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## FOCUS ON HEALTH CARE



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# Joint Ventures Between Tax-Exempt Health Care Organizations and For-Profit Parties: Avoiding Federal Tax Law Traps

LaVerne Woods, Esq., and Thomas C. Schroeder, Esq.

*Joint ventures between tax-exempt health care organizations and for-profit parties provide a popular approach to achieve enhanced medical operations, and increased access to—and implementation of—new medical technologies. This discussion analyzes the maze of federal tax issues that must be navigated in order to achieve the potential synergies that joint ventures offer.*

## INTRODUCTION

The last 25 years have seen an explosion in joint ventures between tax-exempt health care organizations and for-profit parties. Indeed, the recent economic downturn has caused many tax-exempt health care organizations and for-profit parties, including physician practice groups, to examine ways to consolidate their operations. One of the most common approaches is through a joint venture.

The term “joint venture” has no precise legal definition. In this discussion we use the term to refer to arrangements in which a tax-exempt health care organization, such as a hospital, clinic, or managed care organization, and one or more taxable, for-profit parties have agreed to provide capital or services in a common undertaking, and to share in some manner the income or losses from the undertaking.

Joint ventures involving tax-exempt health care organizations fall into one of two categories: (1) “ancillary” joint ventures that involve an insubstantial portion of the exempt entity’s assets and activities, such as ventures to create ambulatory surgery centers or to acquire and operate medical technologies, and (2) “whole-entity” or “whole-hospital” joint ventures, in which a tax-exempt entity contributes all or a substantial portion of its assets and operations to a joint venture entity in partnership with a for-profit entity that contributes

cash and/or assets. Ancillary joint ventures are by far the more common type of joint venture.

The purpose of this discussion is (1) to identify the major federal tax issues that are unique to joint ventures between tax-exempt health care organizations and for-profit parties and (2) to suggest ways that they can be structured to address those issues. Such joint ventures almost invariably also raise significant legal issues in other areas, including (1) federal and state anti-kickback laws, (2) the federal physician self-referral statute (commonly known as the “Stark Law”), and (3) antitrust laws, all of which are beyond the scope of this discussion. It is important that any joint venture structure take these issues into account as well.

## SUMMARY OF MAJOR TAX LAW ISSUES

### Overview

A nonprofit health care organization that is qualified for federal tax exemption under Section 501(c)(3)<sup>1</sup> may permissibly engage in a joint venture with for-profit parties, including physicians on its medical staff, without putting its tax exemption at risk, so long as the joint venture structure meets certain parameters.

The biggest concern for the exempt organization is of course preserving its tax-exempt status. The stakes are much higher in the context of whole-hospital joint ventures, in which the exempt organization must ensure that it has sufficient control over the joint venture so that the hospital will continue to be operated in a manner that satisfies the tax law standards of “community benefit” for exempt hospitals.<sup>2</sup> In the context of ancillary joint ventures, there is generally not a risk of loss of exemption so long as all transactions are at arm’s length and for fair market value.

It is essential that all assets to be contributed to a joint venture be valued appropriately to ensure that each party to the joint venture receives an interest in the venture that is proportionate to its contributions. Any joint venture in which not all transactions are at arm’s length and for fair market value (1) may result in either “private inurement” or an impermissible level of “private benefit” and (2) could jeopardize the exempt organization’s tax status. The exempt organization’s participation in the joint venture may also constitute an unrelated trade or business. From the perspective of the for-profit participant, there is also the possibility of “intermediate sanctions” excise taxes.

### Private Inurement

Private inurement occurs when an “insider”<sup>3</sup> with respect to an exempt organization receives a benefit in excess of the fair market value of goods and services provided by the insider.<sup>4</sup> The level of risk to an exempt organization in a joint venture depends to a significant degree on whether any of the other parties involved is considered an insider with respect to the exempt organization. The term “insider” is not precisely defined, but it clearly includes members of the organization’s board, its officers, and their



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family members, entities owned by them, and likely others who may have a substantial level of influence over the organization (e.g., a key department head, or a medical group responsible for substantial hospital admissions). As a general matter, an exempt organization should ensure that any transactions with for-profit parties are at arm’s length and at fair market value. This becomes especially critical when the other party is an insider. The tax law’s remedy for private inurement is revocation of the organization’s tax-exempt status.<sup>5</sup>

### Intermediate Sanctions

Any transaction that results in private inurement may also result in so-called “intermediate sanctions” on the party that received the undue benefit.<sup>6</sup> The intermediate sanctions rules do not impose any liability on the tax-exempt organization itself. Rather, the rules were designed as an intermediate means of addressing private inurement transactions by penalizing the persons who benefit from such transactions, rather than (or in addition to) revoking the organization’s exemption.

