Federal Law Update: Ancillary Joint Ventures After *Redlands*

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Major Developments for JVs

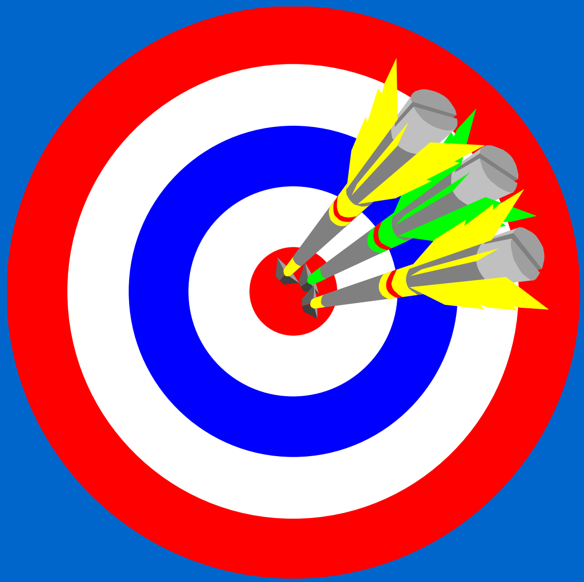
- Audit Activity
  - UCC: Defining “Insiders”
  - TBOR2: Revenue Sharing
- Whole Hospital Joint Ventures
  - Rev. Rul. 98-15
- *Redlands Surgical Services*
  - Sole activity
  - Control = inurement?

Areas not addressed

- Non-tax considerations (*e.g.*, Fraud and Abuse, Stark, Indenbaum, Antitrust)
- Gainsharing (separate session)
- UBI (no recent developments)
- Bond-financed facilities (no developments of note since Rev. Procs. 97-13, 97-14 and 97-15)

Audit Activity

- Traditional EO and CEP Audits
- IRS Coordination with Taxable Sector
- TBOR2 Assessments (Sta-home Home Health, >$40 million)



Audit Activity

- Ongoing joint venture audits
- Common defects from the IRS perspective:
  - secretive process
  - lack of competitive bids
  - lack of “legitimate and rigorous” business investment analyses
  - failure to meet charity care and other covenants
  - diversion of funds for political intervention
  - lack of monitoring by nonprofit

Audit Activity

- Community benefit factors (affected by control):
  - Is charity care actually provided and at what levels?
  - Are joint venture facilities located in an underserved, low-income area?
  - How does the community as a whole fare under the joint venture (*e.g.*, in terms of access to and quality of services)?
  - Are decisions made based on the interests of the community or the interests of the for-profit?

Defining "Insiders"

- No Free "First Bite" . . . or is there?
  - UCC I (Tax Court):
    - favorable terms of initial contract made fundraiser an insider
    - IRS' self-fulfilling prophecy, must be insider based on favorable deal
  - UCC II (7th Cir.)
    - harshly critical of IRS and Tax Court
    - allows one free bite
    - passing reference to staff physicians as insiders
  - "DP" intended to be less inclusive than insiders

UCC: Functional Control Test

- Functional test examining reality of control
- Impact of UCC (7th Cir.):
  - Favorable terms alone may not show control
  - Distinguish control over entity vs. activity
  - Facts and circumstances is “no standard at all”
- IRS may try to limit UCC to its facts now
  - Common type of arrangement (fundraising)
  - No control over actual “charitable activities”

