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Tax Court Upholds IRS Control Requirement for EO Participation in Joint Ventures — Redlands Surgical Services v. Commissioner

The U.S. Tax Court, in *Redlands Surgical Services v. Commissioner*, 113 T.C. No. 3 (July 19, 1999), gave implicit support to the Internal Revenue Service’s position that charitable organizations participating in joint ventures with for-profit interests must have formal or informal control over the ventures to rely on their activities as furthering exempt purposes. Though significant, this case is only the latest development in an emerging trend toward looking carefully at who controls — and who benefits from — the joint ventures in which charities participate.

Due to its unique facts, *Redlands* is unlikely to signal any threat to exemption for organizations involved in common joint venture activities. It does, however, suggest a need for all tax-exempt organizations to consider whether the structure of their joint ventures with for-profit participants include mechanisms that will support the relatedness of venture activities to charitable purposes so as to avoid treatment of venture proceeds as unrelated business taxable income. The win was crucial for the IRS. A loss would have undermined its position on whole-hospital joint ventures announced in Rev. Rul. 98-15. Whether the IRS will step up its examination efforts in the joint venture area in light of *Redlands* remains to be seen.

The Decision

Redlands Surgical Services (Redlands) petitioned the Tax Court for a declaratory judgment, contesting the Service’s 1996 denial of exemption. Redlands had filed a Form 1023, Application for Recognition of Exempt Status in 1990 claiming that it was organized and operated exclusively to promote health for the benefit of the community, a charitable purpose within the meaning of section 501(c)(3). The IRS responded in its final adverse ruling that Redlands was not operated exclusively for charitable purposes and its operations benefited private interests more than incidentally.

It should be noted at the outset that *Redlands* is unusual in that the applicant had as its sole activity participating in the ambulatory surgery center joint venture at issue. Thus, *Redlands* involved a purportedly charitable organization’s participation in an ancillary joint venture, but presented the exemption question on facts more closely resembling a whole-hospital joint venture.

The Tax Court based its decision on all the facts and circumstances, but enumerated five factors supporting its conclusion that the IRS had properly denied Redlands’ bid for exemption: (1) the lack of any express or implied obligation on the for-profit partners to put charitable objectives ahead of noncharitable ones; (2) Redlands’ lack of voting control over the partnership; (3) Redlands’ lack of formal or informal control sufficient to ensure furtherance of charitable purposes; (4) the long-term management contract giving a for-profit vendor too much control and an incentive to maximize profits; and (5) the important competitive advantages secured by the for-profit partners through their arrangement with Redlands.

The Facts

The facts are complicated enough to warrant an 83-page opinion, including an organizational chart. Redlands is a wholly owned nonprofit subsidiary of RHS Corp., a § 501(c)(3) organization and the parent
of a typical reorganized hospital system located in California. Redlands’ sole purpose and activity is to hold a partnership interest in and help govern a partnership that controls another (i.e., second tier) partnership that operates a freestanding ambulatory surgery center located close to Redlands Community Hospital, a sister nonprofit corporation to Redlands.

While Redlands Hospital had an outpatient surgery program of its own, the hospital wanted to increase its outpatient surgery capacity and lacked the funds or capability to construct or operate a freestanding facility. RHS assisted the hospital by becoming co-general partner with Redlands-SCA Surgery Centers, Inc. (“SCA Centers”) in a general partnership (Redlands Ambulatory Surgery Center, or “RASC”) formed to acquire a 61 percent interest in an existing outpatient surgical center near Redlands Hospital. SCA Centers is a subsidiary of Surgical Care Affiliates Inc. (SCA), a for-profit organization that, at the time, owned and operated about 40 ambulatory surgery centers throughout the United States. SCA Centers contributed 63 percent of the capital to RASC in return for a 54-percent interest in profits, losses, and cash flow.

According to the partnership agreement, RASC was to be “equally controlled by representatives of [RHS and SCA Centers].” The agreement called for four managing directors, two chosen by each partner, none of whom were entitled to modify the partnership agreement. With certain limited exceptions, if the directors were unable to reach agreement, either partner could institute binding arbitration. The agreement also called for formation of a medical advisory group to determine “all questions relating to the medical standards and medical policies of the center.” Determining what constituted a medical decision, standard, or policy rested with the managing directors, who chose 50 percent of the medical advisory group. The partnership agreement included a non-compete clause, which prohibited Redlands Hospital from expanding or promoting its own outpatient surgery program.

