# Ancillary Joint Ventures Involving Taxable and Tax-Exempt Health Care Entities: Addressing the Chilling Effect of IRS Inaction

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**Tax-exempt health care systems facing growing operating costs and falling revenues frequently explore creation of ancillary joint ventures (AJVs) as vehicles to raise capital,** share risk, expand coverage, and provide care more efficiently, while preserving exempt status and avoiding unrelated business income tax (UBIT). Joint venture activity among tax-exempt entities is robust.[1] However, tax-exempt systems typically are frustrated in their attempts to partner with taxable organizations because of the inadequate current state of guidance from the Internal Revenue Service (IRS) regarding tax-exempt/taxable combinations.

### Highlights of Distinct Attributes of AJVs

- Unlike a sale, allows the exempt hospital to have continued financial stake in, and some involvement with, the strategic direction of the facility or service and its operations;
- May help the exempt hospital raise capital;
- Allows the entities to share the risk of a new enterprise and pool areas of expertise;
- May bring a new service or medical facility into a new area;
- May expand patient coverage;
- May attract new patient admissions/referrals;
- May persuade physicians to not refer elsewhere;
- May help the exempt entity survive in a competitive marketplace, by helping it compete for managed care and physician organization contracts and keep top physicians on staff; and
- May help to provide care more efficiently for communities by having services available at a lower cost by cutting waste and duplication.

The IRS has not issued sufficiently clear statements of policy or principles to provide the legal guidance that tax-exempt health care systems' managers and governing body members, and their lawyers, require to proceed prudently with development of such ventures. Consequently, tax-exempt systems face uncertainty regarding whether participation in an AJV will negatively impact their exempt status or lead to UBIT. Tax-exempt systems therefore have had no alternative but to assume they are obligated to require supermajority rights and place limitations on AJV scope that can be unattractive to potential taxable partners and not appropriately meet the needs of either party and the purposes of the AJV. These are constraints that AJVs between tax-exempt entities do not face.

While there may be ample IRS guidance and published court decisions regarding how to organize and operate whole hospital joint ventures or "WJVs" (i.e., joint ventures in which the entire exempt activity is contributed to the joint venture), the same cannot be said for AJVs (i.e., joint ventures in which the exempt entity transfers a subset of its assets or contributes funds to operate an ancillary service). Rather, the IRS's only precedential guidance on AJVs leaves open more questions than it answers and does not address concerns related to hospitals or health care more generally (an industry that the IRS consistently treats differently).

Despite this uncertainty, the IRS has stated that it will no longer issue private letter rulings (PLRs) on the tax consequences of AJVs and will not otherwise opine on the issue unless it is presented in an initial application for recognition of exemption. As a result, the IRS is effectively stifling the creativity that would be inspired by changed circumstances and advanced technologies, which arguably would drive the law of tax-exempt entities to keep pace with those circumstances and technologies.

## The State of IRS Guidance on Ancillary Joint Ventures

Before 1980, the IRS sought to preclude tax-exempt entities from participating in any type of joint venture with for-profit entities. It reasoned that such involvement was necessarily incompatible with the charitable purposes of exempt entities because in a partnership there must be a profit motive.[2]

Then, *Plumstead Theatre Society, Inc. v. Commissioner* changed the joint-venture analysis for exempt entities.[3] In 1980, the IRS denied tax-exempt status to Plumstead (a theater company that entered into a limited partnership with three for-profits to raise revenue for stage productions), reasoning that Plumstead was not operating exclusively for charitable purposes. The tax court disagreed, however, based on safeguards contained in the limited partnership agreement that served to insulate Plumstead from potential conflicts with its exempt purposes. The court ruled that Plumstead's joint venture obligations did not conflict with its exempt status because:

1. Plumstead was not obligated for the return of any capital contributions made by the limited partners from Plumstead's funds;

2. The limited partners had no control over how Plumstead operated or managed its affairs; and
3. Neither any of the limited partners nor any officer or director of the corporate limited partner was an officer or director of Plumstead.