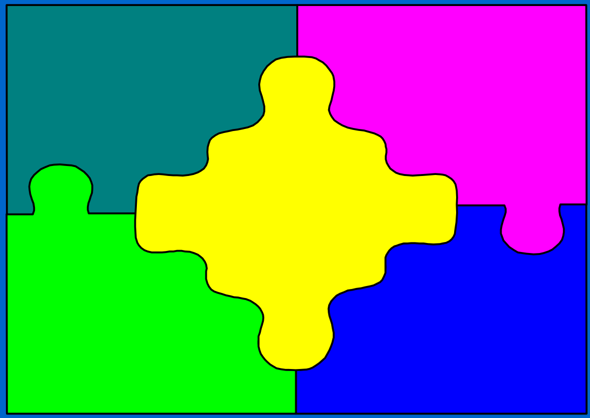
TBOR2 Basics

- Two-tier tax on disqualified persons receiving an excess benefit (25% + 200%)
- Excess benefit includes
  - Receipt of more than fair market value
  - Revenue sharing (gross or net) resulting in inurement
- Tax rate applies to amount of excess benefit
  - Excess over fair market value
  - Entire prohibited revenue sharing payment

Revenue Sharing Arrangements

- Effective only after final Regs. are issued
- Currently FMV limit applies
- Facts and Circumstances Test:
  - proportionate benefit to EO and DP
  - relationship to quality and quantity of services
  - control <u>of activities</u> generating the revenues
- No mention of a “cap” -- still helpful
- Potentially affects all joint ventures

