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Theodore T. Myre Jr.
Wyatt, Tarrant & Combs

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Significant Tax Issues in Hospital Related Joint Ventures

BY THEODORE T. MYRE, JR.*

OVERVIEW

In the past few years, hospital related joint venture arrangements have become increasingly popular. Because of the recent high incidence of hospital failure and the competitive demands placed upon them by the growth of large nonexempt multi-institutional hospital companies, tax exempt hospitals have been forced to take innovative and sometimes dramatic steps to maintain or expand their patient bases. When a hospital enters into a joint venture with a physician group, hospital-physician ties naturally are strengthened, while the referral network, essential to the success of any hospital, is reinforced. Joint ventures allow hospitals to expand the nature and breadth of their services, often at lower costs than would be incurred if the hospital undertook the venture independently, and often with the added expertise of specialized coventurers. Such arrangements also provide hospitals with a fresh source of capital to finance new ventures.

This Article focuses primarily on the tax considerations faced by exempt hospitals when planning a joint venture with unrelated taxable entities or groups of individuals. The Internal Revenue Service ("the IRS") has repeatedly stated that it will view such arrangements with special scrutiny.1 Even closer at-


tention will be given to joint ventures with physician groups, because of the IRS’ growing suspicion that exempt hospitals, unless contained, will shower undeserved benefits upon such physicians. Because of this strict scrutiny standard, exempt hospitals must use great care when entering into these ventures. Where possible, the blessing of the IRS should be obtained by way of a binding private letter ruling (although time constraints may not allow for such a ruling). In addition, the IRS will not rule on many of the factual issues that represent the greatest risk to an organization’s exempt status.

I. TAX CONCEPTS RELATING TO EXEMPT ORGANIZATIONS

As a backdrop to the discussion of specific tax issues arising from a hospital’s participation in a joint venture, this Article first reviews three unique tax concepts that apply to tax exempt organizations, which have as their primary tax concern the maintenance of their exempt status. These concepts are private inurement, private benefit, and the unrelated business income tax.

A. Private Inurement

Section 501(c)(3) of the Internal Revenue Code of 1986 ("the Code") provides that "no part of the net earnings of [the exempt organization] . . . [may inure] to the benefit of any private shareholder or individual." In addition, in order

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2 See, e.g., Gen. Couns. Mem. 39,498 (Apr. 24, 1986). These suspicions are confirmed to some extent in a study by Professor Regina Herzlinger, soon to be published in the Harvard Business Review, which concludes that many exempt hospitals are controlled by and operated for the benefit of their staff physicians. See also Lowry Hosp. Ass’n v. Commissioner, 66 T.C. 850, 859 (1976) (hospital lost § 501 exemption because physicians received net earnings benefit).

3 An exemption determination takes approximately three months; a determination involving a reorganization, including a joint venture arrangement, can take from six months to a year, depending upon the complexity of the transaction.

4 A letter ruling is no longer the only way to obtain advice from the Internal Revenue Service (hereinafter IRS) National Office. In a break from prior practice, rulings division personnel are now allowed, in their discretion, to discuss substantive tax issues with a taxpayer prior to the receipt of a written ruling request. See Rev. Proc. 87-1, 1987-1 I.R.B. 7, and compare Rev. Proc. 83-36, 1983-1 C.B. 763, 770. In addition, IRS personnel very often are cooperative at the District level.

to gain and maintain exempt status, an organization must be organized and operated exclusively for charitable purposes. The penalty for violating this proscription is severe: the organization will lose its tax exempt status. For purposes of section 501(c)(3), "private shareholders or individuals" are broadly defined as "persons having a personal and private interest in the activities of the organization." Generally, if an individual or entity can exercise control over the purse strings or policies of an exempt organization on a less than arm's-length basis, such individual or entity can be the recipient of inurement. Therefore, the term "private shareholder or individual" includes directors and officers, as well as founders and substantial contributors. According to the General Counsel's Office of the IRS, the term also includes physicians on the staff of the exempt hospital. This interpretation, a classic example of casting the net too far, is discussed in greater detail below.

In determining the existence of private inurement, the amount of the private enrichment apparently is irrelevant, even if it is relatively insubstantial. "When Congress conditioned the exemption upon 'no part' of the earnings being of benefit to a private shareholder, it specifically intended that the amount or extent of benefit should not be controlling." However, as a general rule, inurement is found to exist only in egregious circumstances.

The prohibition against private inurement, however, does not preclude a charitable organization from paying compensation or making other payments to "insiders" so long as the

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6 Id.


8 Treas. Reg. § 1.501(a)-1(c) (1986).


10 Human Eng'g Inst. v. Commissioner, 37 T.C.M. (CCH) 619, 632 (1978) (organization lost tax exemption when individuals received small benefit).

11 See supra note 7 and accompanying text.
payments are reasonable in amount.\textsuperscript{12} In dealing with nonexempt entities, the IRS may challenge the characterization of unreasonable compensation by corporations, attempting to convert what otherwise would be a business deduction into a non-deductible dividend.\textsuperscript{13} With exempt entities, the stakes are higher; if the level of compensation is successfully challenged, the organization can lose its exemption.\textsuperscript{14}

Where possible, the participation of "private shareholders or individuals" in a hospital joint venture should be avoided due to the potentially disastrous consequences. If this is not possible, the transaction must be structured with extreme caution.

