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HEALTH CARE JOINT VENTURES BETWEEN TAX-EXEMPT ORGANIZATIONS AND FOR-PROFIT ENTITIES

Michael I. Sanders[†]

I. BACKGROUND

The participation of health care organizations in partnerships and joint ventures is an area of continuing growth and interest. Current economic and social conditions, as well as the issuance of IRS guidance in several key areas has presented nonprofit health care organizations with significant opportunities to further their charitable purposes and fulfill their charitable goals through careful and selective participation in joint ventures with for-profit entities.

Since the Internal Revenue Service's reversal of its *per se* prohibition of an exempt organization entering into a partnership, tax-exempt health care institutions have been able to take advantage of joint ventures with for-profit partners in various ways, including whole hospital joint ventures with for-profit hospital systems and ancillary arrangements involving ambulatory surgical centers, MRI, and other medical specialties. Following the *Plumstead* decision,¹ nonprofit hospital ancillary joint ventures more than doubled in the 1980s from

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¹ *Plumstead Theatre Soc'y v. Commissioner*, 675 F.2d 244 (9th Cir. 1982) *aff'g* 74 T.C. 1324 (1980) (holding that a joint venture between a not-for-profit theatre company and a for-profit limited partnership did not destroy the theatre company's tax-exempt status).

approximately 200 to approximately 450.² In 2004, research data on ancillary joint ventures conservatively estimates the number to be well over 1,000 including joint ventures with physician organizations.³ It is impossible to measure the effect the restrictive tax laws have had on whole hospital joint ventures, but scholars estimate that there are 50 to 100 whole hospital joint ventures currently in operation.⁴

The explosive growth of nonprofit health care joint ventures with for-profits results from competition in the health care industry,⁵ largely due to the increased presence of for-profit hospital systems.⁶ Since for-profit hospitals are subject to fewer restrictions, they are better able to generate revenue, reduce excess capacity, streamline operations, and turn away patients without insurance. Consequently, they are able to realize increased profits and acquire improved technology, which leads to a competitive advantage over nonprofit hospitals. This economic advantage has resulted in substantially less revenue for nonprofits and has led to increased acquisitions of devalued nonprofit hospitals by for-profit entities such as HCA,⁷ OrNda, and Tenet.⁸ Some observers believe it is inevitable that virtually all health care organizations will be forced to affiliate with a larger health care system in order to survive.⁹

² Gary J. Young, *Federal Tax-Exemption Requirements for Joint Ventures Between Nonprofit Hospital Providers and For-Profit Entities: Form over Substance?*, 13 ANNALS HEALTH L. 327, 338 (2004) (citing LESLIE G. ARONOVITZ, U.S. GEN. ACCOUNTING OFFICE, PUB. NO. GAO/HRD-93-124, NONPROFIT HOSPITALS: FOR-PROFIT VENTURES POSE ACCESS AND CAPACITY PROBLEMS 4 (1993), available at <http://www.gao.gov>).

³ *Id.* at 339.

⁴ *Id.* at 338.

⁵ Between 1990 and 2000, 296 urban hospitals closed. The Department of Health and Human Services sighted cited competition as the number one factor for these hospital closings. See, OFFICE OF INSPECTOR GEN., TRENDS IN URBAN HOSPITAL CLOSURE: 1990-2000, Pub. No. OEI 04-02-00611, (2003), available at <http://oig.hhs.gov/oei/reports/oei-04-02-00611.pdf>.

⁶ See Jack E. Karns, *Justifying the Nonprofit Hospital Tax Exemption in a Competitive Market Environment*, 13 WIDENER L.J. 383, 423 (2004).

⁷ One of the biggest players in the consolidation arena is Hospital Corporation of America (HCA). Once a modest eleven-hospital system, HCA has grown to be the nation's leading provider of health care with 191 hospitals and eighty-two outpatient facilities. See HOSPITAL CORPORATION OF AMERICA, HCA COMPANY HISTORY (2003), available at <http://www.hcahealthcare.com/CPM/CurrentCompanyHistory1.pdf>.

⁸ MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS 328-29 (2d ed. 2000). In 1996, Tenet became the second-largest network in the United States when it acquired OrNda. *Tenet to Acquire OrNda in \$3.3 Billion Stock and Debt Deal*, CNN MONEY, Oct. 17, 1996 at <http://money.cnn.com/1996/10/17/deals/tenet/>.

⁹ See, e.g., Karen Pallarito, *Hospital Conversions Raise Thorny Issues*,

The decline in reimbursement rates for inpatient health care services is another important factor contributing to the increase in hospital joint ventures.¹⁰ The dominance of managed care organizations, such as health maintenance organizations (HMOs) and preferred provider organizations (PPOs) has facilitated the process; these entities provide such a large percentage of hospital income that they enjoy an unfair negotiating position with health care providers and can pressure hospitals for discounts that cut into profit margins.¹¹ Further adding to the decline in reimbursement rates is legislation enacted by Congress in 1997 to reduce Medicare payments for inpatient care.¹² While Congress has reversed some of these cuts,¹³ the lack of inpatient Medicare reimbursements continues to present a significant challenge to nonprofit organizations to be able to meet expenses and provide a health care benefit to the community.¹⁴

Due to market pressures and reduced reimbursements for services provided, nonprofit health care institutions have had to adopt a more aggressive business strategy.¹⁵ In doing so, nonprofits have formed whole hospital joint ventures and ancillary joint ventures with physicians, other nonprofits, and for-profit organizations. Ancillary joint ventures are being utilized because they allow exempt health care institutions to raise capital, bring new services or medical facilities to needy areas, and attract physicians with diverse areas of medical expertise.¹⁶ Additionally, nonprofits can gain patient referrals and ensure that their physicians do not establish competing health care providers by establishing ancillary or whole hospital joint ventures with those same physicians.¹⁷

During the 1980s and 1990s, nonprofits were forming both ancillary and whole hospital joint ventures in order to stay competitive in the marketplace. However, as discussed above, the Service provided relatively little guidance and consequently these joint ventures were jeopardizing the exempt organization's status. Fortunately for non-

MOD. HEALTHCARE, June 17, 1996, at 104 (citing comments of California Assemblyman Philip Isenbert).

¹⁰ See Young, *supra* note 2, at 339-40.

¹¹ *Id.*

¹² *Id.* at 340; Balanced Budget Act of 1997, Pub. L. No. 105-33, §§ 4401-54, 111 Stat. 251 (1997).

¹³ See, e.g., Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act of 2000, Pub. L. No. 106-554, §§ 301-15, 114 Stat. 2763 (2000); Medicare, Medicaid, and SCHIP Balanced Budget Refinement Act of 1999, Pub. L. No. 106-113, § 112, 113 Stat. 1501 (1999).

¹⁴ See generally SANDERS, *supra* note 8, at 5 n.4.

¹⁵ Karns, *supra* note 6, at 506.

¹⁶ SANDERS, *supra* note 8, at 5.

¹⁷ *Id.*

profits, the IRS recognized their competitive disadvantage in 1998 and acted to provide guidance to nonprofits to allow them to move forward and enter into joint ventures that would not threaten their tax-exempt status by releasing Revenue Ruling 98-15.¹⁸ By analyzing two hypothetical situations (one good and one bad) the IRS gave nonprofits some tools to use to form joint ventures and thereby remain more competitive, reduce capacity, streamline operations, and lower operating expenses. The IRS, however, addressed only whole hospital joint ventures in Revenue Ruling 98-15. This left nonprofits with little guidance to assist them in structuring ancillary joint ventures. Nevertheless, nonprofits have been entering into some common transactions without risking their tax-exempt status.¹⁹

In the course of its participation in a partnership or joint venture with one or more for-profit entities, the health care exempt organization may take the role of a general partner or managing member, if certain strict organizational and operational requirements are met.²⁰ Alternatively, the exempt organization may participate through a single member LLC (which may be disregarded), a subsidiary, an affiliated organization, or as a limited partner. Generally, an exempt organization may invest as a limited partner (or a non-managing, non-participatory member in the case of an LLC) in any prudent investment.²¹ Note that as a limited partner or non-managing member, the

¹⁸ See MARY JO SALINS, JUDY KINDELL, & MARVIN FRIEDLANDER, INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATIONS TECHNICAL TOPICS: WHOLE HOSPITAL JOINT VENTURES, at <http://www.irs.gov/pub/irss-utl/tropica.pdf> (explaining that the IRS released Revenue Ruling 98-15 to provide guidance on tax consequences in joint venture arrangements); Eileen M. Newell, *Healthcare Joint Ventures: Pushing Tax-Exempt Law to the Limits?*, 18 J. CONTEMP. HEALTH L. & POL'Y 467, 484 (2002) (stating that Revenue Ruling 98-15 provides more information about the IRS's position on the future of tax exemption in the health care arena). Revenue Ruling 98-15 is discussed more fully in Section II above.

¹⁹ See, e.g., Priv. Ltr. Rul. 92-33-037 (Aug. 14, 1992) (explaining that a nonprofit's joint venture did not risk exempt status, but that forming a joint venture with members of a medical staff and selling the revenues derived from the entity's operations would jeopardize the entity's exempt status); Gen. Couns. Mem. 39,732 (Nov. 7, 1987) (a hospital's exempt status was not affected by its participation in joint venture with non-exempt entities); Rev. Rul. 69-464, 1969-2 C.B. 132.

²⁰ See *Plumstead Theatre Soc'y v. Commissioner*, 675 F.2d 244 (9th Cir. 1982), *aff'g* 74 T.C. 1324 (1980); Gen. Couns. Mem. 39,005 (June 28, 1983) (concluding an exempt organization may qualify under § 501(c)(3) notwithstanding its participation in a limited partnership as one of several general partners if the partnership arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted).

²¹ The recently issued IRS 2003-2004 Priority Guidance Plan lists guidance on (1) joint ventures between exempt organizations and for-profits; and (2) low income housing partnerships and § 501(c)(3) participation as priority subjects. News Release JS-600, Internal Revenue Service (July 24, 2003), available at

exempt organization may be subject to UBIT²² on any joint venture activity unrelated to the exempt organization's charitable purposes.

