PHYSICIAN/HOSPITAL JOINT VENTURES IN THE WAKE OF *ST. DAVID'S*

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I. INTRODUCTION

It seems that each day brings with it the announcement of a new joint venture involving a hospital. Some of these are whole-hospital joint ventures, in which a hospital enters into a joint venture with a for-profit entity and contributes substantially all of its assets (usually the hospital facility with equipment) to the joint venture. Other joint ventures involve a hospital and a group of physicians owning and operating an ancillary medical facility. Perhaps the most common example of the latter is a hospital partnering with a group of physicians to operate an ambulatory surgery center. Regardless of the type of health care joint venture at issue, the same basic tax considerations exist.

Those considerations were at the forefront in *St. David's Health Care System v United States,*[1] where the United States District Court for the Western District of Texas granted summary judgment to a tax-exempt hospital and ruled that its participation in a joint venture did not jeopardize its tax-exempt status. However, on November 7, 2003, the United States Court of Appeals for the Fifth Circuit vacated the district court's decision, finding that summary judgment should not have been granted because there were genuine issues of material fact.[2] *St. David's* presents the latest twist on an issue that has troubled health care law practitioners for years: structuring health care joint ventures to minimize, if not entirely eliminate, the risk of revocation of the participating hospital's tax-exempt status.

II. WHAT IT MEANS TO BE TAX-EXEMPT

Under Internal Revenue Code ("IRC") § 501(c)(3), an organization qualifying for tax-exempt status must be both "organized and operated exclusively for . . . charitable . . . purposes." In the context of health care joint ventures, the second prong of this two-part standard, the operational test, has created a fertile ground for disputes. The IRS has issued regulations setting forth a four-part inquiry to determine whether an organization meets the operational test:

1. the organization must be operated exclusively for a charitable purpose;[3]

2. no part of the organization's net earnings can inure to the benefit of private shareholders or individuals;

3. no substantial part of the organization's activities can attempt to influence legislation; and

4. the exempt organization cannot participate or intervene in any political campaign for or against a candidate for public office.[4]

The third and fourth inquiries usually do not present a problem in a health care joint venture. Where joint ventures run into trouble is showing that: (1) the joint venture is in furtherance of an exempt purpose; and (2) the joint venture does not operate for the benefit of private interests.

III. HOW PRINCIPLES GOVERNING TAX-EXEMPT ORGANIZATIONS IMPACT A HEALTH CARE JOINT VENTURE

Two potential risks exist in a health care joint venture. The first is that the joint venture, by placing hospital assets at risk for the benefit of the joint venture (and hence the for-profit member), gives rise to impermissible inurement i.e. personal gain. This could expose the for-profit entity or its members to monetary penalties and the hospital to revocation of its tax-exempt status. The second risk is that the operation of the joint venture may not further the charitable purpose of the hospital, in which case the hospital's tax-exempt status may be revoked.

A. INUREMENT AND THE RISK TO PHYSICIANS OF INTERMEDIATE SANCTIONS

Inurement is used to describe a transaction in which a person who has an interest in the activities of a tax-exempt organization receives economic gain through the use of the tax-exempt organization's assets. Inurement can be a problem when the economic benefit received is not in proportion to the benefit provided to the organization. Prior to 1996, when the IRS had determined that improper inurement occurred, the only option available to the IRS was to take action against the tax-exempt organization that participated in the transaction.

In July of 1996, however, Congress enacted the Taxpayers' Bill of Rights 2, which added § 4958 to the IRC. Section 4958 shifts at least some of the liability to the person receiving inurement. It imposes excise taxes on what are described as "excess benefit transactions" between "disqualified persons" and tax-exempt organizations. These taxes have become known as "intermediate sanctions," since they are less severe than the draconian penalty of revoking an organization's tax-exempt status. In January of 2001, the Department of Treasury issued temporary regulations, which became final in January of 2002.