B. Public Purpose/Private Benefit

A tax exempt organization must serve public rather than private interests.\textsuperscript{15} Similarly, the organization cannot further a substantial nonexempt purpose.\textsuperscript{16} Although similar to private inurement, this concept is broader in scope because the private benefit need not necessarily be bestowed upon an "insider" for the problem to arise. This concept also looks more to the underlying objectives of the organization. Thus, it is less of a "strict liability" offense because pure motives theoretically should absolve the organization of poor business judgment.

Assuming that a hospital will attempt to act in its own best interest, it is difficult to conceive of a situation where a hospital would enter into a joint venture with the primary purpose of

\textsuperscript{12} See John Marshall Law School v. United States, 81-2 U.S. Tax Cas. (CCH) \S 9514 (1981) (private inurement occurred when individuals received payments exceeding reasonable levels); Rev. Rul. 76-441, 1976-2 C.B. 147 (an organization that makes transfers conferring a financial benefit to an individual will not qualify for \S 501(c)(3) exemption).

\textsuperscript{13} See Treas. Reg. \S 1.162-8 (1960).

\textsuperscript{14} See, e.g., 81 U.S. Tax Cas. (CCH) \S 9514; Unitary Mission Church v. Commission, 74 T.C. 507, 514 (1980) (religious organization making excessive salary payments to individuals lost \S 501 tax exempt status).

\textsuperscript{15} Treas. Reg. \S 1.501(c)(3)-1(d)(1)(ii) (1976).

conferring a private benefit at the expense of furthering its public purpose. In any joint venture transaction, each participant is required to give up something in order to receive something in return. The mere fact that the ultimate benefit to the hospital is exceeded by the ultimate cost of the venture should not, in theory, jeopardize the hospital’s exemption unless the “loss” was intended from the outset, an unlikely proposition. Essentially, any benefit conferred upon nonexempt persons in an arm’s-length transaction should be considered as incidental to the public purpose and therefore should not threaten a hospital’s exemption.

The IRS, however, has developed a much stricter “incidental benefit doctrine,” with both qualitative and quantitative components. For a private benefit to be qualitatively incidental, the arrangement must be necessary and must confer the least amount of private benefit possible while still permitting the venture to go forward and sustain its viability. Thus, for instance, if staff physicians are permitted to purchase condominium units in an adjacent medical office building at less than fair market value, the hospital must be able to demonstrate that the failure to include such a feature would cause the recruited physicians to go elsewhere. The hospital must be able to demonstrate that other less costly avenues have been considered and found not to be feasible.

For a private benefit to be quantitatively incidental, the ultimate benefits derived by the hospital from its participation in the joint venture must exceed the costs. In the cost-benefit analysis, the cost to the hospital of participating in the joint venture is relatively easy to measure. It is much more difficult

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17 The hospitals that tend to get in trouble in this regard are typically smaller hospitals that are founded and operated by a group of doctors. See supra note 7 and accompanying text.
21 The shifting of tax benefits to private coventurers is not a “cost” to the hospital (unless shifted by a taxable subsidiary) because tax benefits are generally of no value to tax exempt entities.
to value benefits derived by the hospital because they often include intangible benefits received over a long period of time.

**C. Taxable Income**

The limitations placed on exempt organizations by the private inurement and private benefit concepts compel those organizations to behave in a manner deserving of an exemption, or else face the consequences. These limitations do not, however, prohibit an exempt organization from engaging in a trade or business unrelated to its exempt function, as long as such business is conducted for the benefit of the exempt organization. Because such trade or business is unrelated to the organization's exempt function, however, it is not shielded from tax by the organization's exemption. Instead, special rules have been developed to separate the unrelated trade or business from the organization's exempt activities and to treat it, to some extent, as a separate taxpaying entity.\(^2\)

Income will be taxable to an exempt organization if the income constitutes "unrelated business income" ("UBI").\(^2\) Section 512(a) of the Code defines UBI as "gross income derived . . . from any unrelated trade or business . . . regularly carried on by it, less the deductions . . . which are directly connected with the carrying on of such trade or business."\(^2\) "Unrelated" means not "substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance" of the organization's exempt functions.\(^2\) Generally, UBI does

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\(^2\) At one time, income derived by an exempt organization from an unrelated trade or business was exempted from tax on the theory that the income was being used for an exempt purpose. This was deemed, however, to confer an unfair competitive advantage upon businesses operated by exempt organizations. Eventually, the advantage was eliminated by the enactment and imposition of the unrelated business income tax. See Treas. Reg. § 1.513-1(b) (1983).

\(^2\) I.R.C. § 511(a) (1983).

