ANCILLARY JOINT VENTURES AND THE UNANSWERED QUESTIONS AFTER REVENUE RULING 2004-51

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SUMMARY

Ever since the Internal Revenue Service (the "Service") issued Revenue Ruling 98-15 … in which it emphasized "control" as a critical factor in determining whether a tax-exempt hospital that enters into a whole-hospital joint venture with a for-profit entity would continue to maintain its tax-exemption, practitioners and scholars alike have sought guidance from the Service regarding whether such "control" would also be required of an exempt organization that enters into an "ancillary joint venture" with a for-profit entity. In response, the Service issued Revenue Ruling 2004-51 on May 6, 2004.

… In Revenue Ruling 2004-51, the Service enunciated that a tax-exempt university that formed a joint venture with a for-profit entity by contributing a portion of its assets to, and conducting a portion of its activities through, the joint venture would neither lose its tax exemption nor be subject to unrelated business income tax (UBIT) on its share of income from the joint venture because (the facts state that) the tax-exempt university's activities conducted through the joint venture are "not a substantial part of … [the tax-exempt university's] activities within the meaning of § 501(c)(3) and §

1.501(c)(3)-1(c)(1) …" and the activities of the joint venture are substantially related to the university's exempt purpose.

… Regrettably, however, the Service failed to provide any guidance on how it determined that the assets and activities of the exempt university conducted through the joint venture are not a substantial part of the exempt university's activities.

… Such a conclusive disposition of a key element of determining tax exemption within the ancillary joint venture context is puzzling, and fans the embers of ambiguity, because it fails to provide any quantitative or qualitative guidance, or safe harbor tests, for determining when the assets and activities of a tax-exempt organization that are transferred to, and conducted through, a joint venture are considered "not a substantial part of" the exempt organization's activities within the meaning of I.R.C. §501(c)(3) and Treas. Reg. §1.501(c)(3)-1(c)(1) so as not to jeopardize the organization's continued tax exemption…

… Moreover, the Service's conclusion that "based on all the facts and circumstances," the tax-exempt university's participation in the joint venture "taken alone," will not affect its continued qualification for tax exemption is not unequivocal in many respects. … The phrase "taken alone" could be interpreted as suggesting that ancillary joint venture activities of an exempt organization which may not ordinarily result in the loss of tax exemption (because such activities are not considered a substantial part of the organization's activities when viewed separately) may indeed impair tax exemption if in the aggregate such activities constitute a substantial part of the exempt organization's activities.

… To provide clarity to the rules of federal tax exemption within the context of ancillary joint ventures, the Service needs to issue a new ruling clarifying revenue ruling 2004-51 and establishing safe harbor provisions for determining when the assets transferred to, and activities conducted through, a joint venture by a tax-exempt organization would be presumed "not a substantial part of" the exempt organization's assets and activities so as not to jeopardize it tax exemption within the meaning of I.R.C. §501(c)(3) and Treas. Reg. § 1.501(c)(3)-1(c)(1).

I. Introduction

Ever since the Internal Revenue Service (Service) issued Revenue Ruling 98-15[1] in which it emphasized "control"[2] of the joint venture by the exempt organization as a critical factor in determining whether a tax-exempt hospital that enters into a whole-hospital joint venture with a for-profit entity would continue to maintain its tax-exempt status,[3] practitioners and scholars alike have sought guidance from the Service regarding whether such "control" would also be required of an exempt organization that enters into an "ancillary joint venture"[4] with a for-profit entity.[5] The quest for guidance from the Service became insistent following the United States Tax Court decision in *Redlands Surgical Services v. Commissioner* (*Redlands*)[6] and the Fifth circuit decision in *St. David's Health Care System v. United States* (*St. David's*).[7]

In response, the Service issued Revenue Ruling 2004-51 on May 6, 2004, to provide guidance on the tax treatment of ancillary joint ventures between tax-exempt organizations and for-profit entities.[8] Although the ruling utilized a fact pattern involving a tax-exempt university (rather than the hoped-for tax-exempt hospital),[9] its principles apply equally to tax-exempt hospitals. In Revenue Ruling 2004-51, the Service enunciated that a tax-exempt university that formed a joint venture with a for-profit entity by contributing a portion of its assets to, and conducting a portion of its activities through, the joint venture would neither lose its tax exemption nor be subject to unrelated business income tax (UBIT) on its share of income from the joint venture because (1) under the facts of the ruling, the tax-exempt university's activities conducted through the joint venture are "not a substantial part of … [the tax-exempt university's] activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1)" and (2) the activities of the joint venture are substantially related to the university's exempt purpose.[10]

While the ruling was lauded by some as providing the long awaited guidance on ancillary joint ventures,[11] a close examination of the ruling reveals that it raises more questions than answers because the ruling lacks clarity, its conclusive, and most importantly, it fails to provide any directive, bright line tests, or safe harbor tests, for the determination of when the assets and activities of an exempt organization transferred to, and conducted through, a joint venture are or "are not a substantial part of … [the tax-exempt organization's] activities" within the meaning of I.R.C. § 501(c)(3) so as not to jeopardize the exempt organization's continued tax-exemption.[12]

To properly address these questions, it is imperative to examine joint ventures between tax-exempt hospitals and their for-profit counterparts. Accordingly, the foregoing article begins with an overview of joint ventures between tax-exempt hospitals and for-profit entities and the tax implication on exempt status. Next, the article discusses the Service's initial "per se" prohibition against joint venture limited partnerships between tax-exempt hospitals and for-profit entities and the Service's subsequent reversal of its position following the defeat in *Plumstead Theater Society v. commissioner* (*Plumstead*).[13] Thereafter, the article examines the Service's first precedential guidance on whole-hospital joint ventures in which it enunciated "control" as a critical factor in determining tax exemption and the recent judicial tests of the Service's control requirement. Subsequently, the article discusses ancillary joint ventures, and analyzes Revenue Ruling 2004-51, the Service's recent guidance on ancillary joint ventures. Finally, the article discusses the unanswered questions of the ruling and proposes recommendations to the unanswered questions.

II. JOINT VENTURES BETWEEN TAX-EXEMPT HOSPITALS AND FOR-PROFIT ENTITIES

A. Overview

The economic challenges faced by tax-exempt hospitals to remain competitive in today's healthcare industry that is froth with cutthroat competition and Medicare/Medicaid reimbursement declines cannot be overemphasized.[14] Spurred in part by the need to sustain competition by penetrating new markets, obtain new capital for expansion, or embrace advanced medical technological know-how, tax-exempt hospitals have been engaging in various forms of joint ventures with their for-profit counterparts over the past several decades.[15] By the 1990s, the joint venture trend had encompassed practices such as acute care operations, orthopedic facilities, outpatient surgery facilities, elderly care facilities, and psychiatric hospitals.[16]

B. Joint Venture Defined

Essentially, a joint venture is an association of two or more individuals with an objective to embark on a joint enterprise to share the resulting benefits and burdens of the enterprise.[17] As defined by a US District Court, a joint venture is "an association of two or more persons with intent to carry out a single business venture for joint profit, for which purpose they combine their efforts, property, money, skill and knowledge, but they do so without creating a formal partnership or corporation."[18] While some joint ventures may not entail the creation of a formal legal entity to carryout the venture, others may necessitate the establishment of a formal legal structure to conduct the joint venture activity.[19]

C. Typical Forms of Joint Venture Structures

Depending on the intent of the parties, joint ventures may be structured as joint operating agreements, limited liability companies, or partnerships.[20] Within the healthcare industry, the prevailing forms of joint ventures are the whole-hospital joint ventures and ancillary joint ventures.[21] Under a joint operating agreement, the parties may not necessarily form a separate legal entity to carryout out the venture activity.[22] Rather, the parties may simply execute an agreement (the joint venture agreement) stipulating the terms and manner of operation of the joint venture.[23]

