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RISKY VENTURES: THE IMPACT OF IRS HEALTH CARE JOINT VENTURE POLICY

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IRS oversight of joint ventures between exempt and for-profit organizations has undergone substantial change over the past thirty years. This change has important consequences for the health care industry, where joint ventures have grown increasingly common. In the face of unclear guidance and aggressive enforcement of exemption-policing tools such as the private benefit doctrine and the control test, a hospital risks revocation of its tax-exempt status, or liability for unrelated business income tax, when it engages in a joint venture directly. It may be able to eliminate this risk by operating the same joint venture through a for-profit subsidiary; however, such a structure may be less constrained to serve a charitable mission. Thus, the Service's approach to policing tax-exempt status creates incentives to structure joint ventures in a way that may ultimately reduce charitable care. This Note argues that such incentives are undesirable and avoidable, and proposes several reforms that would help to eliminate them.

INTRODUCTION

Over the past thirty years, regulation of joint ventures[1] between non-profit hospitals and for-profit entities[2] has changed substantially. The Internal Revenue Service ("IRS" or "Service") has shifted from a *per se* prohibition of these ventures to a case-by-case test that evaluates individual facts and circumstances.[3] But in 1991, the IRS

* University of Michigan Law School, J.D. expected 2009; Suffolk University, B.S.B.A. 2003. I would like to thank Professor Jill Horwitz for providing me with the critical grounding in health and non-profit law and policy required to develop this Note, and my mother for diving into unfamiliar legal and tax concepts to help edit it. I owe a special debt of gratitude to my wife Kathleen, whose many sacrifices have made my academic career possible, and to my son Caden, who simply thinks Daddy reads a lot.

1. This Note uses certain simplifications to ease readability. Strictly speaking, "non-profit" and "tax-exempt" are not synonymous, though they are closely related. An entity can organize under state law as operating not-for-profit yet not seek or not qualify for tax-exemption. The inverse is not true due to the "non-distribution constraint" that the prohibition on private inurement imposes. I.R.C. § 501(c)(3) (2006). I will generally use "non-profit" as a synonym for "tax-exempt" throughout this Note since it contrasts more crisply with the for-profit form. Similarly, the phrase "joint ventures" as used herein refers exclusively to commercial partnerships between non-profit entities—hospitals specifically—and for-profit entities. It is quite possible for two or more non-profit entities to engage in a joint venture, and even more common to find joint ventures formed by only for-profit partners, but these structures typically do not raise the risks addressed by this Note.

2. This phrase broadly includes corporations, partnerships and LLCs, as well as individual physicians.

3. *See infra* Part I.A.1.

issued a landmark General Counsel Memorandum[4] ("GCM") signaling a shift back toward increasingly restrictive oversight of these joint ventures.[5] A series of revenue rulings and cases following GCM 39,862 firmly established a control test that places strict limitations on the division of ownership, management structure, and charitable obligations of joint ventures.[6]

The IRS has not been making policy in a vacuum—the use of joint ventures in the health care industry has undergone explosive growth over this same period.[7] Hospitals are responding to both competitive threats and financial opportunities by using joint ventures.[8] Under current federal tax law, hospitals can choose between several joint venture structures.[9] Historically, the risk/benefit balance between these structures has favored direct partnerships between non-profit hospitals and for-profit entities. However, as the framework for evaluating these ventures has become more restrictive, direct joint ventures increasingly risk imposing tax liability on the hospital partner and even jeopardizing its exempt status.[10] In contrast, by operating the joint venture through a for-profit subsidiary, a hospital can eliminate these risks and gain significant business flexibility.[11]

The implications of these altered incentives may be significant. When a non-profit hospital engages in a direct joint venture, it generally takes great care to ensure that the activities of the venture further its charitable mission.[12] In contrast, subsidiary joint ventures are far less constrained in their operations.[13] If hospitals respond to these altered incentives by choosing to use subsidiary joint ventures instead of direct joint ventures, it is likely that the ventures will deliver less benefit to the community.[14] Perversely,

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4. General Counsel Memoranda are drafted by the IRS Office of Chief Counsel and provide legal analysis of proposed Revenue Rulings, Private Letter Rulings, and Technical Advice Memoranda. They are non-precedential, but they may convey valuable insight into the IRS perspective on taxation issues. *See* MICHELE LAFOREST HALLORAN & ANDREW S. CAMPBELL, AN INTRODUCTION TO TAX-RELATED LEGAL RESEARCH 9 (2006), *available at* http://www.irs.gov/pub/irs-utl/tax-related_legal_research_121106.pdf.

5. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991). This GCM applied the newly invigorated private benefit doctrine to criticize and recommend revocation of three previously issued Private Letter Rulings that had approved health care joint ventures. *See* discussion *infra* Part II.A.1 (detailing circumstances leading up to the GCM and their significance).

6. *See infra* Part II.A.

7. *See infra* Part I.A.2.

8. *See infra* Part I.A.2.

9. *See infra* Part I.B.3.

10. *See infra* Part II.B.

11. *See infra* Part III.A.

12. *See infra* Parts I.B.2–3.

13. *See infra* Parts I.B.3, III.A.

14. *See infra* Part III.A.

policies intended to protect the integrity of the charitable exemption system may actually decrease charitable health care overall. Such a result is not only senseless, but also unnecessary. This Note argues that by using existing enforcement tools more consistently and predictably, and by clarifying the control test and applying it in a rigorous fashion, the IRS can continue to police the exemption system without creating these detrimental incentives.[15]

Part I of this Note explains the background of joint ventures in health care and their evolution from prohibition to virtual necessity. It also provides a short overview of the requirements for exempt status and identifies the structures by which a non-profit hospital can engage in a joint venture. Part II examines the policy shifts leading to significantly more restrictive regulation of joint ventures, and evaluates the substantial risks that a hospital now faces when entering into a direct joint venture. Part III shows that these risks, as well as the business problems created by the attempt to mitigate them, make the use of a for-profit subsidiary comparatively appealing, and argues that this has negative societal consequences. Finally, Part III concludes with a discussion of policy refinements that the IRS should employ to eliminate the regulatory incentives that make the use of a for-profit subsidiary desirable in circumstances where a direct joint venture could better serve the public.

I. JOINT VENTURES HAVE BECOME INCREASINGLY COMMON IN HEALTH CARE

The use of joint ventures in health care has changed dramatically over the past thirty years. Part I.A reviews the watershed *Plumstead Theatre Society, Inc. v. Commissioner*[16] decision that forced the IRS to change its policy and permit joint ventures between non-profit and for-profit entities. It continues by discussing the economic considerations that have made joint ventures particularly appealing in health care. Part I.B discusses the basic requirements for obtaining tax exemption and the particular standards hospitals must meet for the IRS to recognize them as charitable. It concludes with an explanation of the organizational structures by which a joint venture may be undertaken. This overview will provide the necessary background to the discussion in Parts II and III

15. *See infra* Part III.B.

16. 74 T.C. 1324 (1980), *aff'd per curiam*, 675 F.2d 244 (9th Cir. 1982).

that explains how current IRS policy makes direct joint ventures more risky and evaluates the impact this policy has on choice of organizational structure.

A. From Total Ban to Business as Usual

In his authoritative text, Michael Sanders has defined a joint venture as "an association of persons or entities jointly undertaking a particular transaction for mutual profit."[17] It is of little wonder, then, that the IRS essentially maintained a *per se* ban on the participation of a tax-exempt organization as a general partner in a joint venture until the early 1980s.[18] However, as this absolute prohibition fell by the wayside, hospitals moved quickly to take advantage of the newfound opportunities and have since become frequent participants in joint ventures.[19]

1. The Shift From Per Se Ban to Facts and Circumstances

For many years, the IRS viewed non-profit participation as a general partner in a joint venture with individuals or for-profit organizations as a presumptive cause for loss of exemption.[20] The prohibition arose from a concern that the exempt organization would inappropriately further the interests of the for-profit partners by participating in the partnership.[21] For example, in GCM 37,259 the Service evaluated a revenue-sharing arrangement between an exempt maker of educational motion pictures and a commercial film distributor and concluded that "the net earnings of the organization clearly inure to the benefit of the distributor, in which case the organization would lose its exemption."[22]

17. MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS 2 (3d ed. 2007).

18. Phil Royalty & Donna Steele Flynn, *Not-For-Profit/For-Profit Joint Ventures: A White Paper*, 25 EXEMPT ORG. TAX REV. 37, 37 (1999).

19. SANDERS, *supra* note 17, at 5.

20. Royalty & Flynn, *supra* note 18, at 37.

21. *Id.* Commentators frequently attribute this concern to the fiduciary duties that a general partner owes to its co-adventurers, and especially to limited partners. *E.g.*, Darryll K. Jones, *Special Allocations and Preferential Distributions in Joint Ventures Involving Taxable and Tax Exempt Entities*, 31 OHIO N.U. L. REV. 13, 21 (2005) (citing Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928)). IRS guidance gives evidence to support this view. *E.g.*, I.R.S. Gen. Couns. Mem. 36,293 (May 30, 1975) ("[A]s the general partner . . . the Corporation would take on an obligation to further the private financial interests of the limited partners."). However there is also evidence to suggest that the IRS viewed any profit sharing between an exempt entity and a for-profit, regardless of how allocated, as *per se* private inurement. *See id.*

22. I.R.S. Gen. Couns. Mem. 37,259 (Sept. 19, 1977).

The Tax Court shattered this absolutist approach in 1980 by rejecting the Service's revocation of a non-profit theatre company's exemption.[23] When it encountered difficulty financing a production, Plumstead Theatre Society entered into a joint venture with two individuals and a for-profit corporation.[24] Plumstead was the general partner, and the three investors were limited partners who would be entitled to a share of the profits or losses of the production.[25] The IRS gave three reasons for revoking Plumstead's exempt status: 1) a substantial purpose of the organization was commercial, 2) part of its earnings would inure to the benefit of a private individual or shareholder, and 3) it operated for private rather than public purposes.[26] However, in its brief for the court, the Service abandoned the private inurement rationale for revocation.[27] As a result, the only questions squarely presented to the court were whether *this* joint venture caused the theatre to have a substantial commercial purpose or to operate for private purposes.

The court's evaluation of these remaining questions makes clear that mere participation in a joint venture no longer justifies the automatic revocation of exempt status. First, the court described the allegation of substantial commerciality as "completely misdirected."[28] It found that Plumstead's activities in advertising via newspapers, selling tickets, and hiring professional actors were not substantially commercial.[29] Significantly, it also rejected the Service's position that this single transaction, even if commercial, sufficed to jeopardize the

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23. Plumstead Theatre Soc'y v. Comm'r, 74 T.C. 1324 (1980), *aff'd per curiam*, 675 F.2d 244 (9th Cir. 1982).