Specifically, the intermediate sanctions rules authorize the Internal Revenue Service (IRS or the “Service”) to impose an excise tax on any individual or entity who is a “disqualified person”<sup>7</sup> with respect to the exempt organization and who receives a benefit from the organization that exceeds the value of goods or services that the disqualified person provides. The tax is initially 25 percent of the excess amount.<sup>8</sup>

The Service may impose an additional tax equal to 200 percent of the excess amount if the disqualified person fails to correct the transaction by repaying the excess to the exempt organization.<sup>9</sup> An exempt organization officer or director who knowingly approves an excess benefit transaction may also be personally liable for a tax of 10 percent of the excess amount.<sup>10</sup>

The private inurement rules and the intermediate sanctions rules use different terms to describe the for-profit party’s relationship with the organization (i.e., insider and disqualified person). Both sets of rules come into play, however, when there is a transaction between the organization and a party that has substantial influence over the organization.

The Treasury Regulations provide a procedure for creating a “rebuttable presumption” that a transaction is reasonable (i.e., not an excess benefit transaction) and, therefore, does not result in imposition of excise tax under the intermediate sanctions rules.<sup>11</sup> Specifically: (1) the arrangement must be approved by the independent members of the exempt organization’s board or an authorized committee; (2) the board or committee must rely on



“appropriate data” as to the fair market value of the transactions; and (3) the board’s or the committee’s action must be documented concurrently in writing on a timely basis (e.g., in meeting minutes).<sup>12</sup>

While the rebuttable presumption procedures are technically a means to protect disqualified persons from liability for intermediate sanctions, as a practical matter an exempt organization that follows the procedures will also help to protect itself from a private inurement situation.

## Private Benefit

A Section 501(c)(3) organization is prohibited from conferring benefits that are more than incidental on private parties (whether or not insiders), except where the benefits are provided to a charitable class of beneficiaries, such as the poor, the sick, or the elderly. For benefits to be incidental, and therefore permissible, they must be both quantitatively and qualitatively incidental.

To be qualitatively incidental, a private benefit must occur as a necessary element of the activity that benefits the public at large.<sup>13</sup> For example, a surgeon derives a private benefit from the use of a hospital’s operating room. However, this is a necessary element of the benefit to the general public from the availability of the combined resources of the hospital and its surgical staff.

To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit that the activity provides.<sup>14</sup> An exempt organization that confers a private benefit that is more than incidental (e.g., by paying more than fair market value under a joint venture management agreement) risks jeopardizing its tax status.

## Unrelated Business Taxable Income

An exempt organization that regularly carries on a trade or business that is not “substantially related” to the organization’s charitable purposes engages in an unrelated trade or business.<sup>15</sup> Gross income from any such activity is unrelated business taxable income (UBTI). UBTI is taxable to the exempt organization on a net basis at regular graduated corporate tax rates (or trust rates, if the organization is formed as a trust).<sup>16</sup>

Most joint ventures, as discussed below, are structured as “flow-through” entities, which means that the exempt organization is treated as engaging directly in its proportionate share of the venture’s activities.<sup>17</sup> As a result, every activity of the joint venture has the potential to be an unrelated trade or business of the exempt organization, and to produce UBTI. Any tax on UBTI will of course affect the organization’s after-tax rate of return with respect to the venture.

## IRS REPORTING AND GUIDANCE

### Reporting Joint Ventures on Form 990

The IRS Form 990, the annual information return filed by most tax-exempt organizations, underwent a major overhaul for the 2008 tax year. Among the new additions is a series of questions regarding the filing organization’s governance and management practices. One such question asks whether the filing organization has invested in, contributed assets to, or participated in a joint venture or similar arrangement with a taxable entity during the applicable tax year.<sup>18</sup> An organization that answers “yes” to this question must indicate whether it has adopted a written policy or procedure requiring it (1) to evaluate its participation in such joint ventures and (2) to safeguard its exempt status with respect to joint ventures.<sup>19</sup> Any exempt organization that regularly engages in joint ventures with for-profit parties should have such a policy in place.