This article will concern itself primarily with the conditions under which an exempt organization may take on the more formidable role of general partner of a limited partnership or managing member of a limited liability company. After summarizing the history and analysis of joint ventures between tax-exempt and for-profit organizations, generally, it will focus on hot issues in this area, including the following:

- Revenue Ruling 2004-51, recently issued by the Treasury Department, Internal Revenue Service.
- The *St. David's* case, in which a jury in U.S. District Court decided in favor of the hospital system after application of the 5th Circuit Court of Appeals' reasoning. After an appeal of the jury verdict, the parties have settled all outstanding issues.²³
- The *Redlands Surgical Services* Tax Court case, affirmed on appeal by the 9th Circuit.²⁴
- Revenue Ruling 98-15, which focuses on whole hospital joint ventures, but also provides guidance applicable to all joint ventures and partnerships involving charitable organizations.²⁵
- The intense scrutiny by the IRS with regard to whether the tax-exempt organization has "control" over the partnership or joint venture.
- The impact of § 4958 and the intermediate sanctions excise taxes.

<http://www.treas.gov/press/releases/JS600.htm>.

²² Unrelated Business Income Tax (UBIT) is a tax imposed on a tax-exempt organization's net income from regularly carried on trade or business not substantially related to the organization's exempt purpose.

²³ *Federal Jury Affirms St. David's Exempt Status*, AM. HEALTH L. ASS'N NEWS & ANALYSIS, Mar. 9, 2004 at http://www.healthlawyers.org/ofnotes/2004/ofnote_stdavid_040309.cfm (reporting that a district court jury affirmed the tax-exempt status of a non-profit health care system after the Fifth Circuit remanded the case for trial).

²⁴ *Redlands Surgical Servs. v. Commissioner*, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001).

²⁵ Rev. Rul. 98-15, 1998-12 I.R.B. 6.

II. HISTORY AND ANALYSIS OF JOINT VENTURES BETWEEN TAX-EXEMPT AND FOR-PROFIT ORGANIZATIONS

A. The Early Days: *Per Se* Prohibition

Prior to *Plumstead Theatre Society*, an exempt organization automatically ceased to qualify as tax-exempt under § 501(c)(3) when it served as a general partner in a partnership that included private investors as limited partners, or otherwise shared net profits.²⁶ The IRS reasoning behind this position was threefold:

1. The limited partnership vehicle served as a means to share profits with private individuals;
2. By agreeing to serve as a general partner, the exempt organization was under a fiduciary duty to further the private financial interests of the limited partners; and
3. As a general partner the exempt organization incurred unlimited liability for the debts of the partnership, and thus exposed charitable assets for the purpose of relieving the private investors from liability.²⁷

The IRS deemed all of the above as being incompatible with operating "exclusively" for charitable purposes.²⁸

B. *Plumstead Theatre Society* and the Two-Prong Test

The IRS's "per se" opposition to exempt organizations' involvement in joint ventures with for-profit investors was abandoned in 1982, with the issuance of the *Plumstead Theatre Society* decision. In *Plumstead*, a theatre company organized to promote and foster the performing arts entered into a limited partnership with three for-profit investors to raise revenue needed to produce a stage play.²⁹ The IRS denied tax-exempt status to *Plumstead* on the grounds that it was not operated exclusively for charitable purposes.³⁰

However, the Tax Court, and later the Ninth Circuit Court of Appeals, disagreed, holding that *Plumstead* was operated exclusively for

²⁶ See Gen. Couns. Mem. 36,293 (May 30, 1975).

²⁷ *Id.*

²⁸ *Id.* (explaining that 501(c)(3) applies to organizations operated for exclusively charitable purposes).

²⁹ *Plumstead*, 74 T.C. at 1328.

³⁰ *Id.*

charitable (and educational) purposes, and therefore was entitled to exemption.³¹ The court based its holding on the safeguards contained in the limited partnership agreement, which served to insulate Plumstead from potential conflicts with its exempt purposes.³² These safeguards included the following:

1. The transaction was conducted at arm's length, and at a reasonable price;
2. The exempt organization had no obligation to return the limited partners' capital contributions;
3. The limited partners had little or no control over the affairs of the partnership;
4. There was no profit motive exhibited by the exempt organization;
5. None of the limited partners, or any officer or director of a limited partner, was an officer or director of the exempt organization.³³

The IRS now utilizes a two-prong "close scrutiny" test (based on *Plumstead, Housing Pioneers Inc. v. Commissioner*,³⁴ and G.C.M. 39,005) to determine the permissibility of joint venture arrangements between exempt and for-profit entities. The two-prong test requires (i) that the activities of the partnership further charitable purposes; and (ii) that the structure of the partnership insulates the exempt organization from potential conflicts between its charitable purposes and its general partnership obligations, and minimizes the likelihood that the arrangement will generate private benefit.

1. First Prong: Charitable Purpose

a. Introduction

Where an exempt organization seeks to conduct activities through a partnership as general partner, or as a managing member in the case of an LLC, the IRS will scrutinize the arrangement to ensure that the joint venture is operating in furtherance of the exempt organization's

³¹ *Id.* at 1334, *aff'd*, 675 F.2d 244, 245 (9th Cir. 1982).

³² *Plumstead*, 74 T.C. at 1333.

³³ *Id.* at 1333-34.

³⁴ 65 T.C.M. 2191 (1993), *aff'd*, 49 F.3d 1395 (9th Cir. 1995), *amended by* 58 F.3d 401 (9th Cir. 1995). The two standards were applied in *Housing Pioneers* to deny a housing organization's 501(c)(3) exemption. Through the organization's involvement as a co-general partner in limited partnerships, the partnerships took advantage of reduced property taxes and low-income housing tax credits. The Tax Court held that the organization furthered non-exempt purposes and served private interests. *Housing Pioneers Inc.*, 65 T.C.M. at 2196.

charitable purposes. Generally, charitable purposes include activities that relieve the poor and distressed or underprivileged; advance religion, education or science; erect or maintain public buildings, monuments or works; and lessen the burdens of government.³⁵

2. Second Prong: Structure of the Limited Partnership Insulates the Exempt Organization

Even if a charitable purpose or purposes are definitively established by the exempt organization participating in the joint venture, conflict between charitable goals and private interests may arise based on the state statutory obligations of the general partner to the limited partners, or through covenants or provisions contained within the operating agreement or other governing instrument. Among these obligations are an assumption of unlimited liability by the general partner for the partnership's debts, an obligation to further the profit interests of the other limited partners or members, and any obligations assumed under certain guarantee or capital call provisions drafted in favor of the private investors.

Essentially, the partnership or joint venture must be structured in such a way as to (i) protect the exempt organization's assets from exposure to unnecessary risk for the benefit of the for-profit partners; and (ii) minimize the potential for private inurement. In its analysis of whether an arrangement adequately shelters the assets of the exempt organization, and resolves, to the greatest degree possible, the statutory obligations of the general partners to the limited partners, certain factors will bear favorably upon the IRS's determination:

- Limited contractual liability of the exempt partner.
- Limited rate of return to the limited (for-profit) partners.
- Exempt organization's right of first refusal on the sale of the partnership assets.
- Lack of control over the partnership by limited partners (e.g., parties are "unrelated" and no limited partner serves as an officer or director of the exempt organization).
- The presence of additional general partners obligated to protect the interest of the limited partners.

³⁵ Treas. Reg. §1.501(c)(3)-(2) (2003). See also SANDERS, *supra* note 8, at 51-61 (providing further detail of "relief of the poor," "religion," "educational organizations," and "scientific organization" activities included in the definition of charitable).

- No obligation on the part of the exempt organization to return the limited partners' capital contribution from the exempt organization's funds.
- Profit is not a primary motivation.
- All transactions with the limited partners are made at arm's length and are reasonable.
- There is a lack of "negative" or unfavorable factors and/or improper guarantees.

On the other hand, the presence of certain factors will bear unfavorably upon the IRS's determination:

- A disproportionate allocation of profits, losses or tax items in favor of the limited partners.
- Commercially unreasonable loans by the exempt organization to the partnership.
- Inadequate compensation paid to the exempt organization for services rendered, or excessive compensation paid by the exempt organization for services received.
- Control of the exempt organization (or the activities of the partnership) by the limited (for-profit) partners.
- Abnormally low or insufficient capital contributions by the limited partners, or provisions requiring disproportional capital contributions by the exempt organization.
- A profit motivation by the exempt partner.
- A lack of positive or favorable factors.

III. ISSUES AFFECTING § 501(C)(3) ORGANIZATIONS AND JOINT VENTURES

A. Revenue Ruling 98-15³⁶

In 1998, the IRS released a long-awaited revenue ruling on whole hospital joint ventures. Revenue Ruling 98-15 incorporates the two-part test from *Plumstead* and *Housing Pioneers* that a joint venture must further a charitable purpose and that the joint venture documents must allow the exempt organization to continue furthering its exempt purpose without benefiting the private parties more than incident-

³⁶ See generally SANDERS, *supra* note 8, at 135-39, 359-75 (discussing in detail the two scenarios involving a nonprofit hospital operator that are included in Revenue Ruling 98-15).

tally.³⁷ Although Revenue Ruling 98-15 focuses on hospitals, it provides significant guidance for all joint ventures and partnerships involving charitable organizations.³⁸ In fact, IRS spokespersons have indicated that they will apply this ruling outside the hospital joint venture context.³⁹ As discussed more fully below, the IRS focuses on whether tax-exempt organizations “control” the ventures in which they participate. The IRS reasons that if a tax-exempt organization lacks fundamental control, it may also lack the ability to cause the venture to carry out their exempt functions.

This rationale has been applied by the IRS in the recent cases *St. David's Health Care System*,⁴⁰ *Redlands Surgical Services*, and *United Cancer Council v. Commissioner*.⁴¹ Consistent with the foregoing analyses, Revenue Ruling 98-15 confirms that an exempt organization should possess control over a venture to ensure that the arrangement does not jeopardize the charity's exempt status. In general, an organization can enter safely into a venture or management contract if it maintains final control over the assets it contributes, and if the terms of the contract are reasonable.⁴² The IRS therefore does not intend Revenue Ruling 98-15 to eliminate joint ventures between exempt organizations and for-profit entities.⁴³ Rather, the ruling simply incorporates existing principles that, in a joint venture, maximization of profits must not override charitable purposes and that the whole community should benefit from the services provided by the joint venture.⁴⁴ The ruling illustrates the type of facts and circumstances that the IRS considers significant, by presenting two situa-

³⁷ *IRS Exempt Organizations Continuing Professional Education Text for FY 1999: Chapter A, Whole Hospital Joint Ventures*, 98 TAX NOTES TODAY 156-15, Aug. 13, 1998, at ¶ 49 [hereinafter “CPE Text”] (detailing the IRS's application of the two-prong analysis in reviewing joint ventures between tax-exempt and for-profit organizations).