24. *Id.* at 1328.

25. *Id.*

26. *Id.* at 1325. The IRS could have plausibly pressed an argument based on fiduciary duties, but the opinion contains no reference to this argument, implying that either that the argument was not made or the court dismissed it as not worth addressing.

27. *Id.* at 1334 n.3. Though not explicitly stated, the IRS likely recognized that under its own long-standing regulations interpreting the meaning of "private shareholder or individual" it would be unable to show that the investors had the necessary "personal and private interest." Treas. Reg. § 1.501(a)-1(c) (as amended in 1982). The opinion supports this supposition by recounting several facts that tend to show there was no inside or personal relationship between *Plumstead* and the investors. *See Plumstead*, 74 T.C. at 1333–34. Whatever the reason, the court clearly agreed that the argument was meritless. *Id.* at 1334 n.8 ("[R]espondant has quite properly abandoned his initial argument.").

The lack of reference to fiduciary duties, and the Service's abandonment of the private inurement rationale for revocation, is significant because fiduciary duties and private inurement were the two main rationales supporting the *per se* ban against joint ventures. *See supra* note 21 and accompanying text.

28. *Plumstead*, 74 T.C. at 1331.

29. *Id.* at 1331–32.

theater's exemption.[30] Second, the court brushed aside the private interest claim, stating that at most the play might be subject to unrelated business income tax if it had profits, but that the circumstances did not warrant loss of exemption.[31]

Shortly after *Plumstead* the IRS released GCM 39,005, which articulated a two-part test for evaluating the effect on a non-profit's tax-exempt status from its participation as general partner in a joint venture.[32] The test initially focuses on whether the non-profit serves a charitable purpose through the venture.[33] If so, the second inquiry is whether the structure of the venture permits it to act exclusively in furtherance of the charitable purpose and not for the benefit of the limited partners.[34] This early expression of what has become known as the "private benefit doctrine" sounds both unequivocal and prohibitive. However, the IRS interprets "exclusively" to mean "primarily,"[35] and GCM 39,005 itself, as well as the *Plumstead* decision, made it clear that the limited partners are not expected to forego a reasonable return on investment in the venture.[36] Professor John Columbo describes the permissibility of non-profit/for-profit joint ventures after GCM 39,005 as "a matter of individual facts and circumstances."[37] Despite the strong-sounding language of the two-part test, hundreds of subsequent private letter rulings applying the test have concluded that exempt organizations could serve as general partners in joint ventures without jeopardizing their exempt status.[38]

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30. *Id.* at 1331 ("Respondent took a still shot of what is an ongoing motion picture of many dimensions."). The IRS relied on *Better Business Bureau v. United States*, 326 U.S. 279 (1945), for the proposition that a single substantial non-exempt purpose was sufficient to defeat exemption. *Plumstead*, 74 T.C. at 1330. Nevertheless this transactional approach has become an important element of the private benefit doctrine. *See* discussion *infra* Part II.A.1; *see also* I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991). Furthermore, the IRS continues to rely on *Better Business Bureau* in its guidance. *See* I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991); Rev. Rul. 98-15, 1998-1 C.B. 718.

31. *Plumstead*, 74 T.C. at 1334 n.8.

32. I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983); *see also* Royalty & Flynn, *supra* note 18, at 38.

33. I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983).

34. *Id.*

35. *E.g.*, Treas. Reg. § 1.501(c)(3)-1(c) (as amended in 2008).

36. Indeed GCM 39,005 condones the partnership even though the limited partners are entitled to preferential returns. I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983). *See also Plumstead*, 74 T.C. at 1328 (approving venture where investors were entitled to 63.5% of profits).

37. John D. Columbo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV. 187, 187 (2001). For example, the many facts and circumstances that can contribute to a joint venture passing the two-part test include the following: independent oversight of the exempt organization's actions as general partner, real and substantial initial contributions by the for-profit partner and allocations based on them pro rata, and liability and risks are not borne disproportionately by the non-profit partner. Royalty & Flynn, *supra* note 18, at 38.

38. Royalty & Flynn, *supra* note 18, at 39.

2. Necessity Creates Strange Bedfellows

There are two basic categories of joint venture: "whole hospital" and "ancillary."[39] In whole hospital joint ventures, one partner, usually the non-profit, contributes the total assets and operations of a hospital while the other partner contributes funds and other assets.[40] Going forward, the for-profit entity formed by the venture operates the hospital.[41] Ancillary joint ventures, by contrast, involve substantially less than the contribution of an entire hospital, such as the shared operation of a particular specialized facility or department.[42] However, as discussed in Part II.B.2, the scope of the joint venture in comparison to the hospital's overall charitable activity can be a critical factor in continuing to qualify for exemption. Ancillary joint ventures can take a wide variety of forms, including ambulatory surgical centers, substance abuse treatment centers, imaging centers, and kidney dialysis centers.[43]

The prevalence of joint ventures between non-profit hospitals and for-profit entities may be surprising. During the 1980s, the number of such ventures more than doubled, reaching around 450.[44] Recent estimates of the number of ancillary joint ventures are in the thousands.[45] Whole hospital joint ventures are comparatively rare, currently numbering between 50 and 100.[46] Nevertheless, some commentators have speculated that virtually all health care organizations will eventually be forced to affiliate with a larger system to survive.[47]

There are several reasons for the increasing popularity of health care joint ventures.[48] First, reimbursement for inpatient care has

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39. Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 25 (2005).

40. *Id.* at 26.

41. *Id.*

42. *Id.*

43. Eileen M. Newell, Comment, *Healthcare Joint Ventures: Pushing Tax-Exempt Law to the Limits?*, 18 J. CONTEMP. HEALTH L. & POL'Y 467, 475 (2002) (citing numerous private letter rulings approving ancillary joint ventures of the aforementioned types).

44. Gary J. Young, *Federal Tax-Exemption Requirements for Joint Ventures Between Nonprofit Hospital Providers and For-Profit Entities: Form Over Substance?*, 13 ANNALS HEALTH L. 327, 338 (2004).

45. *Id.* at 339.

46. Michael I. Sanders, *Health Care Joint Ventures Between Tax-Exempt Organizations and For-Profit Entities*, 15 HEALTH MATRIX 83, 84 (2005).

47. SANDERS, *supra* note 17, at 492.

48. One practitioner, who is also an adjunct professor, has categorized health care joint ventures as defensive, offensive, or a combination of the two, depending on whether the hospital attempts to protect itself from competition, to take advantage of revenue producing or protecting opportunities, or both. Steven H. Pratt, *Hospital-Physician Joint Venture*

declined substantially since the 1990s.[49] The rapid growth in market share of managed care organizations has cut into hospitals' profit margins as negotiating leverage has become more concentrated.[50] Changes in Medicare reimbursement, including the shift from fee-for-service to payment based on diagnosis-related groups, and scheduled yearly reductions, have also had a major impact.[51]

Second, competition also drives joint venture activity. The growth of for-profit hospital systems has caused numerous hospital closings, as well as many acquisitions of struggling non-profit hospitals.[52] At the same time, hospitals face increasing competition from smaller, specialized entities like imaging or surgery centers, and even from their own physicians.[53] Such challenges frequently arise in extremely profitable outpatient services such as orthopedic or cardiac surgery.[54] A health system general counsel recently lamented, "[T]he business is being divided up into little pieces . . . [that] are being taken away one at a time . . . ."[55]

Finally, there are practical business reasons for a non-profit hospital to engage in a joint venture. By partnering with its physicians, a hospital may prevent them from competing on their own.[56] Additionally, in both ancillary and whole hospital joint ventures, the hospital gains access to managerial and technical expertise and is better able to spread the risks of a new venture and to stretch its capital resources.[57]

Relationships: A Useful Tool to Improve Hospital Services, 4 IND. HEALTH L. REV. 239, 244–45 (2007).

49. Young, *supra* note 44, at 339.

50. *Id.* at 339–40. Essentially, as health maintenance organizations ("HMOs") and preferred provider organizations ("PPOs") have taken over large shares of the health insurance market, their ability to negotiate for reduced rates or to impose "capitated" payments, rather than paying according to the traditional fee-for-service model, has driven down reimbursement rates. *Id.*

51. *See id.*; SANDERS, *supra* note 17, at 492. Combined with the reimbursement reductions attributable to private managed care organizations, the shift of Medicare to a managed care model means that health care providers are facing significant, across-the-board cuts in revenue.

52. Sanders, *supra* note 46, at 84.

53. Young, *supra* note 44, at 340.

54. *Id.*; *see also* Symposium, *Hospital-Physician Joint Ventures: A Promising Partnership?*, 4 IND. HEALTH L. REV. 263, 266 (2007) (comments of Norman G. Tabler) ("[T]he new physician-hospital ventures you hear about, are almost invariably specialty hospitals, and it is not an accident that the specialties that are hit are the high-income specialties.").

55. Symposium, *supra* note 54, at 275.

56. Young, *supra* note 44, at 341. It is well known that patient-physician relationships are among the main reasons patients select a hospital; thus, maintaining stable hospital-physician relationships is essential to the financial health of the hospital. However, the Office of the Inspector General within the Centers for Medicare and Medicaid Services closely polices joint ventures to ensure that they do not improperly induce referrals. See *infra* note 98 for a brief discussion of federal fraud and abuse standards.

57. Young, *supra* note 44, at 341.

B. *Reviewing the Requirements for Hospital Tax Exemption*

The previous section explained how the IRS has changed its position to allow exempt organizations to participate in joint ventures and why non-profit hospitals have come to embrace them. In this section, I will provide an overview of the requirements that apply to all organizations seeking tax exemption, as well as the specific charitable standards that exempt hospitals must meet. Finally, I will introduce the two main organizational structures through which a hospital may operate a joint venture.