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**“ . . . the Service has issued formal guidance addressing key questions in both the whole-entity and ancillary joint venture contexts.”**

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### IRS “No Ruling” Position on Tax Consequences of Joint Ventures

Because of the potential for joint ventures to raise significant tax issues for exempt organizations, many exempt organizations in the past sought “private” rulings from the Service regarding the tax consequences of such ventures. Typically, such organizations sought rulings (1) that a proposed joint venture with a for-profit entity would not adversely affect the organization’s exempt status and (2) that the income realized from the joint venture would not be UBTI.

The Service issued a number of such rulings in the mid-1990s.<sup>20</sup> Since that time, the Service has issued formal guidance addressing key questions in both the whole-entity<sup>21</sup> and ancillary joint venture contexts.<sup>22</sup> Because formal guidance is now available, and because Service resources are limited, the Service currently will not issue rulings on the tax consequences of joint venture arrangements.<sup>23</sup> Organizations must accordingly look to the formal IRS guidance and available case law to determine the tax consequences of a proposed transaction. With respect to those private rulings that the Service issued to organizations in the past, (1) they are available to the public on a redacted basis, and

(2) they may be helpful in assessing the likely Service analysis of a particular issue. A private ruling cannot be relied upon as legal precedent, however, by any party other than the organization to which it was issued.<sup>24</sup>

## JOINT VENTURE STRUCTURE OPTIONS

### Flow-Through Vehicles: Partnerships and LLCs

Most joint ventures are structured as “flow-through” entities that are not subject to federal income tax at the entity level. These entities include general partnerships, limited partnerships (in which the exempt organization may serve as either a general or a limited partner), or, most commonly, limited liability companies (LLCs). An LLC is generally treated as a partnership for federal tax purposes.<sup>25</sup> The LLC structure combines the desirable corporate attribute of limited liability for all participants with the flow-through tax treatment of a partnership. Flow-through tax treatment is generally attractive for both tax-exempt and taxable participants. In a flow-through structure, the for-profit’s share of joint venture net income is subject to only one level of tax, in the hands of the for-profit participant. The exempt participant is not taxable on its share of joint venture income, so long as the joint venture’s activities further its exempt purposes.

An exempt organization that participates in a joint venture structured as a flow-through entity will be treated as conducting directly its proportionate share of the joint venture’s activities.<sup>26</sup> This is an important point, because it may affect both the exempt participant’s qualification for tax exemption and its tax liability on UBTI. If the flow-through entity regularly conducts a trade or business that is unrelated to the exempt organization’s purposes, any net income to the exempt entity from the activity will be taxed as UBTI. To the extent that a flow-through joint venture entity regularly conducts an unrelated trade or business that is substantial in proportion to the exempt organization’s overall exempt activities, there is a potential risk to the exempt organization’s tax status.

### Use of Affiliate as Joint Venture Party

An exempt organization may participate directly in a joint venture entity—that is, as a partner or member. Alternatively, the organization may choose to have a controlled affiliate act as the joint venture party. The controlled affiliate could be either a taxable subsidiary or a nonprofit corporation that either has or is applying for federal tax exemption as

a charitable organization under Section 501(c)(3). If a nonprofit affiliate serves in this role, and the joint venture is its only activity, the joint venture is effectively a whole-entity joint venture, rather than an ancillary joint venture, even though it may represent only an insubstantial portion of the parent exempt organization’s activities. Under this structure, the joint venture’s activities must further exempt purposes or the affiliate will not qualify for tax exemption.<sup>27</sup>

If it is clear that the joint venture activities will be unrelated to the exempt organization’s purposes, then the exempt organization may wish to have a wholly owned taxable subsidiary (formed as a C corporation for federal tax purposes) act as the joint venture party. Under this structure, it is the taxable subsidiary, rather than the exempt parent, that is treated as engaging directly in its share of the joint venture’s activities. The subsidiary will be subject to tax on a net basis at graduated corporate tax rates on its share of joint venture income. Conceptually, this structure is not a joint venture between an exempt organization and a for-profit party.