Unlike a joint operating agreement, a joint venture structured as a limited liability partnership or a limited liability company requires the formation of a legal entity to carry out the venture activity.[24] Likewise, a joint venture established as a whole-hospital joint venture may be structured as a partnership or a limited liability company, which similarly may entail the formation of a separate legal entity.[25] Under a typical whole-hospital joint venture, one party (e.g., the tax-exempt hospital) contributes its entire hospital facility to the joint venture in exchange for an ownership interest while the other party (e.g., the for-profit entity) contributes cash to the joint venture in exchange for its ownership interest.[26]

III. TAX IMPLICATIONS OF JOINT VENTURES ON TAX EXEMPT STATUS

A. In general.

A tax-exempt hospital may enter into a joint venture with a for-profit entity without jeopardizing its tax-exempt status provided that the tax-exempt hospital complies with the statutory provisions of I.R.C. § 501(c)(3), the accompanying Treasury Regulations, and the Pronouncements of the Service.[27]

B. Statutory Basis of Tax Exemption.

The statutory basis of exemption of the nonprofit hospital from federal income taxation derives from I.R.C. §501(a).[28] I.R.C. §501(a) provides in relevant part that "[a]n organization described in subsection (c) … shall be exempt from taxation under this subtitle …"[29] In enumerating the organizations referred to under I.R.C. § 501(a) as exempt from federal income taxation, I.R.C. § 501(c)(3) identified "[c]orporations and community chest, fund, or foundation, organized and operated exclusively for religious, charitable, or scientific, testing for public safety, literary, or education purposes … [provided] no part of the net earnings of which inures to the benefit of any private shareholder or individual…"[30]

Treas. Reg. § 1.501(c)(3)-1(c)(1) clarifies that an organization will not be regarded as operated exclusively for one or more exempt purposes unless it engages primarily in activities that accomplishes one or more of the exempt purposes enumerated in I.R.C. §501(c)(3).[31] Thus, an organization will not be regarded as operated primarily for tax-exempt purposes "if more than an insubstantial part of its activities is not in the furtherance of an exempt purpose."[32] As explained by the U.S. Supreme Court in Better Business Bureau v. US,[33] "the presence of a single … [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number of or importance of truly … [exempt] purposes.[34] Accordingly, a nonprofit organization must "establish that it is not organized or operated for the benefit of private interests" to qualify as a tax-exempt organization under I.R.C. §501(c)(3).[35]

In applying these rules, the Service adopted an initial position of per se prohibition against a tax-exempt organization entering into a limited partnership joint venture, as a general partner, with private for-profit individuals whom are limited partners.[36]

C. The Service's Initial Per se Prohibition

Historically, the Service viewed with skepticism the participation by a tax-exempt organization as a general partner in a limited partnership joint venture with private for-profit individuals who are the limited partners.[37] Principal among the Service's concern was that impermissible private benefits would flow to the for-profit partners by reason of their involvement in the joint venture partnership.[38] This cynicism shaped the Service's ruling in 1978 when it held that the participation by a tax-exempt organization in a joint venture partnership as general partner with private for-profit individuals who are limited partners creates an inherent conflict of interest that is legally incompatible with being operated exclusively for charitable purposes.[39]

The Service posited that such an arrangement inherently furthers the private financial interests of the private investors and hence inconsistent with the tax-exempt organization's charitable purpose even though the actual purpose of the partnership was to build low-income housing for senior citizens.[40] This per se prohibition became the guidepost of the Service in evaluating and often denying tax-exemption of charitable organizations participating as general partners in limited partnership joint ventures with for-profit individuals who are limited partners.[41]

No sooner had the Service started enforcing the per se prohibition than it suffered defeats, both in the tax court and on appeal in the Ninth Circuit in *Plumstead*.[42] In *Plumstead*, the Service sought to deny Plumstead Theatre's application for federal tax exemption as a charitable organization on the grounds that Plumstead Theatre was operated for a substantial commercial purpose because Plumstead Theatre participated in a joint venture partnership as a general partner with private for-profit individuals who were the limited partners, to raise capital to co-produce a play.[43] The Tax Court, however, disagreed with the Service's contention, stating that the limited partners had no control over the manner Plumstead Theatre operated or managed its affairs and that none of the limited partners was an officer or director in Plumstead Theatre.[44] Upon appeal by the Service, the Ninth Circuit affirmed the Tax Court, holding that Plumstead Theatre was operated exclusively for charitable and educational purposes and therefore qualified for tax exemption under I.R.C. § 501(c)(3).[45]

D. The Service Abandons its Per Se Prohibition Position

Following the defeat in *Plumstead*,[46] the Service abandoned its hitherto per se prohibition by acknowledging (through its General Counsel) in GCM 39005 that a tax-exempt organization may indeed enter into a joint venture partnership as a general partner with private for-profit individuals who are limited partners without automatically losing its tax-exempt status.[47]

In making this confirmation, the Service's General Counsel articulated a two-part test to be used in determining whether the participation by a tax-exempt organization in a joint venture partnership as a general partner with private for-profit individuals who are limited partners would result in the loss of tax exemption: (1) whether the partnership is serving a charitable purpose,[48] and (2) whether the partnership arrangement permits the tax-exempt organization to act exclusively in the furtherance of the purposes for which tax exemption may be granted and not for the benefit of limited partners.[49]

In applying the second prong of the test, the Service has required that the tax-exempt organization maintain effective majority control over the joint venture to ensure that its assets and activities conducted through the joint venture are used to further its tax-exempt purpose.[50] The Service underscored this "control" requirement with respect to whole-hospital joint ventures in revenue ruling 98-15 discussed infra.

E. Revenue Ruling 98-15

Revenue Ruling 98-15 is the Service's first precedential guidance on whole-hospital joint ventures.[51] In Revenue Ruling 98-15, the Service presented two factual scenarios that it called Situations 1 and 2.[52] Situation 1 involved "good facts" which would not lead to the loss of tax exemption, while Situation 2 involved "bad facts" which results in the loss of tax exempt status.[53]

F. Summary of Facts of Situation 1.

Situation 1 involved two hospitals.[54] The first is Tax-Exempt Hospital (TEH1), which owned and operated an acute care hospital while the second is a For-Profit Corporation (FPC1), which owned and operated a number of hospitals.[55] TEH1 was interested in obtaining additional funding to better serve its community while FPC1 was interested in furnishing the funds to TEH1 provided, however, that it earned a reasonable rate of return on the transaction.[56] To accomplish these objectives TEH1 and FPC1 formed a limited liability company (LLC1).[57] Upon formation, TEH1 contributed all of its operating assets, including its hospital facility to LLC1 in exchange for an ownership interest in LLC1 while FPC1 contributed its assets to LLC1 in exchange for its ownership interest in LLC1.[58]

The articles of organization and operating agreement (the "Governing Documents") of LLC1 stipulated that LLC1 would be managed by a governing board, which consisted of a total of five individuals, three of whom were to be appointed by TEH1 while the remaining two were to be appointed by FPC1.[59] TEH1 intended to appoint disinterested community leaders who had experience with hospital matters.[60] A majority of three board members was required to approve certain major decisions involving the operation of LLC1, such as decisions relating to LLC1's annual capital and operating budgets, distribution of its earnings, selection of key executives, acquisition or disposition of health care facilities, approval of certain large contracts, changes in types of services rendered, and renewal or termination of management agreements.[61]

The Governing Documents also required that LLC1 operate its hospitals in a manner that furthered charitable purposes by promoting the healthcare of a broad class of its community.[62] Moreover, the Governing Documents stipulated that the duty of the board members to operate LLC1 in a manner that furthered charitable purposes by promoting the health of a broad class of the community (community benefits) superseded any other duty that they might have to operate LLC1 for the financial benefit of its owners.[63] Thus, in the event of a conflict between operating LLC1 in accordance with the aforementioned community benefits standard and any other duty to maximize profits, the members of the governing board were to satisfy the community benefits standard first without any regard to profit maximization.[64] All distributions of earnings and returns of capital were to be made to the owners of LLC1 in accordance with their respective ownership interests.[65]

