I. SETTING THE STAGE – TYPES OF HEALTH CARE JOINT VENTURES

A. Whole-Hospital Joint Ventures. In a typical whole-hospital joint venture, a tax-exempt organization contributes all or substantially all of its assets to the joint venture and receives a partnership interest or LLC membership and, in some cases, cash. For this reason, these ventures are sometimes referred to as “disposition-type” joint ventures. The for-profit contributes assets and/or cash to the joint venture and receives a partnership interest or LLC membership. The joint venture operates the hospital assets. Commonly, these ventures have been structured to vest managing control in the for-profit partner. The for-profit partner or affiliate typically:

1. Holds at least a 50 percent interest;
2. Has a long-term management contract;
3. Serves as the managing general partner; and
4. Employs certain senior hospital executives.

B. Ancillary Joint Ventures. In an ancillary joint venture, the tax-exempt participant contributes less than all of the assets used in furtherance of its exempt purposes and the for-profit contributes assets or cash or both, each getting a general or limited partnership interest or LLC membership in return. The joint venture typically holds property or operates an ancillary health care service provider such as an imaging center or specialty hospital. In contrast to most whole-hospital joint ventures, the tax-exempt participant still conducts substantial charitable activities of its own.

C. Specialty Hospital Joint Ventures. A trend that had appeared over the past decade was for hospitals or health care systems to joint venture with members of their medical staffs and, often, a for-profit specialty hospital management company to build a new single-specialty hospital in their communities. Whether this is best viewed as an “acquisition-type” whole-hospital joint venture or an ancillary joint venture probably depends on the extent of other charitable health care activities carried on by the corporation through which the tax-exempt organization participates. In most cases, the tax issues raised are similar to those in other joint ventures. Single specialty providers, sometimes called carveouts or niche players, are not without controversy, but strictly from a federal tax standpoint, establishment of a new provider that serves a broad cross section of the community would likely be viewed as providing a community benefit. The Affordable Care Act prohibits new physician-owned hospitals, so, absent a legislative change, this activity is likely to slow.
D. Participating Bond Transactions. Most of this outline addresses common equity-model joint ventures, in which physician-investors or other for-profit interests own a portion of the venture assets. Over the last few years, speculation has arisen as to whether certain joint venture legal issues could be simplified by offering physician-investors an opportunity to purchase subordinated debt in the form of high yield “participating bonds” instead of equity, in some cases coupled with a management services organization arrangement offering physicians significant input into management of the venture. These transactions have not been thoroughly evaluated by the IRS or other regulators, but apparently raise unique tax and regulatory issues of their own that must carefully be addressed. See generally, Daniel Higgins and Gayl Westendorf, Participating Bond Transactions: Will PBTs Be Silver Bullet for Joint Venture Legal Risks?, BNA’s Health Law Reporter (Jul. 3, 2003) at 1063.

1. The IRS issued a private letter ruling in early 2004 addressing only the very narrow issue of whether the auction process used to set the interest rates for what appears to be a participating bond transaction is an open and competitive bidding process that satisfies the relevant portion of the regulations under Section 4958. See PLR 200413014 (Dec. 30, 2003).

II. APPLICABLE EXEMPT ORGANIZATIONS TAX LAW PRINCIPLES

Nonprofit hospitals are exempt from federal income tax as organizations described in Section 501(c)(3) of the Internal Revenue Code (“Code”) only if they are both organized and operated exclusively for charitable purposes within the meaning of the statute. Treas. Reg. § 1.501(c)(3)-1(c)(2). Thus, they must meet the Organizational Test and the Operational Test for continued exemption. Only the Operational Test is typically at issue in joint venture analyses.

Under venerable IRS Revenue Ruling 69-545, 1969-2 C.B. 117, the basic rationale for tax exemption is that nonprofit hospitals promote the health of a broad cross-section of the community, thereby operating for the benefit of the community as a whole, and serving a charitable purpose. This is the “community benefit standard” for federal tax exemption. Whether joint venture facilities operate for community benefit often is the key issue.