\(^2\) I.R.C. § 512(a) (1983). If an organization can prove that the trade or business is not regularly carried on, it is not subject to the tax on UBI. Treas. Reg. § 1.513-1(c) (1983). See Parklane Residential School v. Commissioner, 45 T.C.M. (CCH) 988 (1983) (receipt of $100,000 from an unrelated business constituted taxable income to normally tax exempt organization).

not include passive income, such as dividends, interest, royalties, and rents from real property.\textsuperscript{26}

Income, such as rental income, normally considered related, will be taxable as UBI if it is derived from debt-financed property, unless substantially all of the encumbered property is used for the exempt organization's exempt purpose.\textsuperscript{27} Substantially all, for these purposes, is eighty-five percent (85\%).\textsuperscript{28}

If an organization's unrelated activities exceed fifty percent (50\%) of its total activities, its exemption could be jeopardized.\textsuperscript{29} If more than eighty-five percent (85\%) of its activities are related, however, there should be no threat to its exemption.\textsuperscript{30} If the level of unrelated activities falls between these two thresholds, the impact is unclear and could depend upon the particular facts and circumstances.\textsuperscript{31} Unrelated activities should not pose a problem for most hospitals because related receipts will almost always dwarf income from unrelated activities. Such unrelated activities could create a problem, however, for a hospital subsidiary or other related organization. For instance, a parent holding company in a hospital system frequently does not conduct substantial activities and therefore a small amount of unrelated activity could threaten its exemption.\textsuperscript{32}

The IRS has indicated that it will step up its search for UBI during audits. In addition, the House Ways and Means

\textsuperscript{26} See I.R.C. § 512(b) (1984). Of course, if an exempt hospital participates in the joint venture by way of a taxable subsidiary, any income earned therefrom will be taxable to such subsidiary.

\textsuperscript{27} See I.R.C. § 514(a) (1986). This rule was enacted in 1969 to close a loophole that allowed a taxable entity to sell a building or business to a charitable organization (at capital gains rates) and rent it back (taking rental deductions against ordinary income) such that the rent and debt payments were virtually a wash. See, e.g., Commissioner v. Brown, 380 U.S. 563 (1965) (illustrating the loophole abuse).

\textsuperscript{28} Treas. Reg. § 1.514(b)-1(b)(1)(ii) (1980).

\textsuperscript{29} Although there are no definitive guidelines on this point, the threshold is derived from the primary purpose test of Treas. Reg. § 1.501(c)(3)-1(c)(1) (1976) (If the amount of unrelated activities exceeds 50\% of the total, the unrelated activities become primary.).


\textsuperscript{31} See S. HOLUB & L. KALICK, HOSPITAL TAX MANAGEMENT (1983).

\textsuperscript{32} If the parent holding company lost its exemption, it is possible that all subsidiaries, including the hospital subsidiary, also could lose theirs.
Committee has scheduled hearings during this year to examine the effect of the UBI provisions on competition between exempt organizations and taxable entities.\textsuperscript{33}

II. \textsc{Choice of Entity}

\textbf{A. Partnership Form}

When entering a joint venture, a hospital must decide whether the resulting entity should be a partnership or a corporation and whether the hospital should participate directly or by way of a taxable or exempt subsidiary.\textsuperscript{34} The inurement and private benefit analysis is in many respects the same regardless of which entity participates.

When a hospital participates in a joint venture, it usually does so as a general partner. This allows the hospital to maintain the day-to-day control necessary to accomplish its objectives and protect its interest.\textsuperscript{35} It is only in recent years that exempt hospitals have been permitted to serve as general partners in limited partnerships with nonexempt coventurers. Prior to 1977, the IRS generally prohibited such participation on the ground that the hospital-general partner's fiduciary duty to the limited partners was inconsistent with the requirement that it be operated exclusively for charitable purposes. This position was reversed in a series of rulings issued thereafter.\textsuperscript{36}

The partnership form increases, to some degree, the private benefit threat because the hospital, as general partner, must expose its assets to the potential claims of partnership creditors. This exposure provides a clear and direct benefit to the limited partners.

\textsuperscript{33} BNA Daily Tax Report (Sept. 16, 1986).

\textsuperscript{34} The word "subsidiary," as used in this Article, does not necessarily refer to a direct subsidiary of the hospital, but also may include subsidiaries of a parent holding company.

\textsuperscript{35} Control by the exempt entity can also be critical from a private benefit standpoint. \textit{See} Gen. Couns. Mem. 39,444 (Nov. 13, 1985); Gen. Couns. Mem. 38,394 (June 2, 1980).

Other major distinctions, from a tax standpoint, between the partnership and corporate form generally involve income tax or UBI considerations. If the hospital participates by way of a taxable subsidiary, all income derived from the joint venture will be taxable to the subsidiary. If the hospital participates directly or by way of an exempt subsidiary, the income derived by the hospital (or subsidiary) will be nontaxable to the extent it is related to the hospital's exempt function. Unrelated income will be taxed as UBI.

An advantage of the partnership form is that losses can be allocated to the limited partners in a manner disproportionate to their ownership interest, thereby providing attractive tax benefits to private coventurers at essentially no cost to the hospital. Such "special allocations," either of loss or gain, will be effective for tax purposes as long as the allocations have "substantial economic effect," as that term has been interpreted by regulations under section 704(b) of the Code.

