EXEMPTION REVOKED: ONE HOSPITAL'S JOINT VENTURE MISHAP

Posted on **January 2, 2018** by **James R. Malone, Jr.**

Introduction

Joint ventures between non-profit hospitals and for-profit enterprises are fairly common in the health care industry. The arrangements, however, require careful attention, or the non-profit may put its tax exemption at risk.

PLR 201744019, released by the IRS in November 2017, illustrates the problem: On August 7, 2017, the IRS retroactively revoked the exempt status of a hospital operator as of February 1, 2011 after concluding that an agreement that it reached sometime during the 20th century meant that it was not operated exclusively for charitable purposes. The joint venture was a whole-hospital arrangement in which the exempt organization leased its land, property, and equipment to a for-profit management company which then operated in the organization's name. In that context, it is worth noting three things:

- The exempt organization entered into the joint venture in an effort to keep a hospital operating in a remote community that otherwise would have limited access to health care;
- The arrangement yielded millions of dollars in charitable care; and
- From the outset, the exempt organization fully disclosed the change in its operations to the IRS on its annual returns.

None of these things mattered.

Background

Section 501(c)(3) requires that exempt organizations be "organized and operated *exclusively* for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . ." I.R.C. § 501(c)(3) (emphasis added). Historically, the IRS interpreted this to preclude any joint venture between an exempt organization and a for-profit enterprise. In 1980, however, the Tax Court rejected that position, ruling that a community theater group was qualified for exempt status despite the fact that it was involved in co-producing a play that had a "commercial hue" and had sold a portion of its rights to investors to raise capital necessary for the performance. *Plumstead Theatre Soc'y, Inc. v. Comm'r*, 74 T.C. 1324, 1330-34 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

For exempt organizations considering a whole-hospital joint venture, a critical piece of guidance is Revenue Ruling 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94 (Mar. 23, 1998), which compares two joint ventures, a "good" joint venture, and a "bad" one.

In the good venture, an exempt organization and a for-profit hospital operator formed an LLC; the exempt organization contributed its hospital to the LLC, and the for-profit entity contributed capital. 1998 IRB LEXIS 94, *2. The exempt organization had elected to enter into the arrangement to obtain additional funding so that it could better serve its community. The arrangement had some key features:

- The exempt organization had voting control over the LLC, as it was entitled to appoint three of the five board members;
- Amendments to the LLC's governing documents required the approval of both owners;
- Certain key decisions required board approval, including budgets, distribution of earnings, selection of senior management, acquisition or disposition of facilities, large contracts over a specific level; changes to the types of services to be offered by the hospital, and renewal or termination of management contracts;
- The LLC was required to run any hospital it operated to further charitable purposes; and
- The LLC's governing documents imposed a duty on the board to operate the LLC in a fashion that served a charitable purpose by promoting health for a broad cross-section of the community, which would trump concerns about profitability.

Id. at *3-*4.

Distributions and returns of capital would be shared proportionally. The LLC entered into a management agreement with an unrelated management company for a five-year term that was renewable on mutual consent and provided commercially reasonable compensation based upon gross revenues. The LLC could terminate the management contract for cause. *Id.* at *4. None of the officers, directors or key employees of the exempt organization were promised employment with either the for-profit participant or the LLC that was formed to carry out the venture, and none of them received any other inducement to agree to enter the joint venture. The exempt organization planned to use its distributions from the LLC to fund grants to support community health initiatives. *Id.* at *4-*5.

In the bad arrangement, the exempt organization apparently went forward with good intentions; it sought additional funds to enhance its operations and entered into a joint venture with a for-profit venture as a result. The resulting LLC was quite similar to the good venture:

- Interests in the LLC were proportional;
- A majority of the board was required to approve key contracts; and
- The governing documents for the LLC could not be changed without both owners' approval.

There were also some key differences: The board was evenly divided, and there was no requirement that charitable purposes trump profit motives. *Id.* at *6-*7.

