to "address the broader point that the management contract gives SCA Management an economic interest to maximize revenues in all aspects of the Surgery Center's operations, and not just as relate[s] to charity care."[30] It almost appears as if the Tax Court is suggesting that all percentage contracts *per se* result in more than incidental private benefit. More likely, however, the Tax Court's concerns were part of a cumulative effect of all the "bad" facts in *Redlands* and could be avoided in other cases by limiting the manager's discretion, shifting the balance of control in the joint venture to the nonprofit through certain initiation rights, providing for meaningful oversight of the manager's performance by the nonprofit, and including appropriate quality assurance and utilization review safeguards on the manager's actions. These countervailing factors were completely lacking in *Redlands*. For example, the quality assurance contract for RSS was terminated after the first year with no replacement contract even though one was required, and there was no proof that RSS ever actually performed any quality assurance work. That

[29] See R. Darling & M. Friedlander, FY1997 CPE Text, Chapter J: Virtual Mergers: Hospital Joint Operating Agreement Affiliations, pp. 131, 136.
[30] Redlands, Slip op. at 57, n. 13.

termination, in the court's view, "vividly evidences [RSS'] lack of effective control over vital aspects of the Surgery Center's operations" or how, without an agreement, RSS could "assure itself that these vital functions will be discharged consistently with charitable objectives."[31]

In addition, according to the court the record did not support RSS' contention that the management contract was negotiated at arm's-length between parties in equal bargaining positions.[32] Instead, the Tax Court observed that the General Partnership agreement includes only a sparse description of certain key features to be included in the management contract and the actual contract was actually even more favorable to the manager (by providing for a longer initial term to match the term of any SCA guaranty of ASC debt, leases or other obligations). The court also suggested, and the IRS emphasized in its appellate brief, that there may have been self-dealing involved because RSS was not a party to the management contract and it was signed by the same person on behalf of both SCA Management and the Operating Partnership.

g. ***Medical Advisory Group*.** All of the members of the Medical Advisory Group were limited partners who owned SCAI common stock (received in the original acquisition). That and other factors persuaded the Tax Court that RSS lacked sufficient influence to affect the outcome of any decision by the Medical Advisory Group. There was also no proof of any oversight review of this group's activities by RSS or its exempt affiliates. If non-interested physicians were included on the Medical Advisory Group, RSS likely would have had a stronger argument for this body serving as a means of monitoring access to and quality of care for charitable, community benefit purposes.

h. ***Informal Control of Venture*.** RSS argued that it would have influence over the physicians (and thus indirectly over SCA) because the physician limited partners' desire for an affiliation with RCH had caused them to accept the SCA/RHS offer for less money than a competing offer. The court rejected this argument, finding that the Medical Advisory Group was not subject to monitoring or oversight by RCH and there was no evidence that RSS commanded any allegiance or loyalty of SCA, its affiliates or the physicians that would cause them to put charitable objectives ahead of a profit motive (especially since the physicians owned stock in SCA's parent).

i. ***Charity Care, Medi-Cal and Medicare*.** RSS further argued that its acquisition of an indirect interest in the ASC led to various changes in operation of the ASC that reflected a community benefit. For example, according to RSS, after its involvement the decision whether to perform a procedure at the ASC became a purely medical one instead of an economic decision, thereby accomplishing RHS' goal of assuring access to the ASC for all members of the community with a medical need for those services regardless of ability to pay. RSS also asserted that the ASC's charity care and Medi-Cal utilization were low because the services typically sought by indigents and low-income individuals are emergency room and OB/Gyn services and, as a result, they are more likely to seek treatment in a hospital setting, such as at RCH, where there is an emergency room. RSS also pointed out that RCH included the ASC as a subcontractor in the hospital's own Medi-Cal agreement and that the ASC treats a substantial number of Medicare patients (12% according to the IRS' appellate brief).

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31 Id. at 61-62.

32 See Rev. Rul. 76-91, 1976-1 C.B. 149 (presumption of fair market value in arm's length negotiations).

The court rejected these arguments from RSS because the amount of Medi-Cal services was negligible (0.8% of total procedures at the ASC) and there was no indication that the ASC had ever provided any true charity care (*i.e.*, other than bad debt). The court also remarked that stating that indigent and low-income patients and typically do not seek outpatient surgical services "may partially explain the virtual absence of relief it provides for such individuals. But it provides no independent basis for establishing petitioner's charitable purposes in its involvement with the Surgery Center."[33] Moreover, there was no evidence that the decision to perform a procedure at the ASC was ever an economic one or, even assuming that it was, that RSS had any role in effecting a change. Although RSS asserted that the ASC did not require patients to demonstrate an ability to pay before receiving treatment, the court found no evidence that such a policy (if it existed) had been communicated to patients. As for Medicare patients, the Tax Court noted that there was no proof that the ASC waived fees in excess of the amount paid by Medicare and, therefore, there was no basis for concluding that a Medicare patient's ability to pay was not a factor in accepting the patient at the ASC. That analysis ignores the issue that balance billing of Medicare patients may be illegal despite contractual language.[34] That oversight, however, likely would not change the outcome inasmuch as the Tax Court noted that this ASC regularly treated Medicare patients prior to the acquisition by the General Partnership (although the level of Medicare business at that time is not stated in the opinion).

j. ***Increased Managed Care Participation.*** One justification frequently offered in support of various health care joint ventures is that the participation in the venture will improve managed care participation which, through controlling health care costs, provides a community benefit.[35] In *Redlands*, RSS pointed out that the ASC's participation in managed care contracts tripled (from 7 to 21) after the RSS' involvement in the ASC. The Tax Court rejected this argument as well, noting that RCH's actions in including the ASC in more managed care contracts did not provide any basis for establishing that RSS qualified for exemption. In other words, in the court's view mere participation in managed care contracts alone was not a sufficient basis for exemption. The Tax Court apparently viewed the increase in managed care contracts as, at most, a result of activities of RCH rather than any direct charitable activities undertaken by RSS itself.

k. ***Coordination of Education Activities with Hospital*****.** The Tax Court in *Redlands* found nothing in the record to indicate that nurse training, surgical resident training and other educational activities at the ASC constituted anything "more than incidental to the for-profit orientation of the Surgery Center's activities."[36] Moreover, there was even conflicting evidence regarding as to which educational activities were even conducted at the ASC.

l. ***Noncompete*****.** In an analysis reminiscent of GCM 39862 (Nov. 21, 1991), the Tax Court found that the covenants not to compete may have detracted from community benefit in the *Redlands* case. The covenant ran concurrently with the term of the

33 Redlands, Slip op. at 65.

34 See, e.g., Social Security Act, §1902(n); 42 C.F.R. §413.35(a); OIG Compliance Program Guidance for Third-Party Medical Billing Companies, at n. 31 (http://www.dhhs.gov/progorg/oig/modcomp/thirdparty.htm).