³⁸ See Rev. Rul. 98-15, 1998-12 I.R.B. 6, 7-9.

³⁹ See, e.g., Alison Bennett, *Control Principle in Hospital Joint Venture Ruling Could Apply Elsewhere*, BNA DAILY TAX REP., May 22, 1998 (citing Marcus Owens, IRS Exempt Organizations Director).

⁴⁰ *St. David's Health Care Sys. v. United States*, 90 A.F.T.R.2d 2002-6878 (W.D. Tex 2002), *vacated by* 349 F.3d 232, 240 (5th Cir. 2003).

⁴¹ *United Cancer Council, Inc. v. Commissioner*, 165 F.3d 1173, 1174-75 (7th Cir. 1999) (applying the rule in a situation where a private party seized control of a charitable organization, therefore destroying its tax-exempt status). See Section III B, below. See also Priv. Ltr. Rul. 97-36-039 (June 9, 1997) (allowing a low-income housing partnership to receive tax-exempt status because those in charge of the charitable aspects of the housing program strengthened control over the operations of the partnership).

⁴² See CPE Text, *supra* note 37, at ¶ 49.

⁴³ *Id.* at ¶ 61.

⁴⁴ See *id.*

tions, one good and one bad. Key factors include, *inter alia*, a long-term management contract; composition of the Board and its fiduciary duty, relative to charitable purpose; related officers including former employees of the for-profit in “day to day” management of the venture.⁴⁵ These situations are summarized below.

1. Example 1 (Good Example)

A § 501(c)(3) public charity (*Charity 1*), which operated a hospital, contributed the hospital and all of its operating assets to a limited liability company (*LLC 1*) in exchange for an interest therein. A for-profit corporation (*For-Profit 1*) that owned and operated several hospitals also contributed assets to the LLC in exchange for an interest therein. The interests in the LLC that *Charity 1* and *For-Profit 1* received were in proportion to their contributions.

The LLC’s Articles of Organization and Operating Agreement (Governing Instruments) provided that its governing board was composed of five individuals, three of whom *Charity 1* selected, and two of whom *For-Profit 1* selected. *Charity 1* intended to select community leaders with hospital experience, but who were not on the contributed hospital’s staff and who did not otherwise engage in business transactions with the hospital.

The Governing Instruments could only be amended with both owners’ approval. They also required a majority of three members to approve certain major decisions, including the following:

- *LLC 1*’s annual capital and operating budgets
- Distributions of *LLC 1*’s earnings
- Selection of key executives
- Acquisition or disposition of health care facilities
- Contracts that exceeded a fixed dollar amount per year
- Changes to the types of services the hospital offered
- Renewal or termination of management agreements

The LLC’s Governing Instruments required it to operate the hospital in a manner that furthered charitable purposes by promoting health for a broad section of its community. They specifically provided that the duty of its board to satisfy the community benefit standard overrode any fiduciary duty to operate *LLC 1* for its owners’ financial benefit. They also provided that all returns of capital and all distributions of income must be in proportion to the ownership interests in *LLC*.

⁴⁵ See Rev. Rul. 98-15, 1998-12 I.R.B. 6, 6-7.

The parties to the transaction also executed a Management Agreement (the "Agreement") with a management company that was unrelated to either *Charity 1* or *For-Profit 1*. The Agreement was for five years, and was renewable for additional five-year periods by mutual consent. It compensated the management company based on the LLC's gross revenues, was comparable to other similar arrangements, and could be terminated for cause.

None of the officers, directors, or key employees of *Charity 1* who were involved in making the decision to form the LLC were promised employment or any other inducement by the LLC or the For-Profit and their related entities, or had any interest in the For-Profit or any of its related entities. *Charity 1* intended to use any distributions that it would receive from the LLC to promote health in the community and to help indigents obtain health care. After forming *LLC 1*, *Charity 1's* grant-making activities and its participation in the LLC constituted its sole activities.

2. Example 2 (Bad Example)

Example 2, like Example 1, involved a § 501(c)(3) exempt organization that operated a hospital (*Charity 2*), a for-profit corporation that owned and operated hospitals (*For-Profit 2*), and an LLC which they jointly formed (*LLC 2*). The facts of Example 2 were virtually identical to those of Example 1, with the following relevant differences:

- *Control.* In Example 2, the LLC's Governing Instruments provided that it was to be managed by a governing board consisting of three individuals chosen by *Charity 2* and three individuals chosen by *For-Profit 2*. In contrast, in Example 1, the Charity clearly controlled the LLC.
- *Purpose and Board's Fiduciary Duty.* In Example 2, the LLC's Governing Instruments lacked a provision comparable to the one in *LLC 1's* Governing Instruments, which required the LLC to operate in a manner furthering charitable purposes by promoting health for a broad section of its community and explicitly provided that the duty of its board to satisfy the community benefit standard overrode any fiduciary duty to operate *LLC 1* for its owners' financial benefit.
- *Management Contract.* The management company in Example 2 was a wholly-owned subsidiary of the For-Profit, rather than an independent organization as in Example 1. Moreover, its contract was renewable in perpetuity at the management company's discretion, rather than

being renewable by mutual consent. Finally, the Management Agreement was terminable only for cause, rather than merely “terminable for cause” as in Example 1.

- *Related Officers.* In Example 2, the parties agreed that the LLC’s CEO and CFO would be two individuals who previously worked for the For-Profit in hospital management, and that they would work with the management company to oversee *LLC 2*’s day-to-day operations. There were no such related key employees in Example 1.
- *Minimum Distributions.* *LLC 2*’s Governing Instruments provided for a minimum level of required distributions, with majority approval of additional distributions required. In Example 1, the Board, which the tax-exempt organization controlled, was required to approve any distributions.
- *Large Contracts.* In Example 2, *LLC 2*’s Governing Instruments required majority approval of “unusually large” contracts, rather than contracts over a specified dollar amount as in Example 1.

3. IRS Analysis

In Example 1, the IRS ruled that *Charity 1* would continue to qualify as a § 501(c)(3) tax-exempt organization because its participation in the LLC would further charitable purposes, and it would continue to be operated exclusively for such purposes. The IRS stated that after the LLC’s formation, *Charity 1*’s activities would consist of the health care services it would provide through the LLC and any grantmaking activities it could conduct using income distributed by *LLC 1*.

The IRS also noted that *Charity 1* could ensure that the benefit to *For-Profit 1* and other private parties, like the management company, would be incidental to the accomplishment of charitable purposes because *LLC 1*’s Governing Instruments committed it to providing health care services for the benefit of the community as a whole and to giving charitable purposes priority over maximizing profits for its owners. It also noted that *Charity 1* could minimize private benefit through (a) its appointment of members of the community familiar with the hospital to *LLC 1*’s board, (b) the board’s structure, which gave *Charity 1*’s appointees voting control, and (c) the specifically enumerated powers of the board over changes in activities, disposition of assets, and renewal of the management agreement.

The IRS also ruled that because *Charity 1*’s grantmaking activity would be contingent upon its receiving distributions from *LLC 1*, its

principal activity would continue to be the provision of hospital care. Therefore, as long as this remained true, *Charity 1* would not be classified as a private foundation.

In Example 2, the IRS ruled that *Charity 2* would violate the requirements of § 501(c)(3) when it formed and contributed all of its assets to *LLC 2* because unlike *Charity 1*, it would fail the operational test, pursuant to which it must be operated exclusively for charitable purposes. In support of its ruling, the IRS stated that absent a binding obligation in the LLC's governing documents for *LLC 2* to serve charitable purposes or otherwise provide its services to the community as a whole, the LLC would be able to deny care to segments of the community, such as the indigent. Moreover, it noted that because it would share control of the LLC with *For-Profit 2*, *Charity 2* would be unable to initiate programs within *LLC 2* to serve new health needs within the community without obtaining the agreement of at least one of the governing board members that *For-Profit 2* appointed. In this regard, it noted that as a business enterprise, *For-Profit 2* would not necessarily give priority to the community's health needs over the consequences for the LLC's profits.

The IRS also supported its ruling by stating that the primary source of information for board members appointed by *Charity 2* would be the chief executives, who had a prior relationship with *For-Profit 2* and the management company, a subsidiary of *For-Profit 2*. Moreover, it noted, the management company itself would possess broad discretion over *LLC 2*'s activities and assets that may not always be under the board's supervision. To illustrate this, the IRS noted that the management company was permitted to enter into all but "unusually large" contracts without board approval, and that the management company could also unilaterally renew the management agreement.

4. Lessons For Joint Ventures Involving Tax-Exempt Organizations

First, as a preliminary note, Example 1 involved a number of facts and circumstances that were entirely favorable and Example 2 involved facts and circumstances that were entirely unfavorable. Some of the factors may not be comparable to those found in the real world. For example, the management contract in Example 2 allows the management company to continuously renew the contract in perpetuity, while in practice, such a provision may be rare.

Second, because there were so many factors in both examples, it is difficult to analyze how far an arrangement may differ from the facts set forth in Example 1 without jeopardizing a charity's tax-

exempt status. However, the IRS 2000 CPE contains an article on health care joint ventures⁴⁶ in which it comments on the various criteria of Revenue Ruling 98-15. For example, the 2000 CPE joint venture article states that it is “important” that the terms of the governing documents in Example 1, which require the LLC to be operated for a charitable purpose, are “legal, binding and enforceable under applicable state law.”⁴⁷ Also, the IRS 2002 CPE contains an article which updates the IRS’s interpretation of Revenue Ruling 98-15 in the health care area, including a new checklist for joint venture arrangements.⁴⁸ The 2002 CPE Article discusses the factors in Situation 1 of Revenue Ruling 98-15, and poses several scenarios in which the joint venture “falls short of Situation 1.” The IRS has indicated its willingness to publish guidance covering certain gray areas.

The 2002 CPE Article states that if the for-profit manager manages the venture, it “is not necessarily fatal” to the tax-exempt status of the nonprofit hospital.⁴⁹ This is a very harsh standard. The burden of proof to overcome a factor that is not necessarily fatal to exemption is very high. Some of the favorable factors that are discussed in the article relate to the decisions connected to the provision of charity care, by the joint venture.