G. Summary of Facts of Situation 2

Like Situation 1, Situation 2 also involved two hospitals.[66] The first is a Tax-Exempt Hospital (TEH2), while the second is a For-Profit Hospital (FPH2).[67] FPH2 owned and operated a number of hospitals and provided management services to several other third party hospitals.[68] TEH2 needed of additional financing to better serve its community while FPC2 was interested in providing the financing provided, however, that it earned a reasonable rate of return for its services.[69] Consequently, TEH2 and FPC2 formed a limited liability company (LLC2), with TEH2 contributing all of its operating assets, including its hospital facility to LLC2 in exchange for an ownership interest, while FPC2 contributed its assets to FPC2 in exchange for an ownership interest.[70]

Unlike Situation 1, LLC2's articles of organization and operating agreement (the "Governing Documents") stipulated that LLC2 would be managed by a 50-50 governing board which would consist of a total of six individuals, three of whom were to be chosen by TEH2 and the remaining three were to be chosen by FPC2.[71] TEH2 was to appoint to the governing board disinterested community leaders who had experience with hospital matters.[72] The Governing Documents further provided that the governing agreement may only be amended with the approval of both owners of LLC2 and that a majority of the board members must approve certain major decisions relating to LLC2's operation, such as decisions relating to LLC2's annual capital and operating budgets, the distribution of its earnings over certain levels, approval of certain large contracts, and the selection of key executives.[73]

Unlike the Governing Documents of LLC1, which expressly required the joint venture to make a commitment that providing community benefits would take precedence over profit maximization, LLC2's Governing Documents merely provided that LLC2's purpose is to construct, develop, own, manage, and operate the health care facilities that it owned and to engage in other health care related activities.[74]

H. The Service's Analysis of the law

(1) Applicability of the Aggregate Principle

Pursuant to Treas. Reg. §301.7701-3(b), the Service stated that the two joint ventures would be treated as partnerships for federal income tax purposes and that the "aggregate principle" would be applied to determine the tax consequences of the joint ventures to the partners.[75] Under the aggregate principle, the activities of the partnership are treated as the activities of the partners.[76] Thus, in evaluating whether TEH1 and TEH2 are operated exclusive for charitable purposes within the meaning of I.R.C. §501(c)(3), we include in the examination the activities of LLC1 and LLC2 because their activities are deemed to be the activities of their owners, TEH1 and TEH2.[77]

(2) Operational Test and Retention of Control

In order to qualify for tax exemption, a tax-exempt organization must be operated exclusively for charitable purposes.[78] In construing this provision within the context of a whole-hospital joint ventures, the Service stated that a tax-exempt organization may form and participate in a joint venture partnership with a for-profit entity and satisfy the operational test if the tax-exempt organization's participation in the joint venture furthers its tax-exempt purpose and the joint venture arrangement permits it to act exclusively in the furtherance of its exempt purposes and only incidentally for the benefit of any for-profit partners.[79]

Likewise, the Service confirmed that a tax-exempt organization might enter into management contract with a for-profit party giving the for-profit party authority to use its assets and conduct it activities provided that the terms and conditions of the contract are fair, and tax-exempt organization retains ultimate authority and control over the assets and activities being managed.[80] Thus, if the for-profit party is allowed to control or use the tax-exempt organization's assets and activities for its own benefit, and such benefit is not incidental, the tax-exempt organization would not be considered operated exclusively for tax-exempt purposes and would lose its tax exemption.[81]

I The Service's Conclusions

(1) In General

In applying the stated rules to Situations 1 and 2, the Service concluded that TEH1 in Situation 1 would retain its tax-exemption.[82] Conversely, the Service concluded that TEH2, in Situation 2, would lose its tax exemption because when TEH2 formed the joint venture with FPC2, it was not engaged primarily in activities that furthered its tax-exempt purpose.[83] The Service's adverse ruling against TEH2 was predicated, in part, on the failure of the Governing Documents vest THE2 with majority voting control over the governing board of the joint venture and the failure of the joint venture to require free charity care to the community at large.[84]

(2) Significance of Voting Control

The retention of voting control by the tax-exempt organization over the governing board and the activities of the joint venture was a significant factor in the Service's determination that TEH1 would retain its tax-exempt status while TEH2 would not.[85] For example, in denying TEH2's tax exemption because it lacked majority control of the joint venture under the governing documents, the Service stated that "[b]ecause … [the tax-exempt hospital] will share control of … [the joint venture] with … [the for-profit partner], … [the tax-exempt hospital] will not be able to initiate programs within … [the joint venture] to serve new health needs within the community without the agreement of at least one governing board member appointed by … [the for-profit partner]."[86] Accordingly, the Service concluded that the tax-exempt hospital did not possess the requisite control of the joint venture to ensure that its activities would be used to further its charitable purposes.[87]

The importance of the Service's requirement of majority voting control was further exemplified in the ruling's express provision, in Situation 1, for the tax-exempt organization to appoint a majority (3 out of 5) of the members of the governing board whereas in Situation 2 (where the tax-exempt organization lost its tax exemption), the Governing Documents provided for a 50-50 governing board with appointees to the board being shared equally between the tax-exempt organization and the for-profit partner.[88] Additionally, the tax exempt organization's board appointees had specifically enumerated board powers over changes in activities, disposition of assets, and renewal of management agreements.[89]

The Service's rationale for requiring that the governing documents vest the exempt organization with majority voting control over the board is that by expressly providing for these powers in the governing documents, coupled with the governing "board's structure, which gives … [the tax-exempt hospital's] appointees voting control, and the specifically enumerated powers of the board over changes in activities, disposition of assets, and renewal of management agreement, … [the tax-exempt hospital] can ensure that the assets it owns through … [the joint venture] and the activities it conducts through … [the joint venture] are used primarily to further exempt purposes."[90]

With such control, the Service contends that the tax-exempt hospital can also ensure that the benefits to the for-profit partner and other for-profit private parties will be incidental.[91] In light of the above, it is clear that the control of the joint venture by the tax-exempt organization is a critical element in the Service's determination of whether a tax-exempt organization that enters into a joint venture with a for-profit entity would continue to maintain its tax exemption.[92] Against this background, the pertinent question is whether the courts would uphold the Service's "control" requirement.

IV. JUDICIAL TEST OF THE SERVICE'S CONTROL REQUIREMENT IN REVENUE RULING 98-15

A. Overview

The two major cases on point that have examined the Service's "control" requirement as espoused in Revenue Ruling 98-15 discussed supra are *Redlands Surgical Services v. Commissioner* (*Redlands*),[93] and St. *David's Health Care System v. USA* (*St. David's*).[94] *Redlands* marked the first judicial test of the Service's control requirement as enunciated in Rev. Rul. 98-15.[95]

B. Facts of Redlands

Redlands Surgical Services (RSS) is a California nonprofit public benefit corporate subsidiary of Redlands Health Systems, Inc. (RHS), with a principal place of business in Redlands, California.[96] RHS, also a California nonprofit public benefit corporation, is exempt from federal income taxation under I.R.C. §501(c)(3).[97] Apart from Redlands, RHS is also the parent of three other subsidiaries namely, Redlands Community Hospital (RH), Redlands Community Hospital Foundation (RF), and Redlands Health Services (RS).[98]

On March 1, 1990, RHS formed a general partnership known as Redlands Ambulatory Surgery Center (RASC),[99] (the “General Partnership”) with Redlands-SCA Centers, Inc (SCA Centers), a for-profit corporation, for the purpose of acquiring sixty one percent partnership interests in Inland Surgery Center LP (the “Operating Partnership”).[100] Inland Surgery Center LP is a for-profit partnership that operated a freestanding Ambulatory Surgery Center (the “Surgery Center”).[101] The Operating Partnership was a successful for-profit entity that served only surgical patients who were able to pay by insurance or otherwise.[102] The Surgery Center’s charges were determined on the basis of customary and usual charges for similar services provided by other organizations in the area.[103] The Surgery Center did not offer free care to indigents and had no emergency room or certification to treat the emergency population.[104] Both RHS and SCA Center were co-general partners of the General Partnership.[105]