III. EFFECT OF JOINT VENTURE PARTICIPATION ON EXEMPT STATUS

A. History of the IRS’s General Approach to Joint Ventures

1. Prior to 1980, the IRS took the position in most cases that participation in a joint venture with a for-profit entity was per se inconsistent with continued tax-exempt status for Section 501(c)(3) organizations. See, e.g., GCM 36293 (May 30, 1975), in which the IRS Office of Chief Counsel stated that a general partner’s fiduciary obligations to promote the interest of limited partners was per se incompatible with the requirement that a Section 501(c)(3) organization operate exclusively for exempt purposes.

2. In Plumstead Theatre Society, Inc. v. Comm’r, 74 T.C. 1324 (1980), aff’d per curiam, 675 F.2d 244 (9th Cir. 1982), a tax-exempt theater organization formed a limited partnership with individuals and a for-profit corporation to produce a play. The tax-exempt organization acted as the sole general partner in the limited partnership.
The U.S. Tax Court found that (1) the formation of the partnership was the result of arm’s-length negotiations; (2) the exempt organization was not obligated for the return of any capital contribution made by the limited partners from its own funds; (3) the partnership had no interest in the exempt organization; (4) the limited partners had no control over the way the exempt organization operated or managed its affairs; and (5) none of the limited partners nor any officer or director of the corporate limited partner was an officer or director of the exempt organization. Based on these facts, the Tax Court concluded that the partnership arrangement did not cause the exempt organization to be operated for private, rather than public, benefit.

**Significance:** Since the Tax Court’s decision in Plumstead, it has been the administrative position of the IRS that, under appropriate circumstances, an exempt organization may participate in a joint venture with a taxable entity without jeopardizing its tax-exempt status.

3. **Housing Pioneers Inc. v. Comm’r,** T.C. Memo 1993-120, aff’d, 58 F.3d 401 (9th Cir. 1995), examines whether a not-for-profit organization formed to act as the co-general partner in limited partnerships to develop low-income housing qualified as an organization described in Section 501(c)(3). The participation of an exempt organization as a co-general partner would enable the partnerships to obtain a reduction in state property taxes. The organization’s role as co-general partner was narrowly circumscribed by a management agreement that gave the organization little authority to manage the affairs of the partnerships. The organization’s compensation as general partner would be based on the amount of the property tax reduction.

The U.S. Tax Court found that, by lending its exempt status to the partnerships, the organization furthered the substantial non-exempt purpose of achieving tax benefits for the for-profit partners. The Tax Court further ruled that the property tax savings resulted in impermissible private benefit to the for-profit partners.

**Significance:** This case, compared to Plumstead, encouraged the IRS to focus on who controls the joint venture beginning in the mid-1990s.

B. **Development of the IRS Two-Part “Close Scrutiny” Test**

Once the IRS abandoned its per se disapproval of charitable organization participation in joint ventures, it began focusing on whether the tax-exempt participant in a joint venture with one or more for-profit participants continues to meet the Operational Test.

1. For over 20 years, the IRS has employed the two-pronged “close scrutiny” test first set forth in GCM 39005 (Dec. 17, 1982) in analyzing the propriety of specific joint ventures. First, the IRS looks to whether exempt organization participation in the joint venture furthers a charitable purpose. Second, the IRS scrutinizes the facts to determine whether the joint venture permits the exempt organization to act exclusively in furtherance of its charitable purposes or whether the arrangement allows private inurement or other than incidental private benefit to be conferred upon private investors.
or other for-profit persons.

2. GCM 39546 (Aug. 14, 1986) states that a tax-exempt organization that is the sole general partner in a limited partnership can meet its fiduciary duties to the other partners and at the same time be operated exclusively for charitable purposes, although this is a highly factual area and each case must be carefully scrutinized. This GCM also acknowledges that a tax-exempt organization acting as a general partner generally cannot isolate itself from losses related to partnership activities.

3. GCM 39732 (Nov. 2, 1987) approved three hospitals’ participation as general partners in limited partnerships formed to provide free-standing ancillary health care services (physical therapy, ambulatory surgery and MRI, respectively). In each case, the IRS Chief Counsel found that the first prong of the IRS close scrutiny test was satisfied because the hospitals represented that, through the partnerships, they would be able to provide better medical services to the people in their communities. In each case, the second prong of the close scrutiny test was met because, at all times, profits and losses would be allocated among the partners on the basis of capital contributions and risks assumed.

