Commissioner’s Testimony

[S]ome exempt providers have entered into joint ventures with for-profit organizations, sometimes placing their entire health care operation in the venture and transforming themselves into what is effectively a tax-exempt holding company with a charitable grant-making function. Although this is not impermissible, we insist that the charitable entity ensure that the charitable purposes of the venture are not sacrificed for the sake of maximizing profits. However, it can be difficult for the IRS and the courts to wrestle with fact-intensive cases.

- Hearing Before the Senate Finance Committee on April 5, 2005
Grassley Gram Questions

- Nine Questions about Joint Ventures
- Please respond to the following assertion: Many nonprofit, tax-exempt hospitals engage in joint ventures that shift the most profitable and valuable procedures, practices, and income streams to the joint ventures so that the greater profits and value may be shared with physicians and other for-profit persons.

- May 25, 2005 Letter from Sen. Charles Grassley to 10 Large Health Systems

Setting the Stage - Types of Health Care Joint Ventures

- Whole-hospital joint ventures
  - Disposition-type JVs
  - Specialty hospital JVs
- Ancillary joint ventures
  - ASC, imaging, etc.
  - Medical office buildings
  - Proton therapy centers
Exempt Organizations Tax Principles

- Nonprofit Hospitals/Clinics/HMOs
  - *Organized* and *operated exclusively* for “charitable purposes.”
- Charitable purposes include
  - *Promotion of health* (community benefit test)
  - *Education*
- Inurement/private benefit

History of the IRS’s Approach to Joint Ventures

- Pre-1980
  - Charitable organization participation is *per se* inconsistent with exemption
History of the IRS’s Approach to Joint Ventures

- *Plumstead Theatre Society, Inc. v. Comm’r (T.C. 1980)*
  - Arm’s length negotiations
  - EO was not obligated for the return of any capital contribution
  - Partnership had no interest in the EO
  - Limited partners had no control over EO

IRS Two-Part “Close Scrutiny” Test

- GCM 39005 (1982)
  - (1) Whether EO participation in the venture furthers a charitable purpose
  - (2) Whether the venture permits the EO to act exclusively in furtherance of its charitable purpose
    - Or does arrangement allow private inurement or private benefit?
Application of Two-Part Test

- GCM 39732 (1987) -- approved 3 hospitals’ participation in ancillary joint ventures:
  - Physical therapy
  - Ambulatory surgery
  - MRI
- Prong (1) CB because better medical services
- Prong (2) OK because profits and losses allocated among the partners on the basis of capital contributions and risks assumed

Control Test Emerges

- PLR 9736039 (June 9, 1997)
  - Low-income housing limited partnership
  - IRS required changes to assure that EO had actual control over the partnership
Redlands Surgical Services v. Comm’r (T.C. 1999)

- NFP hospital sub -- sole activity is participating in ASC JV as minority owner
- IRS denies exemption due to lack of control; T.C. agrees; 9th Cir. affirms

Redlands Surgical Services v. Comm’r (T.C. 1999)

- Minority ownership, 50-50 board/arbitration
- Lack of express or implied obligation on for-profit partners to put charitable objectives ahead of non-charitable ones
Redlands Surgical Services v. Comm’r (T.C. 1999)

- Lack of voting control
- Lack of formal or informal control
- Veto vs. right to initiate

- Management contract giving for-profit vendor too much control - renewal controlled by manager, incentive to maximize profits
- Competitive advantages - non-compete
- No charity care, poor Medicaid record
Redlands Surgical Services v. Comm’r (T.C. 1999)

- Rule: where NFP puts assets at risk, must control venture to further an exempt purpose
- Supports position in Rev. Rul. 98-15

Rev. Rul. 98-15

- Whole-hospital joint venture ruling
  - Situation 1
  - Situation 2
  - Facts and circumstances
- EO seeking to rely on partnership activities as furthering its exempt purposes must be able to exercise “real world” control, so as to ensure that JV activities are conducted in a charitable manner
Good Facts (Situation 1)

• EO had majority voting control (3-2)
• Unrelated management company, 5 year term, renewable on mutual consent
• Reserved powers
• No conflicts of interest
• Valuations and ownership interests fair

Good Facts (Situation 1)