Prior to the Tax Reform Act of 1986, partnerships could be used to allocate losses and investment tax credit to limited partners, such as physicians, who could put such benefits to their best and highest use. Such allocations could be very valuable to a hospital because they diminished the limited part-

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37 The fiduciary duty conflict notion, however, is still around. See Gen. Couns. Mem. 39,444 (Nov. 13, 1985). See also Gen. Couns. Mem. 39,546 (Aug. 14, 1986) (The IRS recognized that there would always be tension where an exempt organization acted on behalf of nonexempt participants in a profit-making venture, stating that the issue was a factual one and each case must be carefully scrutinized.).

38 A partnership is a flow-through entity; that is, all income or loss flows through to the partners prior to the imposition of any tax. I.R.C. § 701 (1984). Accordingly, a single layer of tax is imposed at the partner level.

39 See supra notes 23-25 and accompanying text.

40 See I.R.C. § 704(b) (1984); Treas. Reg. § 1.704-1(b) (1964). These regulations, while quite complicated, basically require that any loss allocated to a partner must actually be borne by such partner by way of a corresponding reduction in the value of his interest in the partnership. Similarly, the allocation of gain must increase a partner's interest. Liquidation of the partnership must be in accordance with each partner's interest in the partnership, as adjusted during the term of the partnership in the manner described above. While this description represents a gross oversimplification of the substantial economic effect rules, it captures their underlying purpose and provides a rough approximation of their operation.


42 See Treas. Reg. § 1.704-1(c)(2) (1985) (giving effect to the allocations provided in the partnership agreement).
ners' interests in the partnership (pursuant to the substantial economic effect rules), thereby increasing the hospital's relative interest, at no cost to the hospital. The partnership format essentially allowed the hospital to sell tax benefits.

The "passive loss rules," enacted as part of the Tax Reform Act of 1986, have markedly reduced this ability. These rules have the effect of diminishing the value of losses derived from a limited partnership interest because such losses are only available to offset gains from similar investments. There are also special rules that limit tax benefits where a partnership has a tax exempt partner. These rules are discussed in Part IV of this Article.

An activity that is expected to be profitable and is related to the hospital's exempt function generally should be conducted in partnership form with the hospital or an exempt subsidiary acting as general partner. The income to the general partner will be nontaxable as related income. On the other hand, if the activity is related and is expected to lose money, conducting the activity out of a taxable subsidiary in order to use such losses against corporate income might be advisable.

Unrelated activities generally should be conducted by utilizing a taxable subsidiary as general partner because a hospital's (or its subsidiary's) exemption could be jeopardized if the hospital engages in excessive unrelated activities. A hospital, however, might prefer to participate directly in the unrelated activity and bear the tax on UBI.

For a partnership to be treated as such for tax purposes, it cannot have too many corporate characteristics. Limited part-

44 See Tax Reform Act of 1986, § 501. On the other hand, income-producing limited partnerships will be in much greater demand than they were prior to the Tax Reform Act of 1986. There are many investors trapped in tax shelters generating passive losses who need passive income against which such losses can be offset.
45 See infra notes 65-68 and accompanying text.
46 Losses sustained by an exempt organization from one unrelated activity probably cannot be used to offset UBI derived by the organization from another unrelated activity.
47 See supra notes 29-32 and accompanying text.
48 See Treas. Reg. §§ 301.7701-2, 301.7701-3 (1983). An organization will not be treated as a partnership for tax purposes if any three of the following corporate
HospitaTAL TAX ISSUES

If the joint venture is operated in corporate form, the resulting corporation cannot qualify as tax-exempt if any of the shareholders are taxable persons. In addition, the corporation cannot pass through its losses (or gains) by making an S corporation election because it will not be eligible for such status. Therefore, if losses are expected from the activity, the partnership form would be preferable, unless non-tax considerations dictate otherwise.

Under the Tax Reform Act of 1986, a corporation and its shareholders have a greatly reduced ability to avoid the double tax on corporations. Under prior law, the double tax could be avoided, at least upon liquidation, because the final sale of assets by a corporation prior to liquidation was generally tax-free under the provisions of section 337. The new Act effectively repeals section 337, at least in part, thereby assuring a double tax on taxable shareholders and a single tax on exempt shareholders.


See infra note 53 and accompanying text.
See I.R.C. § 337(a) (1982).
See Tax Reform Act of 1986, § 631; I.R.C. §§ 336, 337 (1984). There still will be no gain on final distribution at the exempt entity level because § 331(a) treats amounts received in complete liquidation as amounts received in a sale or exchange of stock and § 512(b)(5) excludes gain from the sale or exchange of property from the definition of UBI.
The nonrecognition provisions of section 337 will remain in effect until 1989 with respect to corporations with assets valued at $5,000,000 or less. This relief provision, however, is cold comfort to joint ventures entered into at this time because it is unlikely that they are being formed with the intention of liquidating in such short order.

When a hospital or exempt subsidiary participates in a corporate joint venture with taxable shareholders, the income paid out to the exempt entity will first be reduced by the corporate level tax. The dividends received by the organization, however, generally will be excluded from the tax on UBI.