35 See, e.g., PLR 199913051 (March 2, 1999); PLR 9839042 (July 1, 1998); PLR 9814043 (Jan. 6, 1998).

36 Redlands, Slip op. at 67.

General Partnership agreement (both ran for 30 years), and it restricted not only RSS but also RCH. Specifically, the IRS alleged that the covenant effectively precluded RCH from promoting or providing expanded outpatient surgery services in its existing program or elsewhere without SCA's consent (since SCA controlled 50% of the votes on the General Partnership's governing board). During the period from 1990-1995, with the noncompete in force, the number of outpatient surgeries performed at RCH decreased approximately 17% yet the volume of surgical procedures performed at the ASC increased 10%. The implication of this shift is that RCH acquiesced in the erosion of its revenue stream to the benefit of the partnerships. According to the Tax Court, by restricting RCH's ability to compete, the ASC could charge higher prices and it would not experience the same competitive pressure to invest in expensive new equipment. The record before the court even included a reference to "avoid[ing] a 'medical arms race' in the Redlands health care community."[37] The mutuality of the noncompete in many respects (*i.e.*, restricting SCA as well) did not sway the court's view.

m. *Factors Not Expressly Addressed in Redlands*. Although not addressed expressly in the Tax Court's control analysis, it may be relevant that the *Redlands* case involved an existing surgery center and not a joint venture to create a new provider or increase the level of health care services to meet a community need. The IRS certainly highlights this point in its reply brief on appeal. In fact, in *Redlands* the hospital had concluded that the area could not support another ambulatory surgery center. Typically, community benefit in the health care area reflects increases in access to, quality or cost of health care services. For example, in GCM 39862 the IRS recognized that creation of a new provider or expansion of services to meet a community need for health care services would be a community benefit and a potential justification for an ancillary services joint venture with physicians. Even buying into an existing facility has been approved by the IRS in the past where there were other favorable factors present showing a need to expand services and the parties had committed to providing indigent and Medicaid services.[38] Although hospital volume would likely have been reduced in both of those cases, the IRS may have taken comfort from provisions assuring that tax-exempt hospitals had majority voting control of governance and management in each case. In states such as Michigan where there is a CON law, obtaining a certificate of need can be a successful part of demonstrating community need. The IRS has ruled recently that obtaining and complying with the access and other terms of a CON can be evidence of a community need for services and even of an intention to improve the quality of services (*e.g.*, renovation or replacement equipment).[39]

n. *Integral Part*. RSS argued that the ASC's services had been integrated with the outpatient services of RCH and that the ASC served as an important teaching site for RCH, operating as an integral part of both RCH and RHS. The integral part theory allows an entity to derive its exempt status by virtue of its relationship with another 501(c)(3) organization for which it conducts activities that are essential to carrying out the exempt purposes of the other organization, and which would not be unrelated trades or businesses if conducted directly by that other organization ("essential activities test"). The relationship

[37] Id. at 73, n. 22.

[38] See PLR 9709014 (Feb. 28, 1997) (free standing ASC); PLR 9645018 (Aug. 9, 1996) (renal dialysis center).

[39] See, e.g., PLR 9709014 (Feb. 28, 1997); PLR 9352030 (Dec. 30, 1993); PLR 9319044 (May 14, 1993); PLR 9024085 (June 15, 1990).

between the two organizations must be a close connection by virtue of a structural or financial relationship (similar to a parent and its subsidiary), *i.e.*, the organizations must be structurally and financially integrated and not just serve similar functions or purposes ("relationship test").[40] The ***Geisinger*** court modified the integral part test by adding a "boost" requirement, which the IRS relies on it its appellate brief. In practice, the "boost" requirement has translated into an examination of whether the patient base of parent and subsidiary are substantially identical or, if they are not identical, whether the activities of a subsidiary are somehow made charitable by virtue of how those activities (and the subsidiary) relate to the parent and the accomplishment of the parent's exempt purposes.[41]

The Tax Court rejected RSS' integral part argument for two reasons. First, there was no proof of any substantial relationship between the ASC's activities and the exempt purposes of RHS or RCH. The ASC's patient base apparently did not overlap substantially with that of RCH or such overlap could not be demonstrated (although lack of overlapped should be expected since an ASC is typically an alternative to hospital care). Furthermore, the ASC had been performing essentially these same procedures on a proprietary basis for its own patients before RSS ever was involved, and presumably would continue to do so if RSS withdrew. Second, even if the ASC's activities were substantially related to the exempt purposes of RHS and/or RCH, those tax-exempt entities (and RSS) did not have sufficient control over the ASC's activities to satisfy the relationship test because that control had been ceded to SCA and SCA Management.

4. Impact on Other Ancillary Joint Ventures. In the wake of the ***Redlands*** decision, at least pending a decision from the Ninth Circuit, tax-exempt hospitals will be left to consider which joint ventures are potentially affected by the Tax Court's ruling and by the Service's position as outlined in Rev. Rul. 98-15 and its briefs in *Redlands*. It is clear that the Tax Court believes that not all 50/50 joint ventures *per se* jeopardize tax-exempt status. It also seems likely that tax-exempt status will not be adversely affected in a joint venture where control is shared 50/50 with a for-profit entity with limited or no initiation rights for the nonprofit if: (1) the joint venture does not represent a substantial portion of the exempt organization's activities (measured by common benchmarks such as gross and net revenues, expenses, allocation of staff and other resources, etc.); and (2) the for-profit entity is not an insider of the exempt organization or any of its affiliates. In those joint ventures, the most likely risk is that the joint venture may generate UBI for the exempt organization. This leaves open the possibility of not only ancillary services joint ventures but also whole hospital joint ventures where the exempt organization has a substantial amount of other activities that are charitable in nature (directly or through related organizations from which exemption can be derived under the integral part theory). Hospitals and health systems considering whole hospital joint ventures, however, still should tread carefully, bearing in mind that *Redlands* did not address whole hospital joint ventures per se and the Service's position on such joint ventures following Rev. Rul. 98-15 is decidedly negative. Despite that bias as to whole hospital joint ventures, there may be room for

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[40] See, e.g., GCM 39830 (Aug. 24, 1990); GCM 38568 (Nov. 24, 1980); Rev. Rul. 81-19, 1981-1 C.B. 353, Rev. Rul. 78-41, 1978-1 C.B. 148.

[41] Geisinger Health Plan v Commissioner, 30 F.3d 494 (3rd Cir. 1994); L. Brauer & M. Friedlander, FY1999 CPE Text, Chapter D: Exemption of Medicaid HMOs and Medicaid Service Organizations Under IRC 501(c)(3), pp. 67, 85.

greater flexibility in ancillary services joint ventures in the wake of the ***Redlands*** decision, at least if the prospective partner is not an insider.

In often contradictory comments, IRS officials have stated that Rev. Rul. 98-15 likely will be applied to all joint ventures, then they have also stated that if the joint venture does not involve substantially all of a nonprofit's charitable activities, UBI may be the only issue. Neither set of comments can be relied on with much comfort given the present state of flux in the law in this area. If an ancillary services joint venture, however, does involve one or more insiders, pending further guidance from the courts or the IRS the exemption impact of a true 50/50 arrangement (with no or only limited initiation rights for the nonprofit) is not entirely clear. Under the rationale of Rev. Rul. 98-15 and *Redlands*, control over how the charitable funds or assets contributed to the joint venture is a substantial private benefit. If that is correct, one must ask how providing that same benefit to insiders is not inurement *per se*? Historically, inurement generally could be in any amount, whether or not substantial. If providing that same benefit to insiders is thus inurement *per se*, how can one conclude that there is not exemption risk and only an issue as to whether or not the partnership (or LLC) is engaged in an unrelated trade or business, with the only negative tax consequence likely to be a tax on the resultant UBI? Possible approaches for answering these questions that the IRS and the courts may adopt in the future are discussed in Section III.F. of this outline. Some caution is urged, however, in that neither the IRS in any published ruling nor any court in a published opinion have adopted any of those potential alternatives and they may ultimately follow a different approach.

D. Control Test. As noted above, one of the aspects of *Situation 2* in Rev. Rul. 98-15 that the IRS found troubling was that the for-profit's affiliate had a long-term management agreement to manage all of the joint venture facilities with a unilateral right to renew the contract and no ability for the nonprofit to terminate the contract without cause. In informal comments, IRS officials have likened the situation to the fundraising agreement in the Tax Court's opinion in the UCC case where a long-term fundraising contract was found by the Tax Court to provide sufficient control to render the fundraiser (Watson & Hughey Co. or "W&H") an insider despite the lack of board or officer overlap, absence of any prior relationship with the charity and arm's length negotiation of the contract. The strong rebuke of that reasoning in the recent Seventh Circuit Court of Appeals decision in UCC (*supra*), however, may affect the definition of "control" in joint venture cases.