• Charitable purpose override
  – Charitable purposes take precedent over any profit motive
  – Duty of board members to operate JV in a manner that furthers CB overrides any duty to operate for profit
Bad Facts (Situation 2)

- Lack of voting control by EO partner (3-3)
- No charitable purpose covenant (or override)
- Broad management authority runs to proprietary partner
- Management contract renewable in perpetuity at option of for-profit affiliate
- CEO/CFO previously worked for for-profit partner

Helpful Aspects
Rev. Rul. 98-15

- Confirms two-part close scrutiny test
- Confirms flow-through analysis
- Attribution of JV activities to EO (Butler)
- Public charity status also based on flow-through activities
St. David’s Health Care System v. U.S.

- Fifth Circuit (2003)
  - Vacated and remanded to district court for trial finding material facts in dispute re who controls venture (also vacated fee award)
  - Operational test at issue - did St. David’s operate exclusively for charitable purposes?
  - Court: If EO participating in JV cedes control to for-profit, it should lose exemption

St. David’s Health Care System v. U.S.

- Fifth Circuit (2003)
  - Key issue is whether St. David’s ceded control to HCA
    - If so, we presume benefiting for-profit is a substantial non-exempt purpose
    - No real discussion of substantiality
  - Detailed examination of effective control, including relative bargaining position of parties offered roadmap for trial court on remand
**St. David's Health Care System v. U.S.**

- Fifth Circuit (2003)
  - Looked for power to initiate, not just veto
  - Looked not just to what documents say, but whether they are likely to be enforced (speculation?)
  - Was satisfied with mandatory “shall” language binding venture to charitable purpose; refused to require express override

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**John Gabriel Ryan Association v. Comm’r (“JGR”)**

- NFP sub of multi-hospital system
- Five ancillary health care and medical office building JVs
- IRC 7428 declaratory judgement action in US Tax Court
  - Settled June 2003
- 50-50 control + additional protections
Rev. Rul. 2004-51

• Ancillary J.V., non-health care, provides comfort
• University forms 50-50 LLC with for-profit for distance learning seminars
• 50-50 BOD, university has sole control over curriculum, materials, instructors, standards
• For-profit has sole control over locations and non-teacher personnel

Exemption:
– LLC activities attributed to university
– Not a substantial part of university’s activities, so no effect on exemption

UBTI:
– Substantially related to university’s educational purposes
– Does not discuss formal control in rationale, only university control over educational aspects
– No charitable purpose override present
Where Are We Now?

- Will the IRS issue more guidance?
- Cannot escape control test
  - Majority voting control best
  - Less than majority with protections?
    - Special voting requirements
      - Supermajority voting
      - Class voting
    - Reserved powers
    - Unilateral rights in exempt partner

Where Are We Now?

Structuring Transactions

- If less than majority representation
  - Retain certain reserved powers, absolute veto or approval rights
    - Amendments of governing documents
    - Capital and operating costs
    - Discretionary partnership distributions
    - Capital calls
    - Addition of new partners
  - Merger/consolidation
  - Incurrence of material/unbudgeted debt
  - Significant contracts
  - Changes in services/purposes
  - Hiring/firing
  - Charity care/CB policy
Where Are We Now?

- Charitable purpose clause in agreement
  - Binding commitment to CB, charitable purpose override (??), fiduciary duty on board, binding on arbitrator
- Power to initiate charitable activities
- Charity care/Medicaid policy
- Conflicts of interest policy
- Don’t let other facts/provisions undercut powers

Miscellaneous Joint Venture Issues

- EO must be credited with the value of any existing business transferred to a JV (2002 CPE text)
- IRS rulings?
- Exit strategy advisable
- Following 4958 rebuttable presumption process advisable
- Watch out for political activities, etc.
UBTI

- IRC 512(c)
  - Partnership UBTI flow-through rule
- Interaction with 98-15; Redlands
- Arguments and implications of 2004-51
- Don’t forget exempt purposes other than promotion of health (e.g., education)
- Effect of Section 6694?

