Court Decision and IRS Revenue Ruling Provide Additional Support for 50/50 Joint Ventures

By T.J. Sullivan and Lauren K. Mack

Executive Overview

The jury verdict in the *St. David’s* case and Revenue Ruling 2004-51 provide additional support and guidance for healthcare organizations that participate in 50/50 ancillary joint ventures. In March, a District Court jury in Texas upheld St. David’s tax-exempt status, finding that, although St. David’s shared 50/50 voting control on the governing board of its whole hospital joint venture, St. David’s had not thereby ceded control to its for-profit partner. On May 6, the Internal Revenue Service (“IRS”) published Revenue Ruling 2004-51, in which it explicitly acknowledged that majority voting control on a joint venture board is not an absolute requirement, at least in the context of an ancillary joint venture that is not a substantial part of the organization’s activities. While Revenue Ruling 2004-51 addresses a university that participated in a 50/50 ancillary joint venture to provide interactive video training, the principles applied in the ruling are broadly applicable to all ancillary joint ventures and provide welcome guidance for healthcare organizations. A key factor in each case was that the joint venture was structured to provide the exempt organization significant control, through governance mechanisms such as reserved powers and supermajority voting rights, over those aspects of the joint venture directly related to its exempt purposes. This focus on targeted, rather than overall, control provides a workable framework for healthcare organizations structuring joint ventures for ancillary health services.

St. David’s Jury Verdict

On March 4, 2004, the jury in *St. David’s Health Care System v. U.S.* determined that, despite entering into a whole hospital joint venture where St. David’s shared voting control on a 50/50 basis with a for-profit partner, St. David’s had not ceded control to the for-profit partner, and therefore, returned a verdict upholding St. David’s exemption.

In 1996, St. David’s Health Care System of Austin, Texas (St. David’s) had entered into a whole hospital joint venture in which it holds a minority ownership interest and shares 50/50 voting control of the resulting partnership with Columbia/HCA Healthcare Corporation (now HCA), an investor-owned company. An HCA affiliate manages the joint venture under a management agreement with a fifty-plus year term. The activities conducted through the venture represent substantially all of St. David’s activities.

The IRS audited St. David’s and, in 2000, retroactively revoked its tax exemption on the basis that, by forming the partnership and splitting voting rights 50/50 between the two partners, St. David’s had ceded control of the venture’s operations to a for-profit concern, and therefore, the system no longer qualified as a charitable, tax-exempt organization described in Internal Revenue Code Section 501(c)(3). St. David’s paid taxes for 1996 under protest and sued for a refund in the Western District of Texas. The district court granted St. David’s motion for summary judgment and ordered the government to refund the taxes and to pay St. David’s attorney’s fees and costs of just over $950,000. The government appealed, and on November 7, 2003, the Fifth Circuit reversed and remanded the case to the district court.

The Fifth Circuit determined that control was a material fact and rejected an analysis based solely on the provision of charitable services. The Court, relying heavily on Revenue Ruling 98-15 and the decision of the U.S. Tax Court and the U.S. Court of Appeals for the Ninth Circuit in *Redlands Surgical Services, Inc. v. Commissioner,* held that, in determining whether an exempt entity that forms a partnership with a for-profit entity has ceded control to the for-profit and therefore should lose its exemption, the key issue is whether the exempt organization has sufficient control over the venture to ensure the furtherance of charitable purposes. The Court concluded that, because the record did not clearly establish whether St. David’s retained sufficient control of the venture, there was a genuine issue of material fact in dispute, and thus, the district court’s summary judgment was inappropriate.
On remand, a jury trial was held on the narrow issue of whether St. David’s had ceded control to its for-profit partner. The jury decided that, despite the 50/50 sharing of voting control, St. David’s had proven by a preponderance of the evidence that it retained sufficient control to ensure charitability, and therefore, should retain its exemption.

**Revenue Ruling 2004-51**

On May 6, the IRS published Revenue Ruling 2004-51. This ruling applies the principles developed in prior cases and rulings, such as St. David’s, Redlands, and Revenue Ruling 98-15, to the more common ancillary joint venture. In many respects, the ruling can be seen as an extension of the earlier cases and rulings. It is a critical development, however, in that it is the first published joint venture guidance from the IRS since Revenue Ruling 98-15, and the first time the IRS has explicitly recognized that majority voting control is not an absolute requirement for exempt organization participation in joint ventures. In addition, Revenue Ruling 2004-51 is the first published ruling to specifically address the unrelated business income tax consequences of an ancillary joint venture.

