

**PROPOSED REVENUE RULING ON
ANCILLARY HEALTH CARE JOINT VENTURES**

The proposed revenue ruling set out below represents the views of the members of the Tax and Accounting Interest Group who prepared it and does not represent the position of the Health Law Section or the American Bar Association. Principal responsibility was exercised by Frederick J. Gerhart and David M. Flynn. Substantive contributions were made by Bonnie S. Brier, Bernadette Broccolo, Michael A. Clark, and Douglas M. Mancino. The draft revenue ruling was reviewed by J.A. Patterson, Jr. and Gregory L. Pemberton.

Although members of the Health Law Section who participated in preparing the proposed revenue ruling have clients who would be affected by, or have advised clients on the application of, the federal tax principles addressed by the proposed revenue ruling, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of the proposed revenue ruling.

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INTRODUCTION

Joint ventures between tax-exempt organizations described in section 501(c)(3) of the Internal Revenue Code and for-profit business organizations pose complex tax issues. The Service has stated its position on such joint ventures in the health care context where an exempt organization transfers its sole activity to a joint venture with a for-profit entity. Rev. Rul. 98-15, 1998-1 C.B. 718. The position on sole-activity joint ventures continues to be tested in litigation. *Redlands Surgical Services, Inc. v. Commissioner*, 113 T.C. 47 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001), *St. David's Health Care System, Inc. v. United States*, ___ F.Supp. ___ (W.D. Texas 2002).

The Service appears to agree that the tax rules are different for ancillary joint ventures. An ancillary joint venture is one that represents only an insubstantial portion of an exempt organization's activities, rather than its sole activity. The Service has issued no precedential guidance regarding ancillary joint ventures. The proposed revenue ruling set out below is intended to assist the Service in developing and issuing such guidance.

The proposed revenue ruling would provide helpful guidance to practitioners on three points. First, it would confirm that the only tax risk posed by an ancillary joint venture is that the

distributive share of joint venture income may be subject to the unrelated business income tax, and that participation in such a venture poses no threat to exempt status. Second, it would confirm that voting control is not as important for an ancillary joint venture as it is for a sole-activity joint venture. Third, it would confirm that the private benefit test does not apply in determining whether an activity is subject to the unrelated business income tax.

FACTS

Situation 1

Community Hospital ("Hospital") is a 550-bed acute care hospital in a large suburban area located on the outskirts of a large urban center. Hospital has been tax-exempt for almost 60 years and in an audit eight years ago it was determined by the IRS to have satisfied the "community benefit" standards of Rev. Rul. 69-545.

Based upon its own community needs assessment, Hospital's Board decides that its delivery of surgical services would be enhanced, both in terms of quality and efficiency, by the establishment of a free-standing ambulatory surgery center ("ASC"). To reduce the capital commitment of Hospital and to obtain management expertise, Hospital pursues development and ownership of the ASC with a third party. Hospital's management interviews three highly regarded, for-profit companies engaged primarily in the ownership, operation and management of ASC facilities, and selects one ("ASC Company") to joint venture with Hospital the ownership and operation of an ASC. ASC Company has no pre-existing relationship with the Hospital, its board or its senior management.

The ASC is an important activity for Hospital because it improves the availability, quality and efficiency of surgical services provided to its community. It does not, however, represent a substantial part of Hospital's activities when considered in the context of its overall operations, either in volume of services performed or revenues.

Hospital and ASC Company form a limited liability company ("LLC") to own and operate the new ASC. The LLC Operating Agreement provides that the LLC is to be managed by a Board of Managers ("Board") consisting of three individuals selected by Hospital and three individuals selected by ASC Company. The LLC Operating Agreement requires two-thirds Board approval of several major decisions relating to operation of the ASC, including (1) annual capital and operating budgets, (2) distribution of LLC earnings, (3) the selection of the LLC's CEO, (4) the acquisition or disposition of health care facilities or assets of the ASC, (5) any other contracts providing for expenditures in excess of \$25,000 per year, (6) any material changes in the types of services to be offered by the ASC, and (7) the renewal or termination of management agreements relating to the operation of the ASC. The respective fifty percent membership interests in the LLC (capital, profits and losses, etc.) held by Hospital and ASC Company are proportional and equal in value to their contributions. The LLC Operating Agreement can only be amended with the consent of both members.

The LLC Operating Agreement also requires that the ASC be operated in a manner that is consistent with the "community benefit" standard of Rev. Rul. 69-545, including the treatment of Medicare and Medicaid eligible patients without discrimination, and the specific obligation to adopt Hospital's charity care policy. Operation of the ASC in this manner is expressly given precedence over the objective of maximizing profits in the LLC Operating Agreement.