The 2002 CPE Article specifies several times that such decisions should be made by majority vote of a management committee controlled by the charity.⁵⁰ The for-profit partner may not have veto power over the critical decisions.⁵¹ In the context of the article, these statements assume that the nonprofit hospital has a majority on the board and the quorum.⁵² The CPE Article stresses that it is important that the nonprofit controls all charity-care policy decisions and can

⁴⁶ Mary Jo Salins & Marvin Friedlander, *Update on Health Care Joint Venture Arrangements*, in EXEMPT ORGANIZATIONS: CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 2000 17 (Tax Analysts ed. 2000) [hereinafter Salins, 2000 CPE Article].

⁴⁷ *Id.*

⁴⁸ Lawrence M. Brauer, Mary Jo Salins & Robert Fontenrose, *Update on Health Care*, in EXEMPT ORGANIZATIONS: CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 2002, 155 (2002) at <http://www.irs.gov/pub/irs-tege/topicd02.pdf> [hereinafter Brauer, 2002 CPE Article].

⁴⁹ *Id.* at 160 (explaining when a for-profit partner could manage a joint venture that could still remain a tax-exempt organization under 501(c)(3)).

⁵⁰ *Id.* at 160-61 (providing an example of an organization that would remain exempt under 501(c)(3) that is controlled by a Partnership Management Committee with a majority of members from the not-for-profit hospital).

⁵¹ *See id.* at 161.

⁵² *Id.* at 160-61.

ensure that the charitable purposes prevail over the private for-profit interests.⁵³

Another outstanding issue relates to the fact that both of the situations described in the ruling involve whole hospital joint ventures. As a result, some commentators believe that Revenue Ruling 98-15 should not apply to less than whole-hospital joint ventures.⁵⁴ However, others assert that the IRS will apply its analysis to ancillary joint ventures as well.⁵⁵

Despite its shortcomings, Revenue Ruling 98-15 provides significant guidance for all partnerships and joint ventures involving tax-exempt organizations. Revenue Ruling 98-15 indicates that control by the exempt organization over the operational and organizational structure of a venture is crucial.⁵⁶ To satisfy this requirement, the organizational documents for ventures involving tax-exempt organizations should contain legally enforceable provisions that vest the exempt organizations with control over the venture.⁵⁷ The IRS position on this issue should give exempt organizations significant leverage when negotiating joint venture structures with for-profit partners.

Historically, after a 50/50 joint venture was formed, the exempt organization board members generally possessed only veto authority over major operational decisions, and had little or no ability to influence staff working conditions, compensation or status.⁵⁸ While the exempt organization representatives in a 50/50 joint venture can temporarily block actions proposed by the for-profit, they are essentially powerless to force the joint venture to take affirmative actions that they considered essential to meet charitable purposes.⁵⁹ For example, the exempt organization may be able to block the appointment of a joint venture CEO that it believes may be insensitive to charitable

⁵³ See *id.* at 161.

⁵⁴ *Id.* at 158.

⁵⁵ Michael Peregrine & T.J. Sullivan, *Rev. Rul. 98-15 Confirms Traditional Tax Planning Approach for 'Typical' Joint Ventures*, 98 TAX NOTES TODAY 102-42, May 28, 1998 at ¶ 2 ("Nevertheless, nothing in the ruling limits its scope to whole-hospital joint ventures, and the Service can be expected to apply the analysis in the ruling to all joint ventures."). These commentators point out that the factors described in Revenue Ruling 98-15 are entirely consistent with the "close scrutiny" test that came out of *Plumstead*, *Housing Pioneers*, and G.C.M. 39,005, which applies to all joint ventures between exempt organizations and for-profit entities. See *id.* at ¶ 13.

⁵⁶ See Rev. Rul. 98-15, 1998-12 I.R.B. 6, 9.

⁵⁷ The law in some states may preclude such a requirement, in which case the partnership or LLC would need to be organized in a different state.

⁵⁸ Robert A. Boisture & Albert G. Lauber, Jr., *Caplin & Drysdale Comments on Whole Hospital Joint Ventures*, 16 EXEMPT ORG. TAX REV. 650, 655 (1997).

⁵⁹ *Id.* at 655-56.

goals, but cannot compel the appointment of a CEO it affirmatively supports.⁶⁰

In Situation 2 of Revenue Ruling 98-15, it is apparent that the IRS also believes that the power to block an action is, in itself, insufficient to demonstrate and promote the exempt purpose.⁶¹ The 2000 CPE joint venture article also emphasizes that “effective control” by the nonprofit partner of the entire decision making process is essential.⁶² When answering the question of whether Example 2 could be reformed so that the LLC would not jeopardize the nonprofit partner’s exemption, the IRS states that changing one factor alone, such as requiring the LLC to act for the benefit of the community, or to require a set term for renewal of the management contract, would not necessarily be sufficient. Thus, use of a veto as a viable device for preserving exempt organization control in the 50/50 joint venture is suspect, even when coupled with other safeguards.

The control issue was also analyzed in the 2002 CPE Article, regarding specifically whether the nonprofit hospital must own the majority interest of the venture and control the governing board of the joint venture in order to remain exempt under § 501(c)(3).⁶³ The article concludes that if the tax-exempt entity lacks the majority vote to ensure it controls the major decisions (i.e., decisions relating to charity care) then there must be “another mechanism” in place to ensure that the joint venture will operate to further the exempt organization’s charitable purposes.⁶⁴ There is no indication in the article what “mechanism” would be satisfactory, however the criteria in the Checklist, as expanded and printed below, may be instructive.

Query: Would a supermajority vote or an arbitration provision which recognizes a presumption in favor of the nonprofit in case of a deadlock be favorable in this context?

The 2002 CPE Article’s authors note that the IRS has not recognized exemption in any joint venture where the tax-exempt entity’s share of the control was lower than fifty percent, and only a few organizations have been recognized as exempt when the control over the

⁶⁰ *Id.* at 656.

⁶¹ See Rev. Rul. 98-15, 1998-12 I.R.B. 6, 9 (illustrating in Situation 2 that the board members will not be engaging in activities that further an exempt purpose, and the management company may not always be under the board’s supervision).

⁶² Salins, 2000 CPE Article, *supra* note 46, at 38.

⁶³ Brauer, 2002 CPE Article, *supra* note 48, at 161.

⁶⁴ *Id.*

joint venture was split evenly between the nonprofit and the for-profit.⁶⁵

Joint Venture Checklist⁶⁶

Set forth below are several factors that can be used as guidance in making a determination as to whether a joint venture arrangement allows a nonprofit to operate exclusively for charitable purposes. These questions were developed based upon a review of recent court opinions and IRS administrative materials on joint ventures, including the IRS EO Technical Topics on Whole Hospital Joint Ventures.⁶⁷ While these factors are not exhaustive, they can serve as a starting point for practitioners structuring joint venture arrangements.

In General:

1. Does the participation of the exempt organization in the joint venture further its exempt purposes? The IRS will deny or revoke exemption of an organization that enters into a joint venture where the primary motive is to make a profit.
2. Are the assets of the exempt partner adequately protected? The exempt organization can avoid a negative conclusion by ensuring that:
 - (i) It has taken steps to limit its contractual liability in the joint venture;
 - (ii) The rate of return on the invested capital of the for-profit partner is limited (reasonable under the circumstances, perhaps subject to a reasonable cap); and
 - (iii) There is no obligation on the part of the exempt partner to return the for-profit partner's capital from the exempt partner's own funds.

⁶⁵ *Id.*

⁶⁶ The checklist is excerpted from MICHAEL I. SANDERS, *JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS* 51-61 (2nd ed. Supp. 2004).

⁶⁷ Janet E. Gitterman & Marvin Friedlander, *HEALTH CARE PROVIDER REFERENCE GUIDE (2003) in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2004*. The publication provides a long checklist of items the IRS will consider when processing applications from health care providers applying for recognition of exempt status under § 501(c)(3). The items on the checklist were taken from well-established precedents. The article specifies that all applications from entities that will be entering into whole hospital joint ventures will be reviewed using this checklist. Therefore, both the publication checklist items and the items listed under the Joint Venture Checklist in this Appendix may be used by such entities that are seeking exempt status and at the same time, seeking to participate in joint ventures.

3. Does the exempt partner have a right of first refusal on the sale of the assets of the joint venture?
4. Has the tax-exempt partner obtained a written, reasoned and comprehensive opinion from Counsel prior to proceeding with the joint venture transaction?
5. Is the tax-exempt partner the Tax Matters Partner? It is advisable that the exempt partner be the Tax Matters Partner in the joint venture since this will allow it to control all IRS audit and related issues.
6. Has the tax-exempt partner received an ownership interest in the joint venture commensurate with the value of the assets it contributed?
7. Do the joint venture participants receive distributions of earnings in proportion to their capital contributions?
8. Has the exempt partner entered into a non-compete agreement or restrictive covenant which would cause it to yield significant market advantages and competitive benefits to the for-profit partner?
9. Does the joint venture engage the services of independent attorneys and accountants who do not also represent the for-profit partner?
10. Were any financial or other inducements offered to the executives of the nonprofit or members of the governing board for approval of the affiliation?
11. Is the tax-exempt partner providing any guarantees? While not all guarantees are problematic, the IRS views certain guarantees, especially in the low-income housing area, that have the effect of insulating the for-profit partner from potential risk as problematic, since the guarantees increase the potential risk to the nonprofit.

Board Involvement:

12. Does the tax-exempt partner have voting control of the board of the joint venture so that it can exercise effective control over policies, major actions and decisions that affect its tax-exempt purposes?
13. What criteria are used by the joint venture to select its governing board?
14. What are the qualifications of the members of the governing board of the joint venture, and how much input did the exempt organization have in the selection of these people?
15. Have the board members signed conflict of interest guidelines?

15. Are the members of the board “representative of the community?”
17. Do the governing documents impose on the governing board members a duty to promote the charitable purposes of the nonprofit, which should take precedence over any other fiduciary duty, such as maximizing profits?
18. Does the exempt board have the right to (i) amend or modify the joint venture’s governing documents; (ii) approve the venture’s annual capital and operating budgets; (iii) approve distribution of income and additional capital contributions; (iv) approve the venture’s acquisition and disposition of health care facilities and equipment; (v) approve large contracts and assumption of indebtedness by the venture; (vi) approve changes in the types of services offered by the venture; (vii) select key executives of the venture and of the health care facilities, hire and fire employees, compel an audit and ensure adequate reserves?
19. Does the operating agreement of the joint venture include a dispute resolution provision which would ensure that, in the event that a disagreement arises between the board and the members over the actions or policies of the joint venture, resolution would favor the exempt partner’s charitable purposes?