From a federal tax perspective, there is no advantage to an exempt organization forming a wholly owned subsidiary as a single-member LLC, rather than a C corporation, to participate as a joint venture party in a flow-through entity. The single-member LLC is a “disregarded entity” for federal tax purposes; that is, it is treated as if it did not exist, and its exempt member is treated as the participant in the joint venture.<sup>28</sup> The LLC consequently will not provide the exempt organization with any protection from the tax risks that arise from direct participation in a joint venture.

## ALL JOINT VENTURES: AVOIDING PRIVATE INUREMENT AND PRIVATE BENEFIT

### Overview

All joint ventures, whether ancillary or whole-entity, must be organized in a manner that ensures that the exempt organization will not effectively subsidize the for-profit participant in the venture, in order to avoid private inurement and/or an impermissible level of private benefit. Specifically, (1) each joint venture party must receive an interest in the joint venture that is proportionate to the value of the party’s contributions, (2) payments to participants or their affiliates for goods or services to the joint venture must be at arm’s length at fair market value, and (3) the terms of the joint venture agreement must not put the exempt organization’s assets at risk to the benefit of any for-profit participant.

## Valuation of Assets

It is essential that any noncash assets that either the exempt organization or a for-profit participant contributes to a joint venture be properly valued. This will ensure that the parties' interests in the joint venture fairly reflect the value of their contributions.<sup>29</sup> This will generally require an independent valuation by a qualified appraiser.

As part of the valuation analysis, the exempt organization must be credited with the value of any existing business that is effectively contributed to the joint venture. For example, consider an exempt hospital that transfers its existing licensed rehabilitation beds to a joint venture and agrees to discontinue the provision of rehabilitation services once the joint venture facility is operational. That hospital should be credited not only with the value of the physical assets contributed to the joint venture, but also with the revenue stream from the rehabilitation services that are diverted from the hospital and will be conducted by the joint venture facility. The same analysis applies when the exempt organization discontinues a service in favor of the joint venture without any actual transfer of physical assets.

This issue may be subtle and is sometimes overlooked. Failure to credit the exempt organization with the value of such existing assets effectively permits the transfer of ownership of the exempt organization's existing assets or business to a for-profit venture for no consideration.

Similarly, the exempt organization should be compensated for or credited with the value of any covenants not to compete with the joint venture.

## Joint Venture Distributions and Transactions

The governing documents of the joint venture entity should require that all returns of capital, allocations and distributions to the participants will be proportionate to their ownership interests.

Similarly, the governing documents should provide that all terms of the joint venture entity's contracts and transactions, either with the parties to the joint venture or with third parties, must be at arm's length and priced at fair market value for comparable goods and services. For significant transactions, it may be appropriate to obtain a fairness opinion from an independent consultant.

## Exposure of Charitable Assets to Liability

An exempt organization's assets may be subject to risk in a joint venture directly, through exposure to liability for the joint venture entity's debts, or



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indirectly, by virtue of guarantee, indemnity, or penalty provisions contained within the joint venture arrangement.

Guarantees that have the effect of insulating a for-profit party's assets while increasing the potential risk to a tax-exempt party raise serious issues. For example, an exempt participant should not enter into a guarantee arrangement that would require it to pay any amount in order to provide a for-profit participant with an identified return on its investment.

Joint venture agreements often require members to contribute additional capital to the venture at specific times or upon the occurrence of specific events. Capital calls should be structured to obligate the tax-exempt and for-profit parties to the same extent, taking into account their respective ownership interests. A capital call provision that requires additional contributions solely from the exempt organization, or that requires the exempt organization to make disproportionate contributions without a corresponding increase in its profit interest, could result in private inurement or in an impermissible level of private benefit.

## ANCILLARY JOINT VENTURES

### Overview

An exempt health care organization may form and participate in a joint venture with for-profit parties that comprises only an insubstantial part of its overall assets and activities—that is, an “ancillary joint venture”—without jeopardizing its tax-exempt status, so long as all elements of the arrangement are at arm's length and for fair market value. Whether any income from the ancillary joint venture will be taxable as UBTI will likely depend, in part, upon the extent to which the exempt organization controls the activities and operations of the joint venture.