1. The Organizational and Operational Tests

Section 501(c) of the Internal Revenue Code provides numerous types of qualifying organizations with exemption from federal income taxation.[58] The best-known category is described under § 501(c)(3), exempting corporations "organized and operated exclusively for religious, charitable, scientific, . . . literary, or educational purposes."[59] The regulations implementing § 501(c)(3) have interpreted the statute as setting two distinct requirements, formulated as the "organizational test" and the "operational test."[60] Furthermore, through these two tests, § 501(c)(3) prohibits the inurement of any part of net earnings to the benefit of private shareholders, bars the organization from participation in political campaigns, and limits legislative lobbying to an insubstantial part of the organization's activities.[61]

The organizational test requires that the applicant's constitutive documents, such as its articles of organization or incorporation, limit the organization to one or more purposes for which exemption may be granted and implicitly prohibit the organization from engaging in more than an insubstantial amount of activities that are not in furtherance of exempt purposes.[62] The organization's

58. I.R.C. § 501(c) (2006). In addition to exemption from federal income tax, recognition under § 501(c)(3) confers numerous other benefits. These include, among others, tax deductions for donors to the organization, the ability to issue tax-exempt bonds to raise capital, and in many states automatic exemption from property and sales taxation. I.R.C. §§ 145, 170(c)(2) (2006); *see, e.g.*, CAL. REV. & TAX. CODE § 23701d(c)(1) (West 2008).

59. I.R.C. § 501(c)(3). Section 501(c)(3) also specifies several other, less well-known purposes that qualify for exemption.

60. Treas. Reg. § 1.501(c)(3)-1(a) (as amended in 1990).

61. I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1.

62. Treas. Reg. § 1.501(c)(3)-1(b). The organizational test also separately requires that the articles not expressly permit the organization to participate in political activities or engage in more than an insubstantial amount of lobbying. *Id.*

purposes may be stated specifically, or as broadly as the description in § 501(c)(3).[63] To meet the prohibition against private inurement, the articles must specify the disposition of the organization's assets upon dissolution. Distributions to another exempt organization or to federal, state, or local governments are acceptable; however, if the articles permit distributions to members or shareholders, the applicant will fail the organizational test.[64]

The operational test, in contrast, looks to what the organization actually does rather than what it is chartered to do. Under the operational test, the organization must operate exclusively for exempt purposes.[65] The IRS has interpreted this requirement as meaning that the organization must engage primarily in activities that will accomplish one or more such purposes.[66] If more than an insubstantial part of an organization's activities does not further an exempt purpose, the IRS will not regard it as exempt.[67]

However, as the emphasis on exempt purpose, rather than activity, should make clear, an exempt organization does not jeopardize its exemption by engaging in even a substantial amount of activities that are not themselves exempt, so long as those activities further an exempt purpose. Further, the provision for unrelated business income tax ("UBIT") permits exempt organizations to engage in some amount of unrelated commercial activity without loss of exemption, though the profits from such activity may be subject to taxation.[68] However, as with the organizational test, the operational test implements the ban on private inurement. If any part of the net earnings of the organization inures to the benefit of a private individual or shareholder,[69] the organization will fail the operational test.[70]

63. *Id.*

64. *Id.*

65. I.R.C. § 501(c)(3).

66. Treas. Reg. § 1.501(c)(3)-1(c).

67. *Id.*

68. I.R.C. § 501(b); I.R.C. §§ 511–514 (2006).

69. The Service has interpreted "private individual or shareholder" as meaning "persons having a personal and private interest in the activities of the organization." Treas. Reg. § 1.501(a)-1(c). For practical purposes, the ban on private inurement applies to certain disqualified persons including organizational insiders and family members, but not to unrelated third parties. People of God Cmty. v. Comm'r, 75 T.C. 127 (1980).

70. Treas. Reg. § 1.501(c)(3)-1(c)(2). The operational test also implements limitations on political activity and lobbying. Treas. Reg. § 1.501(c)(3)-1(c)(3).

2. Uncompensated Care or Community Benefit

Health care is not among the enumerated purposes for which exemption may be granted under § 501(c)(3).[71] However, care for the sick and support of hospitals has been considered a charitable purpose since at least the enactment of the Statute of Charitable Uses in 1601.[72] In the United States, charitable health care has traditionally been the provision of uncompensated care to the poor.[73] For example, until as recently as 1969 the IRS required that to be recognized as charitable, a hospital must operate to the extent of its financial ability for those not able to pay.[74]

However, following the enactment of Medicare and Medicaid, which were expected to decrease dramatically the number of patients who were unable to pay,[75] the IRS revised its position and specifically eliminated the uncompensated care requirement of Revenue Ruling 56-185.[76] In its place, the Service articulated what has come to be known as the "community benefit standard," which recognizes that hospitals often provide a variety of public benefits beyond merely uncompensated care.[77] The ruling presented two scenarios, one good and one bad, to illustrate the sorts of "facts and circumstances" the IRS would henceforth evaluate in determining whether a hospital was operating for the benefit of the community rather than for the benefit of its private owners.[78] Factors tending to show that a hospital benefits the community include operating an emergency room open to all persons, placing control over the hospital in a board composed of independent community leaders, and maintaining an open medical staff with privileges available to all qualified physicians.[79]

Since the 1969 ruling, the community benefit standard has become even more diffuse. For example, in 1983 the Service issued a ruling stating that operating an open emergency room was not a *per se* requirement for charitable exemption, particularly when the services would be unnecessary or duplicative, or where the hospital serves a specialty such as eye surgery or cancer care for which

71. I.R.C. § 501(c)(3).
72. MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT: STATE AND FEDERAL LAW AND SUPERVISION 23–24 (Russell Sage Found. 1965).
73. Young, *supra* note 44, at 330–31.
74. Rev. Rul. 56-185, 1956-1 C.B. 202.
75. Young, *supra* note 44, at 331.
76. Rev. Rul. 69-545, 1969-2 C.B. 117.
77. *Id.*
78. *Id.*
79. *Id.*

emergency care is not typically provided.[80] Similarly, in certain circumstances hospitals appear to be able to partially close their medical staffs with regard to certain departments or procedures without affecting their exempt status.[81]

Critics have questioned the continued validity of the community benefit standard. Specifically, they have noted only small differences between non-profit and for-profit hospitals in both the amounts of uncompensated care delivered as well as the quality of services as measured by outcomes.[82] There are signs that the IRS may agree. In 2001, it issued a Field Service Advisory stating that a policy to provide uncompensated care is insufficient to satisfy the community benefit standard.[83] Instead, the hospital "must show that it actually provided significant health care services to the indigent."[84] Similarly, in 2006 the Service submitted a questionnaire to several hundred tax-exempt hospitals asking about their community benefit services. The results led to significant changes in annual reporting requirements for exempt hospitals.[85] This process reportedly represents a first step in ongoing review of the community benefit standard.[86] However, community benefit remains the benchmark by which hospitals satisfy their charitable obligations, at least for now.

3. Possible Organizational Structures

There are two basic structures by which a non-profit hospital may engage in a joint venture: directly, or through a subsidiary.[87] In

80. Rev. Rul. 83-157, 1983-2 C.B. 94.

81. *See* Mateo-Woodburn v. Fresno Cmty. Hosp. and Med. Ctr., 270 Cal. Rptr. 894 (Cal. Ct. App. 1990); Mahan v. Avera St. Luke's, 621 N.W.2d 150 (S.D. 2001).

82. *E.g.*, M. Gregg Bloche, *Tax Preferences for Nonprofits: From Per Se Exemption to Pay-For-Performance*, HEALTH AFF., June 20, 2006, at W304.

83. I.R.S. Field Serv. Advisory 2001-10030 (Mar. 9, 2001), 2001 WL 234018.

84. *Id.*

85. Exempt organizations with more than $25,000 in gross receipts are required to make annual disclosures to the IRS using Form 990, or the shorter 990-EZ if certain criteria are met. Beginning with Tax Year 2008, Form 990 has undergone a major redesign, which other articles have discussed exhaustively. Exempt hospitals will also now also be required to attach the new Schedule H, which requests detailed information about the hospital's community benefit activities. *See* Internal Revenue Service, *Overview of Form 990 Redesign For Tax Year 2008*, (Dec. 20, 2007), *available at* http://www.irs.gov/pub/irs-tege/overview_form_990_redesign.pdf, for a discussion of the Form 990 redesign.

86. I.R.S. News Release IR-2007-132 (July 19, 2007), *available at* http://www.irs.gov/newsroom/article/0,,id=172416,00.html.

87. Once again, this is a simplification. In addition to the structures relevant to the issues this Note raises, exempt organizations have the option to invest as passive limited partners or non-managing members of a limited liability company. For tax purposes, this is treated much like holding shares in a corporation in that it is considered an investment

what I will call a "direct joint venture," the hospital partners with a for-profit entity such as an outpatient clinic or a physician group to undertake a particular project or business. Either a partnership or a limited liability company ("LLC") will be established to run the operation; because of their liability shields, LLCs have now replaced partnerships as the entity of choice.[88] The use of either a partnership or an LLC that has elected pass-through taxation is necessary due to the attribution principle, discussed below.

To understand the importance of attribution, a brief explanation of how the IRS classifies business entities is necessary. For federal tax purposes, business entities involving two or more parties are classified either as corporations or as partnerships.[89] By default, unincorporated entities with more than two members, including LLCs, are classified as partnerships.[90] The default classification can be changed either initially or at a later time at the entity's election.[91] Since the joint venture vehicle will be a for-profit entity, its profits are subject to income taxation. If the entity is regarded as a partnership, tax liability for its earnings will be passed through to the partners—the non-profit hospital and the for-profit entity.[92] Additionally, the joint venture's activities will be attributed to the individual partners.[93]If the activities substantially relate to the exempt purposes of the hospital, its share of the earnings will not be subject to income taxation.[94]

Conversely, if a business entity is regarded as a corporation it will be subject to corporate tax on its profits prior to distributing

rather than the operation of a trade or business. *See* SANDERS, *supra* note 17, at 17. On the other end of the spectrum, health care entities in particular frequently use quite complex structures including parent/child/sibling relationships and contractual or virtual joint ventures such as joint operating agreements to achieve their goals. *See* John C. Columbo, *Reforming Internal Revenue Code Provisions on Commercial Activity By Charities*, 76 FORDHAM L. REV. 667, 668 (2007). The issues that such complicated arrangements raise are beyond the scope of this Note. Finally, a hospital always has the option of engaging directly in a particular activity, such as running a gift shop or pharmacy, without the use of a joint venture.