Health Care Ventures:

20. Do the governing documents of the joint venture require that the services provided by the joint venture promote the health of the community as a whole?
21. Does the joint venture undertake activities for the primary purpose of promoting health rather than to confer private benefits?
22. Does the operating agreement of the joint venture include a provision requiring that the venture operate its facilities for charitable purposes and in accordance with the community benefits standard?
23. Does the exempt partner have the responsibility of adopting and setting medical and ethical standards for the joint venture hospitals?
24. Does the exempt partner oversee the quality of health care provided?
25. Does the exempt partner determine the prices for the delivery of health care, or control how the determination is made?

26. Does the joint venture have a substantial charity care program which is consistent with the community benefit requirements?
27. Does the joint venture have an accounting policy which separates bad or uncollectible debts from charity care?

Day-To-Day Management:

28. Is there a management firm responsible for day to day activities? If so, how is it selected? Is there a requirement that the venture engage the services of a management firm that is affiliated with the for-profit partner?
29. What are the terms of the management contract? Is it comparable to similar arrangements in the marketplace? Is the management agreement one that is for a stated and reasonable time period? (Not to exceed five years) May it be extended without the consent of the nonprofit? The IRS views long term management contracts unfavorably.
30. Is the management agreement terminable by the exempt partner if it determines that the management company is not acting in furtherance of its exempt purpose?
31. Is the management company under a binding and enforceable obligation to further the charitable purposes of the nonprofit?
32. Does the management company have the power to restrict the authority of the exempt partner's board representatives to initiate or react to decisions that would ensure that charitable goals are promoted?
33. Are the duties and responsibilities of the exempt partner within the joint venture meaningful?

Management: Health Care:

34. How are executives selected, and who determines their compensation and compensation for the service provider, including the physicians?
35. What are the duties of the management firm? For instance, does the management firm engage in any duties that may conflict with the exempt partner's purpose to promote the health of a broad section of the community?
36. Do any of the exempt partner's board member representatives have a financial or other kind of dependency on the hospital, the for-profit entity or the partnership, which would create a conflict of interest with their duty to represent the interests of the community?

Management agreements must also be carefully drafted to comply with Revenue Ruling 98-15. The IRS clearly views an independent management company (not affiliated with the for-profit partner) as a positive factor, with terms in the management agreement that allow the exempt organization a "way out." In other words, an agreement that unilaterally permits a management company to renew the agreement is unacceptable, as in Situation 2. The 2000 CPE joint venture article comments that the management agreement in Example 2 is "essentially a perpetual contract" because it was renewable at the sole option of the management company which is run by former employees of the for-profit partner.⁶⁸

Exempt organizations must be extremely careful about allowing employees or former employees of for-profit partners to serve in key positions in the partnership. The IRS appears to be primarily concerned that such persons would limit or "package" information flowing to exempt organization partners so that such partners would, as a practical matter, be deprived of some of their control, due to the limited information flow. In the 2000 CPE Joint Venture Article, the IRS explains that even though these officers' compensation is reasonable, the fact that they were employed by the for-profit creates the appearance of a conflict of interest.⁶⁹

Finally, the ruling indicates that other provisions in the partnership agreement that, as a practical matter limit the exempt organization's control, also will be carefully scrutinized. To illustrate, the IRS implied that the provision in Example 2 allowing the management company to enter all but unusually large contracts, combined with the limited flow of information likely to result from employing former employees of the for-profit entity, meant that the exempt organization could not effectively establish that the activities of the venture would further exempt purposes.

In sum, exempt organizations participating in joint ventures with for-profit entities and/or private investors should carefully structure provisions in the agreements to satisfy themselves that they are *not* deprived of control over the operations of the partnership, or limited in their ability to ensure that the venture will be operated for charitable purposes.

⁶⁸ Salins, *2000 CPE Article, supra* note 46, at 17. The 2000 CPE article does state, however, that Example 1 implies that a management agreement with a nonprofit affiliate of the exempt hospital would be acceptable. *Id.*

⁶⁹ *Id.* at 19.

B. *Redlands Surgical Services, Inc. v. Commissioner*⁷⁰

1. Facts

In a significant case in the health care area, the Ninth Circuit Court of Appeals affirmed the Tax Court opinion upholding the denial of IRC § 501(c)(3) status to Redlands Surgical Services, Inc. (Redlands).⁷¹ Redlands, a California nonprofit public benefit corporation, was a wholly-owned subsidiary of Redlands Health Systems, Inc. (RHS), a charitable organization under § 501(c)(3). RHS was the parent corporation of three other subsidiaries, two of which were also exempt under § 501(c)(3). One of the two exempt subsidiaries was Redlands Community Hospital (Redlands Hospital), a hospital within the meaning of § 170(b)(1)(A)(iii), which provided medical care free of charge or at a discount, and which maintained its own surgery program and emergency room.

In March 1990, RHS became a co-general partner with Redlands-SCA Surgery Centers, Inc. (SCA Centers), a for-profit corporation, in a general partnership formed to acquire a sixty-one percent interest in an existing outpatient surgical center in Redlands, California. RHS contributed cash and SCA Centers contributed cash and stock to the general partnership. In return for its thirty-seven percent investment, RHS received a forty-six percent interest in profits, losses, and cash-flow of the general partnership.

The general partnership agreement provided that the management and determination of all questions relating to the affairs and policies of the partnership were to be decided by a majority vote of the managing directors. The managing directors consisted of four persons – two of whom were appointed by RHS and two of whom were appointed by SCA Centers. In the event the managing directors were unable to agree, either RHS or SCA Centers could submit the matter to arbitration. The decision of a majority of the arbitrators was to be final and binding.

The general partnership became the sole general partner in Inland Surgery Center Limited Partnership (the Operating Partnership), a California limited partnership that owned and operated a freestanding ambulatory surgery center (the Surgery Center) within two blocks of Redlands Hospital. Prior to the Operating Partnership's affiliation with the general partnership, the Operating Partnership had been a for-

⁷⁰ This discussion is updated and excerpted from SANDERS, *supra* note 8, at 344-49.

⁷¹ *Redlands Surgical Servs. v. Commissioner*, 113 T.C. 47, 92 (1999), *aff'd*, 242 F.3d 904, 904 (9th Cir. 2001).

profit venture which served only surgical patients who could pay for its services. The partnership agreement of the Operating Partnership did not contain a statement of charitable purpose or a requirement that it operate for a charitable purpose before its affiliation with RHS and it was not amended to include such a provision after its affiliation with RHS. The Surgery Center offered no free care to indigents and it had no emergency room or certification to treat the emergency patient population.

The Operating Partnership entered into a contract with SCA Management Co. (SCA Management), a for-profit subsidiary of SCA, whereby SCA Management would provide management and administrative services for the Surgery Center. With the exception of decisions relating to the care and treatment of patients or other medical policy matters, SCA Management had wide-ranging authority for the management of the Surgery Center.

In return for its services, SCA Management was to receive a monthly management fee of six percent of gross revenue from the operation of the Surgery Center. The management agreement had a term of fifteen years, renewable unilaterally by SCA Management for two five-year extensions. With the exception of bankruptcy or insolvency, the management contract was terminable by the Operating Partnership only if SCA Management breached the agreement, and then *only* after a ninety-day notice and a ninety-day cure period.

In April 1990, SCA Management entered into a quality assurance agreement with RHS whereby RHS agreed to perform managerial and supervisory quality assurance duties in connection with the operation of the Surgery Center. RHS was to receive a monthly fee after the first year, and it was to be reimbursed for its direct out-of-pocket expenses.

Five months after entering into the general partnership agreement with SCA Centers, RHS incorporated RSS as a California nonprofit public benefit corporation, and transferred its interest in the General Partnership to RSS. RHS also transferred its obligations and rights under the quality assurance agreement to RSS. RSS's sole activity (and its sole source of revenue) was to be its participation in the Operating Partnership.

The IRS argued that RSS was not operated exclusively for charitable purposes because it operated for the benefit of private parties and failed to benefit a broad cross-section of the community. In support of its position, the IRS stated that the partnership agreements and related management contract were structured to give for-profit parties control over the Surgery Center. Moreover, the Surgery Center had never operated with a charitable purpose.

RSS, on the other hand, argued that it met the operational test of § 501(c)(3) because its activities with respect to the Surgery Center further its purpose of promoting health for the benefit of the RSS community, by providing access to an ambulatory surgery center for all members of the community based upon medical need rather than ability to pay, and by integrating the outpatient services of Redlands Hospital and the Surgery Center. RSS further argued that it engaged in arm's length transactions with the for-profit partners, and that its influence over the activities of the Surgery Center has been sufficient to further its charitable goals. RSS also argued that it performed services that were "integral" to the exempt purposes of RHS, its tax-exempt parent, and Redlands Hospital.

2. The *Redlands* Court Decisions

By applying a facts and circumstances analysis, the Tax Court upheld the IRS's denial of RSS's tax-exempt status. The court concluded that RSS had effectively ceded control over the operations of the partnerships and the Surgery Center to private parties, thus conferring impermissible private benefit upon them. In this regard, the court noted that the promotion of health for the benefit of the community is a charitable purpose. However, the community benefit standard also requires that the charity serve a sufficiently large and indefinite class and that private interests not benefit to any substantial degree. Redlands appealed the Tax Court decision to the Ninth Circuit Court of Appeals.

Just ten days after appellate oral arguments, the Ninth Circuit issued a per curiam opinion.⁷² The single paragraph "adopted" the Tax Court holding that Redlands had "ceded effective control over the operations of the partnerships and the surgery center to private parties, conferring impermissible private benefit." Because private parties were obtaining substantial benefit, the surgery center was not being operated exclusively for exempt purposes. The Ninth Circuit also affirmed the Tax Court view that private benefit prevented Redlands from claiming exempt status under the integral part doctrine.