The Service set out its analysis of ancillary joint ventures in a revenue ruling issued in 2004.<sup>30</sup> The ruling considered a situation involving a tax-exempt university that entered into a joint venture structured as an LLC with an unrelated for-profit company to offer teacher training seminars at off-campus locations using interactive video technology. Each member owned 50 percent of the LLC, proportionate to the value of each of their capital contributions.

Under the LLC's governing documents, all returns of capital, allocations, and distributions were proportionate to the ownership interests. The LLC was managed by a six-person board, with three persons chosen by the university and three persons chosen by the for-profit. Under the governing documents the university had the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars.

The for-profit party was responsible for arranging and conducting all of the seminars, including advertising, enrolling participants, arranging for facilities, distributing course materials and broadcasting the seminar to various locations. It also had the exclusive right (1) to select the locations where participants could receive a video link and (2) to approve other personnel, such as camera operators.

The Service concluded that the university's contribution to and operation of an insubstantial part of its activities through the LLC did not jeopardize the university's tax-exempt status. It also ruled (1) that the activities conducted by the university through the LLC were not an unrelated trade or business and (2) that any net income the university received from the joint venture would not constitute UBTI.

## Tax-Exempt Status

In analyzing the impact of the joint venture on the tax status of the exempt participant, the Service relied on the fact that the university's activities conducted through the joint venture were insubstantial. It is clear that a charitable organization may permissibly engage in an insubstantial amount of activities that do not further its exempt purposes.<sup>31</sup> As a result, it was not necessary for the Service to consider whether the joint venture activities furthered the university's exempt purposes. The activities were insubstantial in proportion to the university's overall exempt activities, and therefore it did not matter whether or not they furthered exempt purposes. If an activity is insubstantial, then it will not, taken alone, affect the organization's tax-exempt status.

It should be noted, however, that the facts set out in the ruling are carefully drawn to avoid raising issues of private inurement and private benefit,

discussed above, that could adversely affect the tax-exempt status of the exempt organization. It remains important in any joint venture, even when the level of activities is insubstantial, to ensure that transactions with for-profit parties are at arm's length and represent fair market value.

## Unrelated Trade or Business

The Service also considered whether the university's activities conducted through the joint venture were an unrelated trade or business. The ruling concluded that they were not, because the exempt organization controlled those aspects of the joint venture's activities, specifically the programmatic content, selection of teaching staff and standards for successful completion of the seminars, that were central to fulfilling the university's educational mission. The ruling reached this conclusion in spite of the fact that, under the 50/50 structure, the exempt organization did not have formal majority control over the joint venture, and the for-profit had certain exclusive rights with respect to the day-to-day management of certain of the joint venture's activities.

In the health care context, the exempt participant will want to control those aspects of the joint venture that are relevant to the organization's satisfaction of the "community benefit" standard,<sup>32</sup> such as the level of charity care that may be provided and participation in Medicare and Medicaid.

## WHOLE-ENTITY JOINT VENTURES

### IRS Analysis

The Service set out its analysis of whole-entity joint ventures in a revenue ruling issued in 1998.<sup>33</sup> That ruling presents two examples of exempt hospitals that engage in whole-entity joint ventures with for-profit partners.

The first example illustrates "good" facts, in which the hospital controls the joint venture and is able to ensure that the venture furthers its exempt purposes. The facts include (1) majority hospital representation on the joint venture board, (2) governing documents that required the board to satisfy the community benefit standard without regard to maximizing profitability, and (3) joint venture management by an independent party. (As a practical matter, it is unlikely that such facts exist outside of the text of the ruling.)

The second example illustrates "bad" facts, under which the hospital is not able to further its exempt purposes through its participation in the joint venture. The facts include (1) 50/50 representation on the joint venture board, (2) no charitable override in the governing documents, and (3) joint venture management by an affiliate of the for-profit

participant. The challenge in structuring whole-entity joint ventures lies in applying a more nuanced analysis to strike a balance somewhere between the extreme facts of the two examples. Set out below are key elements that play a role in this balancing act.

## Governance and Control

The following spectrum of control rights (individually or in combination) should be considered for a “whole-entity” joint venture.