88. SANDERS, *supra* note 17, at 13.

89. Treas. Reg. § 301.7701-2(a) (as amended in 2007).

90. Treas. Reg. § 301.7701-3(b)(1) (as amended in 2006).

91. Treas. Reg. § 301.7701-3(a); *see also* SANDERS, *supra* note 17, at 109 (discussing LLC check-the-box elections).

92. I.R.C. § 701 (2006).

93. Rev. Rul. 98-15, 1998-1 C.B. 718; *see also* I.R.C. § 512(c) (2006).

94. However, there are circumstances under which even the non-profit hospital will be required to pay taxes on its partnership returns. In 1950, Congress enacted the UBIT, requiring an exempt organization to pay tax on the proceeds from any regularly carried on trade or business unrelated to its charitable purposes. I.R.C. §§ 511–514 (2006). I discuss UBIT and the issues of relatedness and substantiality in more detail below in Part II.B.2.

dividends to its shareholders.[95] However, the IRS will not normally attribute its activities to its shareholders.[96] While the prospect of a guaranteed level of taxation appears to be undesirable, I will show in Parts II.B and III.A that hospitals have increasingly compelling reasons for avoiding attribution of the joint venture's activities.[97]

This leads to the second structure by which a hospital can engage in a joint venture: through a for-profit subsidiary. What differentiates this from a direct joint venture is that here, it is the for-profit subsidiary, rather than the hospital, that forms the joint venture with the third-party for-profit partner. Using this structure may insulate the hospital parent from attribution of the joint venture's activities, and thus helps to eliminate the risk of the hospital losing its tax exemption. A diagram may help clarify the difference between the two forms:

FIGURE 1
DIRECT JOINT VENTURE

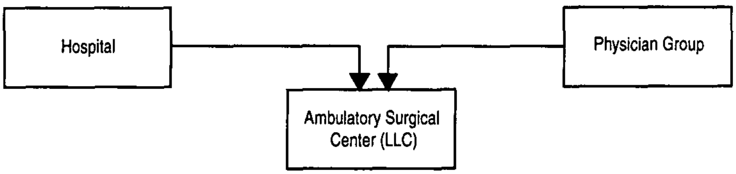
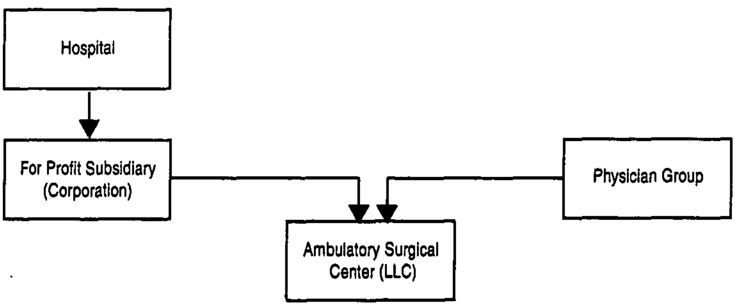


FIGURE 2
SUBSIDIARY JOINT VENTURE



95. I.R.C. § 11(a) (2006).

96. SANDERS, *supra* note 17, at 240. The qualifier "normally" is necessary because the IRS will disregard corporate structures where the subsidiary is a mere sham or instrumentality of the parent. *Id.* at 239. While ownership of 100% of the stock and the ability to appoint an entire board of directors do not necessarily indicate that the subsidiary has no independent purpose, factors such as involvement in the day-to-day operations of the subsidiary and non-arm's-length transactions increase the likelihood that the Service will disregard the corporate boundary. *Id.* at 240.

97. *See also id.* at 239–40.

II. CURRENT ENFORCEMENT MAKES DIRECT JOINT VENTURING RISKY

Part II recounts the evolution of joint venture oversight to the current regime of close scrutiny[98] with an emphasis on control as a principal, or even dispositive, factor. Part II.A discusses the Service's formal guidance and key cases that establish the current standards. Part II.B attempts to unpack these standards and apply them in the context of direct ancillary joint ventures, and concludes that the current regime imposes a great deal of risk for such structures.

A. New and Tighter Standards

In many ways, the IRS unveiled the modern era of joint venture oversight when it issued GCM 39,862 in late 1991.[99] The memorandum took the freshly ratified private benefit doctrine that had been lurking around the edges of various IRS rulings and litigation positions for years and thrust it into the spotlight.[100] With its abrogation of three previously issued private letter rulings approving joint ventures, it also foreshadowed a stricter application of the "close scrutiny" called for under the GCM 39,005 two-part test.[101] The next three sections examine the development of the current enforcement regime and evaluate its effect on the risks of engaging in direct joint ventures.

98. While this Note addresses only the tax exemption issues related to health care joint ventures, practitioners must carefully address several other statutory and regulatory considerations. Chief among these are antitrust concerns, the anti-kickback statute, and the Stark law. For a discussion of antitrust regulation in the health care joint venture arena, see Jonathan M. Joseph, Note, *Hospital Joint Ventures: Charting a Safe Course Through a Sea of Antitrust Regulations*, 13 AM. J. L. & MED. 621 (1987–1988). For an analysis of the impact of the anti-kickback statute and Stark law on health care joint ventures, see David N. Heard, Jr., Note, *The Specialty Hospital Debate: The Difficulty of Promoting Competition Without Stifling Efficiency*, 6 HOUS. J. HEALTH L. & POL'Y 215 (2005).

99. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

100. *Id.*; John D. Columbo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1064, 1069–70 (2006).

101. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991); *see also* I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983).

1. Private Benefit Emerges as a Key Enforcement Tool

Even before the IRS formally allowed non-profits to participate in joint ventures with for-profit entities, it was concerned with the problem of private benefit.[102] Indeed, the Revenue Ruling that established the community benefit standard for hospitals concluded in its "bad" scenario that factors showing that the hospital operated for the private benefit of its owners disqualified the hospital from exemption.[103] However, although the Service had referenced private benefit in various rulings and litigation positions for some time, it had been unsuccessful in persuading a court that a violation of the doctrine was sufficient ground for revocation.[104] One possible explanation for this failure is that the doctrine itself has eluded clear definition.[105] Even within the IRS, there has been confusion and inconsistency in interpreting and articulating the doctrine.[106]

In 1987, the Service tried to provide guidance to explain what it looked for when evaluating possible violations of the private benefit doctrine.[107] It described private benefit as "serv[ing] a private interest more than incidentally."[108] Though incidental amounts of private benefit pose no threat to exemption, both qualitative and quantitative limitations apply. Qualitatively, the private benefit must be a necessary concomitant of an activity benefiting the public at large; quantitatively, the benefit must be insubstantial in light

102. *See* Columbo, *supra* note 100, at 1068–69 (noting that IRS has considered private benefit a limitation on exempt status for thirty years).

103. Rev. Rul. 69-545, 1969-2 C.B. 117.

104. Columbo, *supra* note 100, at 1070–71.

105. *See id.* at 1064. For a thorough evaluation of the lack of statutory textual basis for a prohibition on private benefit and the transformation of the common law doctrine from a class-size emphasis to an incident of private service emphasis, see generally *id.*

106. *See* Columbo, *supra* note 100; *see also* United Cancer Council v. Comm'r, 165 F.3d 1173 (7th Cir. 1999) (rejecting the Service's allegation of private inurement and remanding on private benefit claim arising from same facts); I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991) (describing the same conduct as both violating private inurement and also conferring more than incidental private benefit). Nevertheless, GCM 39,598 conclusively establishes private benefit as a distinct basis for analyzing the effect of joint ventures on exemption. *See* Columbo, *supra* note 100, at 1072.

The IRS has recently amended its regulations to provide several new examples intended to illustrate the requirement that an organization serve a public rather than a private interest. T.D. 9390, 2008-18 I.R.B. 855 (amending Treas. Reg. § 1.501(c)(3)-1). Whether or not these examples will eliminate confusion has yet to be seen. However, the Service expressly declined invitations received during the rulemaking comment period to revise the existing standards and intends the new examples to merely "clarify the principles of the private benefit doctrine under existing law." *Id.*

107. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987).

108. *Id.*

of the overall benefit conferred by the activity.[109] The tolerance of an incidental amount of private benefit is one key distinction between the private benefit doctrine and the ban on private inurement. The other primary difference is that the prohibition against private inurement applies only to a "private individual or shareholder,"[110] while impermissible private benefit can be conferred upon anyone.

Despite this explanation, the IRS struggled to convince a court to adopt its view that private benefit was distinct from the well-established ban on private inurement, and sufficient in its own right to qualify as a basis for revocation. However, eventually the Service prevailed on a claim of private benefit before the Tax Court. In *American Campaign Academy v. Commissioner*, the court found that in spite of a large charitable class and a proper exempt purpose of education, a school conferred more than incidental private benefit on the Republican Party because most of its students ended up working for or supporting it.[111] The case clearly adopted private benefit as a stand-alone doctrine, with a broader reach than the prohibition on private inurement, which is applicable only to insiders.[112] In a further triumph for the Service, the court also approved of a case-by-case process of reviewing individual transactions for private benefit.[113] As a result, even comparatively insignificant joint ventures—as compared to the organization's overall charitable activity—will jeopardize the organization's exemption if they confer more than incidental private benefit.

With its success in *American Campaign Academy*, the IRS began using private benefit aggressively in policing joint venture arrangements.[114] In GCM 39,862, the IRS set its sights on joint ventures in which hospitals had sold future revenue streams at fair market value to physician investors in arms-length transactions.[115] Private letter rulings had previously approved three such arrangements; however, once viewed through the newly polished lens of private benefit, all were found to be incompatible with exempt status and the memorandum recommended that the previous rulings be

109. *Id.*
110. *See supra* note 69 and accompanying text.
111. 92 T.C. 1053, 1072 (1989).
112. *Id.* at 1063, 1078.
113. *Id.*; *see also* Columbo, *supra* note 100, at 1073–74.
114. Columbo, *supra* note 100, at 1074.
115. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

revoked.[116] The message was quite clear: joint ventures were no longer to be taken for granted.

2. Control Test Articulated in Whole Hospital Context

The next major development in creating the current joint venture oversight environment was the release of Revenue Ruling 98-15.[117] Prior to the ruling, practitioners had been limited to reviewing inconsistent and non-precedential private letter rulings to divine the possible effects on exemption of various joint ventures.[118] Revenue Ruling 98-15, issued in response to the rapid growth in non-profit/for-profit joint ventures, finally provided solid insight into how the Service would evaluate such arrangements.[119]

The ruling presents and analyzes two factual scenarios, one passing scrutiny and the other resulting in revocation.[120] Both scenarios involve non-profit hospitals that directly form whole hospital joint ventures with for-profit entities. The joint ventures are organized as LLCs that elect pass-through taxation, resulting in the IRS attributing their activities to the partners.[121] In the "good" scenario, the articles of organization for the joint venture explicitly give the non-profit hospital majority representation on the board of directors, mandate prioritization of community benefit over profit maximization, and provide for financial distributions in proportion to the partners' ownership interests.[122] Management of the venture is vested in an unrelated company, for reasonable compensation and a five-year term.[123] In contrast, in the "bad" scenario, the board is split evenly between the non-profit and for-profit, the articles contain some blocking provisions but no explicit prioritization of community benefit, and management of the venture is vested in a

116. *Id.* In addition to finding private benefit, the Service also determined that the three ventures resulted in private inurement as well as likely violations of federal fraud and abuse law. *Id.*

117. Rev. Rul. 98-15, 1998-1 C.B. 718.

118. Young, *supra* note 44, at 342.

119. Mirkay, *supra* note 39, at 41.

120. Rev. Rul. 98-15, 1998-1 C.B. 718. For a much more thorough analysis of the ruling, including additional "good" and "bad" factors that the Service relied upon, see Gerald M. Griffith, *Revenue Ruling 98-15: Dimming the Future of all Nonprofit Joint Ventures?*, 20 EXEMPT ORG. TAX REV. 405 (1998).