The day-to-day management of RASC was subcontracted under a long-term contract to SCA Management, a for-profit affiliate of SCA Centers.[106] All questions regarding medical standards and policies at the surgery center were determined by a medical advisory group composed of physicians who were limited partners of the Operating Partnership.[107] The general management and determination of all questions relating to the affairs and policies of the partnership, with the exception of questions relating to the medical standards and medical policies of the centers, were decided by a majority vote of the managing directors.[108] The managing directors consisted of four persons, two of which were chosen by SCA Centers and two by RHS.[109]

To insulate itself from potential liability and claims of potential creditors of the partnership, RHS incorporated RSS on August 1, 1990 to succeed to its partnership interests in RASC.[110] On August 7, 1990, RSS filed an application with the Service for recognition as a tax-exempt charitable organization.[111]

C. The Service's Denial of RSS' Application for Tax Exemption

The Service denied RSS' application for recognition as a tax-exempt organization under I.R.C. §502(c)(3), claiming that RSS was not operated exclusively for charitable purposes as required under I.R.C. §501(c)(3).[112] The predicate of the Service's conclusion that RSS was not operated exclusively for charitable purposes was based on its determination that RSS had "ceded effective control" of the General Partnership over to its for-profit partners and the for-profit management company that was an affiliate of RSS' co-general partner.[113] Accordingly, the Service concluded that the partnership was operated for a substantial non-exempt purpose whereby RSS impermissibly benefited private interests and thus failed to qualify for tax exemption within the meaning of I.R.C. §501(c)(3).[114]

D. The Tax Court Opinion

The tax court ruled that it was it was "patently clear that the Operating Partnership, whatever charitable benefits it may produce, is not operated in an exclusively charitable manner."[115] In making its determination, the tax court adopted the Service's majority control test by stating that under the partnership agreement, control over all matters other than medical standards was divided equally between RSS[116] and its for-profit counterpart with each appointing two representatives to serve as managing directors.[117]

Due to this apparent lack of majority control over the managing board of directors, the Tax Court concluded that RSS would not be able to initiate its own actions without the consent of at least one of the for-profit partner's board appointees, or unilaterally cause the Surgery Center to respond to community needs for new health services, or even terminate SCA Management, if it were determined that it was managing the Surgery Center in a manner that was inconsistent with charitable objectives.[118] Because RSS lacked formal majority control of the operations of the Partnership, the Tax Court upheld the Service's determination that RSS was not operated exclusively for charitable purposes within the meaning of I.R.C. §501(c)(3).[119]

E. The Ninth Circuit's Opinion

RSS appealed the decision of the tax court to the U.S. court of appeals for the Ninth circuit.[120] The Ninth circuit ostensibly adopted the tax court's opinion hook, line, and sinker by upholding that RSS was not operated exclusively for charitable purposes within the meaning of I.R.C. § 501(c)(3).[121] In adopting the tax court's opinion, the Ninth Circuit stated thus, "[s]pecifically, we adopt the tax court's holding that appellant Redlands Surgical Services has ceded effective control over the operations of the partnerships and the surgery center to private parties, conferring impermissible private benefit.[122] Redlands Surgical Services is therefore not operated exclusively for exempt purposes within the meaning of sec. 501(c)(3), I.R.C. 1986."[123]

As the preceding discussion clearly indicate, the fact that RSS lacked majority voting control of the operations and management of the joint venture partnership[124] was the key factor in the Service's and the Courts' determinations that RSS was not operated exclusively for charitable purposes. Thus, the Service's requirement of majority control requirement has been upheld, at least in the Ninth Circuit.[125] However, the Fifth Circuit, in *St. David's*, appear to suggest that where there are certain protections in place in the partnership agreement in favor of the tax-exempt organization to prevent the joint venture from being operated to serve private interests, majority voting control may not be controlling.[126]

V. ST. DAVID'S HEALTH CARE SYSTEM

A. Facts of St. David's Health Care System

St. David's Health Care System, Inc. (St. David's) is a nonprofit entity incorporated in Austin Texas and exempt from federal income taxation pursuant to I.R.C. §501(c)(3).[127] For many years, St. David's owned and operated a hospital and other health care facilities in Austin, Texas.[128] Due to financial difficulties in the health care industry, St. David's formed a partnership with Columbia/HCA Health Care (C-HCA), a for-profit corporation.[129] In exchange for its ownership interests in the partnership, St. David's contributed all of its hospital facilities to the partnership while C-HCA contributed its Austin-area facilities to the partnership.[130] The partnership hired Galen Health Care Inc. (Galen), a subsidiary of C-HCA, to manage the day-to-day operations of the partnership and medical facilities.[131]

B. The Service's Field Audit and Denial of Exemption

In 1998, the Service audited St. David's and determined that because of its partnership with C-HCA, St. David's was no longer qualified as a charitable hospital that was exempt from federal income taxation within the meaning of I.R.C. § 501(c)(3) and ordered St. David's to pay taxes.[132] St. David's paid the taxes under protest and filed a refund petition in the District Court challenging the Service's assessment.[133]

C. District Court Decision

St. David's challenged the Service's assessment in the District court and the District Court ruled in favor of St. David's and ordered a refund of the taxes paid by St. David's as well as a reimbursement of St. David's attorneys fees.[134] Upon appeal by the Service, the Fifth Circuit vacated the judgment of the District Court and remanded the case back to the District Court for further proceedings.[135] In its ruling, the Fifth Circuit adopted in part, the Service's "control" test (that was also adopted by the Ninth Circuit in *Redlands*) by stating that "[i]f private individuals or for-profit entities have either formal or effective control, we presume that the organization furthers the profit-seeking motivations of those private individuals or entities.[136] This is true, even when the organization is a partnership between a nonprofit and a for-profit entity."[137] "Conversely, if the nonprofit organization enters into a partnership with a for-profit entity, and retains control, we presume that the non-profit's activities via the partnership primarily further exempt purposes.[138] Therefore, we can conclude that the non-profit organization should retain its tax-exempt status."[139]

Even though St. David's shared a 50-50 voting control with C-HCA on the board of governors and thus did not have a majority voting control of the governing board, the Fifth Circuit stated that St. David's could still exercise "some control" over the partnership through its power under the partnership agreement to terminate the management service agreement, the CEO, block proposed action of the board of governors, and dissolve the partnership.[140] Nevertheless, the court observed that there were reasons to doubt that the partnership documents provided St. David's with "sufficient control" of the partnership to effectively utilize these powers.[141]

For example, the Court noted that although St. David's could utilize its 50-50 vote to prevent the board from taking an action that might undermine its charitable purpose, it did not have the majority vote to ensure that the partnership will take a new action (without the support of C-HCA) that will further its charitable purpose.[142] In light of the above, the Fifth Circuit concluded that because the partnership's Governing Documents left the court uncertain as to whether the hospital had ceded effective control over to the for-profit partners, summary judgment was improper.[143] Accordingly, the Court vacated the judgment of the District Court and remanded the case back to the District court for further proceedings.[144]

Upon rehearing on remand, a jury trial was held on the limited issue of whether St. David's ceded control of the joint venture to its for-profit partner.[145] On March 4, 2004 the jury returned a verdict upholding St. David's tax exempt status despite the fact that that St. David's shared a 50-50 voting power control with its for-profit partner.[146] On May 13, 2004, the Service appealed the verdict to the 5th Circuit and the outcome of the case is pending at the time of writing.[147] But a week before filing the appeal, the Service issued Revenue Ruling 2004-51 to provide guidance on ancillary joint ventures discussed infra.