In Revenue Ruling 2004-51, the IRS analyzes a university’s participation in a joint venture to conduct interactive video training. As part of its educational programs, the university offers teacher training seminars. To expand the reach of these seminars, the university formed a 50/50 joint venture with a for-profit entity that specializes in conducting interactive video training. The joint venture’s governing documents provide that the sole purpose of the joint venture is to offer teacher training seminars at off-campus locations using interactive video technology. The joint venture documents further provide that activities are limited to conducting teacher training seminars and require that the joint venture not engage in any activities that would jeopardize the university’s exemption. In a welcome development, the IRS moved away from the approach of requiring an express override of exempt purposes over all other considerations, which generally was unpalatable to the for-profit participants. The IRS appears to have adopted the Fifth Circuit approach of simply requiring a clear exempt purpose binding on the parties, continuing the emphasis on inclusion of a clear statement of the relevant exempt purpose to be furthered by the joint venture.

The university and the for-profit partner each hold a 50 percent ownership interest, which is proportionate to their capital contributions, and all allocations and distributions will be made in proportion to ownership interests. This is consistent with the “financial interest” test historically applied to joint ventures.

The joint venture has a six-member governing board, with the university and the for-profit each appointing three members. The university has the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars — i.e., those decisions it would make for its other programs that directly further its educational purposes. The application of this principle to ancillary healthcare joint ventures is a bit more complex, as the community benefit standard for the charitable promotion of health is not as clear-cut as the definition of “educational” purposes set forth in the Treasury Regulations. This IRS approach to targeted control suggests that, in the healthcare setting, the exempt organization should retain control over determinations with respect to community benefit. Such control typically is reflected in a requirement that the joint venture address community benefit in a specific manner, such as an agreed-upon standard for provision of charity care, and in reserved powers or special voting requirements on business and financial decisions that affect the joint venture’s ability to fulfill its charitable purposes.

Interestingly, the for-profit participant in the joint venture has the exclusive right to select the locations for video links and to approve the technical personnel necessary to conduct the video training. The inclusion of this fact in the ruling supports a flexible approach in which a tax-exempt organization has, for example, some ability to address concerns of physician investors regarding control over clinical decisions.

All other decisions require the mutual consent of the university and the for-profit. Thus, the IRS did not require majority voting control for all decisions. This approach recognizes the business realities facing exempt organizations that desire to expand their activities through participation in ancillary joint ventures.

The ruling states that the university’s participation in the joint venture will be an insubstantial part of the university’s activities. Inclusion of this fact allows the IRS to clearly distinguish ancillary joint ventures from whole hospital and similar joint ventures in which the activities conducted in the venture represent substantially all of the activities of the exempt organization. This approach effectively limits the application of the control analysis in the Fifth Circuit’s opinion in St. David’s, while leaving open the question of the required degree of control in non-ancillary joint ventures.

The IRS reiterates the position set forth in Revenue Ruling 98-15 that the activities of a joint venture taxed as a partnership are attributed to the tax-exempt partner for purposes of determining whether the tax-exempt partner continues to
qualify for exemption and whether the tax-exempt participant is engaged in an unrelated trade or business. The IRS concludes, without detailed analysis, that the university’s participation in the joint venture does not affect its tax-exempt status.

Revenue Ruling 2004-51 provides a more detailed analysis of the application of the unrelated business income rules to the university’s participation in the joint venture than that provided in Revenue Ruling 98-15. In another welcome development, the IRS applies the traditional approach, looking to whether the university’s activities conducted through the joint venture are substantially related to the exercise and performance of its exempt purposes. Based on all the facts discussed above, the IRS concludes that the manner in which the joint venture conducts the video training seminars contributes importantly to the accomplishment of the university’s exempt purposes. Although the IRS looked to targeted control over the educational aspects of the joint venture’s activities as part of its analysis, the overall focus was on the manner in which the activities were conducted and was not limited to control. This approach provides further support for the position that certain healthcare activities conducted through 50/50 ancillary joint ventures may be substantially related to a healthcare organization’s exempt purposes.

Endnotes

1 Ms. Mack, formerly a partner of Gardner Carton & Douglas LLP, provides various services to the firm and its clients pursuant to a contractual agreement between the firm and Ms. Mack.

2 1998-1 C.B. 718.

3 113 T.C. 47 (1999), aff’d, 242 F.3d 904 (9th Cir. 2001).


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For more information on the St. David’s verdict and Revenue Ruling 2004-51, please contact the Gardner Carton & Douglas attorney who serves as your regular contact. Alternatively, please contact any member of the Health Law Department listed below.

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