Disqualified persons are those persons who are in a position to exert substantial influence over the affairs of the tax-exempt organization, and generally include members of the board of directors, as well as the organization's officers.[5] Tax-exempt organizations themselves, however, cannot be disqualified persons. In the context of health care joint ventures, the Regulations specifically provide (by way of example) that a for-profit entity that manages the day-to-day operations of the joint venture is a disqualified person with respect to the hospital-participant.[6]

An excess benefit transaction is one in which a tax-exempt organization provides a benefit to a disqualified person, the value of which exceeds the value of consideration provided to the tax-exempt organization for providing the benefit.[7] Although § 4589 applies potentially to any transaction resulting in an excess benefit, its most likely application will concern compensation paid by the tax-exempt organization. Under the Regulations, a disqualified person may receive reasonable compensation equal to the fair market value of the benefits provided to the organization.[8] Reasonable compensation, in turn, is defined by reference to IRC §162, which provides that compensation must be tied to services actually rendered. The value of benefits paid by an organization includes not only cash and non-cash compensation, but also liability insurance, but generally excludes fringe benefits not included in gross income under IRC §132.[9]

If an economic benefit received by a disqualified person is not treated as compensation, it is automatically deemed an excess benefit.[10] In fact, the Regulations do not treat an economic benefit as compensation unless the organization provides written evidence that the economic benefit is being provided as compensation.[11]

Fortunately, the Regulations have provided tax-exempt organizations with a way to create a rebuttable presumption that compensation paid is not an excess benefit transaction. Under the Regulations, payment of compensation will not be treated as an excess benefit transaction if: (1) it has been approved by a governing body (such as a board of directors) of the tax-exempt organization; (2) the governing body has relied on comparable data in making its determination; and (3) the governing body adequately documents its reasoning at the time it makes its decision.[12]

There is a five-year look back period, which commences on the date the excess benefit transaction is found.[13] If an excess benefit transaction is found, a two-tiered tax is imposed. The tax liability is 25% on the excess benefit received from the excess benefit transaction.[14] If this 25% tax is not paid by the disqualified person within the taxable period (defined by Treas. Reg. 53.4958-1(c)(2)(ii) as that period of time ending on the earlier of the date of mailing of the notice of deficiency or the date the tax is imposed), then the disqualified person must also pay a tax equal to 200% of the excess benefit received in the excess benefit transaction.[15]

A disqualified person can avoid the 25% tax by: (1) returning to the organization an amount (in cash or cash equivalents) equal to the excess benefit plus interest within 90 days after receiving a notice of deficiency from the IRS; and (2) showing that the excess benefit transaction was due to reasonable cause and not willful neglect.[16] As noted above, if the disqualified person fails to correct the excess benefit transaction at the earlier of: (1) the mailing of a notice of

deficiency for the 25% tax; or (2) the 25% tax is assessed on the disqualified person, then the additional 200% tax on the excess benefit is imposed.[17]

The penalties, however, are not limited simply to the person or persons who received the excess benefit. Under § 4958, "organization managers," which include officers, directors, trustees or anyone having powers or duties similar to those persons[18] can be held liable for participating in an excess benefit transaction. A 10% tax on the excess benefit will be imposed on an organization manager if: (1) a 25% tax was imposed on the disqualified person; (2) he or she knowingly participated in the transaction; and (3) his or her participation was willful and not due to reasonable cause.[19] The final regulations, however, did keep a "safe harbor," which precludes a finding of "knowing" participation where the organization manager relies on a reasoned, written opinion from an appropriate professional.[20]

At first glance, it may appear that physicians need not worry about the intermediate sanctions rule in a joint venture with a hospital, since in most instances compensation or other benefits are paid by the joint venture entity, not the tax-exempt hospital. The Regulations, however, address this situation by providing that, when considering whether an excess benefit transaction occurred, the IRS will consider not only the tax-exempt organization, but also any entity that the tax-exempt organization controls, which is defined to include those situations where the organization owns 50% of the controlled entity.[21] In many instances, the entity in a hospital-physician joint venture is controlled by the hospital.

Nor is a physician immune from § 4958 simply because he or she may not have a direct interest in the joint venture entity, but rather has an interest in the for-profit entity participating in the joint venture. A disqualified person may include a taxable entity such as the for-profit entity owned by the physicians. In the event the for-profit entity is deemed to have received an excess benefit, then the penalties assessed against the for-profit entity would ultimately be borne by its owners i.e. the physicians.