Since *Plumstead*, the IRS's position has been steadfast: under the appropriate circumstances, an exempt entity may participate in a joint venture with a taxable entity without jeopardizing its exempt status, if the arrangement ensures that the exempt entity's participation still allows it to operate exclusively for exempt purposes. That said, the IRS will "closely scrutinize" the facts and circumstances of these arrangements to ensure that the arrangement in fact does so.[4]

The IRS has provided some (albeit limited) guidance, and there have been several court decisions from the 1990s and early 2000s, specifically regarding how to structure and operate WJVs. This authority clearly indicates that control is the key factor to determine whether participation in a joint venture furthers exempt purposes (i.e., is consistent with exemption). Most notably, in Revenue Ruling 98-15, the IRS considered whether an exempt operator of a hospital may retain its status when it forms an LLC with a for-profit entity and contributes its hospital and all of its other operating assets to the LLC, which then operates the hospital. The Ruling considered various factors[5] for determining whether the exempt entity's charitable purposes have been compromised but above all else promulgated that the most important factor is whether the exempt entity has majority control over the charitable activities of the partnership. The Ruling states, "[I]f a private party is allowed to control or use the non-profit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes." Several significant court cases soon followed Revenue Ruling 98-15, each stressing the preeminent importance of the control factor;[6] consequently, practitioners now view majority control of the governing board as the *per se* standard for whether a WJV with a for-profit entity will threaten a hospital's tax-exempt status.[7] One tax law professor commented regarding a recognized 2003 Fifth Circuit decision, "It successfully eliminated [the exempt entity's] strongest and most convincing argument, that actual charitable operations make up for a failure of formal control by the charitable partner. The Fifth Circuit has simply stated that the post-formation activities are irrelevant in the absence of formal organizational control."[8]

However, Revenue Ruling 98-15 and the court cases of the late 1990s and early 2000s were about WJVs, and not AJVs. The IRS did reflect on AJVs in 2003 when it ultimately approved several AJVs in which the exempt entity, the John Gabriel Ryan Association (JGR), had only 50% control but where there were "other mechanisms" to minimize impermissible private benefit. The IRS first denied JGR's application for exempt status, stating that JGR did not have sufficient control and that the AJVs needed to be restructured to fit literally within Revenue Ruling 98-15. However, JGR appealed this decision and after negotiations, the IRS issued favorable determination letters to JGR, concluding that the various agreements provided enough other methods to minimize any potential for impermissible private benefit, despite the lack of JGR's majority control.[9]

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In 2004, the IRS issued its only precedential guidance on AJVs, indicating that majority control of the entire AJV is not essential to protect exempt status and that control in an AJV can be bifurcated, meaning that the exempt entity could control the exempt activities of the AJV while the nonexempt entity controls the nonexempt activities. Revenue Ruling 2004-51 considered an exempt university's partnership with a for-profit company to create video training programs. The ownership and governing board control of the AJV were divided equally between the university and the for-profit company but the AJV's governing documents granted the university the exclusive right to approve all aspects of the educational content of seminars, including curriculum, training materials, instructors, and standards for successful completion. Without reference to any other specific factors otherwise identified in the ruling, the IRS concluded that because the activities of the university conducted through the AJV were "not a substantial part" of its activities, participation in the AJV would not affect the university's continued tax-exempt status. Thus, so long as the university controlled activities related to its exempt purposes, its participation would not jeopardize its exempt status even though it lacked majority control over the AJV's governing board. However, while the university would continue to qualify as exempt, the IRS did state that income produced from the AJV may be subject to UBIT if the AJV conducts a trade or business not

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"substantially related" to the exercise or performance of the university's exempt purposes. Further, the IRS declared that an entity's exempt status will always be implicated if a joint venture results in private inurement or an impermissible level of private benefit, regardless of whether the activities the exempt entity conducts through the joint venture are or are not substantial (i.e., regardless of whether the joint venture is whole or ancillary).