In April 1990, RASC became sole general partner in a second-tier limited partnership (Inland Surgery Center, L.P.) that owned and operated the surgical center. Inland Surgery Center, L.P. had operated a freestanding ambulatory surgery center since 1983. The Inland partnership had 32 limited partners, all physicians on staff at Redlands Hospital, with the exception of a medical clinic. Two of the limited partners were board members of the hospital and RHS.

RHS later formed a wholly owned subsidiary, Redlands, to succeed to its interest in the partnerships. This is what makes the case distinguishable from the usual ancillary joint — Redlands’ sole activity was to hold the partnership interest and help govern the partnerships. Redlands holds 46 percent, and SCA 54 percent, of RASC.

The Inland partnership agreement provides that SCA Management Company, a wholly owned subsidiary of SCA, has a 15-year management contract to operate the ambulatory surgery center, renewable at the management company’s sole option for two successive five-year periods. SCA Management also employs all non-physician personnel at the surgery center. The management agreement is terminable by Inland (the second-tier operating partnership) for cause.

The IRS Denial

After a lengthy consideration, the IRS decided that Redlands did not qualify for tax exemption under § 501(c)(3). In analyzing the case in its final denial letter, the IRS took pains to distinguish the two key court cases involving charitable organization participation in joint ventures. Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff’d, 675 F.2d 244 (9th Cir. 1982), held that a charitable theatre organization’s participation as a general partner in a limited partnership was permissible where the limited partners had no control over the partnership’s operations and no control over the charitable organization. On the other hand,

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2 While RASC initially acquired a 61-percent interest in the Inland partnership, it subsequently reduced its interest to 59 percent by selling 2 percent to a physician.
Housing Pioneers, Inc. v. Commissioner, 65 T.C.M. (CCH) 2191 (1993), aff’d, 49 F.3d 1395 (9th Cir. 1995), held that a low income housing sponsor’s activities performed as co-general partner in a for-profit limited partnership substantially furthered non-exempt purposes where the charitable organization’s authority was narrowly circumscribed and the for-profit partner was in a position of control.

The IRS determined that Redlands was effectively in a minority ownership position, having less than 30 percent ownership of the second-tier partnership. It also determined that Redlands had no meaningful control over the general partnership, because the governance was shared 50/50 with SCA, with a clause requiring binding arbitration for disputes. The Service believed that an arbitrator would be likely to rule in a manner that would maximize profits for SCA and the other private investors. The Service also found that the long-term management contract running to an affiliate of SCA contributed to Redlands’ lack of real control. In the Service’s view, Redlands had the liability of the general partner, but could not exercise control over the partnership because the for-profit participants had control. Thus, it determined that Redlands operated for private benefit, a substantial non-exempt purpose sufficient to preclude exemption under § 501(c)(3).

First Issue: Qualification for “Stand Alone” Exemption

The Tax Court first went through the standard analysis of the applicable legal tests for exemption, the “organizational” and “operational” tests drawn from § 501(c)(3) and the regulations and case law thereunder. As applied by the court, the operational test focuses on the actual purposes the organization advances by means of its activities, not merely its statement of purpose or the nature of its activities. Where, as here, the organization sought to qualify for exemption based solely on its participation in a partnership, the partnership’s activities are attributed to the applicant. The operational test can be difficult to satisfy where for-profit interests are closely intertwined with a charitable organization because the applicable standard is tough: the presence of a single nonexempt purpose, if substantial, will destroy exemption regardless of the number or importance of truly exempt purposes.

Under Tax Court rules, the burden of proof was on Redlands to demonstrate, based on materials in the administrative record, that it was operated exclusively for exempt purposes and did not benefit private interests more than incidentally. Like the IRS, the Tax Court relied chiefly on the distinction between Plumstead Theatre and Housing Pioneers to inform its view that, where private interests have control over a charitable organization’s assets, nonincidental private benefit may result.

The court reasoned that, to the extent Redlands ceded control over its only activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, Redlands could not ensure that the joint venture operated in furtherance of exempt purposes. On the facts before it, the court found that Redlands had effectively ceded control over its only activity to the for-profit parties, and thus conferred significant private benefit on them.