Ancillary Joint Ventures

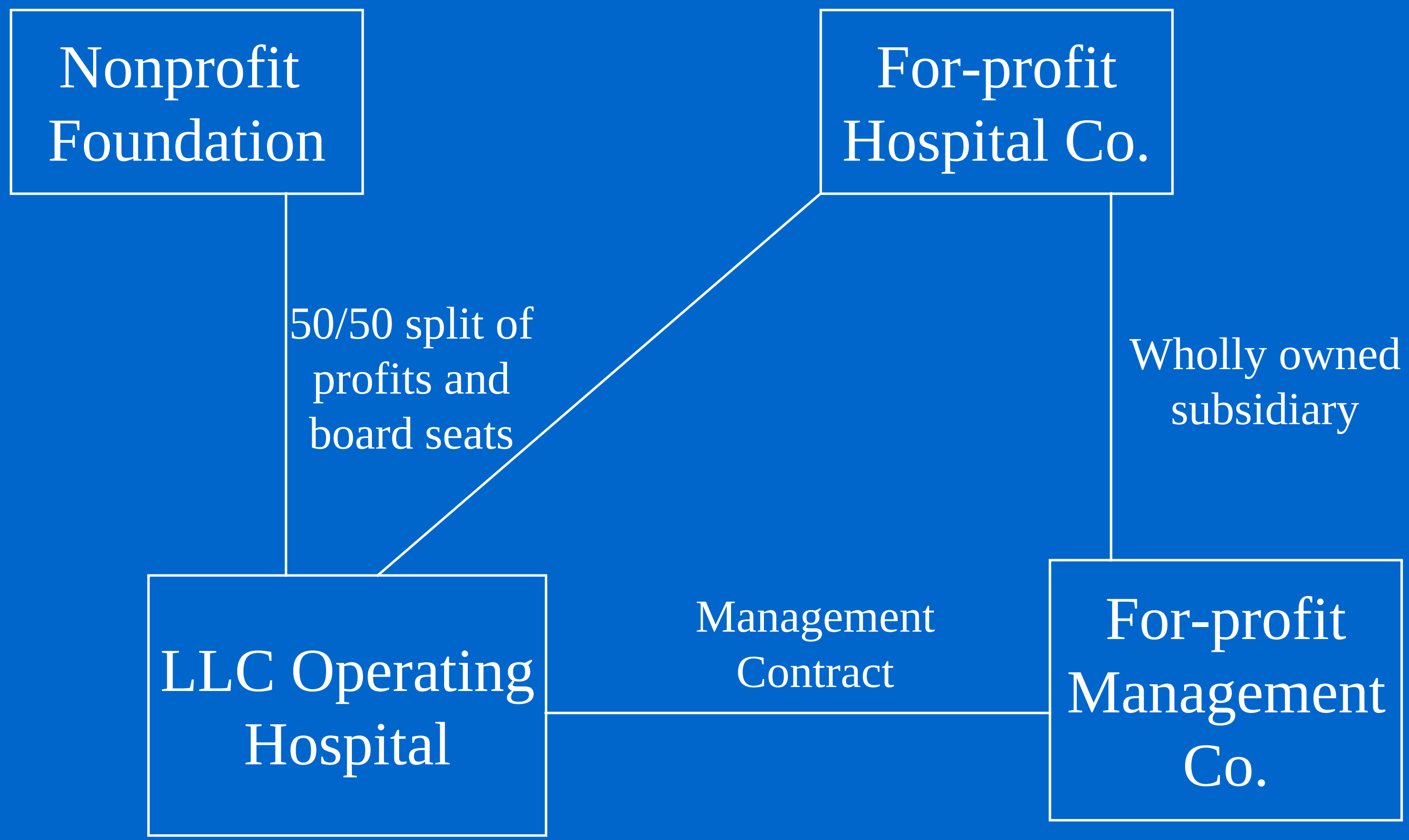


- Two-prong Test
- Rev. Rul. 98-15/*Redlands*
  - Management Contracts
  - Expanded Control Test
  - Community Benefit
- Exemption Impact of 50/50 Ventures
- Unwinding Joint Ventures
- Other Structuring Options

Two-prong Test

- Derived from *Plumstead Theatre* and GCM 39005; same for partnerships and LLCs electing partnership treatment
- (1): does participation further an exempt purpose of the nonprofit?
- (2): does the nonprofit have duties to its proprietary partners (*e.g.*, maximize profits) that would prevent the nonprofit from acting exclusively in furtherance of its exempt purposes? (Historically: 50% control and other GPs)
- Corollary: protection against the nonprofit's assets being used for partnership liabilities (*e.g.*, no unlimited capitals calls and adequate insurance)