121. *Id.* Technically the owners of an LLC are usually described as "members" or "shareholders"; however, the use of the term "partners" here is intended to comport with IRS treatment of business entities rather than the law of business organizations, which varies substantially from state to state. *See supra* notes 89–96 and accompanying text.

122. Rev. Rul. 98-15, 1998-1 C.B. 718.

123. *Id.*

subsidiary of the for-profit organization and two of its former executives.[124]

In determining that the hospital in the "good" scenario continued to qualify for exempt status, the Service emphasized that the organizational structure of the venture permitted it to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.[125] The hospital's retention of formal control over the venture was the dispositive factor.[126] In the "bad" scenario, shared control did not ensure that exempt purposes would trump the service of private interests, and the articles lacked structural protections to elevate community benefit over profit maximization.[127] Additionally, the relationships between the management company, the for-profit entity, and its former employees who served as the venture's top executives created a heightened risk of non-incidental private benefit.[128] Commentators analyzing Revenue Ruling 98-15 widely agree that it raises organizational control to an unprecedented level of importance in joint venture review.[129]

Two major cases decided after Revenue Ruling 98-15 affirm the control test's dominance in determining whether a joint venture jeopardizes exempt status. In *Redlands Surgical Services v. Commissioner*,[130] a hospital entered into a joint venture with a for-profit company through a wholly owned tax-exempt subsidiary.[131] The only activity of the subsidiary, Redlands Surgical Services ("RSS"), was its involvement with the partnership.[132] The partners shared formal control over the venture equally, with RSS and the for-profit

124. *Id.* The ruling has frequently been criticized for setting up such polar opposite scenarios and providing almost no guidance for the majority of structures that fall somewhere between these extremes. *See, e.g.*, Sanders, *supra* note 46, at 96; Young, *supra* note 44, at 345.

125. Rev. Rul. 98-15, 1998-1 C.B. 718.

126. *Id.*

127. *Id.*

128. *Id.*

129. *E.g.*, Mirkay, *supra* note 39, at 44; Griffith, *supra* note 120, at 414.

130. 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001). Numerous commentators have conducted in-depth analyses of the *Redlands* decision. *See, e.g.*, Young, *supra* note 44, at 345–48; Sanders, *supra* note 46, at 105–08. For a particularly unique exposition, see Darryll K. Jones, *Private Benefit and the Unanswered Questions From* Redlands, 89 TAX NOTES 121 (2000).

131. *Redlands*, 113 T.C. at 48–50. This scenario differs from the use of a for-profit subsidiary described in Part I.B.3. Analytically, it makes sense to think of this structure as a direct whole hospital joint venture between the subsidiary, Redlands Surgical Services, and the for-profit entity; this tracks with the issue raised in the case, which is the qualification of the subsidiary—not the parent hospital—for exemption. *Id.* at 48.

132. *Id.* at 48.

entity each appointing two directors.[133] The organizing documents did not acknowledge a charitable purpose.[134] The arrangement included a long-term management contract with a subsidiary of the for-profit partner that conferred unusually broad powers.[135]

Without referencing Revenue Ruling 98-15, the court found that RSS had no effective formal control over the venture.[136] The court also looked for indicia of informal control and found none.[137] Based on all the facts and circumstances, the court held that RSS had not met the requirements for exemption under § 501(c)(3) and affirmed the decision of the Service to deny the subsidiary's application for recognition of exemption.[138] In a single paragraph affirmation, the Ninth Circuit adopted the tax court's finding that RSS had ceded control to the for-profit partner, as well as its holding that this conferred an exemption-precluding private benefit on the partner.[139]

In *St. David's Health Care System v. United States*,[140] a non-profit hospital challenged the retroactive revocation of its exempt status and the imposition of back-taxes after an audit resulted in a determination that its whole hospital joint venture prevented it from acting exclusively in furtherance of its charitable mission.[141] Voting control of the joint venture was, as in *Redlands*, divided equally between the hospital and the for-profit partner, and day-to-day management was vested in a subsidiary of the for-profit partner.[142] But unlike *Redlands*, the organizing documents and management contract included numerous provisions intended to tie the venture to the hospital's charitable purpose. These included specifically requiring the partnership to operate in compliance with the community benefit standard; permitting the hospital to unilaterally terminate the CEO, the management contract, or the entire ven-

133. *Id.* at 68.

134. *Id.* at 67.

135. *Id.* at 48, 82–83. For example, the management company was authorized to unilaterally set patient charges and to negotiate reimbursement rates with third-party payors. Delegation of these key powers gave the management company effective operational control. *Id.*

136. *Id.* at 78–85.

137. *Id.* at 85–88.

138. *Id.* at 92.

139. Redlands Surgical Servs. v. Comm'r, 242 F.3d 904, 904 (9th Cir. 2001).

140. 2002 U.S. Dist. LEXIS 10453 (W.D. Tex. 2002), *vacated*, 349 F.3d 232 (5th Cir. 2003). As with *Redlands*, this case has been thoroughly analyzed. *See, e.g.*, Young, *supra* note 44, at 348–52; Sanders, *supra* note 46, at 108–11.

141. *St. David's*, 2002 U.S. Dist. LEXIS 10453, at *3–5.

142. *St. David's*, 349 F.3d at 241–42. The appellate opinion includes a more detailed recital of facts than the district court opinion.

ture; and providing that neither partner could initiate board action without the support of the other.[143]

The trial court, remarking that "it is difficult to imagine a corporate structure more protective of an organization's charitable purpose," concluded that St. David's continued to qualify for exempt status and granted the hospital's motion for summary judgment.[144] However, the Fifth Circuit disagreed, noting that the blocking provisions only allowed St. David's to veto detrimental actions but did not empower it to ensure that the partnership took new actions serving charitable purposes.[145] Further, St. David's financial circumstances during the formation of the venture suggested that the parties' negotiating power was significantly unbalanced,[146] and the agreement contained a non-compete clause that might deter St. David's from exercising its power to dissolve the venture.[147] Because these issues raised questions of material fact as to whether St. David's had ceded control, the court vacated the order for summary judgment and remanded the case for trial.[148] In its analysis, the court expressly referenced Revenue Ruling 98-15, noting that such rulings were entitled to "significant weight."[149]

3. Control in Ancillary Joint Ventures

Because Revenue Ruling 98-15, *Redlands*, and *St. David's* all involved whole hospital joint ventures, considerable uncertainty remained over the standards that would be applied to ancillary joint ventures.[150] In 2004, the IRS released a new revenue ruling intended to provide precedential guidance specifically for ancillary joint ventures.[151] Revenue Ruling 2004-51 presented a single fact pattern involving an exempt university that had entered into a joint venture with a for-profit entity for the purposes of producing

143. *Id.* at 240–41.

144. *St. David's*, 2002 U.S. Dist. LEXIS 10453, at *24–25.

145. *St. David's*, 349 F.3d at 242.

146. *Id.* at 239.

147. *Id.* at 244. The non-compete clause barred both St. David's and HCA, the for-profit partner, from operating in the Austin area for two years following dissolution. However, while HCA was a nationwide operator of hospitals and could survive the non-compete period relatively unscathed, St. David's would have been utterly ruined because its only service area was Austin. *Id.*

148. *Id.* After trial, a jury found for St. David's on the issue of exemption. St. David's Health Care Sys. v. United States, 2004 WL 555095, at *1 (W.D. Tex. 2004).

149. *St. David's*, 349 F.3d at 240 & n.9.

150. *E.g.*, Young, *supra* note 44, at 353; Columbo, *supra* note 100, at 1077.

151. Mirkay, *supra* note 39, at 57.

interactive video training programs that would enhance the skills of elementary and secondary school teachers.[152] Although the venture was a 50-50 partnership, with a board of directors split evenly between the two entities, the operational aspects of the program were fully bifurcated.[153] The university retained exclusive control over all of the educational[154] aspects of the venture, such as the curriculum, training materials, and instructors.[155] The for-profit partner retained exclusive control over pure business issues, for example, selecting locations for receiving the video link and choosing non-educational personnel, such as camera operators.[156] The articles organizing the venture restricted it to conducting the teaching seminars, and required that it negotiate any transactions at arm's-length and at fair market value.[157]

The ruling stipulated that the joint venture was an insubstantial part of the university's overall activities, thus participation in the venture, taken alone, would not affect the university's tax-exempt status.[158] As will be discussed below, the issue of substantiality is a well-established element of the operational test, so this was certainly a relevant issue.[159] However, this abrupt disposal of the exemption issue without any analysis of the private benefit doctrine is odd. Although the ruling cited important sources—Revenue Ruling 98-15, *Redlands*, and *St. David's*—all of which found impermissible private benefit where joint ventures failed the control test, it did not undertake a similar evaluation of this venture.[160] It is puzzling why the Service, having established private benefit as an independent and sufficient ground for revocation, and having indicated that it would be applied on a per-transaction basis, would omit the consideration of the doctrine altogether.[161]

With the majority of its text focusing on the "substantially related" prong of UBIT,[162] the ruling determined that the university's joint venture provided the same educational content as programs

152. Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

153. *Id.*

154. Education is one of the purposes for which the IRS recognizes exemption. I.R.C. § 501(c)(3) (2006). For the purposes of applying this ruling to ancillary joint ventures in health care, "educational" can be read as if it means "charitable."

155. Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

156. *Id.*

157. *Id.*

158. *Id.*

159. "Substantiality" in the context of the operational test is easily confused with "substantially related" as a factor in the UBIT analysis. *See infra* Part II.B.2 (attempting to unpack these distinct concepts).

160. Rev. Rul. 2004-51, 2004-22 I.R.B. 974; *see also* Columbo, *supra* note 100, at 1078–79.

161. *Id.*; *see supra* Part II.A.1.