Section 4958, however, is not intended to displace the requirements for tax-exempt status discussed above. Hence, even if the transaction is not subject to § 4958, it may nevertheless jeopardize the organization's tax-exempt status.[22]

B. PRIVATE BENEFIT AND THE RISK TO HOSPITALS

1. Private Benefit

In order to maintain its tax-exempt status, a tax-exempt organization must be primarily engaged in activities that promote its charitable purposes. When a transaction primarily promotes a private interest, not a charitable interest, the transaction is said to have resulted in an impermissible private benefit.

Depending upon the extent to which the private interest is served, the transaction may result in the revocation of an organization's tax exempt status.

2. Rev. Rul. 69-545 and the "Community Benefit" Standard

In Rev. Rul. 69-545, the IRS recognized that providing health care is generally a charitable purpose, and that a hospital may qualify for tax-exempt status under § 501(c)(3). The IRS required, however, that the hospital benefit a broad cross section of the community by: (1) providing medical privileges to all qualified physicians in the community; (2) maintaining a board of trustees broadly representative of the community; (3) operating a full-time emergency room available to all without regard to the patient's ability to pay; and (4) admitting those patients able to pay regardless of the source of the payment. These factors have since become known as the "community benefit" standard.

3. Rev. Rul. 98-15.

While Rev. Rul. 69-545 provides a general framework within which to consider the tax-exempt status of a hospital, Rev. Rul. 98-15 represents the IRS' effort to provide guidance to hospitals participating in joint ventures. The ruling offers an example of a whole-hospital joint venture that would be looked upon favorably by the IRS for tax-exemption purposes, while also providing an example of a joint venture that would result in revocation of a hospital's tax-exempt status.

The fact pattern in the first situation described in Rev. Rul. 98-15 involved a tax-exempt hospital ("TEH") contributing the hospital and all of the related operating assets to a limited liability company ("LLC") formed by the TEH and a for-profit corporation to operate the hospital. The TEH: (1) controls the board; and (2) intends to appoint community leaders to fill its positions on the board. In addition, the governing documents of the LLC provide that: (1) a majority vote of the board is required for major decisions concerning the LLC's operations; (2) the LLC be operated to further charitable purposes and promote health across a broad section of the community; (3) charitable purposes override any duty to operate the hospital for the financial benefit of its members; and (4) returns of capital contributions and distributions are made in accordance with the members' interests in the LLC.

The TEH would use distributions it receives from the LLC to make grants to promote the health of the community and to provide health care to the indigent. Day-to-day management of the LLC's operations are to be overseen by an entity unrelated to either party pursuant to a 5-year management contract that is renewable by mutual consent of the parties.

Under the preceding fact-pattern, the tax-exempt status of the TEH would not be affected, since:

1. The members of the LLC would be receiving distributions in accordance with their respective investments;

2. The governing documents provide that charitable purposes override the private/profit interests of its members;

3. The TEH has control over the LLC's board, and hence can ensure that the assets the TEH contributed are being used for charitable purposes;

4. The grants would be used to further charitable purposes; and

5. The TEH's primary activity would continue to be providing health care, since the TEH's ability to make grants and provide care to the indigent would be contingent upon receiving distributions from the LLC.

Rev. Rul. 98-15 also provides guidance on how not to structure a joint venture. The second situation presented a similar fact pattern to the first, except that: (1) the for-profit entity also provides management services to hospitals it does not own; (2) each member in the LLC selects three board members; (3) the governing documents do not give priority to charitable purposes over other purposes; and (4) the LLC would enter into a management contract with a wholly-owned subsidiary of the for-profit entity, with the TEH appointing two of the officers of the subsidiary who have prior experience working with the for-profit entity.