The LLC then entered into a management agreement that provided for a reasonable fee, but the agreement was with a subsidiary of the for-profit partner. The renewal terms for the management agreement were one-sided: The management company could extend the agreement in its discretion, while the LLC could only terminate the agreement for cause. *Id.* at *7-*8. The exempt organization also agreed that two individuals who previously worked for the for-profit partner would serve as the chief executive officer and chief financial officer of the LLC, receiving compensation that was consistent with market norms for those with comparable experience. *Id.* at *8.

The differences in the structure for the bad joint venture proved dispositive: The IRS ruled that the non-profit would lose its exemption if it participated because it had not established that it would continue to be operated exclusively for exempt purposes. This was because the for-profit elements associated with the LLC were attributed to the exempt organization as a member of the LLC.

PLR 201744019

Before drilling into the details of this ruling, a word on the general subject of private letter rulings is in order: They are heavily redacted to protect the privacy of the individual or entity that is the subject of the ruling; while laudable, that can make them difficult to follow. Thus, in PLR 201744019, it is hard to understand the sequence of events because years are listed as 19xx or 20xx; consequently, we can only assign particular events to a particular century. Despite that handicap, the ruling is still instructive.

PLR 201744019 involved a community hospital in an area that apparently had limited available services. After it struggled, it initially entered into an arrangement with a for-profit management company; subsequently, it leased all of its facilities to a for-profit hospital manager that specialized in operating rural hospitals. The for-profit entity agreed to provide charity care in a manner consistent with past practice. All of these events occurred at some point in the 20th century, and the exempt organization reported on the changes in its operations on an ongoing basis through its annual 990 filings.

At some point in *this* century, the lease arrangement was renewed. The exempt organization reported that, and it also advised the IRS in its 990 filings that the arrangement had yielded millions of dollars in charitable care in the community.

The IRS elected to audit the exempt organization, and it determined that it was not operated exclusively for a charitable purpose. Key factors cited in the ruling included the organization's inability to demonstrate that the rent that it received was appropriate. The ruling also focused on the fact that the exempt organization ceded control over the hospital to a for-profit enterprise. While the language in the lease about charitable care was noted, the ruling observed that there was no enforcement mechanism in place. As a consequence, the organization's exemption was revoked. The analysis is consistent with Revenue Ruling 98-15 and appears to be sound on the merits.

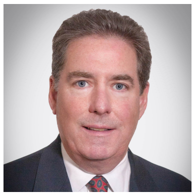
For good measure, the revocation was made retroactive to February 2011, because the exempt organization operated in a way that was materially different from the operational model described in its original application. The revenue agent who conducted the examination justified the retroactive revocation on that basis, despite acknowledging that the exempt organization had regularly reported the changes on its 990s. As a rationale, the agent's report indicates that the organization did not request a private letter ruling on its status or request an affirmation letter. That explanation does not appear to be sound:

- *First*, the IRS has indicated that it will not issue private letter rulings on questions whether "changes in an organization's activities or operations will affect or jeopardize the organization's exempt status." Rev. Proc. 2017-3, 2017-1 I.R.B. 130, 2017 IRB LEXIS 3, § 3.01(71). And it also will not rule on the implications of joint ventures for an exempt organization. , § 3.01(72). In fairness to the agent, it is conceivable that the standards for private letter rulings were more flexible when the exempt organization first entered into the arrangement.
- *Second*, affirmation letters are issued by the IRS when requested to confirm the fact that an organization previously qualified for tax-exempt status; they are commonly sought when an organization changes its name, for example. The affirmation letter process does not involve an examination of how the exempt organization is operating; that is what audits are for.

PLR 201744019 offers two lessons:

- The ruling plainly reinforces the importance of careful planning in the context of any joint venture.

- Perhaps more importantly, it demonstrates that proper planning for a joint venture is only the start, as an existing joint venture may also pose a threat to tax-exempt status either due to changes in the way it operates or changes in the standards applied by the IRS.



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