162. *See infra* Part II.B.2.

offered on the university campus, but extended the reach of the program to individuals who could not be accommodated at or conveniently travel to the campus.[163] Because this activity importantly contributed to the accomplishment of the university's educational purpose, it was not subject to UBIT.[164] Though the ruling favorably cited the authorities establishing the control test, it used control in a new way. Where control previously had been significant for ferreting out illicit private benefit, here it was used in a UBIT analysis to evaluate whether the venture's activities were substantially related to its exempt purposes.[165]

Revenue Ruling 2004-51 thus poses as many questions as it answers. Some commentators have taken the view that the IRS has loosened the control requirement, at least in the context of ancillary joint ventures.[166] Others argue that the control test is alive and well for all joint ventures, regardless of scope.[167] In a thoroughly unhelpful step, the IRS has recently announced that it will no longer issue private letter rulings determining whether a given joint venture will result in either revocation or the imposition of UBIT.[168]

B. Applications and Consequences

Part II.A explained how the monitoring of non-profit/for-profit joint ventures has evolved, from a nominal "close scrutiny" that permitted a vast array of joint ventures, to an aggressive policing of private benefit and control. But the Service's formal guidance leaves substantial uncertainty about the boundaries between ventures that exempt organizations can engage in without adverse consequences and those that risk unrelated business income tax or loss of exemption. To date, research in this area has focused either upon theoretical analysis of what *should* happen under certain assumptions[169] or practical expositions on how to structure a venture

163. Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

164. *Id.*

165. *Id.*; *see also infra* Part II.B.1 (analyzing the two possible meanings of control).

166. *E.g.*, Columbo, *supra* note 100, at 1079 & n.81; Sanders, *supra* note 46, at 111 ("[C]ontrol of the entire venture is not essential . . . as long as the exempt organization controls the substantive, charitable aspects.") (internal quotation marks omitted).

167. Mirkay, *supra* note 39, at 24. Professor Mirkay quotes unofficial comments of an IRS Assistant Chief Counsel stating that Revenue Ruling 98-15 is still valid and that Revenue Ruling 2004-51 does nothing to modify it. *Id.*

168. Rev. Proc. 2007-4, 2007-1 I.R.B. 118; *see also* SANDERS, *supra* note 17, at 209.

169. *See* Columbo, *supra* note 37, at 187–91; Sanders, *supra* note 46, at 112–20.

to minimize the likelihood of a problem.[170] Rather than following these approaches, in this section I assume that the IRS actually means what it has said and examine the consequences this could have for direct joint ventures. The primary consideration for the purposes of this Note is not what the Service is *likely* to do but rather what it *might* do based on the signposts it has erected, and the effect this may have on the selection of joint venture structure. Then in Part III, I will assess the implications of this policy and consider how it could be improved.

1. What Does "Control" Actually Mean?

The combination of Revenue Ruling 98-15, *Redlands*, and *St. David's* has clearly established something known as a "control test" as a dispositive element of whole hospital joint venture analysis, and an important, if not dispositive, element of ancillary joint venture analysis.[171] But what part of the exemption requirements is the test actually addressing? The aforementioned authorities all emphasize the private benefit doctrine.[172] In each situation, a non-profit ceded control of its joint venture to the for-profit partner.[173] This was treated as a *per se* violation of the private benefit doctrine: "[W]e conclude that petitioner has in fact ceded effective control . . . to for-profit parties, conferring upon them significant private benefits, and therefore is not operated exclusively for charitable purposes within the meaning of section 501(c)(3)."[174] The lack of control revealed more than incidental private benefit and therefore triggered revocation.

However, Revenue Ruling 2004-51 used the control test to assess whether or not a joint venture's activities were substantially related to a university's educational mission. Finding that they were, the Service determined that it would not impose UBIT. It disposed of the question of revocation almost in passing, and did so solely based on the insubstantiality of the venture's actions, relative to the

170. *See* SANDERS, *supra* note 17, at 205–09; *see generally* J. Patrick Plunkett & Heidi N. Christianson, *The Quest for Cash: Exempt Organizations, Joint Ventures, Taxable Subsidiaries, and Unrelated Business Income*, 31 WM. MITCHELL L. REV. 1 (2004).

171. *See supra* Part II.A.2–3.

172. *See supra* Part II.A.2.

173. Formal voting control as well as explicit provisions in the constitutive documents were necessary to pass the control test in the revenue ruling. Rev. Rul. 98-15, 1998-1 C.B. 718. The courts were also willing to look for indicia of informal control. *See supra* Part II.A.2.

174. Redlands Surgical Servs. v. Comm'r, 113 T.C. 47, 78 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001).

university's overall exempt activities.[175] The ruling did not evaluate whether private benefit resulted from the transaction.

Thus, on one hand we have a *per se* rule that ceding control over a joint venture confers more than incidental private benefit on the for-profit partner. From GCM 39,598 and *American Campaign Academy*, we know that this is grounds for revocation, regardless of how large or small the joint venture is compared to the organization's overall charitable activity.[176] On the other hand, we have the proposition that ceding control, at least of substantive charitable activities, will probably cause the IRS to determine that the activities are not substantially related to the organization's exempt purpose, and that at minimum UBIT should be imposed. Of course, behind the UBIT analysis hides the ever-present operational test limitation that if the organization is not exclusively (primarily) engaged in activities "in furtherance of" its exempt purpose, its exemption will be revoked.[177] In sum, failing the control test can result in revocation on either private benefit or "in furtherance of"[178] grounds, or in the imposition of UBIT if the activity is insubstantial relative to the other activities of the nonprofit.[179]

175. *See supra* Part II.A.3. Because the IRS assumed that the activities were insubstantial, it did not need to determine whether they were "in furtherance of" an exempt purpose. *See* Treas. Reg. § 1.501(c)(3)-1(c).

176. *See supra* Part II.A.1.

177. Treas. Reg. § 1.501(c)(3)-1(c). For a detailed discussion of the relationship between "in furtherance of" as an operational test requirement, and "substantially related to" as a UBIT factor, see John D. Columbo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 495–514 (2002). Professor Columbo argues persuasively that the IRS and courts have failed to adopt a coherent analytic framework to logically relate these two measures to one another and to consistently dispose of revocation decisions arising under them. For the purposes of this Note, it suffices to assert that their confusing similarity makes it risky to assume that substantial activities deemed unrelated to the charitable purpose would nevertheless somehow be considered in furtherance of it, saving the organization from loss of exemption.

178. What this really means is failing the operational test. However, there are several ways to fail the operational test, such as by engaging in excessive lobbying. From this point forward, this Note is primarily concerned with one specific way to fail the operational test, *viz.*, by engaging in more than an insubstantial amount of activities that are not "in furtherance of" a charitable purpose. I will use the phrase "in furtherance of" to denote this limitation, but the reader should bear in mind that this is really an element of the operational test rather than a separate requirement for exemption.

179. Michael Sanders has engaged in a similar, if perhaps less pessimistic, analysis to the one presented here, coining the phrase "UBIT plus Control" for his model. Sanders, *supra* note 46, at 114–21. However, Mr. Sanders uses his model to derive a short list of best practices for keeping a direct joint venture out of trouble, whereas this Note is concerned with the utility of a policy that generates risks of such a magnitude that, even if rarely realized, create significant incentives to avoid the direct joint venture structure entirely.

2. Relatedness and Substantiality

The preceding section explored the possible meanings of control in the context of private benefit and relatedness. However, even if the non-profit has control, it can still find its exemption at risk or be liable for UBIT, because control appears to be necessary but not sufficient for an activity to be "substantially related" to the organization's exempt purposes. As this Note has mentioned in passing, even an exempt organization is permitted to engage in an insubstantial amount of non-exempt activity without endangering its exemption.[180] However, if the activity is not substantially related to an exempt purpose, the organization may be subject to UBIT.[181] This leaves us with two important questions: First, how much activity is insubstantial? And second, how can we tell whether an activity is substantially related?[182]

Because an activity that is substantially related to an exempt purpose must, by definition, also be in furtherance of it,[183] I will address the second question first; after all, if the activity is in furtherance of an exempt purpose then the "insubstantial" question is irrelevant.[184] Unfortunately, we know little about when the IRS will deem an activity substantially related. An activity is not substantially related to an exempt purpose if its sole function is to provide financial support, even if the organization could not survive or would have to limit its operations without such support.[185] An activity is substantially related if a "causal connection" exists between it and the exempt purpose, and if the activity contributes importantly to the accomplishment of the exempt purpose.[186] Analogizing from

180. Treas. Reg. § 1.501(c)(3)-1(c).

181. I.R.C. § 513(a) (2006). There are exceptions to the imposition of tax liability, such as a qualifier that the activity be a "trade or business" that is "regularly carried on" to name two. *See* Treas. Reg. § 1.513-1 (as amended in 1983). This Note addresses the bulk of circumstances to which no exceptions apply.

182. These phrasings lend themselves to considerable awkwardness. In an attempt to minimize confusion, I will discuss them in terms of "substantiality" and "relatedness." "Substantiality" refers to the scope of the activity, which ranges from insubstantial to primary. "Relatedness" refers to the relationship between the activity of the venture and the organization's exempt purposes. For the purposes of this Note, if an activity is "substantially related" it will be assumed to also pass the "in furtherance of" test, and if an activity is unrelated it will be assumed to fail the "in furtherance test." This is technically imprecise since an activity could theoretically be unrelated—triggering UBIT liability—but still be in furtherance of an exempt purpose. *See* Columbo, *supra* note 87, at 671. However, "in furtherance of" is similarly poorly defined, and as Professor Columbo suggests, once an activity is determined to be unrelated, courts tend to ignore the technical distinction. *Id.* at 505.

183. Columbo, *supra* note 87, at 671.

184. Treas. Reg. § 1.501(c)(3)-1(e).

185. Columbo, *supra* note 87, at 670.

186. Columbo, *supra* note 37, at 188.

precedent is possible, but risky, since the determinations are random and inconsistent. For example, a hospital pharmacy selling drugs to the general public in addition to its patients is engaged in unrelated activity,[187] but a hospital gift shop accessible to visitors and employees is substantially related.[188]

If an activity is unrelated, then it should result in either the imposition of UBIT or revocation. This brings the question of substantiality to the forefront.[189] Again, there is little guidance and no bright line test to help us know when an activity stops being insubstantial.[190] In the past, the IRS has denied exemption for entities receiving between one-third and one-half of their revenues from unrelated business.[191] However, under a "commensurate-in-scope" test it has also approved exemption based on the amount of time and effort spent on exempt activity, regardless of the amount of income from unrelated business.[192] In a call for more specific guidance, one practitioner has urged the IRS to adopt a safe harbor under which organizations whose unrelated joint ventures, in the aggregate, have assets totaling less than ten to fifteen percent of the non-profit's total assets would automatically pass the substantiality test.[193]

Because the IRS does not measure substantiality on a per-transaction basis, but rather by the aggregate of all unrelated activities, the problem becomes even more complicated.[194] Under this aggregation rule, joint ventures have the potential to threaten exemption in two different, insidious ways. First, a hospital may simply engage in too many unrelated activities that are each relatively small, but taken together are more than insubstantial.[195] For the purposes of aggregation, not only would joint ventures be counted, but partnerless activities that the hospital engages in would also be counted, such as directly running a pharmacy selling drugs to the public. Routine institutional communication gaps or

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187. Carle Found. v. United States, 611 F.2d 1192, 1199–1200 (7th Cir. 1979).