The LLC Operating Agreement further provides that, in the event the LLC fails to satisfy its community benefit obligations, Hospital can claim a default and (after notice to ASC Company and a reasonable opportunity to cure the default) proceed to binding arbitration, asking the arbitrator to apply a default provision under the Operating Agreement providing that Hospital would have the right to select a fourth member of the LLC's Board. The arbitrator would only be permitted to take that action in the event that objectively determinable factors demonstrated a failure to meet the community benefit requirements established in the Operating Agreement.

The LLC enters into a Management Agreement with a management company affiliated with ASC Company ("ASC Manager"). Negotiation of the Management Agreement is conducted on an arm's length basis, with the three representatives of ASC Company who are members of the Board not participating in the negotiations or voting upon acceptance of the Management Agreement. The Management Agreement has a ten-year term, and is renewable for three additional three-year terms, subject to the consent of both Hospital and ASC Company. The Management Agreement provides for a fee based on the LLC's gross revenues and contains terms that are reasonable and comparable to industry practice. The Management Agreement imposes the same community benefit requirements set forth in the LLC Operating Agreement on the ASC Manager, and provides that the failure to satisfy those requirements is cause for termination of the Management Agreement, subject to reasonable notice and an opportunity to present a feasible plan to cure the failure to comply within 45 days after notice of default.

Each of Hospital, ASC Company, and ASC Manager sign a standard noncompete agreement under which they agree not to own, operate, or materially participate in the operation of any competitive ASC facility within a 15 mile radius of the ASC owned and operated by the LLC. There are no provisions in the noncompete agreement relating in any way to Hospital's inpatient or outpatient surgical services. Surgeons on the medical staff of the ASC are expected to be most or all of the same surgeons on the medical staff of Hospital, and no special financial incentives are provided to physicians for the performance of surgical services at the ASC as opposed to Hospital.

The LLC Operating Agreement provides that the Board will meet quarterly (and provided for special meetings within ten days at the request of either member) to discuss results of operations and any other matters that might properly come before the Board, and specifically to review reports to be prepared by the ASC Manager and presented by the LLC's executive officers regarding the LLC's compliance with the community benefit requirements. At least two of the representatives of Hospital on the Board are required to attend each such meeting, and are required to present a complete report regarding all matters discussed at LLC Board meetings to

Hospital's Board of Directors at its next regularly scheduled meeting or at any special meeting called by Hospital's Board for that purpose.

Situation 2

Situation 2 is identical in all material respects to Situation 1, except for the following differences:

1. The LLC Operating Agreement contains no provision requiring the ASC to be operated in a manner consistent with the "community benefit" standard of Rev. Rul. 69-545. There is no mention of a charity care policy, and no mention of providing treatment to patients eligible for participation in Medicare, Medicaid, or other governmental programs.

2. A business plan that was prepared by ASC Company and approved unanimously by the Board of the LLC emphasizes the need to concentrate on profitable surgical procedures to the maximum extent possible, and to focus marketing efforts primarily on private pay and private insurance patients.

3. The Management Agreement, like the LLC Operating Agreement, is silent with respect to charity care or community benefit requirements, so that failure by the ASC Manager to conduct the day-to-day activities of the ASC in a manner consistent with the community benefit standard is not cause for termination of the Management Agreement.

4. The provision in the LLC Operating Agreement regarding at least quarterly meetings of the LLC Board states that such meetings would be for the purpose of discussing the results of operations of the ASC, and especially financial results; but is silent with respect to any need for the ASC to provide charity care or to satisfy the community benefit standard.

LAW

Section 501(c)(3) provides for the exemption from federal income tax of corporations organized and operated exclusively for charitable purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as operated exclusively for exempt purposes specified in section 501(c)(3) only if it engages primarily in activities that accomplish such purposes. It also provides that an organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. *See Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 293 (1945)

Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. It further states that "to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized and operated for the benefit of private interests...."