### Formal Majority Control

Majority control of joint venture governance by the exempt organization may not be absolutely required. It is clearly a highly favorable factor in establishing that profit motives do not subvert the exempt organization’s charitable mission, however.<sup>34</sup>

A favorable joint venture governance structure would allow the exempt organization to appoint a majority of the joint venture’s board members, and (ideally) require a majority of the exempt organization’s board members for a quorum, or supermajority voting for certain actions.

### 50/50 Representation with Certain Reserved Powers and Unilateral Rights

An exempt organization that lacks formal voting control of the joint venture to ensure control of major decisions should have another mechanism to ensure that the joint venture will operate to further the exempt organization’s charitable purposes.<sup>35</sup> Informal control may exist if the exempt organization retains certain powers over major actions and has unilateral initiation rights with respect to certain actions of the joint venture. In addition, any special rights accorded the exempt participant should be readily exercisable by the organization as a practical matter in order to count favorably in the control analysis.

Informal control by an exempt organization over a joint venture can be demonstrated by reserving certain powers for the review and approval of the exempt organization’s board of directors.<sup>36</sup> Such reserved powers could include approval of the following:

- capital and operating budgets, and variations over a specified dollar amount threshold
- sale of assets with a value in excess of a specified dollar amount threshold
- the incurrence, assumption, or guarantee of debt in excess of a specified dollar amount threshold
- dissolution, merger, consolidation, or sale of all or substantially all of the assets of the joint venture

- amendment of the joint venture agreement (including any related governance documents)
- affiliations or joint ventures with other parties
- contracts with any of the for-profit parties (including physicians)
- discontinuance of any line of service or closure or reduction in scope of operation of any location or service
- discontinuance of Medicare or Medicaid participation by the joint venture
- appointment and removal of management of the joint venture (at least at the senior management level and all management contracts to manage the business of the joint venture)

An exempt organization can also cause certain actions to be carried out by the joint venture through its unilateral direction. Such unilateral rights could include the following:

- the scope of services offered and locations at which they are offered by the joint venture
- the level of charity care provided by the joint venture
- the ability to enter into new managed care contracts for the joint venture
- the unilateral ability to implement community benefit activities (e.g., new services, publication of charity care policy, increase in charity care, and removal of barriers to Medicare/Medicaid access)
- the meaningful ability to terminate joint venture management agreements for cause or after a reasonable initial term without cause
- open staff policies that allow the joint venture facilities to be utilized by noninvestors
- the ability to dissolve the joint venture if continued participation jeopardizes the organization’s exempt status
- monitoring and audit rights to review the joint venture’s activities

### Charitable Purposes

The joint venture documents (including any management agreement) should include a clear statement of purpose or philosophy that indicates that the joint venture will be operated in a manner that is consistent with the exempt organization’s charitable purposes.

The joint venture documents should also include express language to reflect the for-profit partners’



recognition and understanding of the fact that the operations of the joint venture will not be conducted in a manner solely designed to maximize profits.<sup>37</sup> This is referred to as a “fiduciary duty override.” This is because it supersedes the general duty that partners in a partnership or members of an LLC have to maximize profits of the joint venture.

The joint venture documents should give the exempt organization the right to bring suit to enforce the provisions regarding charitable activities under the laws of the state where the joint venture is formed.

Actual operations are as important as the joint venture’s formal documentation. It is important that the exempt participant be able to excise control over key aspects of the joint venture in actual practice. Simply stating in the joint venture documents that exempt purposes should prevail will not be sufficient to demonstrate that the joint venture arrangement furthers exempt purposes.<sup>38</sup>

## Additional Rights and Obligations

### Dispute Resolution

A dispute resolution provision in the joint venture governing documents should permit the exempt organization to attempt to remedy grievances short of litigation. Ideally, it should include language that gives priority to the fulfillment of charitable purposes in resolving the dispute. This provision should be coupled with a buy-sell or withdrawal right in the event that the exempt organization determines that the venture poses a threat to its tax exemption.

### Quality Assurance

The exempt organization should be able to demonstrate that it has the ability to ensure that the joint venture entity’s services are appropriate and sufficient to meet the needs of the patients served. This could be accomplished through an agreement between the joint venture and the exempt organization under which the exempt organization would provide quality assurance services.