4. GCM 39862 (Nov. 21, 1991) confirms that the question of relatedness to the organization’s exempt purposes is the threshold issue in the analysis of a tax-exempt organization’s participation in a joint venture. This GCM also identifies the following indicia of bona fide community benefit for purposes of the first prong of the IRS close scrutiny test: (1) creation of a new provider of health care services; (2) expansion of community health care services; (3) improvement in treatment modalities; (4) reduction in health care costs; and (5) improved patient convenience and access to physicians.

5. In dozens of private letter rulings in the 1980s and 1990s, the IRS approved of ancillary health care joint ventures involving medical office buildings, imaging centers, ambulatory surgical centers, treatment centers, women’s health centers, physical therapy centers, hospital home care services, nursing homes, HMOs, and the like. Early joint ventures generally involved partnerships, although more recent letter rulings utilize limited liability companies. See, e.g., PLR 9517029 (acute care hospital and psychiatric hospital LLC joint venture between an exempt university subsidiary and a for-profit company); PLR 9645018 (outpatient dialysis service LLC joint venture among an exempt hospital, an unrelated exempt health care system, and nephrologists). PLR 200118054 (Feb. 7, 2001) (proposed joint venture LLC formed between a tax-exempt affiliate of a health care system and a group of local physicians); PLR 200117043 (Jan. 30, 2001) (proposed ASC joint venture between two tax-exempt health care entities).
IV. CURRENT IRS POSITION AND RECENT LITIGATION

A. A Post-Housing Pioneers IRS Begins Looking at Who Controls the Venture

1. The first public indication that the IRS would impose an exempt organization control requirement on charitable organizations participating in joint ventures with private interests appeared in PLR 9736039 (Jun. 9, 1997), in which the IRS refused to provide a favorable ruling to an exempt organization serving as a co-general partner in low-income housing limited partnership until changes were made to assure that the EO, as opposed to the for-profit co-GP, had actual control over the partnership.

B. Redlands Surgical Services and the Emerging EO Control Requirement

1. Lack of control of the joint venture by the applicant was a major issue in Redlands Surgical Services v. Comm’r, 113 T.C. 47 (Jul. 19, 1999); aff’d, 242 F. 3d 904 (9th Cir. 2001). In Redlands, the Tax Court gave implicit support to the IRS’s position (announced in Rev. Rul. 98-15 and discussed below) that charitable organizations participating in joint ventures with for-profit interests must have formal or informal control over the venture to rely on joint venture activities as furthering exempt purposes.

2. Facts: IRS had denied Redlands Surgical Services’ (“RSS’s”) application for exemption under Section 501(c)(3), asserting that RSS was not operated exclusively for charitable purposes and its operations benefited private interests more than incidentally (i.e., it failed the Operational Test). The Redlands facts are unusual in that the sole purpose of RSS, a wholly-owned nonprofit subsidiary of a nonprofit hospital parent organization (“RHS Corp.”), was to hold an interest in a partnership that owned and operated a freestanding ambulatory surgery center. It had to rely on activities conducted through the joint venture to justify exemption.

3. The Tax Court enumerated five factors supporting its conclusion that the IRS had properly denied Redlands’ bid for exemption:

   a) a lack of any express or implied obligation on the for-profit partners to put charitable objectives ahead of noncharitable ones;

   b) RSS’s lack of voting control over the partnership;

   c) RSS’s lack of formal or informal control sufficient to ensure furtherance of charitable purposes;

   d) a long-term management contract giving a for-profit vendor too much control and an incentive to maximize profits; and

   e) important competitive advantages secured by the for-profit partners through their arrangement with RSS.

4. Note that this case had bad facts -- The joint venture ambulatory surgery center at issue had a poor charity care and Medicaid record and there were other facts strongly
suggesting cherry picking and private benefit.

5. *Redlands* was affirmed by the 9th Circuit. *Redlands*, 242 F. 3d 904 (9th Cir. 2001).