In determining that the TEH in the second situation would not be able to maintain its tax-exempt status, the IRS noted the following:

1. The lack of any provision in the LLC's governing documents binding the LLC to serve charitable purposes;

2. The lack of any provision in the LLC's governing documents binding the LLC to provide health care to a broad section of the community;

3. The TEH shared control with the for-profit entity;

4. Both the management company and its officers are affiliated with, or have a prior affiliation with, the for-profit entity; and

5. The management agreement is renewable at the discretion of the subsidiary of the for-profit entity.

Rev. Rul. 98-15 is significant in at least three respects: (1) it appears to equate control with the tax-exempt organization's ability to appoint a majority of the members of the governing body of the joint venture entity; (2) the activities of a tax-exempt organization's affiliates (in this case the joint venture) will be considered for purposes of determining whether the tax-exempt organization is operating for charitable purposes; and (3) it provides what is essentially a safe harbor by identifying those circumstances that, if present in the joint venture, will satisfy IRS scrutiny.

C. THE *REDLANDS* DECISION

At approximately the same time that the IRS promulgated Rev. Rul. 98-15, the U.S. Tax Court was handing down its decision in *Redlands Surgical Services v Commissioner of Internal Revenue.*[23] The petitioner in that case was a non-profit subsidiary ("Organization") of a tax-exempt health system that sought tax-exempt status. The Organization participated in a joint venture with a for-profit entity to acquire a 61% interest in an outpatient, ambulatory surgery center ("ASC").[24] The joint venture entity was a general partnership ("GP"), with the Organization receiving a 46% interest in the profits, losses and cash flow of the GP.[25] The GP subsequently acquired a 61% interest in the general operating partnership ("OP") that operated the ASC, with the GP being the sole general partner of the OP. The IRS subsequently determined that the Organization was operating for a substantial non-exempt purpose and denied the Organization's application for tax-exempt status.[26]

The tax court agreed with the IRS. It first cited the general principles underlying tax-exempt status, including the requirement that the promotion of health must benefit a broad section of the community at large, not private interests.[27] The court then cited several reasons why the joint venture benefited private, rather than public, interests:

1. The lack of a provision in the partnership documents obligating the partners to put charitable purposes ahead of economic/private purposes;[28]

2. The Organization's lack of control (which must include more than the ability to veto certain actions) over the GP;[29]

3. Deadlocks in the GP are to be resolved by arbitration, which is not required to take into account charitable purposes[30];

4. The management company is a for-profit company affiliated with the for-profit entity under a contract that: (a) the management company has the right to renew; (b) ties the management fee to the profitability of the ASC; and (c) does not impose a charitable obligation on the management company;[31]

5. The Organization's lack of control over the medical advisory committee;[32] and

6. The Organization's lack of control of/oversight over the ASC's operations.[33]

Having rejected the Organization's contention that it had formal control over the GP, the tax court next addressed, and dismissed, the Organization's argument that it had informal control over the GP, noting that:

1. There was no evidence indicating that the decision to perform surgery at the ASC was motivated by medical, as opposed to, economic decisions;[34]

2. The ASC provided negligible coverage to Medicaid patients and no indigent patient care, and the Organization did not show that ability to pay is not a factor in determining whether to provide treatment[35]; and

3. There was no evidence that the participation of the Organization's non-profit, tax-exempt parent was anything more than incidental to the for-profit purpose of the ASC.[36]

Also relevant in the court's consideration were the restraints imposed by the joint venture, including limiting the ability of the Organization's parent to provide outpatient services, which the court felt ran counter to the charitable purpose requirement.[37]

The court concluded its opinion by rejecting the Organization's request for application of the "Integral Part" doctrine (which allows subsidiaries of tax-exempt organizations to themselves to be exempt if the activities are an integral part of the exempt activities of the parent), noting that the Organization's activity (participating in the operation of the ASC) was controlled by the for-profit entities.[38] Any exempt interests of the Organization’s parent being advanced, the court said, were incidental to the advancement of the private interests of the for-profit partners.[39]

D. 2002 CPE TEXT

Each year, the staff of the Internal Revenue Service publishes a series of articles on a range of issues that impact tax-exempt organizations. This series of articles is typically referred to as the CPE text. The articles are useful to non-profit organizations because they provide helpful insights into how the IRS views certain tax matters, as well as offering relevant background information.

In October 2001, the IRS issued its Exempt Organization Continuing Professional Education Technical Instruction Program for 2002 ("2002 CPE Text"). Among its update topics was joint ventures in health care. In addition to discussing *Redlands*, the 2002 CPE Text discussed in detail Rev. Rul. 98-15.