1. UCC: Functional Test. In UCC, the Seventh Circuit found that W&H did not have sufficient control in the corporate or agency law sense simply by virtue of an exclusive, five year management contract that was not terminable by the charity. The contract gave W&H joint ownership in and free use of the charity's donor list (while the charity could use the list only to solicit contributions for itself), seed money for the fundraising campaign was advanced by W&H and no funds (including contributions) could be disbursed from the account without W&H's approval. Compensation provisions under the contract also appear to have been above average for fundraisers generally and the charity had been in dire financial straits and on the verge of bankruptcy when it agreed to the contract.

The Seventh Circuit did acknowledge that, as the IRS has contended recently, in determining control, "[t]he test is functional. It looks to the reality of control rather than to the insider's place in a formal table of organization." Nevertheless, the court found no such functional control in W&H in the UCC case. In language that may be encouraging for increasingly common health care joint ventures, the court noted that fundraising contracts are "common" and if such contracts make the fundraiser an insider "triggering the inurement clause of section 501(c)(3) and so destroying the charity's tax exemption, the charity sector of the economy is in trouble." The court was not persuaded by IRS arguments that control was evidenced by the favorable terms obtained by W&H, noting that the inurement prohibition's purpose is "not to empower the IRS to monitor the terms of arm's length contracts made by charitable organizations with the firms that supply them with essential . . . services." Likewise, the court dismissed the importance of the exclusivity provision. Rather than a means "to control UCC and suck it dry," the exclusivity was viewed as a means of protecting W&H against the risk it was taking (presumably by advancing capital to launch the fundraising program and bringing its experience to bear to make the program successful), and if the fundraising campaign was successful the exclusivity provision assured W&H that the charity would not hire another fundraiser to reap the benefit of its efforts. The IRS argued that the effect of the exclusivity provision was to put UCC at W&H's mercy because "if W&H stopped its fundraising efforts UCC would be barred from hiring another fundraiser until the contract with W&H had expired." In one of the more vitriolic passages in the opinion, the Seventh Circuit stated that this argument "merely demonstrates the Service's ignorance of contract law. When a firm is granted an exclusive contract, the law reads into it an obligation that the firm use its best efforts to promote the contract's objectives. If W&H folded its tent and walked away, it would be in breach of this implied term of the contract and UCC would be free to terminate the contract without liability." (Citations omitted.)

Finally, points regarding the high expense ratio, favorable terms for W&H, the use of fundraising techniques (*e.g.*, sweepstakes) that are generally frowned upon and even possible questions as to W&H's reputation "go to UCC's sound judgment, not to whether W&H succeeded in wresting control over UCC from the charity's board." In other words, according to the Seventh Circuit, bad business decisions in arm's length negotiations with previously independent parties do not constitute inurement. Merely driving a hard bargain did not make W&H an insider where it had not prior relationship with the charity such as through overlapping members, owners, directors or officers. In fact, the court asked rhetorically, if W&H had in fact obtained control over UCC, "why did UCC refuse to renew the contract when it expired, and instead switch to another fundraiser?"

Despite the recitation of a functional test for control, the court effectively distinguished between control over the entity (which was not present) and control over one of its activities, its prime activity, fundraising (which appears to have been present under the contract with W&H). It is control over the entity and its decision making process that is necessary for insider status under the UCC case. According to the Seventh Circuit, the record reflects "nothing that corporate or agency law would recognize as control. A creditor of UCC could not seek the satisfaction of his claim from W&H on the ground that the charity was merely a[n] . . . alter ego of W&H." There was no diversion of funds to any insider and no indications of "self-dealing, disloyalty, breach of fiduciary obligation or other misconduct of the type aimed at by a provision of law [the inurement prohibition] that forbids a charity to divert its earnings to members of the board or other insiders." In the Seventh Circuit's view, the Tax Court and the IRS were "using 'control' in a special sense not used elsewhere . . . in the law, including the federal tax law." It is an interpretation of "control" which:

> . . . threatens to unsettle the charitable sector by empowering the IRS to yank a charity's tax exemption simply because the Service thinks its contract with its major fundraiser too one-sided in favor of the fundraiser, even though the charity has not been found to have violated any duty of faithful and careful management that the law of nonprofit corporations may have laid upon it. The resulting uncertainty about the charity's ability to retain its tax exemption – and receive tax-exempt donations – would be a particular deterrent to anyone contemplating a donation, loan, or other financial contribution to a new or small charity . . ..
>
> We were not reassured when the government's lawyer, in response to a question from the bench as to what standard he was advocating to guide decision in this area, said that it was the 'facts and circumstances' of each case. That is no standard at all, and makes the tax status of charitable organizations and their donors a matter of the whim of the IRS.

The IRS, if forced to concede defeat in UCC, may argue that the Court's conclusion was influenced by the common nature of fundraising contracts. In other words, this case may turn on a refusal to treat a common type of arrangement as an indicia of control regardless of the degree of the arrangement (a single exclusive contract versus multiple contracts for portions of the same function). To admit as much though would make the IRS' position on joint ventures even more vulnerable in light of the number of prior partial hospital and ancillary services joint ventures the IRS approved. One might argue that a whole hospital joint venture does not differ from those ventures except in the degree of joint activity.

It is important to note, however, that the Seventh Circuit's opinion is only one decision, the case is still alive on remand and the IRS may prevail with the same control arguments on private benefit grounds, the IRS is not likely to simply acquiesce in the decision and it is not binding precedent outside of the Seventh Circuit. Nevertheless, it is a significant decision and, as an appellate decision, it is persuasive authority.

2. Control in Joint Ventures. Reading Rev. Rul. 98-15 and the Tax Court's opinion in ***Redlands*** together, it appears that in many (if not all) cases, veto power over financial matters will be essential. However, where the other partners to a joint venture are insiders (such as a significant group of physicians) or the joint venture involves substantial activities of the nonprofit, veto rights likely will not be enough alone to assure that the venture is operated for charitable purposes and does not jeopardize the tax-exempt status of its nonprofit partner. Based on prior IRS guidance concerning physician board representation, it appears that purely clinical decisions requiring medical expertise may be delegated to the physicians in an ancillary joint venture.[42] The difficulty in practice, however, is determining which decisions if any can fairly be

[42] See, e.g., L. Brauer & C. Kaiser, Chapter C: Tax-exempt Health Care Organizations – Community Board and Conflicts of Interest Policy, IRS Continuing Professional Education, Exempt Organizations – Technical Instruction Program for FY 1997, pp. 17-29; L. Brauer & C. Kaiser, Chapter E: tax-exempt Health Care

categorized as purely clinical in nature and not involving significant business or financial elements. Although the veto power does not necessarily require equal numbers of board members, it does require equal voting rights such as by as a class voting requirement where actions of the joint venture governing board require the approval of a majority of each class of directors (hospital and physician representatives).

The IRS also is likely to consider whether significant matters are reviewed and approved by the community board of the nonprofit (as opposed to merely being approved by its representatives on the joint venture governing board). Examples of those significant acts include:[43]

- Capital and operating budgets, and variations over a specified dollar amount threshold
- Sale of assets with a value in excess of a specified dollar amount threshold
- The incurrence, assumption or guarantee of debt in excess of a specified dollar amount threshold
- Dissolution, merger, consolidation, or sale of all or substantially all of the assets of the joint venture
- Amendment of the joint venture agreement (including any related governance documents)
- Affiliations or joint ventures with other parties
- Contracts with any of the for-profit partners (including physicians)
- Discontinuance of any line of service or closure or reduction in scope of operation of any location or service
- Discontinuance of Medicare or Medicaid participation by the joint venture
- Appointment and removal of management of the joint venture (at least at the senior management level and all management contracts to manage the business of the joint venture)

In addition to veto rights and reserved powers, where the nonprofit's partner participating in the joint venture is itself a tax-exempt entity, in the wake of ***Redlands***, the IRS is also likely to look for initiation rights for the nonprofit in matters affecting its charitable purposes. In this context, "initiation" means the right for the nonprofit to initiate and approve these actions on

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Organizations Revised Conflicts of Interest Policy, IRS Continuing Professional Education, Exempt Organizations – Technical Instruction Program for FY 2000, p. 45.