C. Rev. Rul. 98-15 Formalizes IRS Focus on Control

1. While *Redlands* was pending, the IRS published its first formal (i.e., precedential) guidance on exempt organization participation in joint ventures in Rev. Rul. 98-15, 1998-1 C.B. 718. Rev. Rul. 98-15, dealing with disposition-type whole hospital joint ventures, analyzes two assumed factual situations, a “good” fact pattern and a “bad” fact pattern.

   a) In the ruling, the IRS adopts an analytical perspective that focuses on whether an exempt organization seeking to rely on partnership activities as furthering its exempt purposes is in a position to exercise “real world” control over the partnership, so as to ensure that joint venture activities are conducted in a charitable manner.

   b) The ruling (a) identifies a “good” fact pattern that effectively creates a tax exemption safe harbor for charitable organization participation in whole-hospital joint ventures, and (b) identifies a separate “bad” fact pattern that will cause loss of tax exemption for participation in a whole-hospital joint venture. Common whole-hospital joint ventures structured in the early 1990s appear to resemble more closely the “bad” fact pattern. The key distinctions turn on whether the exempt organization effectively controls the joint venture.

2. Significance: Rev. Rul. 98-15 reaffirms the two-pronged close scrutiny joint venture analysis discussed above. The ruling also reaffirms the use of a “flow-through” analysis or “aggregate” approach for joint venture entities such as partnerships and LLCs that are flow-through entities for tax purposes.

   a) For purposes of the Operational Test, the activities of the LLC are considered the activities of the owners when evaluating whether a nonprofit organization owner is operated exclusively for exempt purposes.

   b) Similarly, public charity status as a hospital under Sections 509(a)(1) and 170(b)(1)(A)(iii) remains available where the principal activity of the organization remains the provision of hospital care, albeit through the LLC.

3. Current Application of Rev. Rul. 98-15 Seems Unduly Rigid: Rev. Rul. 98-15 implicitly suggests a need for EOs to have majority governing board control (i.e., voting control) to ensure that joint venture assets are used to further a charitable purpose. More than a decade after Rev. Rul. 98-15’s release, it is not clear how flexible the IRS will be on the amount of voting control necessary, especially in combination with other indicia of informal control. It is still unclear whether, in a given case, a charitable purpose
made binding on the parties, with the exempt organization holding certain reserve powers and initiation rights (to assure charitable activity), will satisfy the IRS where the EO has only an equal or minority interest. To date, the IRS has seemed insistent upon ventures fitting within Situation 1 in the ruling and on express provisions making charitable purposes override profit-making purposes. In the Fiscal Year 2002 CPE Text, the IRS observed that, to date, it has recognized exemption in very few cases where the tax-exempt entities share of the control was as low as 50%, and none where control was lower. See Update on Health Care in IRS FY 2002 Exempt Organizations Continuing Professional Education Text.

a) In an earlier CPE Text article, the IRS has discussed the differences between Situation 1 and Situation 2 in the ruling focusing both on structural (voting) control and contractual control through the management agreement running to an affiliate of the for-profit investor. See Update on Health Care Joint Venture Arrangements in IRS FY 2000 Exempt Organizations Continuing Professional Education Text.

4. **UBTI Concerns.** EO participants in ancillary joint ventures, such as a hospital’s ownership of an imaging center or ambulatory surgery center, that choose not to comply with the control requirement probably will not jeopardize exemption because, in the normal course, the joint venture activity would be insubstantial, although there could be unrelated business income tax consequences for joint venture proceeds in the hands of the exempt participant. There may be good arguments against UBTI treatment, and this needs to be carefully considered in each case.

D. **St. David’s Health Care Litigation Confirms Control Test**


2. **Facts:** In 1996, St. David’s contributed substantially all of its assets to a newly created limited partnership. St. David’s holds both general and limited partnership interests and has a 45.9% ownership interest. One affiliate of HCA, Inc. (“HCA”) holds a general partnership interest and is the managing general partner. A second affiliate of HCA holds a limited partnership interest. The HCA affiliates together have a 54.1% ownership interest. St. David’s and the HCA affiliates each appoint one-half of the members of the partnership’s governing board. In addition, the chair of the governing board must be a member appointed by St. David’s. St. David’s has the power to unilaterally remove the Chief Executive Officer of the partnership. The partnership
agreement requires that all hospitals owned by the partnership operate in accordance with the community benefit standard of Revenue Ruling 69-545. Should the hospitals fail to meet that standard, St. David’s has the unilateral right to dissolve the partnership. Every hospital owned by the partnership provides emergency care without regard to the patient’s ability to pay.