The 2002 CPE Text noted that management by a for-profit entity of a joint venture did not necessarily preclude a finding of a charitable purpose. It offered an example where a for-profit entity could manage the day-to-day operations so long as the joint venture documents contain a charitable purpose obligation, and the joint venture's management is controlled by the tax-exempt participant.

The 2002 CPE Text then discussed the situation where the tax-exempt organization did not have the majority interest or control. While noting that Rev. Rul. 98-15 did not explicitly state that such a scenario would result in the denial of tax-exempt status, the IRS noted that, absent such control, there must be a mechanism in place to ensure that charitable purposes take priority over private interests.

The 2002 CPE Text also discussed valuation of the participant's interests in a joint venture, noting that the interests of the tax-exempt organization in the joint venture had to be proportionate to its contribution to ensure that the for-profit entity is not privately benefited.

That portion of the 2002 CPE Text on health care joint ventures concluded with a checklist of the following issues that should be considered to ensure compliance with Rev. Rul. 98-15:

- Did the exempt organization receive an ownership interest in the joint venture proportionate to the value of the assets it contributed?

- Does the exempt organization have voting control over the joint venture board with respect to policies and actions that affect the exempt organization’s tax-exempt purposes?

- Are the representatives of the exempt organization on the joint venture board representative of the community?

- Does the exempt organization have voting control on joint venture policies and actions that affect the exempt organization’s tax-exempt purposes?

- Does the joint venture agreement require the joint venture to operate its hospitals or other health care options for charitable purposes, by community benefit standards?

- Does the joint venture agreement explicitly state that the joint venture's duty to further charitable purposes overrides its duty to operate for the financial benefit of its partners or members?

- Does the joint venture agreement have a dispute resolution provision that would cause the joint venture to satisfy charitable purposes without regard to profitability when a disagreement arises between the board and the members over the joint venture's policies or actions?

- Are the provisions in the joint venture agreement with respect to charitable activities legal, binding and enforceable under the laws of the state where the joint venture was formed?

- Does the joint venture agreement contain a non-compete provision that causes the exempt organization to yield significant market advantages and competitive benefits to the for-profit partner or member?

- Does a company related to the for-profit partner or member manage the day-to-day operations of the joint venture?

- Are the terms and conditions of the management agreement reasonable and comparable to similar arrangements in the marketplace?

- Does the management company have a binding and enforceable obligation to further the charitable purposes of the exempt organization?

- Does the exempt organization have the unilateral right to terminate the management agreement if the management company is not acting to further (or is acting contrary to) the exempt organization's charitable purposes?

- If a CEO manages the day-to-day affairs of the joint venture, does the exempt organization have the unilateral right to remove the CEO if he or she is not acting to further (or is acting contrary to) the exempt organization's charitable purposes?[40]

E. ST. DAVID'S

1. The District Court's Decision

S*t. David's* arose out of the participation of St. David's Health Care System, Inc. ("St. David's") in a limited partnership with HCA, Inc. ("HCA"), a for-

profit entity. St. David's contributed its hospital and all of its medical assets, while HCA contributed hospitals it owned in the Austin, Texas area, with the limited partnership operating the hospitals. St. David's and Round Rock Hospital, Inc. ("Round Rock"), a wholly owned subsidiary of HCA, were general partners (with Round Rock the sole managing partner), while St. David's and another HCA subsidiary were the only two limited partners. St. David's partnership interest, both general and limited, was 45.9%.[41]

In October 2000, the IRS revoked the tax-exempt status of St. David's effective 1996, when it entered into the limited partnership with HCA. The IRS reasoned that by entering into the limited partnership with HCA, St. David's was no longer engaged in activities that primarily furthered a charitable purpose, as required by IRC § 501(c)(3). The IRS found that the partnership did not permit St. David's to act exclusively in furtherance of its charitable purpose, and that its partnership allowed HCA to receive greater than incidental benefits. St. David's then filed suit, and filed a motion for summary judgment on the issue of St. David's tax-exempt status for 1996, arguing that: (1) the partnership hospitals were operated in accordance with the community benefit standard; and (2) the partnership had in place safeguards which assured that it would be operated for a tax-exempt purpose. Although the matter was referred to a magistrate judge, the court undertook a *de* novo review.