[43] This list of reserved powers and the following list of initiation rights represent a synthesis of IRS positions in Rev. Rul. 98-15, *Redlands*, and a series of exemption rulings and other guidance related to joint ventures, including the rulings cited in Section I. of this outline and the guidance discussed in the following articles: G. Griffith, "Physician 'Control' and Section 501(c)(3) Tax-Exempt Status: When a Minority Interest Equals a Majority Interest," 10 The Exempt Organization Tax Review 121 (July 1994); G. Griffith, "Tax-Exempt Status of Hospitals and Physician 'Control'," 27 Journal of Health and Hospital Law 257 (Sept. 1994); G. Griffith, "Impact of Taxable PHOs and MSOs on a Hospital's Tax-Exempt Status," 10 The Exempt Organization Tax Review 887 (Oct. 1994); G. Griffith, "Community Benefits of PHO and MSO Participation," 28 Journal of Health and Hospital Law 129 (May/June 1995); G. Griffith, "IRS Views on Physician Control of Integrated Networks," Healthcare Financial Management, p. 30 (Nov. 1995); G. Griffith, "Practical End to Impractical 20% Safe Harbor," 5 Health Law Reporter (BNA) 799 (May 23, 1996); G. Griffith, "IRS Applies Conflicts of Interest Rules to Clinic Exemption and Compensation Decisions," 15 The Exempt Organization Tax Review 357 (Dec. 1996); G. Griffith, "The Rocky Road of Ancillary Services Joint Ventures," 6 Health Law Reporter (BNA) 1723 (Nov. 6, 1997).

behalf of the joint venture without the need for consent or recommendation of any of its partners. Key initiation rights affecting the charitable purposes of the nonprofit partner include:

- Scope of services offered and locations at which they are offered by the joint venture
- Level of charity care provided by the joint venture, using the HFMA definition to exclude bad debt (perhaps limited to the same percentage of total revenues as the level of charity care provided by the hospital in order to protect the financial interest of the for-profit partners)[44]
- The ability to enter into new managed care contracts for the joint venture
- Meaningful ability to terminate joint venture management agreements with the other partners or their affiliates for cause or, after a reasonable initial term, without cause
- Open staff policies that allow the joint venture's facilities to be utilized by non-investors
- Dissolution of the joint venture if continued participation jeopardizes tax-exempt status (or the nonprofit's continued participation in the Medicare or Medicaid programs)
- Monitoring and audit rights to review the joint venture's activities

Some may argue that the monitoring and audit rights are the most important of all the initiation rights (as evidenced by the U.S. v Anderson case discussed in another session). That is not to say that simply having monitoring and auditing rights without any other substantive rights to enforce will be sufficient. Rather, the longest laundry list of reserved powers and initiation rights imaginable will be of little value if the actual performance of the joint venture is not adequately monitored and audited on a periodic basis to assure compliance with the terms of the written documents and to allow the nonprofit a meaningful opportunity to exercise its reserved powers and initiation rights.

Despite its unanswered questions, the ***Redlands*** decision itself provides important clues for tax planning in the joint venture context. A careful reading of the ***Redlands*** decision suggests three alternative approaches for a nonprofit to avoid jeopardizing exempt status when participating in a joint venture with a for-profit company: (1) retain majority voting control, with no quorum busting, super-majority voting or veto rights for the for-profit partner (in hospital-physician joint ventures, if the control is shared by two unrelated exempt organizations the arrangement may be more acceptable to the physicians); (2) adopt 50/50 voting but with strong charitable initiation rights for the nonprofit to take action on certain matters without consent of its partner(s); and perhaps (3) mandate specific charity care and Medicaid access (consistent with what related tax-exempt hospitals provide) and adopt 50/50 voting without initiation rights in most respects except for a strong dispute resolution mechanism and a requirement for all board members, the arbitrators and any management company to give primacy to charitable objectives in the operation of the joint venture. Pending further clarification, however, that third approach may be overly aggressive unless the nonprofit obtains a favorable advance ruling from the IRS. In that process, the IRS still may insist on certain initiation rights for the nonprofit and require an

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[44] For a definition of charity care that excludes bad debt and is generally acceptable to the IRS, see Statement 15, "Valuation and Financial Statement Presentation of Charity Service and Bad Debts by Institutional Healthcare Providers," issued by the Principles and Practices Board of the Healthcare Financial Management Association (Feb. 1993); PLR 9426040 (April 4, 1994).

independent manager. In each case, limiting the discretion of a for-profit management company in operating the venture and extending its contract (or assigning management to an affiliate of the nonprofit) would bolster the nonprofit's tax-exempt status position.

Assuming the first option is not acceptable to the nonprofit's prospective partners, the particular initiation rights that may be useful include: (a) the ability to terminate the for-profit manager if it is acting inconsistent with charitable objectives, and limiting the "bites at the apple" for the manager to use a cure period for more than a limited number of similar breaches within a limited time period; (b) incorporating a statement of charitable intent, objectives and duties in the definitive agreements, with enforcement rights for the nonprofit (referenced in alternative 3 above); (c) rights for the nonprofit to unilaterally implement community benefit activities (*e.g.*, new services, new locations, new managed care contracts and rates, adopt or modify fee schedules, charity care levels, Medicaid participation); and (d) a tax dissolution clause to allow the nonprofit to either dissolve the venture, buy out its partner or "put" its interest to its partner at appraised fair market value in the event it reasonably determines that its tax-exempt status is jeopardized by continued participation in the joint venture (perhaps triggered by a legal opinion, change in law or change in IRS or judicial interpretation of the Code and mirroring similar provisions for continued Medicare and Medicaid participation).

For nonprofits wanting an additional level of comfort while still accommodating its prospective partners' reasonable business concerns, it may be worth considering a two-step transaction, starting with a conservative approach to control with an agreement to "spring into" a more flexible, shared control structure upon receipt of a favorable ruling from the Service and an opportunity for either party to unwind the venture on fair market value terms if a ruling is not forthcoming within a certain time period. Depending on the course of any appeal in the *Redlands* case, however, rulings in the area may not be issued for some time.

Based on *Redlands*, other factors that would also improve the chances for obtaining and maintaining tax-exempt status for the nonprofit partner would include: (a) adopting and publicizing (in the community) an appropriate charity care policy designed to attract indigents needing the services offered by the venture; (b) assuring that the nonprofit has its own staff (employees or contractors); (c) assuring that the nonprofit, through an independent board or committee (with no direct or indirect financial interest in the venture or the for-profit parties), both has the right to exercise and documents that it actually does exercise oversight of the venture to assure compliance with the charity care policy, monitor quality and propriety of care and verify performance of charitable duties incorporated in the partnership and management agreements; (d) document how establishment of the venture will either create a new provider, expand services for which there is a demonstrable community need or prevent the erosion or discontinuance of such needed services; (e) pay the manager on a reasonable, fixed fee basis or, if there is revenue-based incentive compensation, clearly credit the manager with deemed revenues for charity care, *e.g.*, by using an average charge based on the rates of the venture's payor base after applying a typical collection percentage; and (f) avoid any noncompete for the nonprofit's (or any affiliate's) existing programs, and unless there are strong initiation rights, retain an option to offer new services and programs outside of the venture to meet community needs if the partnership declines to undertake the activity within a reasonable time on reasonable terms. It remains to be seen how many of these extra protections, if any, will be required. Absent further guidance, however, including more of these protections likely would improve the nonprofit's tax-exempt status position.

