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 of activities 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

Nonprofit Foundation

For-profit Hospital Co.

LLC Operating Hospital

Management Contract

For-profit Management Co.

50/50 split of profits and board seats

Wholly owned subsidiary
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)

Nonprofit Hospital

Physicians or For-profit

Management Contract

LLC or Partnership

50/50 split of profits and board seats
Ancillary Services Joint Venture (Hospital Subsidiary)

Nonprofit Hospital

Wholly owned subsidiary

Management Services Co.

Management Contract

50/50 split of profits and board seats

LLC or Partnership

Physicians or For-profit
Ancillary Services Joint Venture (Redlands Final Structure)

- Redlands Health Systems, Inc.
  - Redlands Community Hospital Foundation
  - Redlands Community Hospital
  - Redlands Surgical Services
    - QA Service Contract
    - 41% profits interest
    - Inland Surgery Center, L.P.
      - 46/54 profits and 50/50 board
      - Management Contract
      - 59% profits interest
        - Redlands Ambulatory Surgery Center (GP)
          - 59% profits interest
          - (SCIA/Investors)
            - Redlands-SCA Surgery Centers, Inc.
              - Wholly owned subsidiary
              - SCA Management Co.
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

- **Possible** 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/Redlands (e.g., charity care/Medicaid standards, unrelated Mgr.)

- **Caution**: 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)

• Stark Law

• Indenbaum/16221 (“Stark on steroids”)

• Antitrust