All in all, there is little from a tax standpoint that would recommend a corporate joint venture over a partnership joint venture, especially after the Tax Reform Act of 1986. The corporate form does reduce the potential exposure of the exempt entity to the claims of creditors and eliminates the fiduciary duty conflict, thereby diminishing the private inurement or private benefit risk. In addition, a hospital might choose the corporate form if the activity is related and the hospital cannot bear additional UBI. Of course, other non-tax considerations might dictate that the corporate form be chosen.

III. TAX EXEMPT ENTITY LEASING RULES

A. Basic Rules

Under the tax exempt leasing rules, enacted as part of the Deficit Reduction Act of 1984, property falling within the definition of “tax-exempt use property” is not eligible for the

56 If the hospital or an exempt subsidiary exercises too much control over the day-to-day activities of a taxable subsidiary, the activities of the taxable subsidiary could be attributed to its exempt parent, thereby causing loss of exemption. See Gen. Couns. Mem. 39,326 (Aug. 31, 1984). This can be a significant problem in some restructured hospital systems. A corporate joint venture, however, does not pose as great a threat because control is usually diluted by the presence of unrelated coventurers.
full range of tax benefits that otherwise would be available. In the case of personal property, tax-exempt use property is defined as property leased by an exempt entity. Such property must be depreciated under less generous depreciation rules than otherwise would be available. In addition, the investment tax credit is denied with respect to such property.

In the case of real property, the definition of tax-exempt use property is much more complicated. To be tax-exempt use property, thirty-five percent (35%) of the property must be used by an exempt entity or governmental unit and [i] the property must be financed with tax-exempt bonds and the tax-exempt entity (or a related entity) must have participated in the financing, [ii] the lease must contain a fixed or determinable purchase price or sale option involving the tax-exempt entity (or a related entity), [iii] the lease must occur pursuant to a sale-leaseback, or [iv] the term of the lease must exceed twenty years.

Tax-exempt use real property must be depreciated over the greater of forty (40) years or one hundred twenty-five percent (125%) of its lease term. This lengthened depreciation period only applies to the extent the property is "tax-exempt use property." Thus, if forty percent (40%) of a building is tax-exempt use property, the remaining sixty percent (60%) may qualify for the regular depreciation rates.

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These rules were passed to correct a perceived abuse where an exempt organization would sell tax benefits by arranging for a taxable entity to acquire property needed by the exempt organization, take the tax benefits with respect thereto, and lease the property to the exempt organization at reduced, albeit guaranteed, rents. See S. REP. No. 169, 98th Cong., 2d Sess. 123, 125-27 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. pt. 2, at 1138 (1984).


I.R.C. § 48(a)(4) (1986). The investment tax credit was generally repealed by the Deficit Reduction Act of 1984, effective January 1, 1986. See Tax Reform Act of 1986, § 211. There is, however, always the possibility that it might return.

I.R.C. § 168(j)(3)(B) (1986). Under prior law, the penalty that applied to tax-exempt use real property was comparatively stiffer than under the Tax Reform Act of 1986. This is because the depreciation rules passed under the new Act generally require that all real property be depreciated under the straight-line method over a period of thirty-one and one-half (31.5) years. Under prior law, such property could generally be depreciated under an accelerated method over nineteen (19) years.

If real property is used under a lease of less than three (3) years, its characterization as tax-exempt use property can be avoided. For this purpose, options renewable at fair market value are not taken into account, but certain successive leases are aggregated. Basically, this exception is available only if it is not expected at the time the initial lease is entered into that there will be a renewal of the lease such that the original term and subsequent renewals will have an aggregate term exceeding three (3) years.64

B. Application to Joint Ventures

Special rules apply to property used or leased by a partnership that has a tax-exempt partner. If property is used or leased by such a partnership "[t]he determination of whether any portion of such property is tax-exempt use property shall be made by treating each tax-exempt entity partner's proportionate share . . . of such property as being leased to such partner."65 The tax-exempt entity leasing rules will apply to that portion.

In addition, if property is owned by a partnership with both tax-exempt and taxpaying partners and the property is not otherwise tax-exempt use property, an amount equal to the tax-exempt partner's proportionate share of such property will be treated as tax-exempt use property if any allocation to the tax-exempt partner is not a "qualified allocation."66 A qualified allocation has "substantial economic effect" and is consistent with the tax-exempt partner being allocated the same share of the partnership's income, gain, loss, deduction, credit and basis during the entire period that the exempt entity is a partner.67 These provisions can also be avoided if the activity of the partnership is unrelated to the exempt partner's charitable function such that income derived therefrom constitutes UBI.68

64 See Hokanson v. Commissioner, 730 F.2d 1245 (9th Cir. 1984). The legislative history to § 168(j) indicates that the principles of Hokanson will be applied in determining the actual term of a lease. See S. REP. No. 169, 98th Cong., 2d Sess. 123, 150 (1984).
IV. SPECIFIC VENTURES

A. Doctors' Office Buildings

The IRS has issued numerous favorable rulings permitting an exempt hospital to participate in a medical office building joint venture without such participation threatening its exempt status or exposing it to UBI. The IRS generally looks with greater favor on arrangements in which the hospital retains some elements of control.