VI. ANCILLARY JOINT VENTURES

A. Ancillary Joint Venture Defined

An ancillary joint venture is an undertaking under which an exempt organization transfers less that the entirety of its operations to the venture.[148] Under a typical ancillary joint venture, a tax-exempt organization transfers a portion of its assets to and conducts a portion of its activities through a joint venture formed with a for-profit entity.[149] Thus, the activity conducted by the tax-exempt organization through the joint venture is not the only activity conducted by the tax-exempt organization as it utilizes its remaining assets to carryon its preexisting businesses before it entered into the joint venture.[150]

Because much of the Service's guidance on joint ventures have focused primarily on whole-hospital joint ventures, practitioners and scholars have wondered whether the Service would apply the same "control" requirement enunciated in Revenue Ruling 98-15 in determining whether a tax-exempt hospital that enters into an ancillary joint venture with a for-profit entity would continue to maintain its tax-exempt status.[151] In response, the Service issued revenue ruling 2004-51 discussed infra.

B. The Facts of Revenue Ruling 2004-51

Revenue Ruling 2004-51[152] involves a tax-exempt university (TEU) that is exempt from federal income taxation pursuant to I.R.C. § 501(c)(3).[153] TEU's educational curriculum included summer seminars that were aimed at enhancing the skill level of elementary and secondary schoolteachers.[154]

In order to augment its teacher training seminars, TEU formed a 50-50 joint venture limited liability company (LLC) with O, a for profit company, which specialized in conducting interactive video training programs.[155] LLC's Articles of Organization and Operating Agreement (the "Governing Documents") provides that the purpose of LLC is to offer interactive video teacher training seminars at off-campus locations.[156] Thus, LLC's activities were limited to conducting teacher-training seminars and LLC was not allowed to engage in any activities that would jeopardize TEU's tax-exempt status under I.R.C. § 501(c)(3).[157]

Additionally, the Governing Documents provided that LLC will be managed by a 50-50 governing board that comprised of a total of six directors, three of whom would be chosen by TEU while the remaining three would be chosen by O.[158] LLC was to arrange and conduct all aspects of the video teacher training seminars, including advertising, enrolling participants, arranging facilities, distributing course materials, and broadcasting seminars to various locations.[159] The content of LLC's teacher training seminars was substantially similar to those conducted by TEU on its campus and thus furthered TEU's charitable purposes.[160] Under the Governing Documents, TEU was granted the exclusive right to approve the curriculum, training materials, and instructors.[161] Likewise, TEU was given the exclusive right to determine the standards for successful completion of the seminars and thus TEU had ultimate control and authority over the curriculum.[162]

O, on the other hand, had rights over logistics such as the exclusive right to select the locations where participants can receive a video link to the seminars and approve other personnel (such as camera operators) necessary to conduct the video teacher training seminars.[163] All contracts entered into by LLC with TEU, O, and any other parties were reasonable and at arm's length.[164] Finally, the facts stipulated that TEU's participation in LLC will be an insubstantial part of TEU's activities within the meaning of I.R.C. § 501(c)(3) and § 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.[165]

C. The Service's Discussion of Applicable Law

1. Joint Ventures

For purposes of determining federal tax exemption under I.R.C §501(c)(3), the Service reiterated that a joint venture would be treated as a partnership and that the activities of the joint venture would be deemed the activities of its partners.[166] Additionally, the Service stated that a tax-exempt organization may form a joint venture partnership with a for-profit entity and continue to be treated as being operated exclusively for tax-exempt purposes if (1) its participation in the joint venture furthers its charitable or educational purpose, and (2) the joint venture arrangement permits its to act exclusively in the furtherance of its tax exempt purpose and only incidentally for the benefit of the for-profit partners.[167]

2. The Tax Exemption Issue

Consistent with its previous rulings, the Service stated that the joint venture LLC would be treated as a partnership for federal income tax purposes and that all of its activities will be attributed to its owners for purposes of determining whether the tax-exempt university continues to qualify for federal tax exemption and whether the tax-exempt university's net income from the joint venture would be subject to UBIT.[168]

The Service restated the importance of "control" as a critical factor in meeting the operational test of I.R.C. §501(c)(3) citing to Redlands where the Ninth Circuit held that a tax-exempt partner who lacks sufficient formal or informal control of a joint venture to ensure the furtherance of its charitable purposes would not be considered to have met the operational standard of I.R.C. §501(c)(3) and thus would lose its tax exempt status.[169] Furthermore, the Service referenced the Fifth Circuit's analysis in *St. David's* that the determination of whether a nonprofit hospital that enters into a joint venture partnership with a for-profit entity operates exclusively for tax exempt purposes "is not limited to whether the joint venture partnership provides some (or even an extensive amount of) charitable services."[170] Rather, the nonprofit hospital "also must have the capacity to ensure that the … [joint venture's operations] further … [its] charitable purposes."[171]

Without any further analysis, however, the Service concluded that because the activities, which the tax-exempt university is treated as conducting through the joint venture "are not a substantial part of … [the tax-exempt university's] activities within the meaning of [I.R.C.] § 501(c)(3) and [Treas. Reg.] §1.501(c)(3)-1(c)(1)" and "based on all facts and circumstances, … [the tax-exempt university's] participation in … [the joint venture] taken alone, will not jeopardize … [the tax-exempt university's] continued qualification for exemption as an organization described in [I.R.C.] §501(c)(3)."[172]

With respect to the UBIT question, the Service concluded that because the tax-exempt university's activities conducted through the joint venture are "substantially related" to the exercise and performance of the tax-exempt university's tax-exempt purpose, its share of income from the joint venture would not be subject to UBIT.[173]

To buttress the UBIT conclusion, the Service pointed out that the teacher training seminars conducted by the joint venture using interactive video covered the same content as those conducted by the tax-exempt university on its campus, noting further that the tax-exempt university alone approves the curriculum of the joint venture, training materials, instructors, and the standards for successful completion of seminars.[174] Accordingly, the Service stated that the manner in which the joint venture conducts the teacher training seminars contributes importantly to the accomplishment of the tax-exempt university's educational purposes and the activities of the joint venture are substantially related to tax-exempt university's educational purposes.[175] Therefore, the Service held that tax-exempt university would not be subject to UBIT under I.R.C. §511 on its distributive share of the joint venture's income.[176]

VII. THE UNANSWERED QUESTIONS

A. The Tax Exemption Issue

As shown in the preceding discussions, in order for a tax-exempt organization that enters into a joint venture with a for-profit entity to retain its tax-exempt status, (1) the tax-exempt organization's participation in the joint venture must further its charitable or educational purpose, and (2) the joint venture arrangement must permit the tax-exempt organization to act exclusively in the furtherance of its tax-exempt purpose and only incidentally for the benefit of the for-profit partners.[177] Likewise, a tax-exempt organization that enters into a management contract with a for-profit entity giving the for-profit entity authority to conduct its activities and direct the use of its assets must retain ultimate control and authority over the assets and activities being managed by the for-profit entity in order to maintain its tax-exempt status.[178]

In making the determination, however, the Service has traditionally focused its inquiry on whether the governing documents of the joint venture contain express provisions granting the tax-exempt organization majority voting control over the management and activities of the joint venture.[179] The Service's rationale for requiring that the tax-exempt organization retain majority control over the joint venture is predicated on the Service's presumption that such control enables the tax-exempt organization to ensure that the assets that its transfers to, and activities that it conducts through, the joint venture are used primarily to further its tax-exempt purposes and that the benefits to the private for-profit partners are only incidental to the accomplishment of such exempt purpose.[180]

Thus, activities of the tax-exempt organization that do not further its tax-exempt purpose must be insubstantial because the presence of a single non-exempt purpose, if substantial in nature, will destroy tax exemption regardless of the number or importance of truly exempt purposes.[181] If a tax-exempt organization shares control of the joint venture with a for-profit partner and the governing documents do not expressly require the joint venture to give charitable healthcare needs of the indigent priority over profit maximization, the Service has generally taken the position that the tax-exempt participant is not engaged primarily in activities that furthers its exempt purpose and such exempt organization would lose its tax exemption.[182] The preceding analysis is the typical examination conducted by the Service in determining whether a tax-exempt organization that enters into a joint venture with a for-profit entity will retain its tax-exempt status.[183] In Revenue Ruling 2004-51, however, this was not the case.