3. **Revocation:** After an audit, the IRS revoked St. David’s tax-exempt status retroactively to 1996 on the basis that St. David’s participation in the partnership did not permit St. David’s to act exclusively in furtherance of its charitable purposes and allowed for greater than incidental benefits to HCA and its for-profit affiliates. The essence of the IRS position was that (1) St. David’s lacks sufficient control to ensure that joint venture assets are used for charitable purposes and (2) that the venture confers too much private benefit on HCA. The essence of St. David’s position was that it has sufficient control and a proven track record of operating in a manner that meets the community benefit standard.

4. **District Court – Summary Judgment:** The District Court focused its analysis on the application of the Operational Test in light of Rev. Rul. 69-545, particularly the IRS’ positions that (1) the governing board of the partnership was required to be, but was not, controlled by a community board; and (2) HCA receives an impermissible private benefit. The court first found, as a matter of law, that the presence of a community board is “a point in favor of exemption, but is not an absolute requirement for exemption.” The District Court further ruled that the partnership’s governing board satisfies the community board requirement, stating that “[t]he government focused on majority control, but the law is more concerned with control, regardless of whether it springs from a majority or a corporate structure.” In the view of the court, the provisions of the partnership agreement “clearly protect the non-profit charitable pursuits” and “the other factors from the community benefit standard are met with such overwhelming support as to carry the day.” The key factor identified in this regard is that every hospital owned by the partnership provides emergency care without regard to the patient’s ability to pay. The District Court then turned to the issue of impermissible private benefit to HCA. Using the standard for the Operational Test set out in Redlands, “without deciding whether it is in fact the governing standard,” the District Court found that the purpose stated in the partnership agreement and the voting rules and rights of St. David’s, including St. David’s power to ensure that the manager and CEO are to its liking, gave sufficient control to St. David’s.

5. **Fifth Circuit – Vacated and Remanded:** The U.S. Court of Appeals for the Fifth Circuit vacated the summary judgment and remanded the matter to the District Court for trial on the issue of whether St. David’s ceded control over the partnership’s operations to for-profit interests. The court rejected an analysis based solely on the actual provision of charitable services and reiterated that the key issue is whether the exempt organization has sufficient control over the venture to ensure charitability going forward.

The Fifth Circuit relied heavily on Rev. Rul. 98-15 and Redlands. In determining that control was a material fact in issue, the court broadly stated its view that, when a tax-exempt organization cedes control of a partnership’s operations to for-
profit interests, it is presumed that the tax-exempt organization’s activities via the partnership further a substantial non-exempt purpose (i.e., the profitmaking purpose of the for-profit entity). The twenty-page opinion is worded more broadly than earlier judicial decisions and administrative pronouncements and could, depending on the extent to which it is followed, portend trouble -- or at least increased unrelated business income tax risk -- for ancillary joint ventures in which the tax-exempt participant does not have majority voting control. Interestingly, the Fifth Circuit rejected the IRS insistence on having charitable purposes expressly override other purposes, such as profit-making purposes, of the venture.

6. **Jury Preserves St. David’s Exemption:** On remand, a jury trial was held on the narrow issue of whether St. David’s had ceded control to a for-profit partner and thereby lost its exemption. The jury determined that St. David’s had proven by a preponderance of the evidence that it was entitled to exemption.

  **DBR Analysis:** The jury verdict leaves the IRS position in Rev. Rul. 98-15 intact, as it was upheld by the Fifth Circuit and applied on remand. However, it also may strengthen hospitals’ arguments that, on their particular facts, they retain sufficient control to preserve exemption or avoid UBTI treatment for JV income.