If the building is adjacent to the hospital and is sold or leased to staff physicians, the activity of the joint venture will be deemed related to the hospital's exempt function and any income received by the exempt general partner will not be UBI. This might not be true if the hospital sells condominium units in a medical office building to doctors if such doctors are permitted to resell to persons who are not members of the medical staff. The same problem could arise if physician-tenants sublease to non-physicians. In addition, relatedness could be questioned if the building is not in proximity to the hospital. In such a case, it is more difficult to prove the necessary benefit to patients.


Proximity is considered to be critical because it enables the physicians to serve the outpatient needs of persons seeking medical services from the hospital on an ambu-
Private inurement or private benefit might be a concern when there is insufficient evidence that arm’s-length negotiations took place between the hospital and its physicians, when there is too close a relationship between the physicians and the hospital governing body, or when there are other identifiable attributes that raise the possibility of an impermissible shift in benefits.\(^7\) These attributes might include a lack of adequate loan security, a bargain rate of interest on a loan from the hospital, or a sale or lease at less than fair market or fair rental value to physicians. In addition, it would seem that private benefit or inurement might result, in the partnership setting, if a disproportionate allocation of profits to physicians has been made.\(^7\)

IRS rulings have permitted hospitals to offer bargain arrangements to physicians when there are valid justifications for doing so. Rural hospitals generally are given more freedom to offer incentives than urban hospitals.\(^7\) Any time a physician subsidy is contemplated, however, the approval of the IRS should be obtained through a private letter ruling, especially in light of General Counsel Memorandum ("GCM") 39,498, discussed below.

B. Magnetic Resonance Imagers

The IRS also has ruled favorably with respect to joint ventures set up to own and operate magnetic resonance imagers\(^7\) and computerized axial tomographic (CT) scanners.\(^7\) Like med-

\(^7\) The private inurement issue is raised based upon the IRS position that staff physicians constitute “insiders” for purposes of § 501(c)(3). This position, announced in Gen. Couns. Mem. 39,498 (Apr. 24, 1986), is discussed infra in text accompanying note 87.

\(^7\) This could be true even if the allocation has “substantial economic effect” under § 704(b). The substantial economic effect rules only require that the tax consequences follow the economics of the partnership deal. They do not, however, bless those economics from a business standpoint.


ical office building joint ventures, these ventures usually are carried out in partnership form with the exempt entity serving as general partner. The activities of such ventures generally are considered to be related to the hospital's exempt function and therefore any income derived therefrom by the hospital should not be UBI.

C. Other Health Care Ventures

The IRS also has ruled favorably on a number of other hospital-related joint ventures, including joint ventures established to operate health care service organizations, ambulatory care centers, alcohol and drug treatment centers, home health care agencies, and health maintenance organizations. If the joint venture treats patients of the participating exempt hospital, the income derived by such hospital should be exempt (assuming the joint venture is set up as a partnership). A hospital, under certain circumstances, possibly might derive related income even though the joint venture treats patients of other hospitals.

V. Physician Recruitment Programs/Physician Joint Ventures

In May 1986, the IRS issued a General Counsel Memorandum ("GCM") declaring that a physician recruitment program that provided a two-year income guarantee to the recruited physician could jeopardize the hospital's exemption, absent a

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6. As a general rule, in order for medical treatment to be related to a hospital's exempt function, the persons treated must be patients of the hospital. See Rev. Rul. 85-110, 1985-2 C.B. 166.
7. See id. at 168. This exception is applicable only in "unique circumstances." It provides that treatment of non-patients will be related if such treatment is not otherwise available to such persons or is needed on an emergency basis.
payback requirement. The GCM is disturbing because the IRS concluded that staff physicians with apparently little or no control over hospital policies could be the recipients of private inurement. Accordingly, any undue benefits received by them could result in revocation of the hospital’s exemption. Although the ruling was directed at physician recruitment programs, the legal conclusions reached therein have great relevance to joint ventures between hospitals and physicians.

The facts of the ruling concerned a proposed recruitment plan that obligated the hospital to guarantee a newly recruited physician an annual income for a period of two years by means of a system of subsidies. The physician would be under no obligation to repay any of the subsidies except out of income earned in excess of the guaranteed annual income during the two-year contract period. In setting the amount of guaranteed income, the hospital would carefully consider each physician’s capabilities and specific needs. In exchange for the guarantee, the physician would be required to perform certain services for the hospital, such as training and emergency room duties. The guaranteed minimum annual income would be offered by the hospital when needed to induce a physician to locate his or her medical practice in the hospital service area.

The hospital previously had received a favorable ruling involving a similar arrangement, with the distinction that the physician unconditionally was required to repay any subsidy paid by the hospital. The hospital then sought this second ruling involving the conditional obligation to repay.