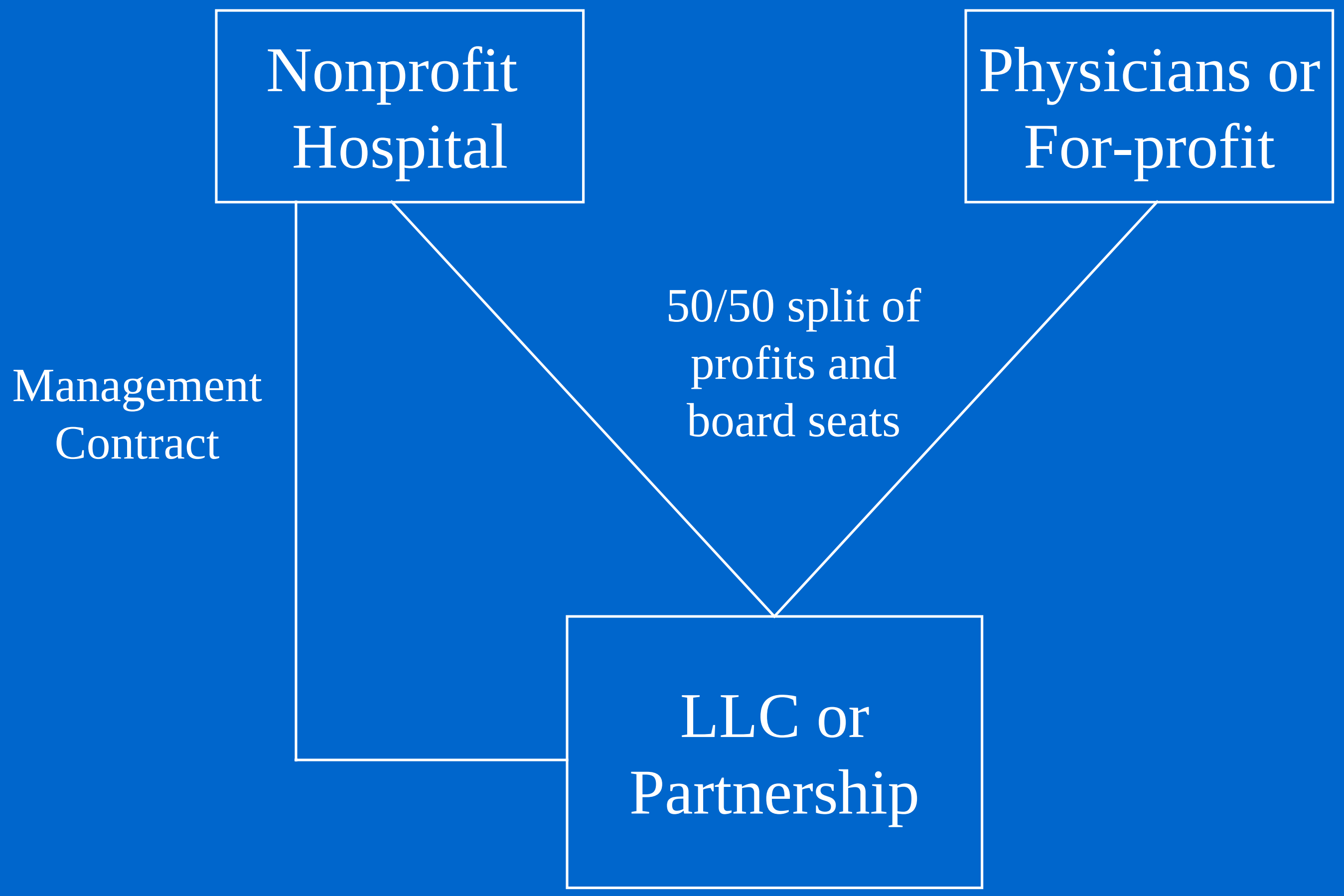
Typical Whole Hospital Joint Venture



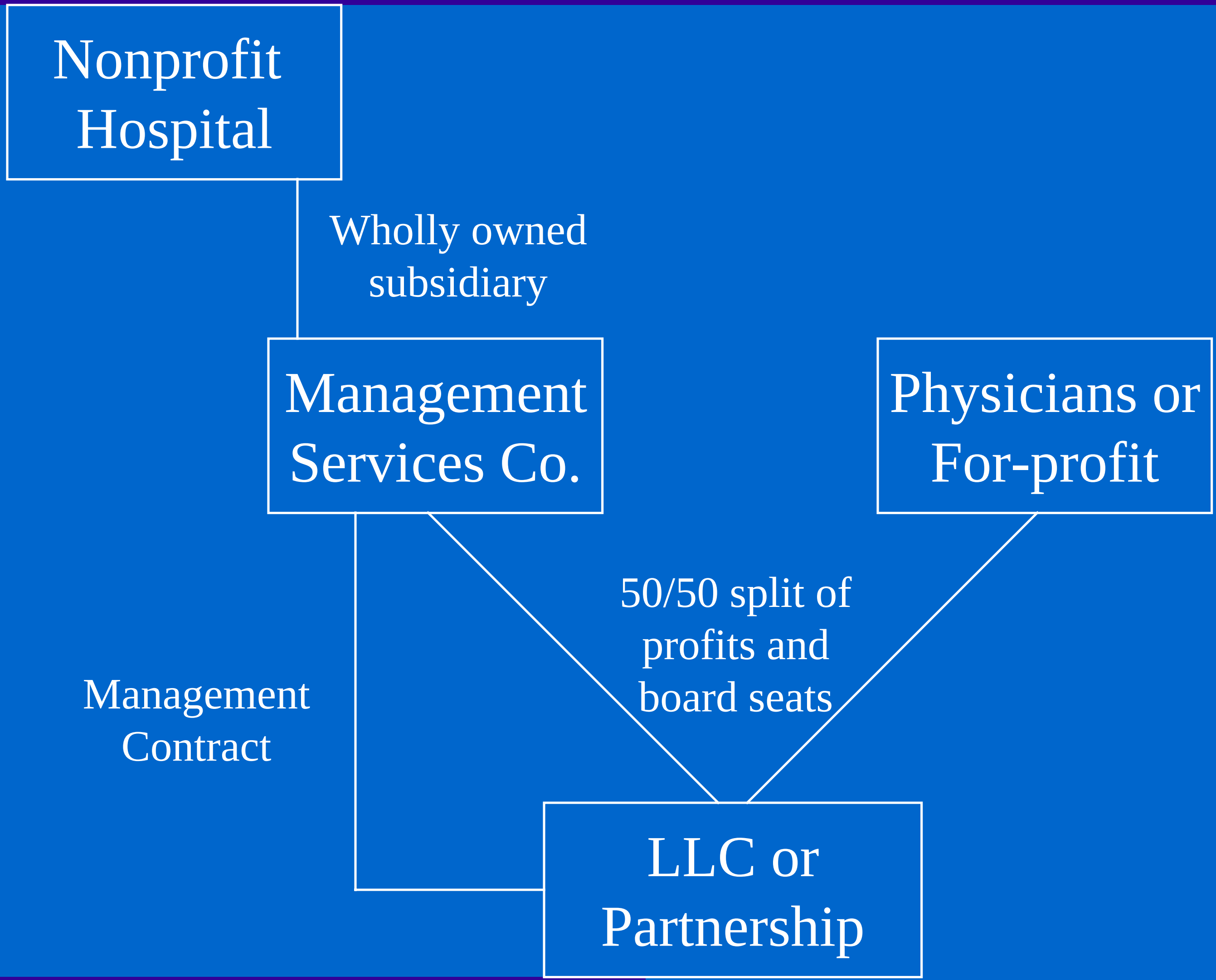
Rev. Rul. 98-15

- Examples at two extremes of control
- Key distinguishing factors for *Situation 1*:
  - EO must have >50% of board votes