The issue in Revenue Ruling 2004-51 was whether a tax-exempt organization that contributes a portion of its assets to and conducts a portion of its activities through a 50-50 joint venture formed and operated with a for-profit corporation would continue to qualify for tax exemption within the meaning of I.R.C. §501(c)(3).[184] Rather than go through the aforementioned analyses to reach its conclusion, the Service dispensed with it and rendered it moot by stating factually (without further elaboration) that the activities conducted by the tax-exempt organization through the joint venture "are not a substantial part of … [the tax-exempt organization's] activities within the meaning of §501(c)(3) and §1.501(c)(3)-1(c)(1)."[185] In other words, the tax-exempt organization's activities conducted through the joint venture are disregarded (and not attributed to the tax-exempt organization) for purposes of determining whether the tax-exempt organization continues to qualify for tax exemption because the activities are "not a substantial part of … [the tax-exempt organization's] activities."[186] The pertinent question therefore, is, how does one determine when the assets and activities of an exempt organization that are transferred to a joint venture are "not a substantial part of" the exempt organization's assets and activities within the context of an ancillary joint venture?

Unfortunately, the Service did not provide any guidance in the ruling beyond merely stating factually (without further elaboration) that the activities conducted by the tax-exempt organization through the joint venture "are not a substantial part of … [the tax-exempt organization's] activities within the meaning of §501(c)(3) and §1.501(c)(3)-1(c)(1)."[187] Such a conclusive disposition of a key element of determining tax exemption within the ancillary joint venture context is puzzling and fans the embers of ambiguity because it fails to provide any quantitative or qualitative bright line test on how to determine whether or not the assets and activities of a tax-exempt organization transferred to, and conducted through, a joint venture are "a substantial part" of the exempt organization's activities within the meaning of I.R.C. §501(c)(3) and Treas. Reg. §1.501(c)(3)-1(c)(1).[188]

Presumably, the reason why the Service concluded that the activities of the exempt organization conducted through the joint venture are not a substantial part of the tax-exempt organization's activities is because the tax-exempt organization transferred only "a portion" of its assets to the joint venture and thus conducted only "a portion" of its activities through the joint venture.[189] Notwithstanding, such a conclusion begs the question of what amount of assets should an organization transfer to suffice for "a portion" of assets that would qualify as "not a substantial part" of the organizations assets or activities within the meaning of I.R.C. §501(c)(3) and Treas. Reg. § 1.501(c)(3)-1(c)(1) so as not to jeopardize its exemption?[190] Would "a portion" be determined based on the relative quantitative and/or qualitative value of the transferred assets vis-à-vis the tax-exempt organization's total assets? If so, would a transfer of, say, between Five to Ten percent of the tax-exempt organization total assets be presumed "not a substantial part of" its assets?

To further compounded the ambiguity, the Service also concluded that "based on all the facts and circumstances," the tax-exempt organization's participation in the joint venture "taken alone," will not affect its continued qualification for tax exemption.[191] This conclusion is also not unequivocal in many respects. First, the Service's "all facts and circumstances"[192] test presupposes or implies that the Service's determination that the tax-exempt organization's participation in the joint venture would not affect its tax-exempt status (because its activities conducted through the joint venture are not substantial) was also based on the other facts in the ruling such as the tax-exempt organization's control of the joint venture, its exclusive right to approve the curriculum, training materials, instructors, and the determination of the standards for successful completion of seminars. Such implication would be incorrect because given that the Service had already established as a matter of fact that the exempt organization's activities conducted through the joint venture are not a substantial part of its activities and thus would not affect its tax exempt status, all the other facts and circumstances contained in the ruling would be relevant, if at all, only with respect to the issue of whether the tax-exempt organization would be subject to unrelated business income tax on its distributive share of income from the joint venture.[193]

Likewise, the Service's use of the phrase "taken alone"[194] in its conclusion that the tax-exempt organization's participation in the joint venture would not affect its continued tax exemption under I.R.C. §501(c)(3) is also not unambiguous. The reason is because the phrase "taken alone" could be interpreted as suggesting that ancillary joint venture activities which would not ordinarily result in the loss of tax-exemption (because such activities are not considered substantial when viewed separately) may indeed impair tax exemption if "in the aggregate" such activities constitute a substantial portion of the tax-exempt organization's activities. In other words, the ruling seem to suggest that when a tax exempt organization is involved multiple ancillary joint venture activities that are individually not considered substantial in comparison to the tax exempt organization's overall activities, such multiple activities are aggregated for purposes of determining the substantiality test.[195] These various interpretations were made possible by the Service's lack of clarity in the ruling.

Besides, the ruling is also not beneficial for planning purposes because the Service drafted the Revenue Ruling to include only "good" facts and failed to include a second set of "bad" facts as it typically does[196] that would apprised the public of potential pitfalls. Furthermore, some of the significant provisions in the ruling do not reflect real-life structures. For instance, the facts state that the ownership of the joint venture is a 50-50 structure between the tax-exempt organization and the for-profit entity with each entitled to appoint three individuals out of the six-member governing board.[197] Yet, the Service skewed the governing documents to disproportionately confer the tax-exempt organization "the exclusive right to approve curriculum, training materials, and instructors, and to determine the standards for successful completion of seminars."[198] Similarly, the joint venture seminars were drafted by the Service to cover the same seminars conducted by the tax-exempt organization (to the exclusion of those of the for-profit partner) even though the joint venture was a 50-50 structure.[199]

Also, the governing documents were disproportionately drafted to prohibit the joint venture from engaging in any activities that would jeopardize the nonprofit member's tax-exemption within the meaning of I.R.C. § 501(c)(3) without regard to the for-profit partner's interest even though the joint venture was a 50-50 structure.[200] While it's apparent that the Service carefully presented the ruling to embrace only the "good facts" that are necessary to arrive at its desired result, it is also clear that the facts do not embody real-life situations where the control and structure of a joint venture typically follow substantially the respective owners' capital contributions to the venture – which in this case was a 50-50 structure.

VIII. RECOMMENDATIONS

To provide clarity to the rules of federal tax exemption within the context of ancillary joint ventures, the Service needs to issue a new ruling clarifying revenue ruling

2004-51 by establishing safe harbor provisions for determining when the assets transferred to, and activities conducted through, a joint venture by a tax-exempt organization would be presumed "not a substantial part of" the exempt organization's assets and activities to jeopardize it tax exemption within the meaning of I.R.C. §501(c)(3) and Treas. Reg. § 1.501(c)(3)-1(c)(1). In establishing these rules under the new ruling, a transfer of between 10 to 15 percent of an exempt organization's assets should fall within the safe harbor presumption of insubstantiality that would not jeopardize tax exemption. Where an organization is involved in multiple ancillary activities, such activities should be aggregated for purposes of determining the substantiality test.

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[1] Revenue Ruling 98-15, 1998 C.B. 718 (March 1998).

[2] Thomas K. Hyatt and Bruce R. Hopkins, *The Law of Tax-Exempt Healthcare Organizations*, p386 (2nd Ed. 2001) ("The central theme of both the IRS's whole-hospital joint venture revenue ruling and the Tax Court's decision in *Redlands* is control.")