E. **IRS Settles -- The John Gabriel Ryan Association v. Commissioner**

1. The IRS settled a second case involving application of Rev. Rul. 98-15 in June 2003. In *The John Gabriel Ryan Association v. Commissioner*, T.C. Docket No. 16811-02X, a nonprofit subsidiary of Providence Health System, Seattle, sued for recognition of exemption based on its participation in several ancillary health care joint ventures on behalf of the system. Certain of the joint ventures involved 50-50 control plus added protections for the charitable participant, while others were majority controlled by the charitable organization. The author represented the taxpayer in court.

2. **Facts:** The John Gabriel Ryan Association (“JGR”), a Washington nonprofit corporation, petitioned seeking a declaratory judgment that it qualified for exemption as an organization described in Section 501(c)(3). JGR’s sole activity was participating on behalf of the system in five ancillary health care and medical office building (“MOB”) joint ventures. Practically speaking, the issue presented was whether JGR had sufficient control over the joint ventures that their activities furthered its exempt purposes and did not generate UBTI. After the stipulated record was filed, but before briefs were due, the IRS settled the case and issued two favorable determination letters to JGR.

F. **Rev. Rul. 2004-51 Addresses Ancillary Joint Ventures.**

In Rev. Rul. 2004-51, 2004-22 I.R.B. 974 (May 6, 2004), the IRS ruled that a university that entered into a limited liability company joint venture with a for-profit to conduct interactive video seminars did not threaten the university’s exemption because the activities it was treated as conducting through the joint venture were not a substantial part of its activities. Venture revenues were not UBTI to the university because the
activities, on the facts described, were substantially related to the university’s exempt purposes. The ruling is not as helpful as it could be because the facts show so much control by the university, including 50-50 voting control and sole university control over the curriculum, training materials and instructors, and the standards for completing the seminars.

While not a model of clarity, Rev. Rul. 2004-51 does confirm that insubstantial activities will not disturb the exempt participant’s exemption and the kinds of factors that go into the relatedness test for UBTI purposes.

**DBR Analysis:** The JGR settlement and Rev. Rul. 2004-51 confirm that charitable organizations may engage in properly-structured 50/50 joint ventures with for-profit interests, so long as the joint venture agreements include adequate protections to ensure that the joint ventures are operated at all times for charitable purposes. Appropriate protections may include binding charitable purpose provisions, provisions granting preferred governance rights and rights upon dissolution, and policies that require the joint ventures to provide specific community benefits. This requires careful negotiation in every joint venture, but is important because properly-structured joint ventures will protect exempt organization participants from unrelated business taxable income and possible loss of exemption.

G. Recent PLR.

The IRS may resume ruling on joint venture issues now that St. David’s is concluded. One recent PLR deals with an imaging joint venture. It breaks no new ground on application of the control test, however, as the exempt participant has complete voting control as sole general partner and both the partnership and management agreements include clear duties to operate the partnership and its facilities in a manner that furthers charitable purposes and include express override provisions. PLR 200436022 (Sept. 3, 2004).

V. MISCELLANEOUS JOINT VENTURE ISSUES

A. **Valuation of Contributed Assets:** In the Fiscal Year 2002 CPE Text, the IRS took pains to explain that a tax-exempt hospital or health care provider must be credited with the value of any existing business that will be transferred to a joint venture to avoid giving a for-profit venture participant an undue private benefit. *Update on Health Care in FY 2002 CPE Text*, *supra*.

B. **Treatment of Income from Joint Venture Operations as Related or Unrelated:**

1. Section 512(c) of the Code requires a tax-exempt partner to include in unrelated business taxable income its share of income (and its share of directly-connected deductions) from any trade or business conducted by the partnership that is an “unrelated trade or business” with respect to the tax-exempt organization.
2. Section 513(a) of the Code defines the term “unrelated trade or business” as the conduct of a trade or business that is not substantially related to the organization’s exempt purpose.

3. In the pre-98-15 private letter rulings addressing participation by exempt organizations in joint ventures, the IRS has consistently held that, so long as the exempt organization’s participation in the venture satisfies the Relatedness Test, the exempt organization’s allocable share of venture income is not subject to the unrelated business income tax. See, e.g., PLR 9616005 (Dec. 19, 1995) (medical clinic joint venture located in medically underserved area); PLR 9407022 (Nov. 22, 1993) (formation of a joint venture to own and operate an existing hospital-owned ASC); PLR 9345057 (Aug. 20, 1993) (formation of partnership to acquire the physical assets of an existing hospital-based ASC).