188. Rev. Rul. 69-267, 1969-1 C.B. 160.

189. *See supra* note 182 and accompanying text (explaining the technical simplification of this statement).

190. *See* Treas. Reg. § 1.501(c)(3)-1(c).

191. Mirkay, *supra* note 39, at 33.

192. *Id.* at 34 (citing an example where exemption was upheld for an organization deriving 98% of its revenue from bingo games, but 40% of its time and resources were used in charitable service).

193. SANDERS, *supra* note 17, at 223.

194. *See* Treas. Reg. § 1.501(c)(3)-1(c).

195. *See* Symposium, *supra* note 54, at 266 (comments of Norman G. Tabler) ("We have a concern that the ever increasing number of taxable ventures will cause a substantial portion of our operations to be for-profit, and that is a test that we cannot afford to fail.").

the lack of formal monitoring of such activities could realistically jeopardize exemption. The second problem is that a venture might experience significant growth, such that at some point the IRS would no longer consider it insubstantial.[196]

The lack of clarity in determining relatedness and substantiality adds additional risk to direct joint ventures. Even if a venture satisfies the control test, a non-profit can still be subject to UBIT if its joint venture is deemed unrelated. Moreover, if the aggregate of all of the non-profit's unrelated activity is or becomes substantial, exemption can also be lost regardless of the non-profit's retention of control.

III. ANALYSIS OF POLICY IMPLICATIONS

Part III analyzes the practical effect of current joint venture policy and concludes that it has been applied too bluntly, creating unnecessary—and potentially harmful—incentives for hospitals to engage in subsidiary, rather than direct, joint ventures. Part III.A explains how the ability of a hospital to conduct joint ventures through a for-profit subsidiary eliminates much of the risk described in the previous section and argues that the certainty of corporate tax, though a drawback, is more than offset by this risk. It further suggests that several business incentives, some independent and some caused by the current enforcement regime, also make subsidiary joint ventures an attractive alternative to direct joint ventures. The section concludes by evaluating likely consequences of a shift towards the subsidiary joint venture structure. Part III.B suggests that the IRS could use a combination of existing enforcement tools, along with a more nuanced approach to making exemption determinations. This would maintain the integrity of the charitable exemption system while eliminating many of the incentives to use subsidiary joint ventures instead of direct joint ventures, particularly when the latter may be more socially beneficial.

A. Subsidiary Joint Ventures: More Attractive But Less Charitable?

Part II.B showed that a non-profit engaging in a direct joint venture faces a number of uncertainties that could result in either revocation of exemption or the imposition of UBIT. Though a

196. *See* SANDERS, *supra* note 17, at 27.

hospital can structure a direct joint venture to minimize the chances of triggering these land mines, *St. David's* teaches us that even a carefully constructed venture can have severe hidden consequences. I argue in this section that the aforementioned risks, along with certain business factors, make the subsidiary joint venture structure more appealing, on balance, than it would be otherwise.

As noted above,[197] exempt status under § 501(c)(3) confers a vast array of benefits on a hospital. Revocation is a devastating penalty that a hospital would not dismiss lightly. This Note has already thoroughly discussed the risk of revocation created by non-profit/for-profit joint ventures. However, something more should be mentioned with regard to tax liabilities. The primary drawback to using a subsidiary joint venture is that it will be subject to at least one level of normal corporate income tax, whereas a direct joint venture may be tax-free to the non-profit partner. If, *ex ante*, the hospital does not expect the venture to generate unrelated business taxable income, the direct form will be financially superior. If the IRS is likely to deem the joint venture unrelated and to impose UBIT, then from a tax liability perspective, the hospital should theoretically be indifferent to the form of the venture.[198] But significant uncertainty arises about precisely how the IRS will decide issues of relatedness, substantiality, and whether control has been sufficiently reserved. When we add in this uncertainty, we see that a hospital's real choice is between surrendering to guaranteed corporate tax in the subsidiary form, or risking possible revocation for the chance of avoiding UBIT in the direct form.

Besides risk-reduction, the subsidiary structure confers substantial business benefits as well. It may make it easier for the hospital to obtain financing for the joint venture, since creditors may be more willing to lend capital to a for-profit entity than to an exempt organization that they cannot force into involuntary bankruptcy if it defaults.[199] It also eliminates the need for highly restrictive control structures and for binding distributions solely to ownership

197. *See supra* note 58 and accompanying text.

198. This is so because the UBIT rate is the same as the corresponding corporate income tax rate; therefore, the tax imposed will be the same under either source. I.R.C. §§ 11, 511(a)(1) (2006). The hospital faces no risk of so-called "double-taxation" in this scenario because the income it receives from the subsidiary will probably take the form of dividends, which are expressly excluded from the definition of unrelated business taxable income and will therefore be treated as normal exempt revenues. I.R.C. § 512(b)(1) (2006). This simplification assumes that no offsetting losses, deductions, or other factors exist that might affect the tax burden to either partner.

199. SANDERS, *supra* note 17, at 26.

interests and initial contributions.[200] One commentator has argued that obtaining even equal control is unrealistic and unattainable in the current health care market.[201] Additionally, though most analyses of IRS joint venture policy presume that only two entities are involved,[202] from a real-world business perspective it may be desirable to involve more entities, particularly where the goals are related to public health or welfare, as opposed to simply providing a product and maximizing profits.[203] Finally, using a subsidiary helps reduce the expensive legal analysis and drafting needed to protect a hospital from the risk of revocation associated with a direct joint venture.

To the extent that non-profit hospitals respond to these risks and incentives by choosing subsidiary joint venture structures where they would have used direct joint ventures in a less restrictive regulatory environment, the time-honored question "so what?" arises. After all, we can expect at least one outcome that does not seem at all problematic: tax revenues should rise as health care joint ventures conduct more activity in the taxable, rather than exempt, environment.

However, one serious drawback to the increased use of subsidiary joint ventures exists. Because the IRS will not impute the ventures' activities to the hospital, no incentive remains for the ventures to adhere closely to their parents' charitable mission. Indeed, the converse is true: as a for-profit joint venture between two for-profit entities, we can reasonably expect the venture to place a high priority on profit maximization. While it is tempting to believe that a hospital has higher motivations, and would seek to impose its charitable mission on the venture regardless of the structural form, good reasons exist to ignore this temptation.[204] As Professor Darryll Jones points out, hospitals depend heavily on cross-subsidization where excess revenues from profitable services

200. *See, e.g.*, Jones, *supra* note 21, at 16. Professor Jones recounts statements to the effect that no for-profit entity would ever subject itself to control by a non-profit.

201. Mirkay, *supra* note 39, at 59.

202. *E.g.*, Jones, *supra* note 21, at 13–14.

203. A multi-party joint venture could still conceivably be structured in a way that passes the control test, but since this Note is primarily concerned with the effect of risk on incentives, I would assert that the additional complexity of such a structure translates into an even higher level of risk. Though a venture between two or more non-profits and one for-profit seems comparatively less problematic, a venture between a single non-profit and two or more for-profits would likely pose insurmountable business problems in establishing a level of control sufficient to satisfy the Service, unless the for-profits were willing to act more or less as mere passive investors.

204. In fact the IRS is apparently so convinced that exempt organizations do not behave in this way that it has gone to great lengths to adopt and enforce the private benefit doctrine and control test.

or departments fund other, very expensive departments or services.[205] In *Redlands Surgical Services v. Commissioner*, for example, even while attempting to operate as an exempt entity, RSS had still structured its venture to significantly limit the amount of Medicare, Medi-Cal, and indigent care that it would provide.[206] Similarly, it ceded control over charges and reimbursement to the management company affiliated with the for-profit partner.[207] Researchers have found that for-profit health care entities typically charge five to ten percent higher prices than comparable non-profits, and have argued that the negative public impact may be tremendous.[208] Therefore, a shift toward subsidiary joint ventures may mean a shift away from community benefit.

B. Policy Refinements

The final section of this Note considers refinements to the current enforcement regime that would maintain the integrity of the charitable exemption system and also would eliminate the artificially heightened attractiveness of the subsidiary joint venture structure.

Some commentators have called explicitly for the repudiation of the control test with regard to ancillary joint ventures.[209] Professor Columbo recently advocated a sweeping multi-part reform that includes restoring the "destination of income" test,[210] taxing all commercial activities conducted by charities whether related or not,[211] and evaluating private benefit on an aggregate rather than a per-transaction basis.[212] Numerous commentators have called for increased use of the UBIT framework as the proper tool for evaluating

205. *See* Jones, *supra* note 130, at 128.

206. 113 T.C. 47, 67–68 (1999); Jones, *supra* note 130 at 125 (noting that RSS would not offer an emergency room, obstetrics, or neo-natal care).

207. *Redlands*, 113 T.C. at 59–60; *see supra* note 135 and accompanying text.

208. Mark Schlesinger & Bradford H. Gray, *How Nonprofits Matter in American Medicine, and What To Do About It*, HEALTH AFF., June 20, 2006, at W296–W297.

209. *E.g.*, Mirkay, *supra* note 39, at 67–68. Professor Mirkay does not propose the elimination of the control test in the whole hospital context, however. *Id.* While I agree that control has relevance in the whole hospital context, the reforms I suggest here would be applicable and effective in both whole hospital and ancillary joint ventures.

210. Columbo, *supra* note 87, at 687–88. Briefly, the destination of income test permitted an organization to engage in unlimited amounts of commercial activity without loss of exemption so long as it used the revenues for charitable purposes. *Id.* at 669. The enactment of the UBIT and feeder organization provisions of the tax code in 1950 repudiated the destination of income test. *Id.* at 670; *see also supra* note 185 and accompanying text.