[3] Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, §32.4(b) p. 950 (8th Ed. 2003). ("The IRS stated its position with respect to whole hospital joint ventures in 1998")

[4] *See* note 148 *infra* ("An ancillary joint venture is an undertaking under which an exempt organization transfers less that the entirety of its operations to the venture**"**)

[5] John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 Exempt Org. Tax Rev. 187 (Sept. 10. 2001) ("A recent issue of 'EOTR Weekly' headlined the pleas by practitioners for clearer guidance in the 2002 EO CPE text regarding the effects on tax exempt status of joint ventures, particularly "ancillary" joint ventures by health care providers"). *See* also, Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, *supra* note 3, p 956, ("Assuming that the tax-exempt organization … must retain control of its assets in connection with entire and primary involvement in a joint venture, the question remains as to whether control is needed in the ancillary joint venture setting.")

[6] *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), petition for review denied, 242 F. 3d 904 (9th Cir. March 15, 2001).

[7] John D. Colombo, *Achieving Convergence in the Exemption Treatment of Stock and Partnership Investments*, 2004 TNT 59-53 (March 1, 2004) ("Unfortunately, St. David's shed no light on the more difficult issues raised by the IRS policies toward joint ventures, such as the treatment of ancillary joint ventures. IRS guidance on these issues is still promised as forthcoming, but nothing concrete has yet appeared.")

[8] Rev. Rul. 2004-51, 2004-22 I.R.B. 974 (May 6, 2004).

[9] *See* Colombo, and Bruce R. Hopkins, *supra* note 5.

[10] Rev. Rul. 2004-51, at 12, *supra* note 8.

[11] Fred Stokeld, Tax Notes Today, *Practitioners Pleased With Revenue Ruling on Ancillary Joint Ventures*, 2004 TNT 89-3 (May 7, 2004).

[12] Rev. Rul. 2004-51, 11, *supra* note 8.

[13] *Plumstead Theatre Society v. Commissioner*, 74 T.C. 1324 (1980), *aff'd* 675 F. 2d 244 (9th Cir. 1982).

[14] Lawrence E. Singer, *The Conversion Conundrum: The State and Federal Response to Hospitals' Changes in Charitable Status*, 23 Am J.L. and Med. 221, 221 (1997).

[15] Rochelle Korman & William F. Gaske, Patterson, Belknap, Wehn & Tyler, *Joint Ventures Between Tax-Exempt and Commercial Healthcare Providers*, 16 Exempt Or. Tax Rev. 773, 775 (May 1997). *See* also Jack E. Harns, *Justifying the Nonprofit Hospital Tax Exemption in a Competitive Market Environment*, 13 Widener L.J. 383, 451 (2004).

[16] Jack E. Karns, supra, note 15; *See* also IRS LTR 814101 (dealing with X-ray facility ventures), LTR 9518014 (dealing with Elderly care facility ventures); LTR 9345057 (dealing with Outpatient Surgical Care Facility venture); LTR 8432014 (dealing with Psychiatric hospital venture); LTR 9318033 (dealing with orthopedic hospital venture).

[17] Rochelle Korman & William F. Gaske, et al at 781, *supra* note 15.

[18] *Whiteford v. US*, 61-1 U.S. Tax Cas. (CCH) ¶9301; 7 A.F.T.R. 2d (RIA) 949; *See* also, *Harlan v. US,* 812 F. Supp. 130; 93-1 U.S. Tax Cas. (CCH) ¶50,090 ("A joint venture contemplates an enterprise jointly undertaken; that it is an association of such joint undertakers to carry out a single purpose, a proprietary

interest in the subject matter, a right to direct and govern the policy in connection therewith, a duty, which may be altered by agreement, to share both in profit and losses.")

[19] Rochelle Korman & William F. Gaske, et al, at 781, *supra* note 15.

[20] Id.

[21] Gary J. Young, *Federal Tax-Exemption Requirements For Joint Ventures Between Nonprofit Hospital Providers and For-Profit Entities: Form over Substance?*, 13 Ann. Health L. 327, 336 (2004).

[22] Rochelle Korman & William F. Gaske, et al, at 784, *supra* note 15.

[23] Id at 784.

[24] Id.

[25] Id at 786.

[26] Gary J. Young, at 337, *supra* note 21.

[27] Rev. Rul. 1998-1 at 18, *supra* note 1, citing *Plumstead Theatre Society Inc. v. Commissioner*, 74 T.C. 1324 and *Housing Pioneers, Inc. v. Commissioner*, 65 TCM 2191("A section 501(c)(3) organization may form and participate in a partnership, including an LLC treated as a partnership for federal income tax purposes, and meet the operational test if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.")

[28] *See* I.R.C. §501(a). *See* also, Gabriel O. Aitsebaomo, *The Nonprofit Hospital, A Call for New National Guidance Requiring Minimum Annual Charity Care to Qualify For Federal Tax Exemption*, 26, Campbell L. Rev. 75, 80 (Summer 2004).

[29] I.R.C. § 501(a).

[30] I.R.C. § 501(c)(3) (emphasis added); *see* also Aitsebaomo, at 80.

[31] Treas. Reg. §1.501(c)(3)-1(c)(1).

[32] Id.

[33] *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945

[34] Rev. Rul. 98-15, *supra* note 1; Rev. Rul 2004-51, *supra* note 8.

[35] Treas. Reg. §1.501(c)(3)-1(d)(ii)

[36] Bruce R. Hopkins, at p. 939, *supra* note 3.

[37] Id at p. 936.

[38] Id**.**

[39] Private Letter Ruling 7820058.

[40] Private Letter Ruling 7820058.

[41] Bruce R. Hopkins, at p. 939, *supra* note 3.

[42] *Plumstead Theatre Society Inc. v. Commissioner*, 74 T.C. 1324 (1980), aff'd per curiam, 675 F. 2d 244 (9th Cir. 1982).

[43] Id at 1326-29.

[44] Id. at 1335

[45] *Plumstead Theatre v. Commissioner*, 675 F. 2d 244 (9th Cir. 1982).

[46] Id.

[47] GCM 39005.

[48] Id.

[49] Id.

[50] In Rev. Rul. 98-15, 1998-12 I.R.B. 6, 19, the Service stated: "… if a private party is allowed to control or use the non-profit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes." To support its requirement of "control" the Service, in Rev. Rul. 98-15, 1998-12 I.R.B. at 14, cited the following line of cases: ("In *Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980),* aff'd, *675 F.2d 244 (9th Cir. 1982)*, the Tax Court held that a charitable organization's participation as a general partner in a limited partnership did not jeopardize its exempt status. .... One of the significant factors supporting the Tax Court's holding was its finding that the limited partners had no control over the organization's operations." "In *est of Hawaii v. Commissioner, 71 T.C. 1067 (1979),* aff'd in unpublished opinion *647 F.2d 170 (9th Cir. 1981),* several for-profit est organizations exerted significant indirect control over est of Hawaii… The Tax Court concluded that the for- profits were able to use the non-profit as an "instrument" to further their for-profit purposes. … Consequently, est of Hawaii did not qualify as an organization described in section 501(c)(3)." "In

Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), a non-profit hospital with an independent board of directors executed a contract with a medical partnership composed of seven physicians. The contract gave the physicians control over care of the hospital's patients and the stream of income generated by the patients while also guaranteeing the physicians thousands of dollars in payment for various supervisory activities. The court held that the benefits derived from the contract constituted sufficient private benefit to preclude exemption.") *See* also *Redlands Surgical services v. Commissioner*, 113 T.C. 47, 71 (1999), aff'd 242 F.3d 904 (9th Cir. 2001), ("Respondent [the Service] contends that petitioner is not operated exclusively for charitable purposes because it operates for the benefit of private parties and fails to benefit a broad cross- section of the community. In support of its position, respondent [the Service] contends that the partnership agreements and related management contract are structured to give for-profit interests control over the Surgery Center.") *See* also, St. *David's Health Care System v. US*, 349 F. 3d 232, 236, ("The Government does not contend that a non-profit organization should automatically lose its tax-exempt status when it forms a partnership with a for-profit entity. Instead, the Government argues that a non-profit organization must sacrifice its tax exemption if it cedes control over the partnership to the for-profit entity.").