While Revenue Ruling 2004-51 is the IRS's official interpretation of the law, its precedential impact on AJVs is questioned by practitioners and scholars; further, it is unclear how the ruling applies to hospital- or health care-related joint ventures.[10] Nonetheless, it is unlikely that additional clarity and guidance from the IRS is forthcoming in the near future as the IRS has since stated that it will no longer issue PLRs on the tax consequences of joint ventures.[11]

## Additional Guidance Is Needed Regarding AJVs

The state of the IRS's limited guidance on AJVs, coupled with its refusal to address other AJV fact situations in PLRs, leaves practitioners with more questions than answers.

For example, one unresolved issue is how an AJV must be structured in order to avoid UBIT. It is clear from Revenue Ruling 2004-51 that when an exempt entity conducts "not a substantial part" of its activities through a joint venture (i.e., conducts an AJV) then such participation will not, by itself, adversely affect its exemption status (absent private inurement or private benefit issues), but may generate UBIT. However, the IRS has not clarified how it might determine whether the assets and activities of an exempt entity conducted through a joint venture rise to the level of "substantial" (i.e., how it might determine whether the joint venture is no longer an AJV and is now a WJV). While prior case law and practitioners suggest amounts up to at least 15% of revenue or expenses would not be considered substantial, there is no bright-line rule.[12] Further, even if an exempt entity is not troubled by generating some UBIT, too much aggregate UBIT can on its own be a tax-exempt bond issue[13] as well as lead to loss of tax-exempt status.[14]

Moreover, it is unclear if control over an AJV's activities is a relevant inquiry for the purposes of UBIT.[15] Some commentators argue that, even if the majority control requirement does apply to AJVs in the same way that it does for WJVs, it should apply narrowly and only for the purposes of determining whether the AJV triggers UBIT. Under this approach, an exempt entity lacking control of an AJV would not endanger its exempt status but, rather, would merely subject it to UBIT on its income from the AJV.[16]

Another key open issue is what aspects of a health care-related AJV an exempt entity must control in order to avoid loss of exempt status. In Revenue Ruling 2004-51, the IRS indicated that it is not essential to control an AJV's governing board and that control can be bifurcated. Applying the underlying facts, the university had only to control those aspects of the AJV that were essential to the fulfillment of its educational mission (e.g., program content, selection of teaching staff, standards for successful completion of seminars).

What does this mean for health care-related entities? It is clear in other respects that the IRS treats hospitals and health care-related entities differently from other entities (e.g., IRC § 501(r), Form 990 Schedule H, Form 1023 Schedule C, etc.) and there has been heightened scrutiny during the last 20 years over whether nonprofit hospitals should be able to benefit from federal income tax exemption at all. In the context of an AJV, would the IRS require control over supervising the quality of the health care services provided? Determining prices? Providing free or low-cost care? Participating in Medicare/Medicaid? Determining how to fulfill community benefit? Establishing community education programs? Designating board seats for community members? Speculation abounds from the non-precedential and/or non-analogous revenue rulings, private letter rulings, and court opinions.[17] Further, the IRS has not addressed the scenario of a participating entity not having "exclusive control" over activities that relate to its own exempt purposes. For example, what if activities related to exempt purposes were controlled only 50/50, but then the exempt entity had informal controls on these?

Without the ability to obtain PLR confirmation, tax-exempt health care entities are unlikely to accept the risks to tax-exemption and of creation of UBIT involved in pursuing AJVs with taxable entities to any meaningful extent. Moreover, absent a means to request PLRs, the issues that could be the basis for a definitive published ruling may never achieve appropriate attention from the IRS. This leaves looming the unattractive potential for tax court litigation over exempt status and taxability of income in the context of an AJV. Under these circumstances, no one may be willing to expand the envelope of AJV activity and the benefits that could be derived from broadened joint venture activity for tax-exempt entities will never be realized.