The IRS ruled that the arrangement could jeopardize the hospital’s exemption. The ruling stated that recruited physicians “are persons who have a personal and private interest in the activities” of the hospital and therefore are subject to “the inurement proscription.” The ruling further stated that the program, on its face, did not appear to pose any obstacles to continued exemption for the hospital. Recruitment of doctors is a legitimate objective of tax exempt hospitals. The problem,

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88 Id.
89 Id.
90 Id.
said the IRS, arose from the fact that there was no way of determining in advance whether all possible subsidies paid under the program would constitute reasonable compensation. The method of payment was found to bear "no discernible direct relation to the value of a particular physician" to the hospital. For instance, a physician who earned a great deal of income outside the hospital and was also of great value to the hospital would receive less of a subsidy than a physician who earned less income from his or her private practice and also conferred less benefit upon the hospital. Based on this reasoning, the IRS concluded that the subsidies would not necessarily have any relationship to the value received by the hospital and therefore could prove to be unreasonable.

The IRS focused on the fact that the magnitude of the subsidy that each doctor would receive was impossible to determine in advance. For this reason, the IRS could not determine whether the method of awarding subsidies was the only way the hospital could achieve its desired ends. The IRS also noted that the proposed guaranteed minimum annual income amount was not capped (except by the total income guaranteed), so that a recruited physician could receive a substantial economic benefit that would not be quantitatively incidental to the hospital's exempt purpose.

Viewing the arrangement as a whole, the IRS concluded that the overall benefit to the hospital from the recruitment program might not outweigh and render incidental all possible doctors' subsidies under the two-year program. If this proved to be true, it would provide a basis for the revocation of the hospital's exemption.

This ruling is of great concern in the joint venture area. If physicians are "insiders" subject to the inurement proscription, a joint venture with physicians will be tested by the much stricter private inurement standard, where a single misstep could
prove disastrous. Moreover, many joint ventures with physicians have a recruitment element, such as reduced rents for medical office building space, reduced interest rates, and sales at less than fair market value. A high percentage of the joint ventures entered into by hospitals are entered into with physicians either to recruit them or to cement the existing relationship between hospital and physician. Accordingly, this GCM is highly pertinent in analyzing such transactions.

The legal conclusions reached in the GCM, however, are open to challenge. First, physicians generally are not considered to be "insiders." They generally do not have inside control over hospital policy, but are able to influence the hospital only through their market power. For this reason, joint venture transactions with physicians, as well as physician recruitment, should be tested under the more relaxed standard of the private benefit concept.

In addition, the GCM tests the reasonableness of compensation on an after-the-fact basis. It is an established principle of tax law that the reasonableness of compensation is to be measured at the time the agreement is entered into, rather than at the time compensation is paid. Accordingly, the fact that the cost to a hospital of a transaction with a physician ends up exceeding the benefits received does not necessarily mean that there has been unreasonable compensation for tax law purposes. The GCM appears plainly wrong on this point.

The GCM is also inconsistent with prior rulings. For instance, the IRS ruled that a recruitment program for osteopathic physicians did not adversely affect the hospital's exemption where half of the principal and all of the interest on loans were forgiven on the condition that the physicians practice in the area for five years.

Although the GCM appears to be faulty on the law, the position taken therein is enough to strike fear in the hearts of

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hospital administrators and their tax advisors. It is not clear how or even if the IRS will carry this policy through into practice. Until answers are forthcoming, however, great care should be taken when hospitals enter into joint venture transactions with physicians. A private letter ruling should be obtained when possible. Competitive demands, however, could require that a hospital offer more than the IRS is willing to approve in a ruling.

The threat can be reduced somewhat by documentation. A joint venture arrangement should result from verifiable arm's-length negotiations. In addition, the expected benefits to the hospital should be estimated and compared favorably to the expected cost to the hospital. This comparison should be as accurate as possible. Finally, the hospital should document carefully the need for the arrangement, the consideration of alternatives, and the expected consequences if it fails to enter into the arrangement as is.101

VI. EFFECT ON EMPLOYEE PLANS

Qualified plans cannot discriminate, in coverage or benefits, in favor of stockholders, officers, or highly paid employees.102 There are elaborate rules for testing whether coverage103 or benefits104 are discriminatory.

In joint ventures, certain aggregation rules can cause a retirement plan to be tested as if the employees of the coventurers are employees of a single employer.105 Generally, this result will not pose a threat to the qualification of a hospital plan. For instance, if the joint venture is with a physician group, the hospital probably will still meet the nondiscrimination tests due to its disproportionate size.

The risk of plan disqualification is much greater, however, for joint venturers, such as physician groups, that are compar-

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105 See I.R.C. § 414(m) (1986).
atively smaller in size than the hospital and that tend to pay higher average compensation. Hospital planners should be aware of this risk, for entering into a joint venture with a physician group that results in the disqualification of the group’s retirement plan would, in many cases, defeat one of the underlying purposes of the joint venture.

VII. IMPACT ON PUBLIC CHARITY STATUS

An organization that is exempt under section 501(c)(3) of the Code will be subject to the highly restrictive private foundation rules unless it qualifies as a public charity under section 509(a).106 Section 509 sets out three alternative means by which a health-related organization can gain public charity (or non-private foundation) status.107 The first, provided for in section 509(a)(1), is an automatic determination granted to organizations conducting certain specified activities. These activities include the operation of a hospital and of a medical research organization. Accordingly, a hospital organization generally derives its public charity status pursuant to section 509(a)(1). An organization can also obtain public charity status under section 509(a)(1) if a substantial part of its support is received from the general public in the form of charitable gifts.108 A fund-raising organization generally can qualify under this provision.