The district court analyzed the partnership under the operational test, i.e. it focused on how the organization actually operated as opposed to whether it was properly organized for tax-exempt purposes. The district court then found that St. David's activities in the partnership did not run afoul of its tax-exempt status. The IRS had argued that the promotion of health care is not per se charitable. The district court, however, rejected this argument, finding that the IRS's interpretation of charitable purpose was too narrow. Instead, the district court relied upon Rev. Rul. 69-545, and found that the provision of health care was a charitable purpose[42] and that the community benefit standard adopted in Rev. Rul. 69-545 provided the proper framework for resolving St. David's claim.[43]

The district court then scrutinized the IRS' two arguments for revocation: (1) the board was not a community board; and (2) HCA received an impermissible private benefit. The district court explained that a community board, while favoring exemption, is not a requirement.[44] Even though HCA could appoint 50% of the partnership board, the district court concluded that the joint venture nevertheless satisfied the community benefit standard because: (1) the partnership documents required operation of the partnership in accordance with the community benefit standard; (2) the chairperson of the board was appointed by St. David's; and (3) St. David's retained the right to unilaterally terminate the partnership and its chief executive officer.[45] This, combined with the existence of other aspects of the joint venture (such as the provision of emergency care without regard to ability to pay), was sufficient evidence to the district court that the community benefit standard was met.[46]

The district court then turned to the IRS' second argument that HCA received an impermissible private benefit, and hence the joint venture was not in furtherance of charitable purposes. It cited that portion of *Redlands* (which the district court found to be otherwise inapplicable) discussing the lack of charitable obligations, but concluded that the partnership documents in this case ensured that the partnership was operated for charitable purposes "despite the facial 50-50 split in voting rights[.]"[47] The district court distinguished *Redlands* on the basis that the surgery center in *Redlands*: (1) did not operate an emergency room; and (2) provided no free care to indigents.

2. The Fifth Circuit's Ruling

On November 7, 2003, the United States Court of Appeals for the Fifth Circuit reversed the district court's decision. As did the district court, the Fifth Circuit found that St. David's met the organizational test because its Articles of Incorporation (1) limited its purpose to one or more exempt purposes; and (2) did not empower St. David's to engage in more than an insubstantial part of its activities in conduct that fails to further its charitable goals.[48]

However, the Fifth Circuit reached a different conclusion when analyzing the joint venture under the operational test. The court noted that St. David's was required to show: (1) that it "engage[s] primarily in activities which accomplish" its exempt purpose; (2) that its net earnings do not "inure to the benefit of private shareholders or individuals"; (3) that it does "not expend a substantial part of its resources attempting to influence legislation or political campaigns"; and (4) that it "serve[s] a valid purpose and confer[s] a public benefit."[49] The IRS argued that St. David's could not demonstrate the first element of the operational test, because it ceded control over its operations to HCA. St. David's countered by citing Revenue Ruling 69-545, and arguing that "the pivotal question is one of *function*: whether the partnership engages in activities that further its exempt purpose." Analyzed in this way, St. David's argued that it met the "operational test," and that its activities through the partnership furthered its charitable purpose of providing health care to all persons, because: (1) the partnership provides free emergency room care, (2) it has opened the rest of its facilities to all persons, regardless of their ability to pay, (3) the partnership hospitals maintain open medical staffs, and (4) St. David's uses the profits that it receives from the partnership revenues to fund research grants and other health-related initiatives.[50]

The Fifth Circuit rejected St. David's approach to determining how the operational test was applied. It stated that the central issue in the case was not whether the partnership provides an extensive amount of charitable services. Instead:

> [i]t is important to keep in mind that § 501(c)(3) confers tax-exempt status only on those organizations that operate *exclusively* in furtherance of exempt purposes. 26 CFR § 1.501(c)(3)-1(a). . . . If more than an 'insubstantial' amount of the partnership's activities further non-charitable interests, then St. David's can no longer be deemed to operative *exclusively* for charitable purposes."[51]

Thus, according to the court, St. David's cannot qualify for tax-exempt status under § 501(c)(3) if its activities through the partnership substantially further the private, profit-seeking interests of HCA.[52]