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## Endnotes

1 For example:
- In December 2009, Maple Grove Hospital in Minnesota, a joint venture between North Memorial Health Care and Fairview Health Services, opened. www.linetec.com/Press_Release/Linetec_Maple-GroveHospital.pdf.
- In 2012, the Santa Monica-UCLA Medical Center and Orthopedic Hospital, a joint venture between Los Angeles Orthopedic Hospital and The University of California-Los Angeles, was completed. http://ortho-htc.org/hospital.
- As of 2013, Emory Healthcare was involved in separate joint ventures with Saint Joseph's Health System, Adventist Health System, and Children's Healthcare of Atlanta. https://www.emoryhealthcare.org/community/pdfs/sjh-chna071913.pdf.
- In January 2014, Catholic Health Initiatives St. Luke's announced it would enter into a joint venture with Baylor College of Medicine to build a new hospital on Baylor's McNair Campus. https://www.bcm.edu/news/expansion/new-partnership-chi-stl-baylor-texas-heart.
- Dignity Health entered into a joint venture with the Stanford's Lucile Salter Packard Children's Hospital to operate a pediatric subspecialty clinic at Dominican Hospital in Santa Cruz, CA. http://www.dominicanhospital.org/Who_We_Are/Serving_the_Community/181894.

2 In GCM 36293 (May 30, 1975), the IRS stated that an exempt entity serving as a "direct participant in an arrangement for sharing the net profits of an income-producing venture with private individuals or institutions of a noncharitable nature . . .would be inherently incompatible with being operated exclusively for charitable purposes within the meaning of IRC 501(c)(3)."

3 *Plumstead Theatre Society, Inc. v. Comm'r,* 74 T.C. 1324 (1980), *aff'd per curiam,* 675 F.2d 244 (9th Cir. 1982).

4 *See, e.g.*, GCM 39,005 (June 28, 1983) ("[A]n exempt organization's participation in a partnership arrangement as a general partner should not per se result in denial of section 501(c)(3) status. The partnership arrangement, however, should be closely scrutinized to assure that the statutorily-imposed obligations on the general partner do not conflict with the exempt organization's ability to pursue its charitable goals. Thus, in all partnership cases, initial focus should be on whether the organization is serving a charitable purpose."); Rev. Rul. 98-15; Mary Jo Salinas and Marvin Friedlander, "IRS 2000 EO CPE Text," at 34; PLR 9407022; PLR 9709014.

5 Such factors include, for example: preparation and contents of governing documents; the structure of contributions and distributions; the structure of management agreement and fees; and avoiding conflicts of interest. *See also* PLR 200448048.

6 *Redlands Surgical Servs. v. Comm'rs*, 113 T.C. 47, 78 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001) ("Based on the totality of factors . . . we conclude that [the exempt entity] has in fact ceded effective control of [the partnership] and the surgery center's activities to the for-profit parties, conferring on them significant private benefits, and therefore is not operated exclusively for charitable purposes within the meaning of §501(c)(3)."); *St. David's v. United States,* 349 F.3d 232, 237-238 (5th Cir. 2003) (internal citations omitted and emphasis in the original) ("In order to ascertain whether an organization furthers non-charitable interests, we can examine the structure and management of the organization . . . In other words, we look to which individuals or entities control the organization . . . If private individuals or for-profit entities have either formal or effective control, we presume that the organization furthers the profit-seeking motivations of those private individuals or entities . . . When the non-profit organization cedes control over the partnership to the for-profit entity, we assume that the partnership's activities substantially further the for-profit's interests. As a result, we conclude that the non-profit's activities via the partnership are not exclusively or primarily in furtherance of its charitable purposes . . ."). *See also* PLR 200118054, where the IRS noted that the exempt entity's voting control of the LLC and the LLC's board

of directors, like the favorable situation in Rev. Rul. 98-15, assured that the assets owned by the nonprofit through the LLC and the activities the nonprofit conducts through the LLC primarily will further the nonprofit's exempt purposes.

