SPECIAL REPORTS

Joint Operating Agreements Between For-Profit and Nonprofit Health Care Organizations: Is There A Future?

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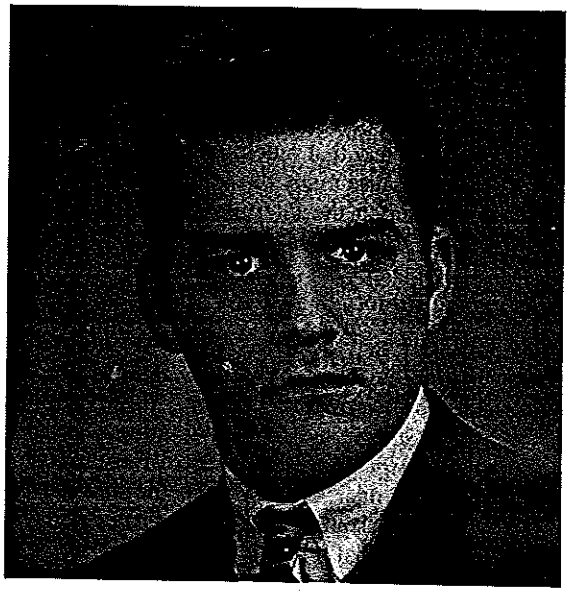

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Introduction

With the release of Rev. Rul. 98-15[1] in March, the Internal Revenue Service issued long-awaited guidance regarding joint ventures between nonprofit and for-profit hospitals.[2] Prior to this issuance, any tax-exempt organization seeking to enter into a joint venture with a for-profit corporation or individual had to request a specific letter ruling from the Internal Revenue Service.[3] With the decision in Rev. Rul. 98-15, tax-exempt hospitals seeking to create a whole hospital joint venture now had a specific framework for structuring the venture agreement without jeopardizing the nonprofit's tax-exempt status.[4]

Although it provided specific guidance and a framework for whole hospital joint ventures, Rev. Rul. 98-15 did not specifically address whether it would apply to joint operating agreements (JOAs) between tax-exempt and for-profit health care organizations.

A JOA is an arrangement that allows two entities to pool resources in order to obtain goods and services necessary to their common goal while still retaining their respective assets and limited control.[5] Typically, the parties to a JOA form a joint operating company (JOC), in a manner similar to a joint venture, to manage the agreement.[6] The nonprofit partner to the JOA is generally controlled by the JOC.[7]

JOAs are commonly regarded as nothing more than detailed cooperative contractual arrangements that do not amount to formal mergers under state law.[8] For this reason, they are often referred to as "virtual mergers,"[9] which are

[1]Rev. Rul. 98-15, 1998-12 I.R.B. 6, reprinted in *The Exempt Organization Tax Review*, April 1998, p. 142.

[2]Carolyn D. Wright, "Joint Venture Ruling Gets High Marks, With Some Reservations," *The Exempt Organization Tax Review*, April 1998, p. 9. (Discusses the recent issuance of Rev. Rul. 98-15.)

[3]Carolyn D. Wright, "Owens Discusses Newly Released Joint Venture Rev. Rul.," *The Exempt Organization Tax Review*, April 1998, p. 11. (Remarks of Marcus Owens, Director, IRS Exempt Organizations Division.)

[4]Wright, *supra* note 2.

[5]Michael W. Peregrine & Robert L. Capizzi, "New Developments in Tax Planning for Joint Operating Company Arrangements," *The Exempt Organization Tax Review*, July 1996, p. 101.

[6]C. Thomas Smith, "VHA Comments on Joint Operating Agreements, Whole Hospital Joint Ventures," *The Exempt Organization Tax Review*, April 1997, p. 648.

[7]*Id.*

[8]Daryll K. Jones, "Creating Complex Monsters: Joint Operating Agreements and the Logical Invalidity of Treasury Regulation 1.502-1(b)," *The Exempt Organization Tax Review*, February 1997, p. 165. (Provides detailed definition of joint operating agreements.)