E. Unwinding Joint Ventures. In the wake of Rev. Rul. 98-15, a number of hospitals are looking at the possibility of unwinding their whole hospital joint ventures. To the extent that Rev. Rul. 98-15 is applied to ancillary services joint ventures, this trend could expand to certain hospital-physician joint ventures if the deals can not be restructured to provide the necessary control to the nonprofit hospital. One example of a whole hospital joint venture being dissolved in the wake of Rev. Rul. 98-15 is the Columbia Arlington Healthcare System LLC, based in Arlington, Virginia. On January 28, 1999, the parties announced that the IRS had refused to approve the joint venture by the parties agreed upon target date (February 14, 1999, approximately two years after the ruling request was filed) and it would be dissolved. There is growing consensus that more dissolutions or buy-outs will follow.[45]

One of the key players on the for-profit side in whole hospital joint ventures, Columbia/HCA (which has between 11 and 22 such joint ventures still in place depending on which source one believes), had this to say about Rev. Rul. 98-15 in its annual SEC Form 10Q filed March 31, 1998 for the fiscal year ended December 31, 1997 (page 15):

> During March 1998, the IRS issued guidance regarding the tax consequences of joint ventures between for-profit and not-for-profit hospitals. The Company has not determined the impact of the tax ruling on its existing joint ventures, or the development of future ventures, and is consulting with its joint venture partners and tax advisers to develop an appropriate course of action. The tax ruling could limit joint venture development with not-for-profit hospitals, require the restructuring of certain existing joint ventures with not-for-profits and influence the exercise of 'put agreements' (that require the Company to purchase the partner's interest in the joint venture) by certain existing joint venture partners.

Whether or not a hospital can easily extricate itself from a joint venture depends at least in part on exit strategies negotiated in advance in the joint venture agreement and whether or not the venture was actually substantially implemented before the decision was made to unwind it. After services have been consolidated, it becomes difficult at best to "unscramble the egg" and reallocate programs and services to their former locations. State CON and licensure laws also may make that reallocation difficult. A typical way to plan for the exit strategy in advance is to include a contingency for fair market value payments to the hospital that gave up particular programs or services rather than trying to restore the pre-joint venture service configuration.

Another key factor in determining how easily a joint venture can be unwound (or restructured to come into compliance) is the presence or absence of specific triggering events and the extent of any associated penalties for unwinding the joint venture. It is not unusual for whole hospital and other joint venture agreements to have tax conditions or dissolution rights (*i.e.*, triggering the nonprofit's right to unwind the venture if there is reasonable cause to deem its

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[45] *See* B. Yuill, "Unwind," *supra*; K. Hallam, "Tax-ruling Delay Kills Columbia Va. Venture," Modern Healthcare, p. 8 (Feb. 1, 1999); M. Freudheim, "Hospitals' Mixed Marriages Raise Eyebrows at the I.R.S.," New York Times (Feb. 28, 1999).

exemption at risk), springing reserved powers allowing greater control for the nonprofit if certain contingencies occur, specific time periods and procedures for renegotiating certain affected terms to respond to a change in law or governmental agency or court interpretation of existing law, or a provision tying the effective date or continuation of the venture to receipt of a favorable tax ruling (often by a specific target date). Penalty provisions can include payment of liquidated damages by the party triggering the unwind and either puts or calls at prices that may be above or below fair market value (as a disincentive to dissolution) if certain triggering events occur. Without a specific exit strategy planned in advance, nonprofits could be left with no leverage to force a buy out and no willing buyer for their minority share, at least not at anywhere close to the value the nonprofit may have expected. At that point, a sale of the remaining interest to the for-profit partner may cause even more exemption related problems.

After operating as the hospital as a partner, likely with a management contract for an affiliate to manage the venture, the for-profit entity is likely to be viewed as both an insider and a disqualified person by the IRS. Consequently, dissolutions of whole hospital joint ventures can themselves result in inurement (jeopardizing the nonprofit's continued exemption to the extent it still qualifies despite the whole hospital joint venture) and excess benefit (taxable to the for-profit at the two-tier rates of 25% and 200%, which exposure continues under TBOR2 for excess benefit transactions entered into up to 5 years after loss of exemption). Even without insider/disqualified person status, the dissolution may result in more than incidental private benefit that can jeopardize the nonprofit's tax-exempt status.

The IRS has faced similar issues in the past when hospitals unwound joint ventures in the wake of GCM 39862 (prohibiting net revenue stream joint ventures) and the restrictions on physician investment under the Stark Law. In that context, the IRS noted that buy-out of the physician partner's interest at appraised fair market value may result in inurement or private benefit if the appraisal does not take into the impact of changes in the Stark Law on future cash flows (*i.e.*, due to referral restrictions). C. Kaiser, P. Haney & T.J. Sullivan, IRS Continuing Professional Education Text for FY1995, <u>Chapter L: Integrated Delivery Systems and Joint Venture Dissolutions Update</u>, pp. 153, 177-179. Similarly, any appraisal of a whole hospital joint venture for purposes of a buy out of the for-profit should take into account how the dissolution of the partnership will affect revenues and expenses, *e.g.*, by loss of favorable supply contracts, affect on managed care rates and contracts, and loss of referrals from facilities related to the for-profit partner. Certain hospital-physician joint ventures have been terminated in the wake of GCM 39862 after an announcement from the IRS inviting hospitals to terminate arrangements and seek a ruling or closing agreement to resolve their tax liability.[46] In fact, more than ten hospitals entered into closing agreements with the IRS to unwind net revenue stream joint ventures in the wake of GCM 39862 and Announcement 92-70. *See* J.E. Kindell & T.J. Sullivan, FY1995 CPE Text, <u>Chapter K: Health Care Update</u>. It remains to be seen whether the IRS will issue a similar invitation to nonprofit hospitals to unwind whole hospital joint ventures and seek closing agreements.

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[46] <u>See</u> Announcement 92-70, 1992-19 I.R.B. 89; PLR 8820093 (Feb. 26, 1988), <u>*revoked in*</u> PLR 9231047 (May 5, 1992); PLR 8942099 (July 28, 1989), <u>*revoked in*</u> PLR 9233037 (May 20, 1992); unpublished ruling described in GCM 39862 (hospital in effect leased departments to the partnership and the partnership paid hospital a management fee and reimbursed direct and indirect operating costs); PLR 9323035 (March 17, 1993).

In the wake of GCM 39862 (prohibiting net revenue stream joint ventures), the Service issued an announcement inviting tax-exempt hospitals to terminate similar arrangements and seek a ruling or closing agreement to resolve their tax liability.[47] In fact, more than ten hospitals entered into closing agreements with the Service to unwind net revenue stream joint ventures in the wake of GCM 39862 and Announcement 92-70.[48] It remains to be seen whether the Service will issue a similar invitation to nonprofit hospitals to unwind whole hospital and ancillary services joint ventures and seek closing agreements in the wake of Rev. Rul. 98-15 and ***Redlands***. Hospitals that do unwind such joint ventures, however, must be mindful of avoiding private inurement or more than incidental private benefit by paying more than fair market value to extricate themselves from the joint ventures.[49] In that regard, any appraisal of a joint venture for purposes of a buy-out of the for-profit should take into account (within the legal limits of fraud and abuse, self-referral and other laws) how the dissolution of the partnership will affect revenues and expenses, *e.g.*, by loss of favorable supply contracts, effect on managed care rates and contracts, and loss of referrals from facilities related to the for-profit partner. The for-profit partner may have some added incentive to cooperate in reaching an agreement on fair market value terms because by virtue of the management contract or partnership agreement, the for-profit may have become a "disqualified person" and any payments it receives above fair market value in the unwind may be subject to the penalty excise tax under Section 4958 of the Code.