### Covenants Not to Compete

Any covenants not to compete should be tailored to achieve the minimum protection necessary to make the joint venture viable. Covenants that restrict the ability of the exempt organization to expand its existing health care services or to acquire additional facilities without the approval of its for-profit party raise concerns.

## Management by the For-Profit

A key area of concern is whether the for-profit participant or an affiliate of the for-profit serves as

manager of the joint venture. Since the manager generally has day-to-day control over the joint venture’s activities, it is important to consider whether the manager can effectively prevent the joint venture from furthering charitable objectives. A fact pattern in which the for-profit participant or an affiliate manages the venture will tend to make it harder to demonstrate that the joint venture will further the exempt participant’s charitable purposes.<sup>39</sup>

Long-term management contracts with renewals solely at the discretion of the for-profit participant raise serious concerns. Any management agreement (1) should be limited to a five- to seven-year initial term, (2) should be terminable for cause (including for failure to further charitable objectives), and (3) should be renewable only through mutual agreement or at the sole option of the exempt organization. The exempt participant should have the right to select or to veto the choice of personnel who will manage the joint venture.

All management agreements should be carefully documented to establish that they are priced at fair market value and that the terms of the relationship are comparable to terms customarily found in the marketplace for similar services. Payment by flat fee is likely preferred. Payment by percentage of revenues may be acceptable, however, if it includes a cap or a collar (i.e., decreasing percentage at higher revenue levels) and includes charity care revenues for purposes of determining percentage of revenue fees.

The management agreement should include objective performance benchmarks for the manager tied to the tax law’s community benefit standard, in order to permit termination of the management agreement for cause for failure to pursue charitable objectives.

## CONCLUSION

Joint ventures between tax-exempt health care organizations and for-profit parties offer opportunities for collaboration and consolidation, the potential for improved operations, and increased access to and implementation of new medical technologies. Such joint ventures present a maze of federal tax exemption and other legal and regulatory issues, however, that must be carefully navigated in order to achieve the desired synergies.

### Notes:

1. All Section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations thereunder. All references to Section 501(c)(3) organizations refer to organizations classified as public charities under Section 509(a), including hospitals, medical research organizations and publicly supported organizations. Different rules apply to Section 501(c)(3) organizations that are classified as private foundations within the meaning of Section 509(a).