The Court of Appeals had little choice but to affirm the decisions of the Tax Court and the IRS. The Redlands venture incorporated none of the positive factors and many of the negative factors that the Service has discussed in Revenue Ruling 98-15 and elsewhere:

⁷² *Redlands Surgical Servs. v. Commissioner*, 242 F.3d 904, 904 (9th Cir. 2001).

- No charitable purpose in partnership documents (in fact, *profit* motive protected by partnership documents);
- Charity does not have control of the Board (equal representation on board);
- No charitable override for deadlocked board or arbitration decisions;
- Management company is a subsidiary of the for-profit partner;
- Long management contract (fifteen years) renewable in sole discretion of management company;
- Surgery center did not perform any free medical care even after it formed the venture;
- An agreement restricted the ability of charitable hospital to expand its own ambulatory surgery center; and
- Rate of return on the venture was in excess of forty-three percent.

Based on the totality of these factors, the Tax Court and the Appellate Court concluded that RSS impermissibly served private interests. Although the courts did not specifically refer to Revenue Ruling 98-15, *Redlands* buttresses the IRS's authority to enforce Revenue Ruling 98-15 with respect to whole hospital joint ventures and other types of joint ventures involving exempt organizations. Again, the analysis will be based on the totality of all relevant factors, including, but not limited to, the exempt organization's formal and informal control of the day-to-day activities of the venture, as well as a binding commitment of the parties in the operative documents that charitable purposes, as opposed to for-profit purposes, must prevail. Factors that will mitigate *against* charity are long term management agreements with a for-profit entity which has the unilateral right to renew the contract, arbitration provisions that do not take into account charity, and the lack of any evidence of actual charitable operations.

C. *St. David's Health Care System*

In *St. David's Health Care System v. United States*, the jury in a United States district court found in favor of the nonprofit,⁷³ having applied the Fifth Circuit's reasoning, which expands the control test of Revenue Ruling 98-15 and *Redlands*. In 1996, St. David's contributed all of its health care facilities to a joint venture with a for-profit

⁷³ *St. David's Health Care Sys. v. United States*, No. A01CV046JN, 2004 U.S. Dist. WL 555095 (W.D. Tex. Mar. 18, 2004).

health system, Columbia/HCA Healthcare Corporation (HCA).⁷⁴ HCA contributed a small portion of its property to the partnership, and the partnership hired a subsidiary of HCA to manage the day-to-day activities of the partnership's medical facilities.⁷⁵ All parties agreed that the St. David's joint venture performed substantial charity care and that its activities met the community benefit standard.⁷⁶ The disagreement between the taxpayer and the IRS was whether St. David's retained enough control over the venture to ensure that the charity care would continue into the future, without substantial private benefits flowing to HCA.⁷⁷

After the IRS revoked its exempt status, St. David's paid the federal taxes allegedly owed for one year and proceeded to district court in Texas under a claim for refund.⁷⁸ The Texas district judge ruled in favor of St. David's on a summary judgment motion; however, the Fifth Circuit Court of Appeals found that there were genuine issues of material fact, and so reversed the District Court and remanded the case for a jury trial.⁷⁹ The Fifth Circuit, in its lengthy opinion, relied upon Revenue Ruling 98-15 but expanded the legal analysis and held that the tax-exempt organization does not have to retain formal control of the partnership if it has effective control over the major decisions of the partnership.⁸⁰ The Fifth Circuit specifically noted that the non-profit should retain effective control to enable it to dissolve the partnership, if warranted.⁸¹ On remand the district court, following the Fifth Circuit, instructed the jury to consider the totality of the circumstances in deciding whether the partnership's operations primarily furthered charitable purposes, including the partnership's benefit to the community.⁸² The circumstances highlighted by the District Court in the jury instructions included the following:

⁷⁴ *St. David's Health Care Sys. v. United States*, 349 F.3d 232, 233 (5th Cir. 2003).

⁷⁵ *Id.* at 234.

⁷⁶ Jury Instructions at ¶ 9, *St. David's Health Care Sys. v. United States*, No. A-01-CA-46JN, 2002 U.S. Dist. LEXIS 20265 (W.D. Tex. 2002) (explaining that when deciding the charitable purposes issue, the community benefit standard may be considered).

⁷⁷ *St. David's Health Care Sys.*, 346 F.3d at 232.

⁷⁸ *Id.* at 234.

⁷⁹ *Id.* at 244.

⁸⁰ *Id.* at 238.

⁸¹ *Id.* at 241, 244. Although St. David's argued that its power to dissolve the partnership provided it with a significant amount of control over partnership operations, the court reasoned that it was unlikely that St. David's would exercise its option to dissolve the partnership.

⁸² *St. David's Health Care Sys. v. United States*, No. A01CV046JN, 2004 U.S. Dist. WL 555095 (W.D. Tex. Mar. 18, 2004).

[t]o “give up control” of the Partnership ... means to give up the direct or indirect ability to determine the direction of management and policies through ownership, contract or otherwise. In determining whether St. David’s retained sufficient effective control, you should consider all the facts and circumstances, including, but not limited to, (i) any applicable powers or rights allocated to St. David’s in the Partnership’s governing documents, (ii) evidence of St. David’s ability and willingness, if any, to enforce any such powers, (iii) the structure of the Partnership, (iv) the management of the Partnership, and (v) the actual operation and subsequent activities of the Partnership.⁸³

The court also instructed the jury that even if the community benefit test was met and St. David’s and the partnership provided an extensive amount of charity care, “[y]ou must also find that the Partnership’s activities do not substantially further the private benefit of HCA.”⁸⁴ The jury was also instructed that:

[i]n considering whether Partnership operations primarily further charitable purposes, you must determine whether St. David’s, when it entered the Partnership, retained sufficient control over Partnership operations to ensure that Partnership operations primarily further charitable purposes, and that no more than an insubstantial amount of the Partnership’s activities further non-exempt interests. If St. David’s gave up formal or effective control, it is presumed that the Partnership operations further the profit-seeking motivations of HCA and that St. David’s activities via the Partnership are not primarily in furtherance of its charitable purposes.”⁸⁵

The jury ultimately found in favor of St. David’s, and the government’s appeal of the jury verdict was settled out of court by the parties.⁸⁶

The jury instructions, derived from the Fifth Circuit opinion, extend the two-prong charitable purpose and control test that is most clearly applicable to whole hospital joint ventures. The test that was utilized in *St. David’s* encompasses a community benefit standard,

⁸³ Jury Instructions at ¶ 15, *St. David’s Health Care Sys. v. United States*, No. A-01-CA-46JN, 2002 U.S. Dist. LEXIS 20265 (W.D. Tex. 2002).

⁸⁴ *Id.* at ¶ 10.

⁸⁵ *Id.* at ¶ 13.

⁸⁶ *St. David’s Health Care Sys. v. United States*, No. A01CV046JN, 2004 U.S. Dist. WL 555095 at *1 (W.D. Tex. Mar. 18, 2004).

unique to the health care area, as an important part of the first prong charitable purpose test. The *St. David's* test also utilizes a broader facts and circumstances determination as to whether the exempt partner has retained effective control over the activities carried on by the joint venture.

IV. REVENUE RULING 2004-51

Soon after the jury decided *St. David's*, the IRS issued Revenue Ruling 2004-51, 2004-22 IRB 974.⁸⁷ This ruling analyzes a non-health-care ancillary joint venture and is the first published guidance of its kind, involving an ancillary venture between a non-health care charitable organization and a for-profit entity, where each party maintains a fifty percent share in the venture. The ruling demonstrates that "control" of the entire venture is not essential; control can be "bifurcated," as long as the exempt organization controls the substantive, "charitable" aspects. Moreover, given the exempt organization's exclusive control over the venture's charitable aspects, the need for an affirmative charitable "override" is no longer required.

In the revenue ruling, a § 501(c)(3) university expanded the scope of its educational programs by forming a limited liability company (LLC) with a for-profit entity specializing in interactive video training. The activities of this joint venture between the exempt university and the for-profit corporation were an insubstantial part of the university's overall activities.

The Articles of Organization and the Operating Agreement (Agreement) provided that the LLC's sole purpose was to offer teacher training programs to satellite locations using interactive video technology. The university and the for-profit each owned a fifty percent share in the company, and had equal representation on the Board of Directors. All allocations, returns of capital and distributions were to be made commensurate with the nonprofit and for-profit members' respective ownership interests.

The LLC was responsible for arranging and conducting all administrative details regarding the video training seminars for teachers. The video seminars covered the same substantive material as the university's seminars conducted on campus. Additionally, the Agreement gave the university the exclusive right to determine and approve the curricula, training materials, instructors, and standards of completion for the seminar. It gave the for-profit, on the other hand, the exclusive right to select video training technicians and locations. All

⁸⁷ Rev. Rul 2004-51, 2004-22 I.R.B. 974 (the following portions of the text analyze the facts by which Revenue Ruling 2004-51 was issued).

other decisions were to be made by mutual consent of both the for-profit and the university. Furthermore, in accordance with the Agreement, all transactions entered into by the LLC were presumed to be conducted at arm's length, with all prices presumed to be at fair market value. The Agreement restricted the LLC's activities to the administrative tasks connected with the teacher training seminars, and mandated that the LLC not engage in any activities that would jeopardize the university's 501(c)(3) exempt status.

The Service analyzed two issues: 1) whether the university would lose its exempt status due to its participation in this ancillary joint venture; and 2) whether the university would recognize unrelated business taxable income on its distributive share of the net profits.

A. Issue 1: Exemption Under § 501(c)(3)

Whether, under the facts described above, an organization continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company (LLC) formed with a for-profit corporation.

The Internal Revenue Service, in the revenue ruling, makes three important assumptions: 1) the joint venture activity is an "insubstantial" part of the university's total activities; 2) all transactions are conducted at "arm's length"; and 3) all contract and transaction prices are at "fair market value."⁸⁸ Given these three fundamental assumptions, it is difficult to envision a scenario in which any activity would endanger an organization's exempt status. Indeed, the revenue ruling provides little analysis regarding this issue, and merely states that based upon all the facts and circumstances, the university's participation in the joint venture, taken alone, will not affect the university's continued qualification for exemption as an organization described in § 501(c)(3).

However, the inquiry does not stop there, because prior to reaching its conclusion about exempt status, the IRS sets forth what it views as the relevant legal standards: applicable provisions of the Internal Revenue Code, Treasury Regulation, and Revenue Ruling 98-15, *Redlands* and *St. David's*. It is the Service's reliance upon Revenue Ruling 98-15, *Redlands* and *St. David's*, in particular, that gives rise to the significance of this otherwise "plain vanilla" ruling. Implicitly, the ruling suggests, but does not state, that given a different set of facts, the cited legal standards would govern the analysis.