Whether or not such an invitation is forthcoming from the Service, all tax-exempt organizations should seriously consider reevaluating their existing joint ventures in light of the ***Redlands*** decision. If an existing joint venture raises concerns, whether or not a hospital can easily extricate itself from that joint venture without a financial or other penalty will depend at least in part on exit strategies negotiated in advance in the definitive agreements (*e.g.*, whether there is a tax dissolution clause and what the triggering event is). Also, as a practical matter, after services have been consolidated, it becomes difficult at best to "unscramble the egg" and reallocate programs and services to their former locations. State certificate of need and licensure laws also may make that reallocation difficult. A typical way to plan for the exit strategy in advance would be to include a contingency for a buy-out of one party's interest at fair market value if a triggering event occurs, or providing for fair market value payments to the hospital that gave up particular programs or services rather than trying to restore the pre-joint venture service configuration. At a minimum, the ***Redlands*** decision increases the importance of planning some type of exit strategy in advance in many joint ventures and closely evaluating both existing and proposed nonprofit/for-profit joint ventures.

As of January 2000, the IRS had already seen some ruling requests involving the proposed unwinding of joint ventures in the wake of Rev. Rul. 98-15 and ***Redlands***. These requests have involved tax-exempt organizations attempting to buy back or lease back hospitals from for-profit entities that have decided to close the facilities. In each situation, the IRS will be concerned with the valuation of the hospital. Where the transaction is structured as a leaseback

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47 See Announcement 92-70, 1992-19 I.R.B. 89.

48 See J.E. Kindell & T.J. Sullivan, FY1995 CPE Text, Chapter K: Health Care Update.

49 See C. Kaiser, P. Haney & T.J. Sullivan, FY1995 CPE Text, Chapter L: Integrated Delivery Systems and Joint Venture Dissolutions Update, pp. 153, 177-179 (noting potential for inurement or private benefit in unwinding joint ventures prohibited by the Stark Law if the appraisal does not take into the impact of changes in the Stark Law on future cash flows, *i.e.*, due to referral restrictions).

rather than an outright sale, the IRS also "will look for community benefit, the amount of control the for-profit owner retains, and whether there is a community board to ensure that the arrangement operates in a manner consistent with Revenue Ruling 69-545, 1969-2 CB 117."[50] One senior IRS official indicated that the Service is willing to consider requests for closing agreements in this area; however, the IRS may insist on performing a "limited scope" examination to verify the facts before entering into a closing agreement. Although closing agreements are generally not made public, that same official reported that the IRS already has approved unwinds of joint ventures in some cases.

F. Other Structural Alternatives. In addition to the approach of assuring control for the nonprofit partner, there are four other alternatives to ancillary joint ventures for nonprofit systems. First, the nonprofit could use a taxable subsidiary to participate in the joint venture. Under the doctrine of *Moline Properties*,[51] the IRS and the courts typically respect the separate corporate identity of a subsidiary if certain corporate formalities are followed. Second, if the nonprofit wishes to be a mere passive investor in the joint venture rather than an active participant, if there is a reasonable expectation of a market rate of return then the joint venture then the joint venture may be justifiable as a pure investment. Third, limiting support of a joint venture to specific projects that further the exempt organization's charitable purposes may require a narrower scope of control over the venture's activities – if the exempt organization's contributions can be segregated from other assets and operations of the venture and effectively controlled and monitored by the exempt organization. Fourth, if the joint venture is a relatively insubstantial portion of the total activities of the nonprofit, the IRS may be willing to issue a private letter ruling that restricts any negative tax impact to a finding of unrelated business income rather than a potential threat to tax-exempt status. None of these approaches, however, have been sanctioned by the IRS or the courts as of yet, and they may adopt a different approach.

1. Taxable Subsidiaries. Another potentially beneficial approach is the use of a taxable subsidiary to participate in the joint venture. Using a taxable subsidiary may provide some protection for the parent's exempt status if corporate formalities and separateness are observed. In that regard, Section 501(c)(3) and 501(c)(4) organizations have long established taxable subsidiaries to shield exemption from unrelated trades or businesses that may become substantial and otherwise could threaten exemption.[52] The IRS also has permitted use of taxable subsidiaries to shield a 501(c)(3) organization from 501(m) commercial-type insurance activity.[53] Certain safeguards must be followed, however, when utilizing taxable subsidiaries.

If a taxable subsidiary's activities are attributed to its exempt parent, they may result in UBI (under Section 501(m) or otherwise) and may jeopardize exemption if the non-exempt activities are substantial. In order to avoid the activities of a taxable subsidiary being attributed to the parent, it is important to preserve their separate corporate identities, to demonstrate that the subsidiary was organized for a valid business purpose and has legitimate business activities. It is

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[50] New Health Care Trends, *supra*.

[51] Moline Properties, Inc. v Commissioner, 319 U.S. 436, 438 (1943); Britt v United States, 43 F.2d 227, 234 (5th Cir. 1970).

[52] See, e.g., GCM 39776 (Aug. 25, 1988); GCM 39326 (Aug. 31, 1984); PLR 199941051 (July 22, 1999); PLR 9819046 (Feb. 11, 1998); PLR 9245031 (Aug. 10, 1992); PLR 9201039 (July 24, 1991).

[53] See PLR 9404004 (Sept. 30, 1993) (non-health care educational organization).

also important to observe corporate formalities for the subsidiary and to establish that the parent does not control the day-to-day operations of the subsidiary. In that regard, the IRS typically looks to whether the officers, directors or employees of the exempt organization comprise a majority of the taxable subsidiary's board, officers and employees, whether the parent participates in day-to-day management decisions of the subsidiary, whether transactions between the organizations are conducted on an arm's length basis, and other indicia such as funding by the exempt organization, common office space and books and records, and the subsidiary's activities constitute a not insignificant portion of the exempt organization's total activities. In certain circumstances where supported by these factors, the IRS may look through the separate corporate structure of a taxable subsidiary and attribute its activities to the tax-exempt parent.[54] In addition, if the exempt organization's primary activity becomes its investment interest in the taxable subsidiary (alone or with other non-exempt purposes), the HMO's exemption could be jeopardized.

It must also be noted that use of a taxable subsidiary will not excuse all potential inurement and excess benefit. The subsidiary's transactions with its tax-exempt parent generally should be at arm's length and reflect fair market value. If the subsidiary receives bargain rent or services from the tax-exempt parent or was overpaid by the parent in similar respects, then in addition to attempting to reallocate items of income and expense under Section 482 of the Code, the Service may argue that the effect of the non-fair market value transaction is to subsidize any excessive compensation arrangement or other non-fair market value payments by the subsidiary to individuals or entities who would be insiders or disqualified persons as to the tax-exempt parent. Furthermore,. so as to avoid indirect inurement, any differentials from fair market value in the subsidiary's transactions are not subsidized by the exempt parent.[55] The IRS has also noted that indirect payments through a taxable subsidiary to a disqualified person can result in an excess benefit taxable under Section 4958 of the Code (TBOR2).[56]

2. Mere Investment Interest. Another potential argument that was not fully addressed in ***Redlands*** is the possibility that a nonprofit's participation in a joint venture is justifiable as a mere investment on fair market value terms. Although investment in a for-profit business itself is not a charitable activity, it is clear that a tax-exempt organization may invest its funds as an incidental part of its activities (as opposed to being in the business of acting as an investment advisor or broker for unrelated parties who control or benefit from the investment decisions).[57] The rationale behind this argument focuses on the expected return to the nonprofit, which of course must be achieved in a legal manner in light of other restrictions such as the fraud

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[54] See GCM 39326 (Aug. 31, 1984); GCM 39598 (Dec. 8, 1986); PLR 8716004 (Jan. 1, 1987); PLR 8716054 (Jan. 20, 1987). The IRS has allowed up to a six month transition period, however, for overlap of officers. See PLR 9542045 (July 28, 1995).

[55] See, e.g., Moline Properties, Inc. v Commissioner, 319 U.S. 436, 438 (1943); Britt v United States, 431 F.2d 227, 234 (5th Cir. 1970); GCM 39776 (Aug. 25, 1988); GCM 39646 (undated, released June 30, 1987); GCM 39598 (Dec. 8, 1986); GCM 39326 (Aug. 31, 1984); PLR 9819046 (Feb. 11, 1998).