2. The Service adopted what has come to be known as the “community benefit” standard in Revenue Ruling 69-545, 1969-2 C.B. 117. Indicators of community benefit, as listed in the ruling, include: having a governing board that consists of individuals who represent a broad cross-section of the community; reinvesting net profits in the organization’s facilities, training, and patient care; accepting and treating Medicare and Medicaid patients; operating a full-time emergency room that is open to all, regardless of their ability to pay; and an open medical staff policy. The Service stated in the ruling that it would consider these factors under a facts and circumstances test, and that failure to meet one factor would not preclude exemption.
3. See Treas. Reg. § 1.501(a)-1(c) (defining the terms “private shareholder or individual” in Section 501(c)(3) as persons having a personal and private interest in the activities of the organization).
4. See Treas. Reg. § 1.501(c)(3)-1(c)(2).
5. See Section 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(f)(2)(ii).
6. See Section 4958.
7. See Section 4958(f)(1).
8. Section 4958(a)(1).
9. Section 4958(b).
10. Section 4958(a)(2).
11. See Treas. Reg. § 53.4958-6.
12. See Treas. Reg. § 53.4958-6(a)(1)-(3).
13. See Technical Advice Memorandum 9451001 (Dec. 23, 1994).
14. *Ibid.*
15. Section 513(a).
16. See Section 511(a).
17. See Section 512(c).
18. See 2008 IRS Form 990, Part VI, Section B, Line 16a.
19. See 2008 IRS Form 990, Part VI, Section B, Line 16b.
20. See, e.g., the rulings cited at note 35, *infra*.
21. See Revenue Ruling 98-15, 1998-1 C.B. 718.
22. See Revenue Ruling 2004-51, 2004-22 I.R.B. 974.
23. See Revenue Procedure 2010-4, 2010-1 I.R.B. 122 at §6.12 (noting that, with the exception of when the issue is present in an initial application for recognition of exemption, the IRS Exempt Organizations Technical Office does not issue letter rulings as to whether a joint venture with a for-profit organization affects an organization’s exempt status or results in unrelated business income).
24. See Section 6110(k)(3).
25. Under the “check-the-box” tax rules regarding entity classification, an LLC is treated as a partnership for federal tax purposes unless it makes an affirmative election to be treated as a corporation for federal tax purposes. See Treas. Reg. § 301.7701-3(b)(1).
26. See, e.g., Revenue Ruling 2004-51, 2004-22 I.R.B. 974.
27. See *Redlands Surgical Services v. Commissioner*, 113 T.C. 47, 72 (1999), *aff’d per curiam* 242 F.3d 904 (9th Cir. 2001).
28. See Treas. Reg. § 301.7701-3(b)(1)(ii).
29. See Lawrence M. Brauer, Mary Jo Salins, and Robert Fontenrose, *Topic D, Update on Health Care*, Exempt Organizations Continuing Professional Technical Instruction Program for Fiscal Year 2002 (the “CPE Text”) at 161. The IRS CPE Text (formerly published on an annual basis) is a training text authored by senior Service personnel that the agency used to train Service revenue agents and other Service staff. The CPE Text cannot be cited as legal precedent and is not binding on the Service. The CPE Text does, however, provide some guidance on the reasoning and analysis that the Service would likely apply to a particular tax issue.
30. See Revenue Ruling 2004-51, *supra*.
31. See Treas. Reg. § 1.501(c)(3)-1(c)(1); Section 513.
32. *Supra* note 2.
33. See Revenue Ruling 98-15, *supra* (articulating a two-pronged framework for analyzing joint ventures set out first in General Counsel Memorandum 39005 (Dec. 17, 1982)).
34. See CPE Text at 161.
35. See *Id.*; see also Private Letter Ruling 9308034 (Nov. 30, 1992) (50/50 acute care hospital partnership); Private Letter Ruling 9318033 (Feb. 8, 1993) (50/50 orthopedic center); Private Letter Ruling 9319044 (Feb. 18, 1993) (50/50 facility partnership); Private Letter Ruling 9323030 (Mar. 16, 1993) (50/50 rehabilitation hospital partnership); Private Letter Ruling 9349032 (Sept. 17, 1993) (co-equal general partners to renovate facility); Private Letter Ruling 9352030 (Oct. 8, 1993) (50/50 rehabilitation partnership); Private Letter Ruling 9518014 (Feb. 1, 1995) (50/50 elder care facility partnership). Private Letter Rulings may not be relied upon as legal precedent by any taxpayer other than the organization to which such rulings are issued. See Section 6110(k)(3). They can, however, be instructive regarding the Service’s analysis of certain issues.
36. See, e.g., Revenue Ruling 98-15, *supra*; *Redlands Surgical Services v. Commissioner*, *supra*.
37. See *Redlands Surgical Services*, *supra*.
38. See, e.g., *St. David’s Health Care System, Inc. v. United States*, 002-1 U.S. T.C. 50,452 (W.D. Tex. 2002), *rev’d and remanded*, 349 F.3d. 232 (5th Cir. 2003) (considering whether an exempt health care organization had ceded its control over a whole-entity joint venture to for-profit partners that have an independent economic interest in the activity and no obligation to put charitable purposes ahead of their for-profit making objectives). The case was tried to a jury on remand in *St. David’s Health Care System, Inc.* No. 101CV-046 (W.D. Tex. 2004). The jury found that St. David’s had not relinquished control, with the result that it did not lose its tax exemption. Notwithstanding the ultimate outcome, the case illustrates that documentary evidence of control by the exempt organization is not by itself sufficient to support continuing exemption if there is no factual evidence that the exempt organization was as a practical matter able to exercise control over the joint venture.
39. See CPE Text at 160.

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*LaVerne Woods is a partner based in the Seattle office of Davis Wright Tremaine LLP, and chairs the firm’s Tax-Exempt Organizations practice group. LaVerne can be reached at (206) 757-8173, or at lavernewoods@dwt.com.*

*Thomas C. Schroeder is an associate in the Seattle office of Davis Wright Tremaine LLP, and a member of the Tax-Exempt Organizations practice group. Thomas can be reached at (206) 757-8140, or at tschroeder@dwt.com.*