  - Joint venture profit motive must be subordinated to charitable purposes
  - Management contract must be of reasonable duration
  - Manager and top administrators must be independent of for-profit partner

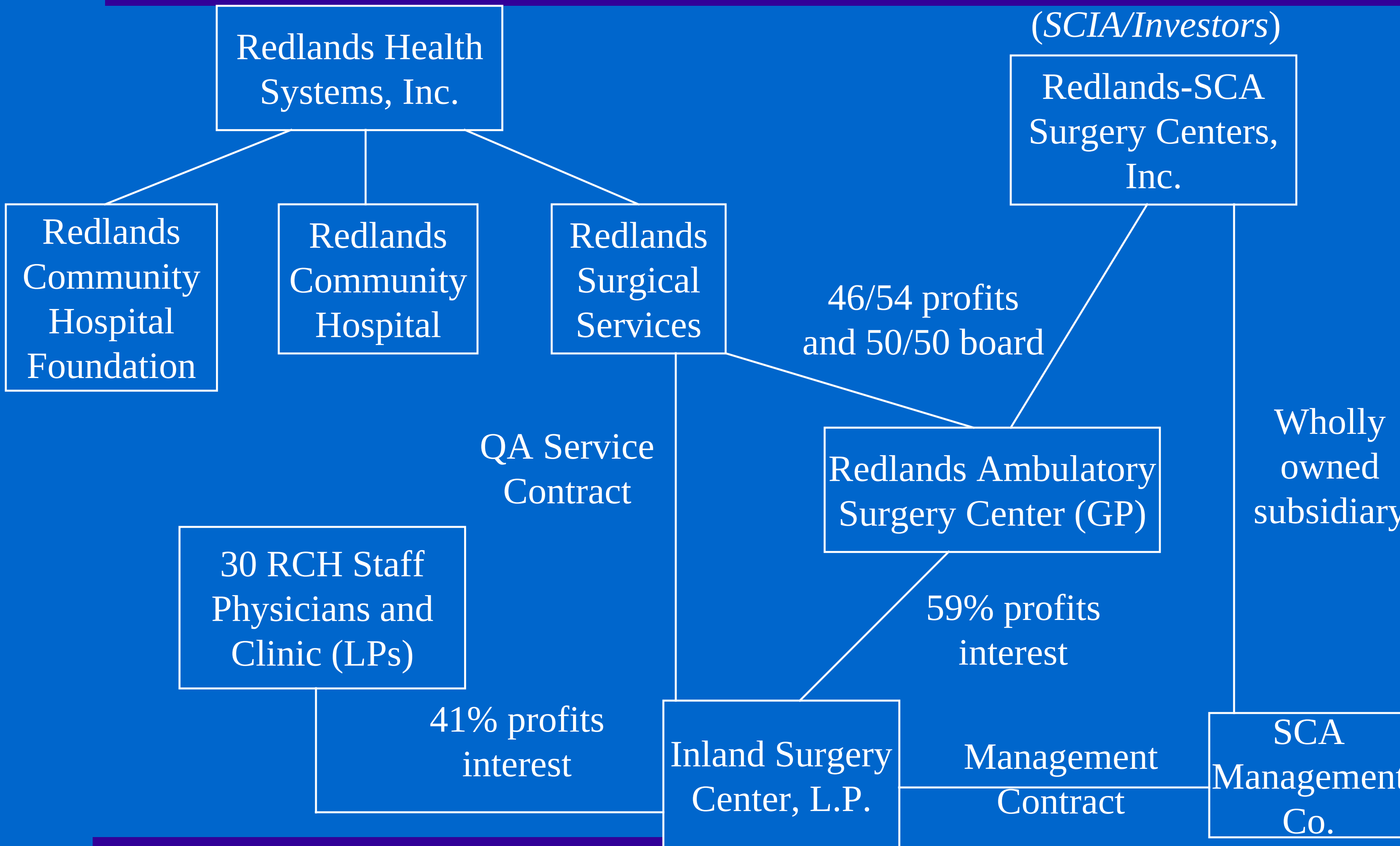
Ancillary Services Joint Venture (Hospital)