⁸⁸ *Id.* at 976.

In its reliance upon the legal precedent governing joint ventures, the IRS reiterates the two prong test of Revenue Ruling 98-15, that: 1) participation in the joint venture must further a charitable purpose, and 2) the partnership arrangement must permit the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners. *Redlands* is cited for the holding that an exempt organization may form a partnership, so long as it does not thereby impermissibly serve private interests. Ceding “effective control” of partnership activities is highlighted as a factor that impermissibly serves private interests. Finally, *St. David’s* is cited for the proposition that it is not enough to conclude that the joint venture actually serves charitable interests. Rather, the nonprofit partner must have the “capacity to ensure” that the partnership’s operations further charitable purposes, again reemphasizing that if the nonprofit cedes control to the for-profit entity, the non-profit should lose its tax-exempt status.

While none of these principles came into play given the favorable facts and circumstances of Revenue Ruling 2004-51, they *imply* that the analysis in ancillary joint ventures will follow the principles set down in Revenue Ruling 98-15, *Redlands* and *St. David’s*, that control over the joint venture, or at a minimum, “bifurcated” control over the charitable aspects of the venture, is necessary to avoid unrelated business income as well as loss of exemption, at least in the context of a “substantial” activity.

Accordingly, this ruling suggests the application of a new test, referred to herein as the “UBIT plus Control” test which includes a Revenue Ruling 98-15 “control” analysis as an added component to the standard UBIT analysis, converting an otherwise “related” activity to an “unrelated” activity, if the exempt organization cedes control over the substantive aspects of the venture. The “conversion” occurs because the lack of control *presumes* unwarranted private benefit.⁸⁹

B. Issue 2: Unrelated Business Income

Whether, under the same facts, the organization is subject to unrelated business income tax under § 511 on its distributive share of the LLC’s income.

⁸⁹ See Bruce R. Hopkins, *Nonprofit Counsel: IRS Issues Ancillary Joint Venture Guidance*, LAW TAX-EXEMPT ORG. MONTHLY, July 2004, at 3. Mr. Hopkins, in discussing Revenue Ruling 2004-51, stated: “The IRS is implicitly saying that the business in the joint venture is thereby converted to an unrelated business, even though the business remains inherently related. Presumably, this transformation occurs by application of the private benefit doctrine – a novel theory.” *Id.*

The second issue raised by the IRS in Revenue Ruling 2004-51, should require a standard unrelated business income tax analysis under §§ 511, 512, and 513 of the Internal Revenue Code. Again, however, the IRS has set forth a factual scenario that should lead to an obvious conclusion that the educational activities of the joint venture are substantially related to the university's exempt purpose, which renders the unrelated business analysis superfluous, at best.

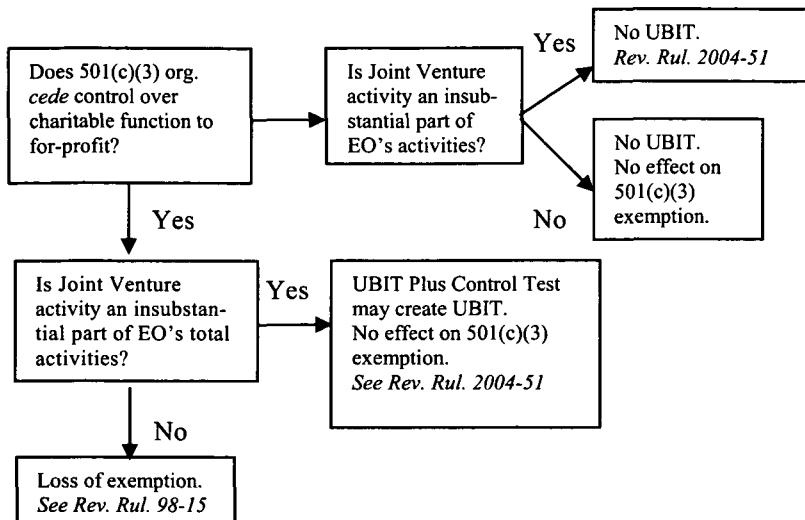
As stated, in this factual scenario, the university has an educational exempt purpose, clearly defined by the Treasury regulations. The ancillary joint venture furthered the pursuit of that purpose by broadening the outreach of the educational activities of the university. Significantly, as to the educational functions of the LLC, the exempt organization had exclusive control. Moreover, the manner in which the for-profit conducted the administrative functions did not affect the educational nature of the venture. Thus, based upon all of the facts and circumstances, the IRS concluded that the activities of the joint venture were related to the clearly defined educational exempt purpose of the university, and so the university did not have any unrelated business tax liability attributable to its participation in the joint venture.

As mentioned previously, an interesting question in the analysis in Revenue Ruling 2004-51, is whether the IRS is now applying a "UBIT plus Control" test, which applies the standard UBIT analysis to ancillary joint ventures involving exempt organization, and superimposes upon that standard the "control test" of Revenue Ruling 98-15, *Redlands* and *St. David's*; so that even if the activity of the partnership is "substantially related" to the exempt organization's purpose, it will be deemed to be an "unrelated" trade or business if the exempt organization cedes effective control over the substantive aspects of the venture to the for-profit entity.

Stated another way, what this ruling implies is that, given other factual patterns or scenarios *not* presented in the ruling, even a substantially related activity may cause loss of exemption, or generate UBIT to the nonprofit, if the nonprofit cedes control to the for-profit, at least as to the "charitable" or substantive aspects of the venture. In order to illustrate this new standard, we have set forth below eight different "scenarios" or fact patterns, with various combinations of factors, to illustrate the possible implications of Revenue Ruling 2004-51.

C. Factual Scenarios 1-4: Joint Venture is a “Substantially Related” Charitable Activity

FIGURE 1



1. Scenario 1:

- Exempt organization does *not* cede control over joint venture activities to for-profit; and
- The joint venture is an insubstantial part of the exempt organization's total activities.

This is the “plain vanilla” scenario described in Revenue Ruling 2004-51, in which the exempt organization's status is not jeopardized by its participation in the joint venture, since it *retains control over the charitable aspects of the venture* and the *venture is an insubstantial part of the nonprofit's total activities*. As in the ruling, the university is not subject to unrelated business income tax liability for the activities of the joint venture.

2. Scenario 2:

- Exempt organization does not cede control over joint venture activities to for-profit; and
- The joint venture is a substantial (but less than fifty percent) part of the exempt organization's total activities.

Again, this scenario is similar to the fact pattern in Revenue Ruling 2004-51 in that the activity is “related” to the exempt organization’s charitable purpose, and the exempt organization retains control over the joint venture’s educational activities. Thus, even though the activities are a substantial part of the exempt organization’s total activities, the organization’s exempt status is not jeopardized, and there is no unrelated business income tax liability, pursuant to the analysis contained in Revenue Ruling 2004-51; Revenue Ruling 98-15; *Redlands* and *St. David’s*.

3. Scenario 3:

- Exempt organization cedes control over joint venture activities to for-profit; and
- Joint venture activities are an insubstantial part of exempt organization’s total activities.

Under this scenario, the university (using the fact pattern of Revenue Ruling 2004-51) would cede control over the educational aspects of the venture, to the for-profit. Since the joint venture is an insubstantial part of the university’s total activities, the exempt status of the university would presumably not be affected. Similarly, since the activities of the joint venture are “related” to the university’s educational purposes, under a traditional UBIT analysis, there should be no unrelated business income tax liability. However, given the new “UBIT plus Control” test, which looks to Revenue Ruling 98-15, *Redlands* and *St. David’s*, certain unanswered questions remain. For example:

- Since the activity is “related,” is it relevant that the non-profit cedes control over the joint venture activities?
- Does the fact that the for-profit partner controls the venture’s activities convert clearly “related” activities to unrelated activities, similar to the analysis in Revenue Ruling 98-15?
- Is the inquiry no longer a straightforward UBIT analysis for an ancillary joint venture, but rather a determination as to whether the joint venture’s activities will *always* further the nonprofit’s exempt purpose and *never* result in private benefit?
- Is control over the joint venture activities a relevant inquiry for purposes of a UBIT analysis?

Those questions remain unanswered, since Revenue Ruling 2004-51 does not provide clarity on these issues. However, applying the

analysis of the “bad” example in Revenue Ruling 98-15 results in the conclusion that “control” over the activities of an ancillary joint venture is an important, if not essential, factor and conversely, a for-profit’s control over the venture could convert an otherwise “related” activity into an “unrelated” activity. In this factual scenario, since the activities of the venture are “insubstantial” in view of the exempt organization’s overall activities, the exempt status of the organization should not be jeopardized. However, the exempt partner may be liable for an unrelated business income tax on the income from the venture.

4. Scenario 4:

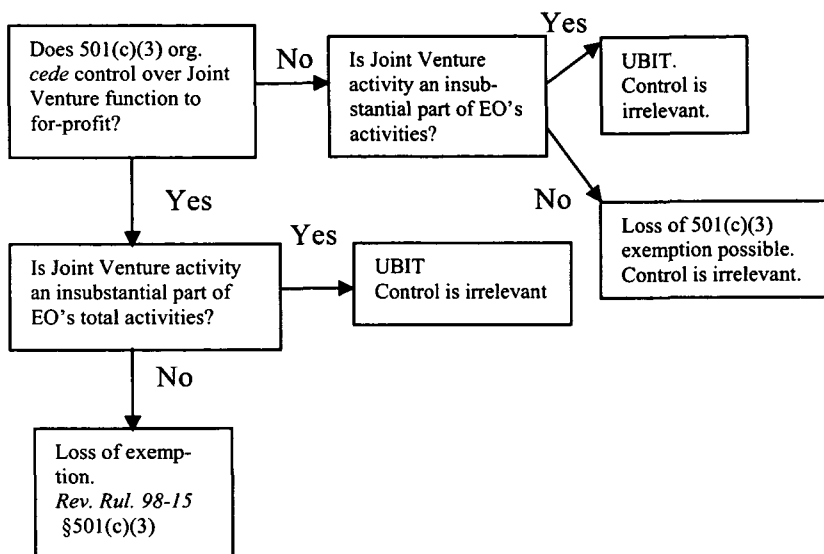
- Exempt organization cedes control over joint venture activities to for-profit; and
- The joint venture is a substantial (but less than fifty percent) part of the exempt organization’s total activities.