[56] See, e.g., Internal Revenue Manual – 7.8.1 Exempt Organizations Examination Guidelines Handbook, Ch. 28 Taxes on Excess Benefit Transactions, ¶ 28.2, Example (Indirect Economic Benefit), *reprinted in*, Tax Notes Today, 2000 TNT 2-19 (Jan. 4, 2000).

[57] See Fund for Anonymous Gifts v IRS, 83 AFTR2d 99-1796 (D.C. Cir. 1999); Rev. Rul. 67-149, 1967-1 C.B. 133; GCM 37789 (Dec. 18, 1978); PLR 9714016 (April 4, 1997); PLR 9642051 (July 22, 1996); PLR 9501037 (Oct. 6, 1994).

and abuse and self-referral laws. To justify participation in a joint venture as a mere investment, it is likely that the nonprofit must be able to demonstrate that it reasonably expects that it will receive a reasonable rate of return on its investment in the venture in light of the size of the investment and the risk factors associated with the venture as compared to alternative investments (adjusted for their relative risk levels). The mere investment argument could be bolstered if the nonprofit's role is truly passive with limited liability (*e.g.*, as a limited partner and not a general partner like RSS), the investment has reasonable liquidity under the circumstances and the nonprofit obtains the same type of rights that another reasonable investor would insist on in a similar venture. If any of those protections are lacking or the rate is below market for the risk involved, this argument could be weakened substantially.

The IRS has not ruled expressly (publicly at least) on the mere investment argument as applied to a traditional nonprofit/for-profit ancillary services joint venture. There is, however, some guidance available on the mere investment argument generally for tax-exempt organizations. In Rev. Rul. 67-149, the IRS acknowledged that receipt of incidental investment income did not jeopardize exempt status. In GCM 37789, the IRS analyzed the interest rate on a construction loan by a hospital to a physician group in terms of whether the interest would represent a reasonable rate of return on the hospital's funds (though the bargain rental rate was questioned). In one ruling that did involve a partnership (PLR 9642051), the IRS approved a 501(c)(3) exempt organization's investment in a limited partnership comprised of other exempt organizations and qualified plans (and one individual as one of the limited partners, which individual is a general partner of the partnership which was general partner of the investment limited partnership). The investment limited partnership in turn invests those funds in short-term interest bearing debt instruments or accounts as well as stock and stock equivalents. Another investment partnership also was found not to jeopardize exemption in PLR 9714016, and in that case the exempt organization established the investment partnership and sold interests therein as a fundraising vehicle. Finally, in PLR 9501037, the IRS found that a lease of a facility to an unrelated party at a fair market rental rate (as determined by an independent appraisal) did not itself further exempt purposes but was "a permissible investment activity of a section 501(c)(3) organization that otherwise has a clear independent basis for exemption." Perhaps that last ruling best summarizes the limited nature of the mere investment argument – investment is not itself a charitable activity yet as long as the return is reasonable under the circumstances it should not jeopardize exemption. Active participation in a partnership, however, is still likely to be judged by the more traditional two-prong test and, at least in the IRS' view, the more stringent control standards of Rev. Rul. 98-15 and ***Redlands***.

In arguing the ***Redlands*** case before the Tax Court, the IRS itself noted that even if "a charity previously has received a reasonable return on an investment in a joint venture[, that prior rate of return] will not insulate the charity from scrutiny under the private benefit test if the primary purpose of the investment is to benefit private individuals."[58] In fact, it was an investment in an active business venture which was RSS' sole activity in ***Redlands***, and not a mere passive investment of a portion of its assets. The Tax Court opinion made clear that merely being a passive investor is not itself a charitable activity (at best it is a neutral one, neither charitable nor noncharitable).

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[58] Revised Denial Letter, *supra* (*citing* Stevens Bros. Foundation, Inc. v Commissioner, 39 T.C. 93 (1962)).

3. Charitable Donation. Another, less passive approach to the mere investment argument also may pass muster. It may be more accurate, however, to phrase this approach as a charitable donation approach rather than an investment, though it is arguably an investment in benefiting the community. Specifically, the argument revolve around whether the contribution of cash or other assets or services to a joint venture with a for-profit party necessarily furthers only charitable purposes and does the exempt organization have the power to assure its contribution is used only in that manner. In this case, the cash, other assets or services are donated to further exempt purposes but not necessarily qualifying for any deduction in part because the value of services generally is not deductible under the Code, in part because the donor is tax-exempt and, even if it makes contributions from UBI, the "donee" for-profit is not a qualified recipient of charitable contributions.

If the activities of the venture are limited to charitable projects and the nonprofit controls the use of its donated funds to limit their use to such projects, that may be sufficient to avoid inurement. For example, in one case the Court of Claims overturned the IRS' denial of 501(c)(3) exempt status for a nonprofit organization that operated to raise and distribute funds to other nonprofit, tax-exempt organizations while retaining sufficient control to assure that its donations were used for charitable purposes.[59] That level of control, however, leads back to the mainstream joint venture analysis and may prove indistinguishable from the control tests developed or to be developed in the wake of Rev. Rul. 98-15 and ***Redlands***. Arguably though the control need relate only to the contributions of the exempt organization and not the entire assets and operations of the joint venture.

This charitable donation approach, however, is untested and it raises at least a few serious questions which, absent further guidance, make this approach highly aggressive and risky in most circumstances. First, in the charitable donation precedents, the donee was often an exempt organization.[60] Second, in those precedents, the donor did not have any equity interest or general participation in the broader venture(s) of the donee (the two rulings that did involved partnerships related to partnerships formed strictly for investment purposes and, in the more recent ruling, controlled by a wholly owned subsidiary of the exempt organization as general partner – see PLRs 9642051 and 9714016. Third, in many cases involving individual professionals or for-profit "donees" the contributions were in the nature of services directly to a charitable class such as ministering to the non-medical needs of patients in a for-profit hospital (by reading, writing letters and other similar personal services) or by operating a gift cart for the convenience of patients and their visitors at a for-profit hospital,[61] or it was a subsidy reasonably related to an agreement to provide a substantial amount of services to indigents free of charge or to Medicaid beneficiaries.[62] Fourth, in the other cases that did involve cash contributions and were not recruitment arrangements, the nonprofit retained absolute control and discretion over the use of the funds it contributed, limiting their use to specific projects which further its own exempt purposes and maintaining records sufficient to verify their use.[63] Yet, where cash (and to

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[59] National Foundation, Inc. v United States, 13 Cl. Ct. 486, 60 AFTR 2d 87-5926, 87-2 USTC ¶ 9602 (1987). See also Rev. Rul. 68-489, 1968-2 C.B. 210; Rev. Rul. 67-149, 1967-1 C.B. 133.

[60] Rev. Rul. 78-310, 1978-2 C.B. 173; Rev. Rul. 67-149, 1967-1 C.B. 133.

[61] Rev. Rul. 68-73, 1968-1 C.B. 251 (personal services); GCM 39762 (Feb. 23, 1988) (gift cart).

[62] Rev. Rul. 97-21, 1997-1 C.B. 121 (recruitment of physicians); Rev. Rul. 72-559, 1972-2 C.B. 247 (recruitment of lawyers).

[63] Rev. Rul. 68-489, 1968-2 C.B. 210; PLR 8936002 (May 24, 1989).

a lesser extent other tangible property) is contributed the respective contributions of the exempt organization and its for-profit partner may become commingled and are often viewed as fungible making it practically impossible to control the contributions made by the exempt organization without necessarily controlling the overall assets and operations of the joint venture.

