Wednesday, December 6, 2017

There has been a growing trend of strategic joint ventures throughout the healthcare industry with the goal of enhancing expertise, accessing financial resources, gaining efficiencies, and improving performance in the changing environment. This includes, for example, hospital-hospital joint ventures, hospital-payor joint ventures, and hospital joint ventures with various ancillary providers (e.g., ambulatory surgery, imaging, home health, physical therapy, behavioral health, etc.). Extra precautions need to be taken in joint ventures between tax-exempt entities and for-profit companies.

The Internal Revenue Service (“IRS”) issued a final adverse determination letter revoking a general acute care hospital’s 501(c)(3) status. Although various details have been redacted, it is clear that the hospital entered into a lease agreement with a for-profit entity in a manner found to be incongruent with its exempt status.

The hospital leased its land, property, and equipment to the for-profit, which specialized in operating rural hospitals. Control of the hospital’s operations (including revenue collection) was given to the for-profit. The for-profit agreed to provide charity care in a manner that was to be consistent with the hospital’s past practice.

IRS § 1.501(c)(3) states that an organization must be organized and operated exclusively for one or more exempt purposes. The regulations further note that an organization is not exempt if it fails to meet either the organizational or operational test. Although an argument was made that the for-profit served an exempt purpose by maintaining the hospital’s land, building, and equipment in order to ensure that it would be available to the public, the IRS noted that there was not enough information to sufficiently make the facts at hand analogous to the authorities that support serving such an exempt purpose.

Ultimately, the IRS revoked the hospital’s status because it was not operated exclusively for a tax-exempt purpose. The lease agreement resulted in the for-profit deriving private benefit that is inconsistent with tax exemption. The IRS noted that the hospital operated in a manner materially different than what was originally represented in the Application of Exemption. Sometime in the 1990s the hospital first transferred management and then operational control to the for-profit. Even though the lease agreement had a provision on providing charity care, the IRS focused on the lack of control the hospital had over its own operations.

In giving an example of a permissible and not-permissible level of control, the IRS brought up the two hospital examples provided in Rev. Rul. 69-545. The IRS stated that the hospital in this instance is more similar to the non-exempt hospital described in Situation 2 of Rev. Rul. 69-545, which was controlled by physicians who had a substantial economic interest in the hospital. By comparison, the exempt hospital in Situation 1 was controlled by independent civic leaders who comprised the board of trustees.

The IRS highlighted Rev. Rul. 98-15, which explored how a joint venture may operate between a non-profit and a for-profit. The IRS further noted that the arrangement between the hospital in this situation and the for-profit
missed the mark. The Revenue Ruling on joint ventures makes it clear that the tax-exempt organization must retain control of the joint venture. Safeguards from Rev. Rul. 98-15 (as noted by the IRS) include the following components in the governing documents of a limited liability company formed to run a hospital:

- The limited liability company will be managed by a governing board that has three individuals chosen by the hospital and two individuals chosen by the for-profit partner.
- Language that effectively prevents the for-profit from amending the governing documents.
- Requirement that the hospital be operated in a manner that furthers charitable purposes by promoting health for the broad cross section of its community.
- Conflict language that states in the event of a conflict between the community benefit standard and any duty to maximize profits, the community benefit standard must win (without regard to the consequences of maximizing profitability).

As joint ventures in the healthcare industry become more prevalent, this final adverse determination letter highlights the importance of properly structuring joint ventures between for-profit entities and tax-exempt organizations by taking into consideration this and other guidance, including Rev. Rul. 98-15 and St. David’s Health Care Sys. v. United States, 349 F.3d 232 (2003).

©2019 Epstein Becker & Green, P.C. All rights reserved.