4. However, the position announced in Rev. Rul. 98-15 implicitly suggests that participation in a joint venture fails the Relatedness Test if the tax-exempt participant does not have sufficient control over the venture. The IRS has hinted that this might be the case. See, e.g., Janet Gitterman and Marvin Friedlander, Health Care Provider Reference Guide, FY 2004 CPE Text Article, available at www.IRS.ustreas.gov/pub/irs-tege/eotopic04.pdf (“When a health care provider that engages in other charitable activities also participates in a joint venture with for-profit entities where this activity does not further its charitable purposes, the tax-exempt entity may be subject to unrelated business income taxation under IRC 512(c).”)

**DBR Analysis:** Joint Venture unrelated business income issues have not yet been fully addressed in formal IRS guidance or litigation. In the meantime, tax-exempt participants should carefully analyze the proper treatment of joint venture revenues on a case by case basis.

C. **Political Activities**

Consider including an express prohibition on political activities in the joint venture operating agreement to prevent having such an expenditure or activity attributed to the exempt participant.

D. **Form 990 Reporting**

For tax years 2008 and following, exempt organizations participating in joint ventures have to report information about venture activities on their Form 990. This information is required in the following places:

1. Core Form Part IV, Q. 37 triggers the requirement to complete Schedule R where the organization conducts more than 5% of its exempt activities through an entity that is not a related organization and that is taxed as a partnership.
2. Core Form Part VI, Q. 16 asks whether the organization invested in, contributed assets to, or participated in a joint venture with a taxable entity during the year. If yes, the organization must state whether it has adopted a written policy requiring the organization to evaluate the arrangements under federal tax law and take steps to protect the organization’s exemption. See Attachment for a Sample Policy.

3. On Schedule H, Part IV, hospitals are required to disclose additional information about joint ventures with officers, directors, trustees, key employees and physicians.

4. On Schedule R, Parts III and VI, organizations are required to disclose information about related and unrelated organizations taxable as a partnership. For unrelated organizations, a 5% of activities threshold for reporting applies.

E. Section 501(r)

In June 2012, the IRS issued proposed regulations implementing certain aspects of new Code Section 501(r), added by the Affordable Care Act. In the proposed regulations, as well as in Notice 2011-52, in which the IRS had sought comments on the issues to be addressed in the regulations, the IRS stated an intention to include within the definition of “hospital organization” for purposes of the regulations, an organization that operates a hospital facility through a disregarded entity or a joint venture. The proposed regulations acknowledge that the IRS is considering the comments received regarding the operation of hospital facilities through partnerships and will address the issue in future guidance.

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The author gratefully acknowledges the assistance of Karen Brown McAfee, Esq., formerly of Drinker Biddle & Reath LLP, Washington, in preparing this outline.
SAMPLE JOINT VENTURE POLICY

I. INTRODUCTION AND PURPOSE

This Policy and Procedure on Joint Venture Participation (this “Policy”) has been created and approved by the Board of Directors (the “Board”) of XYZ Hospital System, Inc. (the “System”) to provide guidance as to participation of the System, directly or through any of its tax-exempt controlled entities (together with the System referred to herein as the “System Entities”), in a Joint Venture or similar arrangement. For these purposes, “Joint Venture” means any joint ownership or contractual arrangement with any for-profit or private interest (including, without limitation, any physician(s) on the medical staff of any System Entity) through which there is an agreement to jointly undertake a specific charitable or business enterprise. Joint undertakings between a System entity and one or more other IRC Section 501(c)(3) organizations are outside the scope of this policy.

[Drafter’s Note – As written, this Policy would encompass Joint Ventures regardless of their legal form, i.e., via an entity treated as a partnership for tax purposes, via a separate corporation, or via contract. Organizations should consider whether this relatively broad approach is workable for their circumstances. At a minimum, the policy should address arrangements treated as partnerships for tax purposes, however, since these arrangements have been (and likely will continue to be) subject to substantial IRS scrutiny.]