4. Insubstantial Portion of Activities. One argument that the Tax Court opinion in ***Redlands*** does not address is whether the same result would be reached if the partnership activity is not the nonprofit's sole activity, but its partner is an insider. The Tax Court's opinion noted that ceding effective control of the two partnerships and the ASC's activities to SCA and its affiliated management company "conferr[ed] on them significant private benefits." This point is emphasized in the government's brief on appeal to the Ninth Circuit. Presumably that private benefit to SCA had economic value in that the ability to control the use of the partnership assets would be useful in maximizing the potential profit for SCA and its affiliate (the management company). Because the ASC joint venture was essentially the nonprofit's sole activity in ***Redlands***, the nonprofit's operations were found to be noncharitable. If RSS' partner, however, had been an insider and had received the same significant private benefit (control of charitable assets to be used to maximize its own profits) with no more than incidental community benefit, it is difficult to imagine how one could conclude there would be no inurement. This potential inurement aspect of ***Redlands***, if pursued by the IRS here or in another case, may have profound effects on a variety of incorporated and unincorporated hospital-physician joint ventures including PHOs, MSOs and ancillary services joint ventures (*e.g.*, MRI, ASC, etc.). Although in ***Redlands*** all of the limited partners were staff physicians at RCH (plus the clinic owned by those physicians), and the IRS historically considered staff physicians to be insiders (though that view is changing), there was no mention of any inurement issue in the case.

Nevertheless, informal comments from some IRS officials have suggested that where a joint venture involves only an insubstantial part of a nonprofit's charitable activities, the consequence of failing to pass muster under the Rev. Rul. 98-15/***Redlands*** control standards may be limited to income tax liability for UBI rather than loss of exemption due to inurement or more than incidental private benefit. Absent further binding guidance from the IRS or the courts, however, it is difficult to support that conclusion without disturbing other IRS positions or settled precedents as to who is an insider and what constitutes inurement (although as discussed below, the Tax Court opinion in ***Redlands*** lays some of the ground work for one alternative analysis). The IRS' continued unwillingness to rule in the area pending a final decision in ***Redlands*** does little to clarify the matter. Likewise, the IRS' article on joint ventures in the FY 2000 CPE Text (Chapter D: Update on Health Care Joint Venture Arrangements, pp. 35-44) does not even address the traditional ancillary joint ventures but rather speaks solely to whole hospital joint ventures following Rev. Rul. 98-15, nonprofit-to-nonprofit joint ventures and the status of the ***Redlands*** case. In fact, in that CPE Text article, the IRS notes that:

> It would be difficult, if not impossible, to discuss what changes, if any, could be made to Situation 2 [in Rev. Rul. 98-15] so that the LLC described would not jeopardize the nonprofit hospital's exemption. . . . [T]he analysis is a facts and

circumstances test. It is not feasible to identify any one factor as determinative or critical.[64]

Not all hospital-physician joint ventures would be considered a substantial activity in the same sense that the ASC venture was a substantial portion of RSS' total activities. Yet it is difficult to distinguish the joint ventures reviewed in Rev. Rul. 98-15 and *Redlands* from typical ancillary services joint ventures on any basis other than the amount of the nonprofit's charitable assets that are committed to the joint venture. Given the IRS' historical position that staff physicians were insiders *per se* (a position tempered by Congress in the legislative history of TBOR2),[65] it may be argued that many 50/50 ancillary services joint ventures between tax-exempt hospitals and physicians will jeopardize the hospital's tax-exempt status unless the IRS either (1) redefines the term "insider" to require clear, high-level substantial influence rather than applying the term to what are arguably instances of mere potential economic importance or input, (2) acknowledges a generous allowance for acceptable *de minimis* levels of inurement that will not jeopardize exemption (though that *de minimis* amount would need to be substantial itself given the revenues of many ancillary services joint ventures), or (3) acknowledges that the result the Tax Court reached in *Redlands* (and that the IRS reached in *Situation 2* of Rev. Rul. 98-15) may be different if one or more of the negative factors were reversed (such as by including and enforcing reasonable standards for charity care and Medicaid participation by the joint venture and selecting an independent manager under a more reasonable contract), although this approach requires guidance from the IRS through additional rulings or more informal means (or from the courts) as to how that balance will be struck and how many negative factors must be reversed.

Following *Redlands*, the third possibility appears to be the most realistic and likely outcome. That approach essentially is based on the theory that the difference between an exemption risk and a UBI risk is merely one of degree. That same justification has been given by some IRS officials already to explain why prior rulings on hospital joint ventures with for-profits were favorable – *i.e.*, because they only involved a portion and not substantially all of the nonprofits' activities.[66] This approach would be very fact intensive, however, requiring an inquiry into the number and quality of other activities, perhaps measured by revenues (net and gross), expenses, staff time, historical significance and importance, community benefits provided, and other benchmarks (which is consistent with more recent comments from the IRS about conducting limited scope audits in connection with closing agreements in this area). The downside of this approach from the IRS' perspective would be that it may open the door for more whole hospital joint ventures with for-profits – specifically, in circumstances where the nonprofit hospital contributed to the joint venture is only one part of a larger system with other charitable activities (so that the hospital is not a substantial part of the system's total activities).

Despite potential IRS concerns as to the impact on certain whole hospital joint ventures, the "substantiality" argument for treating "bad" ancillary services joint ventures as mere source of UBI is the most promising. It is an argument that appears to be consistent with the control analysis in *Redlands* in that it would focus on the effect of control of the joint venture on the

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64 FY 2000 CPE Text, at p. 39.

65 See H.R. 104-506 at n.12 (1996).

66 One exception would be PLR 9517029 (Jan. 27, 1995), where the IRS issued a favorable UBI ruling even though the joint venture was the nonprofit's only activity.

exempt organization. Specifically, the question would be whether control of the joint venture is tantamount to control of the nonprofit entity. Unilateral control of the joint venture's activities seems to be less important for avoiding more than incidental private benefit (and inurement) if the nonprofit has not committed substantially all of its activities to the joint venture.

The Tax Court opinion in ***Redlands*** (supported by the tenor of the argument in the government's brief on appeal) helps to lay the ground work for this argument by concluding that where all of the nonprofit's allegedly charitable activities are conducted in the partnership, control of the partnership is tantamount to control of the nonprofit itself. Conversely, if substantially all of a nonprofit's activities are conducted outside the scope of the joint venture (which is the case with many ancillary services joint ventures, the RSS arrangement in ***Redlands*** being an anomalous situation), control of the joint venture would not be tantamount to control of the nonprofit itself. Rather, the nonprofit would have other assets and operations of a charitable nature under its unilateral control. It also could continue to further charitable purposes through its other activities while avoiding private inurement or more than incidental private benefit in the joint venture through veto rights and a 50/50 governance structure. This result appears to be consistent with the Congressional intent underlying TBOR2, as reflected in the legislative history wherein the Ways & Means Committee noted that intermediate sanctions under Section 4958 generally would be the sole remedy for inurement or excess benefit if the activity in question "does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization."[67]

At the same time, however, if the venture is not subject to sufficient control to allow the nonprofit alone to cause the venture to act in a charitable manner, the IRS may conclude that the nonprofit's share of partnership income is not substantially related to its exempt purposes. An analogy can be found in a number of UBI rulings and court decisions focusing on the patient/non-patient distinction, and cited by the IRS in its brief on appeal in ***Redlands***. In those rulings and cases, for example, certain revenue for laboratory tests provided to or pharmacy sales to individuals who are not hospital patients is typically treated as UBI for the hospital but typically does not jeopardize exempt status if it is not substantial in amount with other unrelated trade or business activity.[68]

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[67] H.R. Rep.104-506 at 59, n. 15

[68] See, e.g., St. Luke's Hospital v United States, 494 F. Supp. 85 (W.D. Mo. 1980); Carle Foundation v United States, 611 F.2d 1192, 1199 (7th Cir. 1979), cert. den., 449 U.S. 824 (1980); Rev. Rul. 85-110, 1985-2 C.B. 166; Rev. Rul. 85-109, 1985-2 C.B. 165; Rev. Rul. 68-374, 1968-2 C.B. 242; Rev. Rul. 68-375, 1968-2 C.B. 245; Rev. Rul. 68-376, 1968-2 C.B. 246.

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