Section 1.501(c)(3)-1(d)(2) provides that the term "charitable" is used in section 501(c)(3) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See *Restatement (Second) of Trusts*, sections 368, 372 (1959); 4A Austin W. Scott and William F. Fratcher, *The Law of Trusts* sections 368, 372 (4th ed. 1989). However, not every activity that promotes health supports tax exemption under section 501(c)(3). For example, selling prescription pharmaceuticals certainly promotes health, but pharmacies cannot qualify for recognition of exemption under section 501(c)(3) on that basis alone. *Federation Pharmacy Services, Inc. v. Commissioner*, 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980). Furthermore, "an institution for the promotion of health is not a charitable institution if it is privately owned and is run for the profit of the owners." 4A Austin W. Scott and William F. Fratcher, *The Law of Trusts* section 372.1 (4th ed. 1989). See also *Restatement (Second) of Trusts*, section 376 (1959); *Sonora Community Hospital v. Commissioner*, 46 T.C. 519, 525-526 (1966), *aff'd* 397 F.2d 814 (9th Cir. 1968); *Sound Health Association v. Commissioner*, 71 T.C. 158 (1978), *acq.* 1981-2 C.B. 2; *Geisinger Health Plan v. Commissioner*, 985 F.2d 1210 (3rd Cir., 1993), *rev'g* 62 T.C.M. 1656 (1991).

Rev. Rul. 69-545, 1969-2 C.B. 117, establishes a community benefit standard under section 501(c)(3) by comparing two hospitals. The first hospital qualifies as an organization described in section 501(c)(3) because it is controlled by a board of trustees composed of independent civic leaders, maintains an open medical staff, operates a full-time emergency room open to all patients regardless of ability to pay, and otherwise admits all patients able to pay (either themselves or through third party payers), and therefore is operated for the benefit of the community. The second hospital does not qualify as an organization described in section 501(c)(3) because it is controlled by physicians who have a substantial economic interest in the hospital, restricts the number of physicians admitted to the medical staff, enters into favorable rental agreements with the individuals who control the hospital, and limits emergency room and hospital admissions substantially to the patients of the physicians who control the hospital, and therefore is operated for the private benefit of the physicians who control the hospital.

Rev. Rul. 98-15, 1998-1 C.B. 718, holds that for federal income tax purposes the activities of a partnership, including a limited liability company ("LLC") treated as a partnership for federal income tax purposes, are considered the activities of the partners in applying the operational test of Section 1.501(c)(3)-1(c)(1). It compares two situations where an exempt organization operating a hospital forms an LLC joint venture with an unrelated for-profit entity and contributes all of its operating assets to the LLC. Situation 1 concludes that the organization continues to be described in section 501(c)(3) even though its sole activity is its interest in the LLC, where the organization has voting control of the LLC, the LLC's governing documents require that charitable purposes take precedence over maximizing profits, and the LLC enters into a reasonable management agreement with an unrelated for-profit management company. Situation 2 concludes that the organization does not continue to be described in section 501(c)(3) where it does not have voting control of the LLC, the LLC's governing documents do not require that charitable purposes take precedence over maximizing profits, and the LLC enters into a management agreement that cedes too much authority to a management company affiliated with the for-profit member of the LLC.

Redlands Surgical Services, Inc. v. Commissioner, 113 T.C. 47 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001), involves a nonprofit subsidiary of a hospital system parent that, as its sole activity, entered into a joint venture with a for-profit entity and private investors to operate an ambulatory surgery center. The nonprofit subsidiary lacked not only voting control of the joint venture, but also any agreement or other assurance that the joint venture would operate in accordance with the community benefit standard. The Tax Court held that the surgery center was not a charitable activity because there was insufficient assurance that the joint venture would be operated in a charitable manner, and denied section 501(c)(3) status. The Ninth Circuit affirmed.

St. David's Health Care System, Inc. v. United States, ___ F.Supp. ___ (W.D. Texas 2002) [Civil No. A-01-CA-046 JN] involved a whole-hospital joint venture similar to the one described in Situation 1 of Rev. Rul. 98-15, except that the exempt partner did not have voting control of the joint venture. The District Court found that, despite the lack of voting control, there were other sufficient protections within the joint venture's structure to assure that the exempt partner's charitable purposes would be carried out, and upheld exemption. [The case will be appealed?]

Section 511(a) imposes a tax on the unrelated business income of organizations exempt from federal income tax under section 501(a).

Section 512(c) provides that an exempt organization that is a member of a partnership conducting an unrelated trade or business with respect to the exempt organization must include its share of the partnership income and deductions attributable to that business in computing its unrelated business income. *See also* H.R. No. 2319, 81st Cong., 2d Sess. 36, 111-112 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 26, 109-110 (1950); section 1.512(c)-1.

Section 513(a) defines unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of the organization for funds or the use it makes of the profits derived) to the exercise of the organization's exempt purposes or functions.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is substantially related to exempt purposes if it contributes importantly to the accomplishment of those exempt purposes.