Ancillary Services Joint Venture (Hospital Subsidiary)



Ancillary Services Joint Venture (Redlands Final Structure)



Ancillary Services Joint Ventures

- IRS likely to apply Rev. Rul. 98-15
- Issue is control of contributed charitable assets
- Exemption denial upheld by Tax Court in *Redlands*; appeal pending (9th Circuit)
- PLR due out Dec. 1999 delayed pending *Redlands* and now TBOR2 final regulations
- IRS may limit to UBI if not whole hospital

Redlands: Why Not Exempt?

- Sole purpose: ASC joint venture with for-profit
- 50/50 board of General Partnership
  - veto rights only (for both parties)
  - no initiation rights for RSS
- No other influence for RSS
  - physicians owned stock in SCIA
  - no active supervision by RCH
- Partnership Agreements fail to mention primacy of charitable motives

Redlands: Why Not Exempt?

- High returns vs. losses at RCH outpatient dept.
- SCA subsidiary as manager with broad authority
  - 25 year no cut management contract
  - Compensation: 6% of collectable revenues + expenses
  - No clear incentive for charity care/Medicaid services
- Arbitration with no requirement to consider community benefit
- No pure charity care (as opposed to bad debt)
- Negligible Medicaid (<0.8% of invoices)

Redlands: Why Not Exempt?

- RSS was a shell
  - Minimal QA and other activities (contract terminated)
  - No employees or paid officers
- Zero community need; could not support 2nd ASC
- Noncompetition covenant with RSS and Hospital
  - Eliminated price competition
  - Avoided pressure to upgrade equipment
- No proof RSS had any impact on proprietary operations of ASC
- Education programs at ASC insufficient

Expanded Control Test

- Veto power over all actions at JV board
  - Exception if purely medical
  - What is purely medical?
- Reserved Powers for (c)(3)'s community board
  - capital and operating budget and variations over $X
  - sale of assets over $X
  - incur, assume or guaranty debt over $X
  - dissolution, merger, consolidation, sale of substantially all assets
  - amendment of the joint venture agreement and governance documents
  - affiliations or joint ventures with others
  - contracts with for-profit partner(s)
  - discontinuance, reduction or termination of service line or location
  - discontinuance of Medicare/Medicaid participation
  - appointment and removal of management personnel and manager