211. Columbo, *supra* note 87, at 688.

212. *Id.* at 689–90.

ancillary joint ventures, and for the IRS to provide clearer standards or safe harbors so that application of the test will be more predictable.[213]

Unlike some of the more sweeping reforms above, my view of the necessary change is more conservative. First, I argue that the IRS needs to reform, but not eliminate, the control test. As discussed in Part II.B.1, the IRS uses the control test to presumptively, if not dispositively, assess private benefit and relatedness. Part of the problem is the ill-defined concept of private benefit.[214] It can be taken to mean something akin to private inurement, or more generally it can serve as a safeguard to ensure that an activity actually serves the public in the way we expect charity should.[215] Though the Service has firmly established private benefit as an independent doctrine from private inurement,[216] the concepts are related. In fact, as the IRS has acknowledged, private inurement can be viewed as a subset of private benefit.[217] Private inurement applies solely to insiders,[218] and only with regard to improper economic inurement in any amount.[219] Private benefit, in contrast, can be found where any non-incidental benefit, economic or other, accrues to any person whether an insider or an unrelated third party.[220] Viewed in this way, private inurement is simply the worst type of private benefit.[221]

However, intermediate sanctions[222] now serve as the primary policing mechanism for private inurement. They permit the IRS to impose the far less onerous penalty of monetary penalties for con-

213. *See, e.g.*, Mirkay, *supra* note 39, at 60–67 (analyzing proposals made by Professor John Columbo and Mr. Michael Sanders).

214. *See supra* notes 105–106 and accompanying text.

215. *See* Treas. Reg. § 1.501(c)(3)-1(d)(2) ("The term charitable is used in section 501(c)(3) in its generally accepted legal sense . . . ."); *id.* at (d)(1)(ii) (stating that an organization is not serving an exempt [charitable] purpose unless it serves a public interest).

216. *See supra* note 113 and accompanying text.

217. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

218. *See supra* note 69 and accompanying text.

219. *See* I.R.C. § 4958(c)(1)(A) (2006) (referring to "economic benefit"); Treas. Reg. § 1.501(c)(3)-1(c)(2) (referring to "net earnings").

220. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987).

221. Reasonable people might disagree about whether private inurement is the "worst" type of private benefit or merely one particular type that is no better nor worse than any other is. Even on the latter view, the point that the disparity in remedies—revocation on the one hand and monetary penalties on the other—remains valid. However, strong arguments are available to support the assertion that private inurement is worse. Aside from being explicitly forbidden by the statute, where private benefit is at most implied, private inurement only occurs when insiders (who normally have influence over the operation of the organization) receive inappropriate economic benefit. This implicates self-dealing and disloyalty. Similarly, society will tolerate an insubstantial amount of private benefit, but any amount of private inurement at all is forbidden.

222. § 4958.

ferring excess benefits on "disqualified persons," rather than proceeding directly to revocation.[223] Commentators disagree about the desirability of using intermediate sanctions in the context of private benefit.[224] Nevertheless, if the worst type of private benefit should rarely trigger revocation, it makes no sense that a lesser type would. Therefore, whether the correct approach is imposition of an excise tax or, as Professor Mirkay suggests, higher rates of UBIT or forced divestiture,[225] the disparity in remedies must be resolved.[226]

Reducing the likelihood of revocation under the private benefit doctrine would do much to eliminate the disproportionate risk of engaging in direct joint ventures. But this alone does not provide a suitable framework for analyzing a given joint venture or the aggregate joint venture activity in which a non-profit engages. When the IRS polices improper private benefit in its "superset of inurement" guise, it is not only sensible, but also necessary to engage in the per-transaction analysis it has espoused in GCM 39,598 and in various litigating positions. However, when policing private benefit in its "charity is activity for the public good" guise, the per-transaction approach fails. This is because the substantiality

223. Commentators generally agree, and the legislative record suggests, that revocation should be very rare under the intermediate sanctions regime. John D. Columbo, *Private Benefit, Joint Ventures, and the Death of Healthcare as an Exempt Purpose*, 34 J. HEALTH L. 505, 514 n.55 (2001).

224. *Compare* Mirkay, *supra* note 39, at 70–87 (favoring such a change), *with* Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 FORDHAM L. REV. 735, 752–62 (2007) (opposing such a change). Professor Manny believes that unlike private benefit, private inurement is subject to a "hair-trigger" that perhaps justifies intermediate sanctions in the latter but not the former. *Id.* at 746. This may be true in the sense that the IRS tolerates an incidental amount of private benefit. However, I would argue that at a higher level of abstraction, under the intermediate sanctions regime the hair-trigger argument actually works in the other direction. A single transaction that violates the prohibition against private inurement will result in excise tax, but a single transaction that violates the prohibition against private benefit will—if we take the IRS at face value—result in revocation. *See* I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987).

225. Mirkay, *supra* note 39, at 70–71.

226. Unfortunately, recent amendments make it abundantly clear that the Service continues to view private benefit as necessitating revocation even where private inurement has been present and can be remedied through the imposition of excise taxes. Treas. Reg. § 1.501(c)(3)-1(f)(2)(i) ("Regardless of whether a particular transaction is subject to excise taxes under section 4958, the substantive requirements for tax exemption under section 501(c)(3) still apply . . . . Accordingly, an organization will no longer meet the requirements for tax-exempt status under section 501(c)(3) if the organization fails to satisfy the requirements of paragraph (b), (c), or (d) of this section."). Incomprehensibly, though, the very next clause specifies that private inurement violations will be evaluated on a facts and circumstances basis to determine whether revocation should result. Treas. Reg. § 1.501(c)(3)-1(f)(2)(ii).

element of the operational test,[227] augmented by the UBIT provisions that explicitly permit an exempt organization to engage in an unrelated trade or business if it is willing to be taxed on it,[228] make it clear that an exempt organization can engage in a limited amount of activities that confer no public benefit at all.[229] Only in the aggregate, when such activity becomes more than insubstantial, should the organization's exempt status be implicated. Thus, on one hand, revocation is an improper remedy when policing private benefit in the "superset of inurement" guise. However, on the other hand, revocation is an entirely appropriate remedy for an exempt organization that engages primarily in activities not related to or furthering its exempt purposes.

As the foregoing analysis shows, the current IRS approach to assessing remedies for problematic joint ventures is flawed and should be reformed. However, clarifying the distinction between the different guises of private benefit, and handling violations accordingly and consistently with the treatment of private inurement, does not entirely solve the problem. The Service must also review its approach to determining whether a given joint venture is problematic in the first place. Understanding the dual roles of private benefit helps to reveal the proper application of the control test in detecting a violation. Control of a particular joint venture may be directly relevant to the issue of private benefit in its "superset of inurement" guise. To that end, the IRS should continue to evaluate control on a per-transaction basis, but without an automatic penalty of revocation for failure.

But when the issue is private benefit in its "charity is activity for the public good guise," control tells us much less. After all, a given joint venture itself need not be charitable, so long as its activities are either insubstantial or they further the hospital's exempt purposes. Control of such a venture, in itself, would be irrelevant. Yet a control test still may have value in this guise. It may aid the analysis of relatedness of a particular joint venture for UBIT purposes. Similarly, control of individual joint ventures is relevant to the question of whether, in the aggregate, the organization continues to operate for charitable purposes. Because these distinctions are subtle and complicated, it is all the more important that a court considering the tax liability and exemption consequences of a joint

227. Treas. Reg. § 1.501(c)(3)-1(c), (e); *see supra* Part II.B.2.

228. I.R.C. §§ 511–514 (2006); *see supra* Part II.B.2.

229. It could be argued, particularly in light of the repudiation of the destination of income test, that such an operation generates *nothing but* private benefit, even if engaged in directly by the exempt organization without the use of a for-profit partnership.

venture engage in a structured and rigorous evaluation of each issue.

In each application of the test, control should be a factor rather than an outcome-determinative conclusion. The IRS polices private benefit, substantiality, and relatedness, and engages—or purports to engage—in a "facts and circumstances" evaluation.[230] After exhaustively reviewing articles of organization, management contracts, and the like, there is simply no need to arrive at an intermediate conclusion that pre-determines the holding. With such an intensive review already under way, a *per se* rule fails to serve the objectives of administrative or judicial economy. A dispositive intermediate conclusion is also inappropriate since joint ventures are evaluated to determine their impact on the non-profit's ability to satisfy the operational test.[231] The entire point of having an operational test is to review what an organization actually does as opposed to what it says it will do; in this context, ignoring other evidence in favor of a single structural conclusion is irrational.[232] Use of control as a factor rather than as a conclusion restores the proper focus of the evaluation without imposing new, additional costs.

Finally, as others have already urged,[233] the IRS should provide meaningful guidance to eliminate the uncertainty surrounding critical terms like "in furtherance of," "insubstantial," and "substantially related." Granted, this is no easy task. However, since joint ventures are becoming increasingly critical to hospitals' survival,[234] forcing them to risk their exemption by guessing incorrectly[235] about the consequences evades responsibility, and instead of deterring problematic joint ventures may simply channel them into less

230. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

231. The joint venture itself will be a for-profit entity and not subject to the organizational and operational tests. The non-profit has presumably already satisfied the organizational test, and it is hard to imagine why it would amend its own constitutive documents in a manner that no longer satisfies the organizational test.

232. A reasonable counter-argument might be made that by virtue of creating the joint venture the non-profit has engaged in activities reviewable under the operational test. But while this argument does justify taking control into account in assessing the manner in which the venture is operated, it fails to show why the Service or a court should ignore other factors such as the actual work the venture does.

233. *See supra* note 213 and accompanying text.

234. *See supra* Part I.A.2.

235. This is not sarcasm; the combination of unclear standards, individual transaction review under a *per se* test, and a moratorium on private letter rulings virtually dictates that the exemption and UBIT effect of any given joint venture will have to be guessed at. *See supra* note 168 and accompanying text.

risky structures with potentially adverse consequences for the public.

CONCLUSION

This Note has argued that joint ventures, previously prohibited, have become an important and increasingly necessary mode of modern health care operation. As their use has expanded to significant proportions, IRS oversight has centered on a confusing and inconsistently applied set of tests and doctrines, with the result that direct joint ventures now carry significant risks that hospitals can only partially alleviate. In contrast, the subsidiary joint venture model eliminates these risks and presents several business incentives. Furthermore, its principal drawback of guaranteed taxation may be a worthwhile price to pay, particularly since direct joint ventures may also be subject to tax liability. Since such subsidiaries are not bound to operate in furtherance of their non-profit parent's exempt purposes, the net result of a shift toward their use is likely to be less overall community benefit. Ultimately, the inflexible application of a policy meant to preserve the integrity of the charitable exemption system may reduce overall charitable activity. Nevertheless, by employing a more analytically rigorous approach to the problem, using existing enforcement tools, and providing improved prospective guidance, the IRS could eliminate this distorting effect without compromising the valid goal of deterring abuse.