[9]*Id.*

best described as creating an unincorporated passthrough entity. The cooperative entity most similar to a JOA is a partnership.[10] The Internal Revenue Code defines a partnership as "a syndicate, group, pool, joint venture, or *other unincorporated organization*, through or by means of which any business, financial operation, or venture is carried on" and which is not a corporation.[11]

Currently, the IRS has still not commented publicly on whether a JOA between a tax-exempt and for-profit health care organization would be permissible, although there is one such case pending before the IRS.[12] Thus far, the minimal guidance regarding JOAs concerned only those JOAs between nonprofit entities, never addressing the situation above. These cases have spawned their own separate body of law.[13] Practitioners and scholars have commented briefly on for-profit/tax-exempt types of arrangements, but have not provided any detailed guidance. Some even question their feasibility.[14]

Before a JOA between a for-profit and tax-exempt entity can occur, numerous questions must be answered. It remains to be seen from what body of law the appropriate guidance will come. It is unlikely that much will come from the nonprofit JOA rules because many of the essential issues in this area do not focus upon the interrelation of the tax-exempt and the for-profit entities. However, the IRS has created a checklist for tax-exempt JOAs, which may possibly be used as a broad guide for forming a JOA.[15]

It is more likely that the IRS will rely on the rules laid out specifically in Rev. Rul. 98-15, *Plumstead Theatre Society Inc. v. Commissioner*,[16] and its progeny. These cases along with the various GCMs, and other IRS pronouncements all focused on the concept of "control." Who drives the business? Who can make key decisions? What is the makeup of the board? How can the arrangement be terminated? These are all pivotal questions that need to be addressed in JOAs as well as joint ventures. In Rev. Rul. 98-15 the IRS saw "control" of the venture as the major factor in its decision.[17] The Service sought to ensure that a tax-exempt entity would have reasonable means to see that its charitable care function remains undisturbed. The same is most likely true for JOAs.

This article will focus on the following issues facing JOAs: revenue sharing and private benefit, unrelated business income, intermediate sanctions, and governing documentation. These issues will be explored in detail, paying specific attention to the concept of "control."

Although there are no definitive answers for JOAs between tax-exempt and for-profit entities, this article will attempt to create a logical framework for developing these types of agreements.

History/Development of the Law

In 1978, the IRS ruled in LTR 7820058,[18] that participation in a partnership where the charitable organization was the general partner and the private investors were the limited partners was per se impermissible.[19] The IRS found that this type of partnership arrangement would be contrary to the organization's tax-exempt status and thereby create a private economic benefit for the limited partners.[20] The IRS rule was clear: any tax-exempt organization engaged in a partnership, joint venture, etc. would automatically lose its tax-exempt status regardless of its purpose.[21] Thus, even if the purpose of the partnership was to advance a purely charitable purpose, the IRS would revoke the partnership's tax-exempt status.[22]

In 1979, the per se rule was advanced again in several cases dealing with housing projects. In a private letter ruling (PLR) from early 1979,[23] a charitable organization that was the general partner in a limited partnership for the purposes of maintaining a low-income housing project had its tax-exempt status revoked. As it did a year earlier, the IRS stated that the tax-exempt organization was a "direct participant in an arrangement for sharing the net profits of an income producing venture"[24] with private individuals.[25] Therefore the organization was potentially "furthering the private financial interests of the limited partners."[26] Later that year however, the exempt status of the tax-exempt entity that was the subject of the 1979 IRS ruling was placed in question in a litigation matter before the U.S. Court of Claims.[27] This litigation, although eventually settled, was an important step in the development of the law in this area.

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[10]Charles A. Bruder, "Charting the JOA Waters: Joint Operating Agreements, Tax-Exempt Health Care Entities, and a Proposed Safe Harbor," *The Exempt Organization Tax Review*, November 1997, p. 227. (Discusses the development of joint operating agreements up to but not including Rev. Rul. 98-15.)

[11]*Id.*, citing section 7701(a)(2) (emphasis added).

[12]Currently, there is a proposed JOA before the IRS. This involves a potential agreement between Columbia/HCA Health Care Inc. (for-profit) and University Medical Center of Jacksonville, a tax-exempt facility operated by the University of Florida. The proposed JOA is awaiting a ruling letter to determine its tax consequences. *See* John Dunbar, "University: Help With Free Care," *The Florida Times-Union* (Jacksonville, Fla.) March 28, 1996, at a-1.

[13]The law regarding joint operating agreements between tax-exempt and for-profit entities has its own specific rules. *See* Jones, *supra* note 8.

[14]Smith, *supra* note 6.