In the court’s view:

- There was no obligation binding on the parties to put charitable purposes ahead of economic objectives.
- Redlands lacked majority control. It had the power to block actions, but not to initiate action without consent of at least one director appointed by the for-profit participant.
- Redlands had no other rights or powers that might compensate for lack of control. For example, the binding arbitration process did not require the arbitrators to take into account charitable or community benefit objectives.
- A for-profit affiliate was authorized to manage the day-to-day operations of the venture and had a financial incentive to maximize profits. The
management agreement had a 15-year term and gave the management company sole discretion to renew for two 5-year periods. Redlands’ only power to terminate the agreement for cause was through its 50/50 control of RASC, the general partner.

- The Medical Advisory Group was made up entirely of limited partner physicians who held stock in the for-profit participant.

- There were no indications in the administrative record that Redlands had any informal control to offset the lack of formal control.

- The surgery center “provides no free care to indigents and only negligible coverage for Medi-Cal patients.”

- By entering into the joint venture, Redlands’ parent and predecessor in interest, RHS, restricted its future ability to provide outpatient services at Redlands Hospital or elsewhere without consent of its for-profit partner. The court found it difficult to conceive of a charitable purpose that would be furthered by this restriction.

Second Issue: Qualification for “Integral Part” Exemption

In a second-level analysis, the court determined that Redlands could not be exempt as an integral part of Redlands Community Hospital or their common parent (RHS) because, on the facts presented, its activities were not substantially related to the exempt purposes of either affiliate. Drawing heavily on its earlier decision in *Geisinger Health Plan v. Commissioner* and other cases, the court observed that “the integral part doctrine requires the organization in question to provide ‘necessary and indispensable’ services solely to an exempt organization to which it bears some legal or significant operational relationship.”

The court focused on two issues in denying integral part status to Redlands. First, there was no showing that the patient population treated in the joint-ventured ambulatory surgery center overlapped substantially with that of Redlands Hospital. This lack of patient overlap had been a key factor in the court’s denying integral part status in *Geisinger*. Second, the court looked at whether the appropriate supervision or control relationship with an exempt affiliate was present. It seems beyond dispute that a sufficient parent-subsidiary corporate relationship was present in *Redlands*. However, the court fastened upon its finding that Redlands’ sole activity was controlled by for-profit parties, and reasoned that Redlands’ activities served private interests and, therefore, were not substantially related to the exempt purposes of its affiliates.

Practical Effect

The most important effect of the Redlands decision is that it tracks the analysis applied to exempt organization participation in joint ventures announced in Rev. Rul. 98-15, and thus implicitly supports the ruling. As a practical matter, most organizations participating in joint ventures with for-profit interests engage in a multitude of activities that further exempt purposes, so that activities pursued through joint ventures are a minor part of their overall activities. Accordingly, the key issue for most of these organizations under Rev. Rul. 98-15 and Redlands is whether revenues received from the ventures are related or unrelated.

Under Code § 512(c), a tax-exempt organization that is a partner in a partnership must examine each item of income and deduction flowing through from the partnership to determine the appropriate reporting of that income on the exempt participant’s Form 990 or 990T. Joint venture participants may need to take a fresh look at the character of income they receive from joint ventures to determine whether it is related or unrelated. In addition, they should evaluate the desirability of making adjustments in existing and planned joint venture arrangements to (1) obtain

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3 100 T.C. 394 (1993), aff’d, 30 F.3d 494 (3d. Cir. 1994).

4 Id. at 405.
majority control or (2) maintain other formal or informal control that is sufficient to ensure that the joint venture conducts its activities in a manner that furthers exempt purposes.

Individual tax-exempt organizations participating in joint ventures with physicians or for-profit interests are encouraged to compare the Tax Court’s opinion with the facts and circumstances of their own ventures. Important issues to consider in individual circumstances include (1) the potential effect of additional unrelated business income on the participating exempt organization; (2) the extent to which the exempt participant has sufficient formal or informal control through the venture agreement and any related management agreement; (3) whether the potential risks posed by noncompetition clauses are offset by other provisions in the venture documents addressing the public or community benefit provided by the venture; and (4) the extent to which the venture agreement requires that the venture itself be operated in a manner that furthers the exempt participant’s charitable purposes (e.g., by operating consistently with the community benefit standard of Rev. Rul. 69-545).

If you have any questions, please do not hesitate to contact Bernadette Broccolo at (312) 245-8454 or any member of the Gardner, Carton & Douglas Health Law or Tax Departments.