This scenario raises similar questions to those raised in Scenario 3 above, and is very close to the “bad” example in Revenue Ruling 98-15. The IRS concluded in Revenue Ruling 98-15 that since the nonprofit ceded control over the health care activities to the for-profit partner, the joint venture was not required to serve charitable purposes and the private benefit to the for-profit partner would therefore not be incidental. Thus, the exempt status of the nonprofit partner was denied. Essentially, in that ruling the “related” activity of the provision of health care was converted into an “unrelated” activity, due to the nonprofit’s lack of control over the venture and its inability to initiate programs to meet the community benefit standard without the support of the for-profit partner. Again, in that ruling the presence of substantial private benefit to the for-profit partners was assumed.

Presumably, the analysis for an ancillary joint venture with these three criteria would follow the “whole hospital” joint venture in Revenue Ruling 98-15 since a substantial part of the exempt organization’s total activities will be encompassed by the joint venture, even though those activities do not constitute all of the exempt organization’s operations.

D. Factual Scenarios 5-8: Joint Venture is an Unrelated Business Activity

FIGURE 2



1. Scenario 5:

- Joint venture is an unrelated trade or business, and the exempt organization cedes control over the joint venture's activities to for-profit; and
- The joint venture is an insubstantial part of the exempt organization's total activities.

An example of this scenario would be if the university as described in Revenue Ruling 2004-51, were to enter into a joint venture with AMC Widgets, Inc., to manufacture widgets for sale to the public. Clearly an "unrelated" activity, yet an insubstantial part of the university's overall activities.

It would seem at first blush that Revenue Ruling 2004-51 should have no impact on this scenario: § 513(c) of the Internal Revenue Code provides that an exempt organization's share of partnership income from an unrelated trade or business carried on by a partnership

of which it is a member must be included in calculating the organization's unrelated business taxable income.⁹⁰

However, under the "UBIT plus Control" test, since the for-profit has control over the joint venture activities in this scenario there may be a presumption of unwarranted private benefit under the analysis in Revenue Ruling 98-15. In that case, there could, but would not likely, be jeopardy to the exempt organization's charitable status.

2. Scenario 6:

- Joint venture is an unrelated trade or business, and the exempt organization cedes control over the joint venture's unrelated activities to for-profit; and
- The joint venture is a substantial (but less than fifty percent) part of the exempt organization's total activities

This factual scenario is closest to *Redlands* where the for-profit partner had control over the activities of the joint venture (in that case, the outpatient surgical center), and thus, the health care activities of the surgical center were deemed to be "unrelated" to the nonprofit's exempt purpose. In *Redlands*, the court held that the nonprofit partner did not qualify as a tax-exempt entity, since the unrelated joint venture activities were its sole activities.⁹¹

Accordingly, in this scenario, there is a question as to whether substantial unrelated activities will result in a denial or revocation of exemption. Under a standard UBIT analysis the answer would be determined by analyzing all of the facts and circumstances. However, assuming a "UBIT plus Control" test, the analysis looks to the fact that the for-profit entity controls the joint venture, and thus, private benefit is assumed. Under that type of analysis, the exempt organization's status would likely be in jeopardy. Given the fact that Revenue Ruling 2004-51 has cast doubt upon the well established analysis utilized in unrelated business inquiries when the unrelated business is conducted through an ancillary joint venture, the better option in this case may be to spin the unrelated business activity off into a wholly owned for-profit corporate subsidiary.

⁹⁰ I.R.C. § 513(c) (2000) (explaining that activities carried out for profitable purposes shall not be excluded from taxes even if such activity does not actually generate profits).

⁹¹ *Redlands Surgical Servs. v. Commissioner*, 113 T.C. 47, 92-93 (1999).

3. Scenario 7:

- Joint venture is an unrelated trade or business, and the exempt organization does not cede control over joint venture's activities to for-profit; and
- The joint venture is an insubstantial part of the exempt organization's total activities

This scenario would require a standard unrelated business taxable income analysis in which control is irrelevant. The activity is insubstantial, and the exempt organization would be liable for the unrelated business income tax, but its exempt status would not be jeopardized. Because the activity is controlled by the exempt organization, private benefits flowing to the for-profit partners would not be assumed, pursuant to the reasoning in Revenue Ruling 2004-51.

4. Scenario 8:

- Joint venture is an unrelated trade or business, and the exempt organization does not cede control over joint venture's activities to for-profit; and
- The joint venture is a substantial (but less than fifty percent) of exempt organization's total activities.

Although the exempt organization does not cede control, the activity is unrelated and substantial, and even under the conventional unrelated business income tax analysis, this activity could impact the exempt status of the nonprofit organization. The issue of control over the unrelated activity should be irrelevant. However, since the nonprofit retained control there presumably would not be any presumption of private benefit. In any event, the nonprofit would be subject to the unrelated business income tax under §§ 511-513.

E. General Legal Analysis of Revenue Ruling 2004-51

As discussed above, the importance of Revenue Ruling 2004-51 is not in what it says, but in what it implies and leaves unsaid. As suggested, the addition of the "UBIT plus Control" test to what would otherwise be a straightforward unrelated business income tax analysis raises many questions. The practitioner should be aware of this implication and recognize that the IRS may require that a "UBIT plus Control" test be applied to determine whether an organization's exempt status will be impacted by an ancillary joint venture's activities in which the substantive aspect of the venture is controlled by the for-profit entity, whether or not the venture constitutes a "related" activ-

ity. Under the theory of Revenue Ruling 98-15, when the for-profit partner controls the activity, a “related” activity may be analyzed as “unrelated” and private benefit may be assumed.⁹² Moreover, the entity’s exempt status may be jeopardized if the activity is substantial.

As indicated, the variable that is absent in the eight scenarios discussed above is the specific presence or absence of private benefit to the for-profit partners. In Revenue Ruling 2004-51, it is stated that there is *no* private benefit, although there are of course, certain benefits flowing from the joint venture partnership to the for-profit partner.⁹³ It can be argued that when the nonprofit partner controls the joint venture, it is safe to assume there will be no unwarranted private benefit to the for-profit partners, other than the proportional benefits of the partnership interests. If impermissible private benefit develops within a joint venture structure in which the nonprofit maintains control, this premise assumes that the nonprofit will exercise its control to protect its charitable assets. On the other hand, if the nonprofit cedes its control to the for-profit, it appears that the IRS will likely assume the presence of impermissible private benefit.

F. Structural Guidance

Revenue Ruling 2004-51 provides certain lessons to the tax-exempt practitioner. Significantly, the governing documents between the university and the for-profit entity incorporate certain safeguards to prevent the venture from serving private interests. Any exempt entity contemplating such a venture should ensure that its venture documents contain similar provisions. First, the governing documents should require that the terms of all contracts and transactions entered into by the joint venture, both with its ventures and with any other parties, be at arm’s length and for fair market value, based on comparables. Second, the governing documents should restrict activities in which the joint venture may participate, to activities that further the exempt purposes of the nonprofit partner. Third, the governing documents should contain a general prohibition against engaging in *any* activity which might jeopardize the exempt organization’s status. Finally, the facts should demonstrate that the joint venture did, in fact, operate in accordance with the terms of the governing documents.

Furthermore, and most important in forming a joint venture or partnership, the governing documents should ensure that the exempt organization has full control over the substantive exempt function activities of the joint venture. For example, in Revenue Ruling 2004-

⁹² See Rev. Rul. 98-15, 1998-12 I.R.B. 6, 9.

⁹³ Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

51, the university had control over the educational content, including sole approval of course curricula, training materials, and instructors, even though the for-profit partner had control over certain administrative matters.⁹⁴ This bifurcation of the functions of the joint venture is a significant concession on the part of the IRS, that “control” of the entire venture is not essential, as long as the exempt organization controls the substantive “charitable” aspects of the venture.

Finally, in order to avoid unrelated business income, it is necessary for the joint venture to participate in an activity that is “substantially related” to its exempt purpose. In Revenue Ruling 2004-51, the determination that the activities were related was straightforward, given the regulatory definition of “educational purposes.”⁹⁵ Therefore, it may be easier to demonstrate “substantially related” in the education and low-income housing⁹⁶ context, where there is a clear definition of charitable purpose, and particularly in the low-income housing tax credit context, there is a significant level of governmental oversight and review, than it would be to demonstrate activities that are substantially related to the provision of health care and other charitable activities, where there are no clear statutory or regulatory definitions.

V. SUMMARY

Health care exempt organizations have many options regarding their structure and affiliations with for-profit entities. As long as any joint ventures are carefully structured and the nonprofit retains control over the exempt health care activities, the Internal Revenue Service should not question the structure. However, as outlined above, if the for-profit entity effectively gains control over the activities of the venture, the structure is not likely to be upheld by the IRS or the courts, and either the exempt status of the nonprofit will be denied or revoked, or health care income will be subject to the unrelated business income tax.

In summary, the health care industry has been severely impacted by many economic forces, including uncertainty in the area of joint

⁹⁴ *Id.*

⁹⁵ Fred Stokeld, J. Christine Harris & Joseph J. Thorndike, *EO Reps Focus on Ancillary Joint Ventures, Shelters*, 103 TAX NOTES 824, 824 (2004) (IRS Assistant Chief Counsel, Catherine E. Livingston, stated in a recent meeting with the ABA tax section that the regulations containing a definition of educational purposes “was an important underpinning to our ability to do the guidance.”).

⁹⁶ See Rev. Proc. 96-32, 1996-1 CB 717 (which sets forth safe harbor guidelines that if satisfied, demonstrate that the organization meets the § 501(c)(3) standards of “charitability.”).

ventures between nonprofits and for-profit health care systems. The uncertainty as to whether the joint venture would negatively impact the nonprofit's tax-exempt status undoubtedly caused many nonprofits to form for-profit subsidiaries and otherwise expanded operations in a for-profit marketplace. Fortunately, with the guidance that is currently available in the form of Revenue Ruling 98-15, *Redlands, St. David's*, and now Revenue Ruling 2004-51, health care institutions can move forward with properly structured joint ventures with greater confidence that the joint venture will not endanger the tax-exempt status of the nonprofit.