T.J. Sullivan , a partner with Gardner, Carton, and Douglas, general counsel to the Coalition for Nonprofit Health Care, and former IRS Special Assistant for Health Care, has stated that he doubts the IRS would view a JOA between a nonprofit and for-profit favorably. However, he is reserving judgment until the Treasury issues guidance.

[15]IRS Checklist for Hospital Joint Operating Agreement Applicants, *96 TNT 149-42.*

[16]*Plumstead Theatre Society Inc. v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

[17]Rev. Rul. 98-15, *supra* note 1.

[18]LTR 7820058 (1978).

[19]*Id.*

[20]*Id.*

[21]*Id.*

[22]*Id.*

[23]LTR (Feb. 6, 1979).

[24]*Id.*

[25]*Id.*

[26]*Id.*

[27]Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, Seventh Edition (1998) at 827.

As a result, the IRS temporarily abandoned the use of the per se rule. As part of the settlement, the charitable organization was allowed to serve as the general partner of a limited partnership without jeopardizing its tax-exempt status.[28] The charitable organization was able to show the IRS that it had little involvement in the finances and the overall control and management of the partnership.[29] The other general partner, a for-profit entity, was primarily responsible for managing the financial and business aspects of the project, which the IRS reasoned would allow the charitable organization to focus on its tax-exempt functions without becoming unduly involved in the nonexempt portion of the business.[30] Although the IRS permitted the venture, it did not do so on the same grounds it used later. At this point, "control" of the entity by the tax-exempt partner was not at issue. As will be evidenced later, this position differs from the ruling in Rev. Rul. 98-15, where the IRS looked specifically at the ability of the tax-exempt organization to influence or "control" the joint venture. Despite this temporary reprieve, the IRS continued in its attempt to advance the per se rule in other cases.[31]

In 1980, *Plumstead Theatre Society Inc. v. Commissioner*[32] changed the landscape regarding for-profit/tax-exempt joint ventures. In this case, a tax-exempt theater group (Plumstead) intended to stage a production at the Kennedy Center in Washington. The group was struggling to meet the financial demands of this endeavor and entered into an arrangement which provided them with much-needed financial assistance. Plumstead formed a limited partnership with private investors who would serve as limited partners. These limited partners had no control over the management of the organization nor were they officers or members of the board of the charitable organization. The IRS, once again, advanced its per se argument and attempted to revoke Plumstead's tax-exempt status regardless of the purpose of the partnership, abandoning their progressive decision of only one year earlier. However, the IRS lost at trial and on appeal because the courts considered that the purpose of the charitable organization was not disturbed by this arrangement nor did the limited partners have any control of the partnership's management or direction.[33] For the first time, the courts and the IRS began to seriously consider the question of who was in "control" of the joint venture.

As a result of the *Plumstead* decision, the IRS began to further relax its stance on these joint ventures. The IRS subsequently began its practice of "close scrutiny," whereby it began to carefully analyze the specific facts and circumstances of each particular transaction.[34]

[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Plumstead, supra* note 16.
[33] *Id.*
[34] GCM 37852 (Feb. 9, 1979).

In GCM 39005,[35] which dealt with a low-income housing venture, the IRS chief counsel stated for the first time that it was possible for a charitable organization to participate as a general partner in a limited partnership without jeopardizing its tax exemption.[36] The Service based its ruling on the grounds that a section 501(c)(3) organization may participate in a joint venture with a for-profit entity if doing so: (1) furthers its exempt purposes under section 501(c)(3) (the "charitable purposes test") and (2) does not prevent the tax-exempt organization from acting exclusively to further exempt purposes and does not confer a substantial private benefit on the non-exempt partners (the "private benefit test").[37] Although the "exclusively" standard in the private benefit test was not quite as harshly followed in Rev. Rul. 98-15, these two tests still remain the basis for the body of law concerning joint ventures between tax-exempts and for-profits. "Control" of the direction of the venture now played a significant role in structuring a joint venture.