Form 990 Reporting

- Core Form Part VI, Line 16a, b
  - Did organization participate in a JV with a taxable entity?
  - Has organization adopted a written policy requiring it to evaluate JVs under tax law and to safeguard exempt status?
New Ancillary JV Example: Proton Therapy

- Simply too expensive for most hospitals to build alone
  - $150-200M
  - 25 times the space and capital (Advisory Board)
- Too expensive for most physician groups
- Private operators need a stream of patients
- Investors need to be sure of utilization/ROI
- A JV is one way of financing a center that shares risks and brings varied strengths to the table
- 6 of next 12 involve third party facilitator (AB)

Legal Issues to be Satisfied

- For hospital: Tax exemption requirements
- For all parties: Medicare Anti-Kickback Statute and Ethics in Patient Referrals Act (“Stark Law”)
  - Cannot intend remuneration for referrals
  - Likely to turn on arrangements being at fair market value and commercially reasonable in absence of referrals
  - Can let tax analysis take lead
- Get lawyers involved in structuring the JV (not after)
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How to Structure a Proton Therapy JV to Meet IRS Rules

- Hospital should have 51% voting control on Board OR there must be charitable purpose requirement in operating agreement and reserved powers in hospital to ensure charitable operation of JV facility
  - Serve Medicare/Medicaid patients
  - Provide some amount of charity care (best practice is follow same financial assistance policy as hospital)
  - Prevent changes to above without hospital consent
How to Structure a Proton Therapy JV to Meet IRS Rules

- Capital contributions and shares of income and loss should be proportional to investment in JV
- Non-cash investments in JV must be at fair market value

Example—ProCure Treatment Center JV (New Jersey)

- ProCure Treatment Centers is a privately held company with a comprehensive model for designing, financing, building, staffing and operating centers (“turnkey”)
- Collaborates with oncologists and hospitals
- Operates a dedicated training facility in Indiana for Proton Therapy staff
Example—ProCure Treatment Center JV (New Jersey)

- Multi-tier structure—Three partners
- ProCure, Princeton Radiology Associates, CentraState Medical Center
- Parties entered JV through different LLCs at different times
- ProCure brought intellectual property, expertise, and advantageous third party financing
- Physicians and Hospital brought local market goodwill and cash

Example—ProCure Center JV

- Structured transaction as closely as possible to above-described legal standards
- Hospital was minority investor, so could not obtain majority voting control
- Reserved powers and charitable purpose clause carefully built into operating agreement
- Facility and physicians will follow hospital financial assistance policy
Example—ProCure Center JV

- To ensure fair market value of capital contributions and fairness of terms to exempt hospital, given different times of investment, obtained fairness opinion from investment banking firm
- Issued tax exemption opinion conditioned on fairness opinion
- Issued Anti-kickback and Stark opinions based on fairness opinion

Example

- ProCure Proton Therapy Center in Somerset, New Jersey opened in 2012
- Centers under development in Michigan and Florida
Medicare Shared Savings Program--IRS Updates ACO Guidance

- Fact Sheet 2011-11 (posted 10/20/2011)
- Confirms basic IRS position announced at time of HHS Proposed Reg.
- Provides nuanced additional interpretation in Q&A format
- Helpful to EOs considering ACO participation, but not a free pass

IRS Updated ACO Guidance

- Confirms that Notice 2011-20 (3/31/2011) continues to reflect IRS view
- Issued in concert with HHS Final Regs. and continues to focus principally on MSSP
- Tax implications of ACO activity depend on legal structure—corporation, partnership, LLC
- Continues to focus on:
  - whether ACO activities further an exempt purpose
  - whether EO participation in ACO gives rise to prohibited inurement or private benefit
  - whether EO participation, if unrelated, is a substantial part of EO’s activities
IRS Updated ACO Guidance

- IRS gives a pass on JV control test due to CMS oversight (for MSSP participants)
- For non-MSSP, activities are governed by existing law
- Regular UBTI rules apply
- New: IRS acknowledges that the ACO itself may qualify under (c)(3) (MSSP and non?)

Practical ACO Advice

- IRS had trouble approving early HMOs, PSROs, PHOs, RHIOs; ACOs will be no different
- Absent physician ownership, exemption should be available to nonprofit ACO corps controlled by EOs
- Carefully structured joint ventures should be OK (watch control/UBTI issue in non-MSSP)
- Carefully manage private benefit to physicians, insurers, and taxable orgs