To make this determination, the Fifth Circuit examined the structure and management of the joint venture, and found that issues of fact existed with respect to whether the joint venture furthered primarily charitable purposes; i.e. whether St. David's had effectively ceded control to HCA. The court was troubled by the fact that St. David's participation in the joint venture was out of economic necessity, and hence it may have not had the bargaining leverage to ensure that charitable objectives received the highest priority.[53]

Applying Rev. Rul. 98-15, the court identified a number of problems with the structure which could suggest that control had been ceded to HCA:

1. St. David's did not control the Board of Governors. While it did have veto power, it could not initiate action to further its charitable purposes.[54]

2. The management company was a for-profit subsidiary of HCA. While certain controls were in place, the only real mechanism to enforcement was commencing litigation.[55]

3. There was no mechanism to ensure that St. David's could appoint a manager that prioritized charitable purposes.[56]

4. Although St. David's had the authority to exercise control over the CEO, there was no evidence that St. David's had undertaken any action with respect to those instances where the CEO acted in a manner inconsistent with the partnership documents.[57]

5. St. David's control over the partnership by having the power to dissolve the partnership was subject to question inasmuch as: (1) such power could only be exercised if there is a change in the law; and (2) there were provisions in the partnership agreement (such as a noncompete clause) that would make it unlikely for St. David's to actually want to exercise such power).[58]

In view of these shortcomings, the Fifth Circuit reversed the district court's ruling.[59]

IV. HEALTHCARE JOINT VENTURES AFTER *ST. DAVID'S*

The appellate decision in *St. David's* seems to suggest that healthcare joint ventures enjoy very little flexibility when it comes to structure and operational issues. Whereas the district court's decision appeared to embrace a balancing test, the Fifth Circuit appears to have embraced a "checklist" approach based upon Rev. Rul. 98-15.

It is unclear, however, whether the reasoning in *St. David's*, which involved a whole-hospital joint venture, would be adopted in a hospital-physician joint venture. One example of this type of venture would be a hospital and a group of physicians (with the physicians forming a limited liability company or corporation) partnering to operate an ASC. Such an arrangement may be attractive to the physicians because the hospital is often able to help provide the financial backing that is needed to construct and operate such a facility. The arrangement may be attractive to the hospital because it permits the hospital to provide ambulatory surgical services to the community, as well as provides the hospital with physicians who are able to carry out those services. The potential concerns with this type of arrangement include excessive compensation to the physicians and subordination of the tax-exempt purposes of the hospital to the interests of the physicians.

To avoid the plight of the participants in the joint venture that was the subject of scrutiny and criticism in *Redlands*, the following characteristics should be present in a hospital/physician joint venture (these "characteristics" will take the form of provisions in the governing documents for the joint venture):

1. The primary purpose of the joint venture is to promote the health care needs of the community, and that this purpose overrides the financial interests of its participants;

2. The participants and the governing board of the joint venture entity will carry out any duties or obligations imposed by the joint venture to promote charitable purposes, with the hospital having the right to seek specific performance of this provision;

3. Depending on the interests of the participants:

    a. If the hospital's interest in the joint venture is 50% or less, the business decisions made by the participants require unanimous consent, which provides the hospital with veto power over any and all actions that are inconsistent with its

charitable purposes (although *St. David's* suggests that even this may not be enough since);

b. If the hospital has an interest greater than 50%, a simple majority is required to approve actions (thereby assuring the hospital has control);

4. Any management agreement must contain provisions binding the management company to further the hospital's charitable purposes, as well as provide the hospital with the right to unilaterally terminate the management contract if it reasonably believes that the management company is acting contrary to those purposes;

5. The hospital shall have the right to elect at least one-half of the members of the governing body of the joint venture, and at least two of the members so elected by the hospital shall be representatives from the community;

6. The governing body may take action upon the affirmative vote of a majority of both: (1) the members of the governing body selected by the physicians; and (2) the members of the governing body selected by the hospital;

7. With respect to the services and any assets contributed by the physicians (such as land upon which the ASC is constructed) to the joint venture, payment for such services or the use/ownership of such assets shall be based upon fair market value;

8. A policy for charity care shall be developed that is consistent with the community benefit standard;

9. The joint venture shall participate in Medicare and Medicaid programs; and

10. The distributions of the joint venture shall be in accordance with the participants' interests in the joint venture.

The presence of the preceding provisions in the joint venture documents will help ensure that the tax-exempt status of the hospital is not jeopardized by participating in the joint venture. Of course, the participants need to monitor the actual operations of the joint venture to make sure the operations are consistent with the terms of the joint venture documents (the court in *St. David's* criticized St. David's for not doing this very thing), since failure to do so could expose the joint venture and its participants to IRS scrutiny.