[51] Rev. Rul. 98-15 at 1, *supra* note 1.

[52] Id.

[53] Id.

[54] Id at 2

[55] Id.

[56] Id.

[57] Id.

[58] Id.

[59] Id at 3.

[60] Id.

[61] Id.

[62] Id.

[63] Id. ("The governing documents explicitly provide that the duty of the members of the governing board to operate [LLC1] in a manner that furthers charitable purposes by promoting health for a broad cross section of the community overrides any duty they may have to operate [LLC1] for the financial benefit of its owners.")

[64] Id. ("Accordingly, in the event of a conflict between operation in accordance with the community benefit standard and any duty to maximize profits, the members of the governing board are to satisfy the community benefit standard without regard to the consequences for maximizing profitability.")

[65] Id at 5.

[66] Id at 6, ("D is a nonprofit corporation that owns and operates an acute care hospital. … E is a for-profit hospital corporation that owns and operates a number of hospitals and provides management services to several hospitals that it does not own.")

[67] Id.

[68] Id.

[69] Id.

[70] Id.

[71] Id at 7.

[72] Id.

[73] Id.

[74] Id.

[75] Id at 5 - 18.

[76] Id.

[77] Id.

[78] *See* I.R.C. § 501(c)(3).

[79] Rev. Rul. 98-15, 17-19, supra note 1, ("A section 501(c)(3) organization may form and participate in a partnership, including an LLC treated as a partnership for federal income tax purposes, and meet the operational test if participation in the partnership furthers a charitable purpose, and the partnership

arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners”).

[80] Id at 19.

[81] Id. (“However, if a private party is allowed to control or use the non-profit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes.”)

[82] Id at 23.

[83] Id at 22.

[84] Id at 21-22

[85] Id

[86] Rev. Rul. 98-15, 22, *supra* note 1.

[87] Id at 23.

[88] Id at 3-6. (“C's Articles of Organization and Operating Agreement ("governing documents") provide that C is to be managed by a governing board consisting of three individuals chosen by A and two individuals chosen by B”). (“F's Articles of Organization and Operating Agreement ("governing documents") provide that F is to be managed by a governing board consisting of three individuals chosen by D and three individuals chosen by E.”).

[89] Id at 19.

[90] Id.

[91] Id.

[92] *See* note 81, *supra*.

[93] *Redlands Surgical Services v. Commissioner*, supra note 6.

[94] *St. David’s Health Care System v. United States of America*, 349 F. 3d 232 (2003). Note: The government filed a notice of appeal with the Fifth Circuit on May 13. *See* 2004 TNT 101-3

[95] Bruce R. Hopkins, *supra* note 3, (The IRS’ position with respect to whole hospital joint ventures was basically adopted wholesale when the issue was first litigated.”)

[96] *Redlands Surgical Services v. Commissioner*, *supra* note 6.

[97] Id.

[98] Id.

[99] Id at 50-51.

[100] Id. at 50.

[101] Id.

[102] Id.

[103] Id at 68.

[104] Id.

[105] Id at 50.

[106] Id at 49

[107] Id at 51-52

[108] Id.

[109] Id at 51-52.

[110] Id at 65.

[111] Id at 70.

[112] Id at 71

[113] Id at 76-77.

[114] Id.

[115] Id at 78

[116] Id.

[117] Id at 81

[118] Id.

[119] Id at 79.

[120] Redlands v. CIR, 242 F. 3d 904, 905 (9th Cir. 2001)

[121] Id.

[122] Id.

[123] Id.

[124] *Redlands Surgical Services v. Commissioner*, 80, *supra* note 6.

[125] Redlands v. CIR, 905 supra note 120.

[126] *St. David's Health Care System v. US*, 242-244, *supra* note 94.

[127] Id at 234.

[128] Id.

[129] Id.

[130] Id at 235.

[131] Id.

[132] Id.

[133] Id.

[134] Id.

[135] Id. at 244.

[136] Id at 238.

[137] Id. *See* also, *Redlands Surgical Services v. Commissioner*, 75, *supra* note 6.

[138] Id.

[139] Id. *See* also, Plumstead, 1334, supra note 45.

[140] *St. David's Health Care System v. US*, at 243, supra note 94.

[141] Id at 242 ("[T]here are reasons to doubt that the partnership documents provide St. David's with sufficient control.")

[142] Id.

[143] Id.

[144] Id at 244.

[145] *See* TNT May 25, 2004, Government Appeals Verdict in St. David's Joint Venture, 2004 TNT 101-3 (May 25, 2004).

[146] Id.

[147] Id.

[148] Bruce R. Hopkins, ¶32.5 p. 955, *supra* note 3.

[149] Rev. Rul. 2004-51, supra note 8.

[150] Bruce R. Hopkins, ¶32.5 p. 955, *supra* note 3.

[151] Bruce R. Hopkins, ¶32.5 p. 956, *supra* note 3, ("Assuming that the tax-exempt organization … must retain control of its assets in connection with entire and primary involvement in a joint venture, the question remains as to whether control is needed in the ancillary joint venture setting.").

[152] Rev. Rul. 2004-51, *supra* note 8.

[153] Id.

[154] Id.

[155] Id at 2.

[156] Id.

[157] Id at 3.

[158] Id.

[159] Id.

[160] Id.

[161] Id.

[162] Id.

[163] Id.

[164] Id.

[165] Id.

[166] Id.

[167] Id at 7

[168] Id at 10.

[169] Id. at 7.

[170] Id at 8.

[171] Id

[172] Id.

[173] Id ("Therefore, the manner in which … [the joint venture] conducts the teacher training seminars contributes importantly to the accomplishment of … [the ax-exempt university's] educational purposes, and the activities of … [the joint venture] are substantially related to … [the tax-exempt university's] educational purposes.").

[174] Id at 12 (E.g., "M alone approves the curriculum, training materials and instructors, and determines the standards for successfully completing the seminars.")

[175] Id.

[176] Id.

[177] Id at 6-7 (citing Rev. Rul. 98-15, Rev. Rul. 2004-51 notes: "A § 501(c)(3) organization may form and participate in a partnership and meet the operational test if 1) participation in the partnership furthers a charitable purpose, and 2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.")

[178] Id at 19.

[179] Rev. Rul. 98-15, at 18, *supra* note 1.

[180] Id at 19.

[181] *Better Business Bureau of Washington D.C. v. US,* 326 U.S. 279, 283 (1945).

[182] Rev. Rul. 98-15, at 22, *supra* note 1.

[183] Id. See, *supra* note 50.

[184] Rev. Rul. 2004-51, *supra* note 8.

[185] Id at 10.

[186] Id.

[187] Id.

[188] Id. (the facts of Revenue Ruling 2004-51 provides that the tax-exempt university's "participation in … [the joint venture] will be an insubstantial part of … [the tax-exempt university's] activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1) of the Income Tax Regulations."

[189] Id at 1. (In formulating the issues, the Service stated "[w]hether, under the facts described below, an organization continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company (LLC) formed with a for-profit corporation.")

[190] *See* Rev. Rul. 2004-51, supra note 8, (enunciating that the tax-exempt organization's assets and activities conducted within the joint venture must not be a substantial part of the tax-exempt organization's activities within the meaning of I.R.C. §501(c)(3))

[191] Id at 10. ("Therefore, based on all the facts and circumstances, … [the tax-exempt university's] participation in … [the joint venture], *taken alone*, will not affect … [the tax-exempt university's] continued qualification for exemption as an organization described in § 501(c)(3).")

[192] Id.

[193] Id.

[194] Id

[195] Id.

[196] Rev. Rul. 98-15, at 22, *supra* note 1.

[197] Rev. Rul. 2004-51, 2, *supra* note 8.

[198] Id at 3.

[199] Id.

[200] Id.