7 Nicholas A. Mirkay, *Relinquish control! Why the IRS Should Change its Stance on Exempt Organizations in Ancillary Joint Ventures,* 6. Nev. L.J. 21, 48 (2005): "The IRS praised the Fifth Circuit's decision in *St. David's,* while practitioners viewed the decision as creating a per se standard—if control, namely majority voting control, is ceded by an exempt organization in a joint venture with a for-profit entity, more than incidental private benefit is deemed to exist."

8 Fred Stokeld, *Fifth Circuit Cites Control Issues in Granting IRS Win in St. David's Joint Venture Case*, 42 Exempt Org. Tax. Rev. 337, 338 (2003). *See also* PLR 200448048; PLR 200436022.

9 In the final resolution of the case, the IRS issued favorable determination letters to JGR on June 25, 2003 that (1) recognized JGR as a Section 501(c)(3) organization, retroactive to December 1998, and (2) recognized JGR as a 501(c)(4) organization from January 1995 to December 1998. The parties then moved to dismiss the Tax Court petition. *John Gabriel Ryan Assoc'n v. Comm'r,* T.C., No. 16811-02x (settled in 2003).

10 In response to these practitioners and scholars, an IRS representative unofficially issued a reminder that Rev. Rul. 98-15 is "still on the books" and that "Revenue Ruling 2004-51 does nothing to modify Revenue Ruling 98-15." *See* Fred Stokeld, et al., *ABA Tax Section: EO Reps Start Meeting Discussing Rev. Rul. on Ancillary Joint Ventures,* 44 Exempt Org. Tax Rev. 273 (2004) (citing comments of Catherine E. Livingston, then IRS Assistant Chief Counsel, at the ABA Tax Section Meeting in Washington, D.C., on May 7, 2004).

11 The IRS announced the "no ruling" policy on exempt organization joint ventures (except when the issue is presented in an initial exemption application) in Revenue Procedure 2006-4, 2006-1 C.B. 132, and has continued that policy to the present day. *See* Revenue Procedure 2014-4, 2014-1 I.R.B. 125, at § 6.12.

12 In PLR 200610022, the IRS indicated that where activities conducted through a joint venture were not insubstantial, Rev. Rul. 98-15 applies (i.e., majority control). In this PLR, the activity (the publication of a scholarly journal) was categorized as the exempt entity's "primary activity." In his book Joint Ventures Involving Tax Exempt Organizations (4th Ed. 2013) at 373, author Michael Sanders suggests a numerical test to distinguish AJVs could be based on the total assets of the charity (avoiding any need to examine a percentage of revenue), including both exempt functions and other activities. He states, "The result would provide a satisfactory bright-line standard without the need to have specific appraisals made for the safe harbor. A standard of 10 to 15 percent is reasonable with a provision that would not allow the charity to fragment investments to fit within the safe harbor (i.e., an aggregation rule)." This proposal has not been accepted to date.

13 Too much involvement in unrelated activities could result in change-in-use within the meaning of IRC § 141, which could result in the adverse effect of causing the bonds to no longer be tax-exempt because the joint venture entity would be considered the owner of the assets, not the hospital.

14 *See* PLR 200325003 confirming aggregate treatment for UBIT purposes.

15 Sanders, *supra* note 12, at 373 suggests that the IRS "should make it clear that [AJVs] will not impact on the taxexempt status simply because of certain defects in management control. Indeed, the focus of the IRS would be on the unrelated business income tax issue as well as perhaps, private inurement or the excess benefit tax." As such, Sanders suggests that Rev. Rule 98-15 should not be directly applicable to AJVs.

16 *See supra* note 15. It is also undetermined whether if the for-profit entity controls the activities, this converts clearly "related" activities into unrelated activities.

17 *See* PLR 200206058 where positive factors included: allowing for an open medical staff; having a charity care policy as adopted and enforced by the exempt entity; the exempt entity having the sole authority to cause the joint venture to provide care for all patients regardless of ability to pay, including Medicare, Medicaid, and patients not covered by Medicare or Medicaid; services provided to patients not covered by third party insurance will not differ from those covered by insurance; and the exempt entity having authority to cause the joint venture to conduct community needs assessments and meet such community needs.