Expanded Control Test

- Initiation Rights (in lieu of true majority control)
  - Scope of services offered and locations
  - Charity care
    - Use HFMA definition to exclude bad debt
    - Note: Partners can be protected by limiting JV's charity care to the same percentage of total revenues as hospital
  - Managed care contracts
  - Meaningful termination rights for management agreement with for-profit partner (for cause or, after reasonable initial term, without cause)
  - Open staff policies
  - Dissolution if exemption at risk (or Medicare/Medicaid)
  - Monitoring and audit rights

Management Contracts

- Select Mgr. unrelated to for-profit partners
- Charity care/Medicaid: minimum standards and a factor in any incentive compensation formula
- Require Mgr. to follow community benefit goals
- Cap percentage compensation (still Fraud & Abuse risk)
- Reasonable term and termination provisions:
  - reasonable initial term (follow Rev. Proc. 97-13, term is a function of compensation methodology)
  - mutual agreement for renewal
  - terminable at least for cause without terminating JV
  - termination rights exercisable by nonprofit alone

Community Benefit

- New services
- Substantial charity care, Medicaid, Medicare
- Remedy shortage and other access problems
- Communicate charity care policy to community
- General oversight by nonprofit's community board
- CON reflecting community need

Exemption Impact of 50/50 Ventures

- Concerns are exemption, TBOR2, UBI (and bonds)
- Non-issue if insubstantial part of total activities and partners are not insiders
- Is control over charitable assets is a substantial private benefit? (See Rev. Rul. 98-15/*Redlands*)
- If yes, how is providing that same benefit to insiders not inurement *per se* and only a UBI issue?

Exemption Impact of 50/50 Ventures

- **<u>Possible</u>** alternatives for a change in IRS interpretation:
  - change/clarify definition of who is an insider
  - clarify insubstantial inurement is only TBOR2
  - if it is not the nonprofit's sole activity, control of joint venture is not tantamount to control of the entity and not a substantial private benefit, so veto rights are enough if eliminate some "bad facts" of Rev. Rul. 98-15/*<u>Redlands</u>* (*e.g.*, charity care/Medicaid standards, unrelated Mgr.)
- **<u>Caution</u>**: The IRS has not clarified which, if any, alternative applies or how many bad facts must go

Unwinding Joint Ventures

- Exit strategies negotiated in advance are key
  - Unscrambling the egg: FMV payments to compensate for lost programs
  - Put/buy-out right upon adverse tax event
- Partner/manager may now be insider and DP
  - Unwind can result in inurement or excess benefit
  - Adjust historical results for future circumstances without partner (*e.g.*, lose key HMO contract?)
- IRS entertaining closing agreement requests (a la GCM 39862): valuation and control are key

Other Structuring Options

- Taxable subsidiary
  - *Moline Properties*: respect separate corp. identity
  - JCT would require disclosure of returns
- Investment
  - No management role, truly passive
  - Comparable returns for the risk
- Charitable donation
  - Requires specific control over use of contributions
  - Unlikely to apply in traditional joint ventures

Other Structuring Options

- Insubstantial portion of activities--UBI only
  - No joint ventures with insiders
  - IRS favorably inclined, no rulings pending appeal
    - not involve substantially all assets
    - reverse one or more bad facts of Rev. Rul. 98-15/Redlands (*e.g.*, charity care and Medicaid at same levels as hospital, independent management company with a more reasonable contract)
    - unclear how many “bad facts” must become “good facts”

Non-tax Considerations

- Antifraud Statute
  - Gainsharing Special Advisory Bulletin (reference to clinical joint ventures)
  - New safe harbors: 64 Fed. Reg. 63517 (Nov. 19, 1999)
- Stark Law
- Indenbaum/16221 ("Stark on steroids")
- Antitrust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