II. APPLICABILITY

This Policy applies to any Joint Venture where participation by a System Entity involves either (i) activities that would, but for the Joint Venture, be in furtherance of the tax-exempt purposes of the System Entity, or (ii) the transfer into joint ownership of any health care activity previously conducted by the System Entity. This Policy excludes investments of cash or marketable securities or other joint ownership arrangements where the primary purpose of the System Entity’s participation is either investment or the active conduct of an unrelated trade or business with respect to the System Entity (and not the provision of health care or other activities that would, but for the Joint Venture, be in furtherance of the tax-exempt purposes of the System Entity). As to the latter, the System’s Chief Financial Officer will annually provide to the Board a report describing all such excluded Joint Ventures and the amount, if any, of unrelated trade or business income generated by the Joint Ventures.

III. POLICY AND PROCEDURE

A. Charitable Purposes and Effect.

It is the policy of the System that appropriate provisions be included in the terms of any Joint Venture arrangement covered by this Policy that are sufficient to protect the tax-exempt status of any System Entity participating in the Joint Venture.
1. All Joint Venture operating agreements or similar documents will contain a binding statement of charitable purpose of the Joint Venture that ensures, and explains how, participation in the Joint Venture furthers the tax-exempt purposes of the System Entity participating.

2. All patient care Joint Ventures in which a System Entity participates will have a written charity care policy that is either (i) the same as the policy of such System Entity as now in effect or subsequently modified, or (ii) has been approved by the Board.

3. All Joint Venture operating agreements or similar documents will contain clear, binding provisions sufficient to ensure that charitable purposes are furthered by Joint Venture activities and that a System Entity participating does not cede control of Joint Venture activities to for-profit interests. A System Entity may participate in a Joint Venture that furthers charitable purposes, if either:

   (i) The System Entity at all times maintains majority voting control, or

   (ii) The System Entity at all times maintains fifty percent (50%) voting control and the Joint Venture operating agreement or similar documents contain adequate reserved powers to establish that the System Entity does not cede control of Joint Venture activities to for-profit interests.

4. The System’s legal counsel or designee will review all Joint Venture operating agreements or similar documents prior to execution and will, pursuant to Sections 1 and 3, above, determine the adequacy of provisions governing majority voting or applicable reserved powers after considering the effect of any other applicable governance provisions or arrangements, including, without limitation, any management agreements.

5. A System Entity will not participate in any Joint Venture covered by this Policy if such Joint Venture is not described in Section 3(i) or Section 3(ii) above, without advance approval of the Board.

B. Economic Terms.

1. All transfers of property or existing charitable or business activity to any Joint Venture by a System Entity will be valued at fair market value, and such System Entity will receive fair market value consideration or appropriate credit to its capital account for such transfer.

2. Unless otherwise approved by the Board, a System Entity will not participate in any Joint Venture covered by this Policy that is treated as a
partnership for tax purposes unless such Joint Venture involves allocations of items of income and loss that are proportional to the owners’ respective capital accounts.

3. A System Entity will not make any loan to any Joint Venture or to any other participant in any Joint Venture without the prior approval of the Board.

4. Any provision of services to any Joint Venture covered by this Policy by a System Entity will be at fair market value, except as otherwise determined by the Board based on a review of the totality of the facts and circumstances.

C. **Prohibited Activities.**

The operating agreement or similar documents of any Joint Ventures in which a System Entity participates will include an express prohibition on Joint Venture participation in political campaign activities and political campaign contributions, including contributions to any political action committee (“PAC”).

D. **Required Approvals.**

If a proposed Joint Venture will involve any of the following: (i) participation by physicians on the medical staff of any System Entity; (ii) assets of any System Entity in excess of $250,000; or (iii) the ownership or operation of any hospital; such Joint Venture will require prior approval by both the governing body of the System Entity proposing such Joint Venture and the System Board.

IV. **AMENDMENTS TO POLICY**

Any substantive change to this Policy will require the approval of the Board.

V. **REFERENCE TO OTHER POLICIES**

In addition to this Policy, the Board has approved additional policies to provide specific guidance on particular common transactions, including, without limitation, the XYZ Hospital System Policy on Excess Benefit Transactions and the XYZ Hospital System Policy on Conflicts and Dualities of Interest. These policies should be consulted in addition to this Policy, as appropriate.