ANALYSIS

The activities of a partnership, including an LLC treated as a partnership for federal income tax purposes, are considered to be the activities of a nonprofit partner when evaluating whether the nonprofit partner is operated exclusively for exempt purposes within the meaning of section 501(c)(3) and Section 1.501(c)(3)-1(d)(1)(ii) (the "operational test") or whether it is engaged in an unrelated trade or business within the meaning of section 513 (the "relatedness test"). *Redlands, supra*; *St. David's, supra*, Rev. Rul. 98-15; *supra*; Section 512(c). This treatment of partnerships is commonly referred to as the aggregate approach.

The operational test and the relatedness test serve different purposes. The operational test is a condition of exempt status and applies to an organization's overall activities to determine whether the organization is engaged primarily in activities that accomplish its exempt purposes. The relatedness test generally applies where an organization is already primarily engaged in exempt activities, to determine whether a specified activity is substantially related to those exempt activities.

In addition to meeting the operational test, to be exempt under section 501(c)(3) an organization must serve public rather than private interests within the meaning of Section 1.501(c)(3)-1(d)(1)(ii) (the "private benefit test"). The private benefit test does not apply in determining whether an activity is subject to the unrelated business income tax. In applying the unrelated business income tax to a specified activity it is assumed that the organization is already exempt and serves a public interest based on its other activities.

In both Situations 1 and 2, after Hospital and ASC Company form the LLC, Hospital continues to engage in the same hospital and health care services it previously provided in a manner consistent with the community benefit standard of Rev. Rul. 69-545. This is unlike Rev. Rul. 98-15, *Redlands* and *St. David's*, where the organization's sole activity was participating in the LLC or partnership. The Hospital in both Situations 1 and 2 is engaged primarily in exempt activities without regard to its participation in the LLC, and satisfies the operational test and the private benefit test based on those exempt activities. Moreover, the Hospital's participation in the LLC in both Situations 1 and 2 is an insubstantial activity in the overall context of the Hospital's activities. Accordingly, in both Situations 1 and 2 the issue is whether Hospital's participation in the LLC is an unrelated trade or business, not whether it is inconsistent with the Hospital's continuing status as an organization described in section 501(c)(3).

The relatedness test requires a lesser degree of control over a partnership than the operational test. The operational test applies where participation in the partnership is the basis for the organization's exemption, and the participation in the partnership must itself be an exempt activity. The relatedness test applies where the organization is already engaged primarily in exempt activities and its participation in the partnership must only be substantially related to those exempt activities.

Situation 1

In Situation 1, Hospital has sufficient control over the LLC to ensure that the LLC will be operated in a manner that is substantially related to the Hospital's exempt purposes and its exempt activities. Voting control of the LLC is not essential for this purpose. The governing documents of the LLC commit the LLC to operate the ASC in a manner that will provide health care services for the benefit of the community and to give charitable purposes precedence over maximizing profits. Although Hospital does not have numerical voting control of the LLC, Hospital has enforceable legal rights under the LLC Operating Agreement and the Management Agreement that permit it to ensure that the ASC is conducted in a manner that contributes importantly to Hospital's exempt purposes. The terms and conditions of the Management Agreement, including renewal and termination, are reasonable. All of these facts and

circumstances establish that, when Hospital participates in the LLC, and the LLC operates the ASC in accordance with the LLC's governing documents, the activities and operations of the LLC that are attributed to Hospital will be substantially related to Hospital's exempt purposes.

Situation 2

In Situation 2 the Hospital has neither voting control of the LLC nor the other assurances present in Situation 1 that the ASC will be operated in a manner that contributes importantly to Hospital's exempt purposes by promoting health in a manner consistent with the community benefit standard of Rev. Rul. 69-545. There is no provision giving precedence to community benefit over profit maximization, no mention of a charity care policy, and no mention of providing treatment to patients eligible for participation in Medicare, Medicaid, or other governmental programs. Without these assurances that the LLC will be operated in a manner that contributes importantly to Hospital's exempt purposes, Hospital's participation in the LLC will be considered an unrelated trade or business.

Even though Hospital's participation in the LLC is an unrelated business, it is an insubstantial part of the Hospital's overall activities and will not by itself threaten the Hospital's qualification as an organization described in section 501(c)(3).

HOLDINGS

Situation 1

Participation by Hospital in the LLC is consistent with Hospital's section 501(c)(3) status and does not result in unrelated business taxable income because the ASC's operations are substantially related to Hospital's exempt purposes.

Situation 2

Participation by Hospital in the LLC is treated as an unrelated trade or business because Hospital cannot be assured that the ASC will be operated in a manner that is substantially related to its exempt purposes. Such participation does not jeopardize Hospital's section 501(c)(3) status because the ASC's operations do not constitute a substantial portion of Hospital's activities.