[1] 89 AFTR 2002-2909 and 29998 (W.D.Tex. 2002)
[2] *St. David's Health Care System v. U.S.*, 349 F.3d 232 (Fifth Circuit, No. 02-50939, November 7, 2003).
[3]With respect to the first inquiry, 26 C.F.R. § 1.501(c)(3)-1(c)(1) explains:

> An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

[4] 26 C.F.R. § 1.501(c)(3)-(1)(a).
[5] Treas. Reg. 53.4958-3(a)-(c).
[6] Treas. Reg. 53.4958-3(9)(Example 7).
[7] Treas. Reg. 53.4958-4(a).
[8] Treas. Reg. 54.4958-4(b)(1)(ii).
[9] Treas. Reg. 53.4958-4(a)(4).
[10] Treas. Reg. 53.4958-4(c).
[11] Treas. Reg. 53.4958-4(c)(3).
[12] Treas. Reg. 53.4958-6(a)
[13] Treas. Reg 53.4958-1(e).
[14] Treas. Reg. 53.4958-1(c)(1).
[15] Treas. Reg. 53.4958-1(c)(2).
[16] Treas. Reg. 53.4958-1(c)(2)(iii).
[17] Treas. Reg. 53.4958-1(c)(2).
[18] Treas. Reg. 53.49581(d)(2),
[19] Treas. Reg. 53.4958-1(d).
[20] Treas. Reg. 53.4958-1(d)(4)(iii).
[21] Treas. Reg. 53.4958-4(a)(2)(ii)(B).
[22] Treas. Reg. 53.4958-8.
[23] 113 T.C. 47 (1999). The Tax Court's decision was affirmed on appeal by the 9th Circuit Court of Appeals. *Redlands Surgical Services v Commissioner of Internal Revenue,* 242 F3d 904 (9th Cir. 2001).
[24] *Id. at 49-50.*
[25] *Id. at 50.*
[26] *Id. at 70.*
[27] *Id. at 73-74.*
[28] *Id. at 78-79*
[29] *Id. at 81-82*
[30] *Id. at 81*
[31] *Id. at 82-84*
[32] *Id. at 84*
[33] *Id. at 84-85*
[34] *Id. at 85-86*
[35] *Id. at 85-87*
[36] *Id. at 88-89.*
[37] *Id. at 89.*
[38] *Id. at 96.*
[39] *Id. at 97.*
[40] Exempt Organization Continuing Professional Education Technical Instruction Program for 2002, pp. 162-163.
[41] *Id. at *1.*
[42] *Id. at *3*
[43] *Id. at *4.*

[44] *Id. at *5.*
[45] *Id. at *6-7.*
[46] *Id. at *7.* The court also noted that St. David's provision of emergency care without regard to ability to pay was not compromised by its attempts to collect payment before determining whether the care was charity or bad debt.
[47] *Id. at * 8.*
[48] 349 F.3d at 234.
[49] *Id.* at 235.
[50] *Id.* at 235-236.
[51] *Id.* at 237.
[52] *Id.*
[53] *Id.* at 239.
[54] *Id.* at 241-242.
[55] *Id.* at 243.
[56] *Id.*
[57] *Id.*
[58] *Id.* at 243-244.
[59] *Id.* at 244.

If you have any questions about the issues raised in these materials, please contact Mr. Christopherson at christopherson@ddc-law.com or 231-929-0500.

The opinions expressed in these materials are intended for general guidance only. They are not intended as recommendations for specific situations. The laws, rules, regulations and statutes are subject to change. As always, please consult a qualified attorney for specific legal guidance.

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