Public charity status can also be obtained pursuant to section 509(a)(2), based upon a “public support test.”109 To satisfy the requirements of this section, an organization must derive one-third of its support from contributions and related business receipts from the general public and cannot derive more than

106 These restrictions are set out in I.R.C. §§ 4940-4945 (1984). They include an excise tax on investment income (§ 4940), a tax on self-dealing (§ 4941), a tax on failure to distribute income (§ 4942), a tax on excess business holdings (§ 4943), a tax on speculative investments (§ 4944), and a tax on certain prohibited expenditures (§ 4945). As an example of the severity of these rules, if a parent holding company loses its public charity status, it will be required to divest itself of its taxable subsidiaries pursuant to § 4943.


one-third of its support from net investment income. The statute and corresponding regulations set out technical tests to ensure that the requirement of public support is met. Organizations described in either section 509(a)(1) or section 509(a)(2) are considered to be "publicly supported organizations."

Finally, an organization can derive its public charity status under section 509(a)(3) as a supporting organization. A supporting organization must satisfy one of the following three relationship tests, as set forth under section 509(a)(3)(B): it must be [i] operated, supervised and controlled by a publicly supported organization; [ii] supervised or controlled in connection with a publicly supported organization; or [iii] operated in connection with a publicly supported organization.

Any time a hospital or related subsidiary enters into a joint venture, careful examination should be given to the impact of the joint venture on the public charity status of the participating exempt organization. For instance, an organization that barely qualifies under the public support tests of either section 509(a)(1) or section 509(a)(2) might be adversely affected if the venture produces a large amount of income that would not be considered to be derived from the general public. Moreover, an organization that qualifies under section 509(a)(3) as a supporting organization might jeopardize its supporting status if it engages in such a venture, because such an organization must be "operated exclusively" to support a publicly supported organization.

VIII. JOINT VENTURES WITH OTHER HOSPITALS

Thus far, this Article has addressed the numerous tax issues arising when a hospital or related entity enters into a joint venture with nonexempt coventurers. There are, in addition, a number of situations in which exempt hospitals themselves will combine to form a joint venture. In these instances, the threat to a hospital's exempt status often is reduced greatly, if not virtually eliminated.

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110 See id.
111 I.R.C. § 509(a) (1986).
A joint venture between two or more exempt hospitals generally will qualify for exempt status under section 501(c)(3). The private inurement and private benefit questions are essentially eliminated because there are no non-exempt participants. Therefore, any diversion of profits or assets should not jeopardize the exempt status of either hospital.

An important caveat exists, however. If services are provided to two or more hospitals by the exempt joint venture and the services are not specified in section 501(e), the resulting corporation could lose its exemption. The services provided either must be qualified section 501(e) services, in which case the organization will be subject to the provisions of section 501(e), or they must be provided directly to patients.

If two or more exempt hospitals form an organization to provide services such as collection, clinical, laboratory, or personnel services to exempt hospitals, the resulting organization can obtain an exemption under section 501(e). Only specified services can be provided or the organization will lose its exemption under section 501(e) and cannot look to section 501(c)(3) for backup exemption. Laundry and insurance services, for example, are not permitted.

In addition, a number of other fairly rigorous requirements must be met for an organization to maintain exempt status under section 501(e). A section 501(e) organization should never enter into a joint venture with a private entity. If any of the income from such a joint venture is UBI, the section 501(e) organization will lose its exemption, even if the amount is minimal.

A third form of exempt joint venture involving exempt hospitals was authorized by the Tax Reform Act of 1986. Under

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117 Permitted services are data processing, purchasing, warehousing, billing and collection, food, clinical (including radiology), industrial engineering, laboratory, printing, communications, record center, and personnel services. Treas. Reg. § 1.501(e)-1(c)(1) (1986).
118 See generally Treas. Reg. § 1.501(e)-1 (1986).
119 A § 501(e) organization is prohibited from engaging in an unrelated trade or business. See Treas. Reg. § 1.501(e)-1(b)(4) (1986).
section 501(c)(25), as added by the new Act, an organization will be exempt if it [i] is operated for the exclusive purpose of holding title to real property and distributing the income therefrom to eligible shareholders, [ii] has no more than thirty-five (35) shareholders or beneficiaries, [iii] has only one class of stock, and [iv] meets certain other requirements. Eligible shareholders include tax exempt organizations described in section 501(c)(3) and section 501(c)(25). This new provision parallels section 502(c)(2), which grants an exemption to titleholding organizations owned by one or more related organizations. Section 501(c)(25) provides the same benefit to organizations set up by unrelated exempt organizations, thereby allowing them to pool their resources and still obtain an exemption.

CONCLUSION

In the next few years, dramatic changes can be expected in the world of hospital joint ventures. The IRS has never really decided how to view these creatures, especially when they involve physicians. Exempt hospitals themselves have come under increasing attack by commentators, legislators, and regulators. Although there is clearly a current necessity for hospitals to be aggressive from a business standpoint, it is also important that they enter into joint ventures fully cognizant of the tax risks and, in this connection, remain as conservative as reality permits.