The position taken in GCM 39005 paved the way for numerous favorable private letter rulings concerning charitable organizations engaged in partnerships with for-profit entities. The common thread in all of these rulings was that the partnership was always held to be acting in furtherance of the charitable purpose of the exempt partner. In 1986, the IRS even suggested additional factors that should be considered to determine whether the purpose of the partnership agreement is inconsistent with its tax-exempt status.[38]

However, the problem with the way the law developed is two-fold. First, the entire body of law up until that point was contained in GCM 39005 and a series of private letter rulings along with various speeches made by service personnel. This created a lack of guidance for those contemplating creation of a joint venture, since private letter rulings are non-precedential and are personal to the party requesting them. Second, PLRs cannot be used as reliable guidance in structuring a joint venture agreement.[39]

Rev. Rul. 98-15 represented the first specific guidance proffered by the IRS on whole hospital joint ventures.[40] The ruling discusses two specific fact patterns involving whole hospital joint ventures. The fact patterns are as follows:

[35] Gen. Couns. Mem. 39005 (June 28, 1983). *See also Housing Pioneers Inc. v. Commissioner*, T.C. Memo. 1993-120, *aff'd*, 58 F.3d 401 (9th Cir. 1995). (Examines whether a not-for-profit organization formed to act as the co-general partner in limited partnerships to develop low-income housing qualified as an organization described in section 501(c)(3).)
[36] *Id.*
[37] Gerald M. Griffith, "Rev. Rul. 98-15: Dimming the Future of All Nonprofit Joint Ventures?," *The Exempt Organization Tax Review*, June 1998, p. 405, *see* pp. 408-409.
[38] Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal 1986, Chapter K: "The Use of Limited Partnerships to Accomplish Charitable Objectives," *see 94 TNT 50-20* or *Doc 94-128*. (Lists additional factors to qualify for tax-exemption.)
[39] Robert C. Louthian, "IRS Provides Whole Hospital Joint Venture Guidance in Rev. Rul. 98-15," *BNA Health Law Reporter*, March 19, 1998, p.77.
[40] Griffith, *supra* note 37.

Situation 1: *A* is an exempt organization under section 501(c)(3) of the code. *B* is a for-profit corporation that owns and operates a number of hospitals. *A* decided that it could better serve the community if it obtained additional funding. *B* was interested in financing *A*'s hospital provided it earned a reasonable return.

A and *B* subsequently form a limited liability company (LLC) called *C*. Since this is a whole hospital joint venture, *A* contributes all of its assets including the hospital to the *C* as does *B*. In return, both *A* and *B* receive interest in *C* equal to their respective contributions.

The LLC was treated as a partnership for tax purposes. *C*'s governing documents provided that *C* was to be managed by a governing board consisting of three individuals selected by *A* and two selected by *B*. *A* was to appoint community leaders who have hospital experience, but who are not on the hospital staff and do not engage in business transactions with the hospital. The governing documents further provided that the documents may only be amended with the approval of both owners and that a majority of three board members must approve certain important decisions relating to *C*'s operation. Some examples include: (1) *C*'s annual capital and operating budgets; (2) distributions of *C*'s earnings; (3) selection of key executives; (4) acquisition or disposition of health care facilities; (5) contracts in excess of *X* dollars a year; (6) changes to the types of services offered by the hospital; and (7) renewal or termination of management agreements.

The governing documents required the charitable purpose of the organization to override any duty to operate *C* for the financial benefit of its owners. Additionally, any distributions made must be proportional to the respective ownership interests. The business of *C* would be handled by a management company unrelated to the business of either *A* or *B*. None of the officers, directors, or key employees involved in the formation of *C* was promised employment by the LLC or with *B*. Also, *A* intended to use the distributions that it received from *C* to fund grants to support activities that promote community health and indigent health care.[41]

Situation 2: This situation also involved the formation of an LLC, with some key differences from the first situation. Hospitals *D* and *E* created an LLC, with *D* contributing all of its assets and *E* contributing some of its assets to the LLC. The interests received by *D* and *E* were proportional to their contributions. The difference in this scenario is contained in the LLC's governing documents.

In contrast to the structure in Situation 1, the governing board consisted of an equal number of board members. There would be three individuals selected by *D* and three selected by *E*. *D*'s appointees to the board were community members who were not on the hospital staff and did not engage in business transactions with the hospital. The board structure could only be amended with approval of both owners. A majority of board members is needed to approve certain major decisions similar to Situation 1. As part of the agreement to form the LLC, hospital *D* agreed to approve the selection of two individuals to serve as the LLC's CEO and CFO. These two individuals had previously worked for *E* in hospital management. Like hospital *A* in Situation 1, *D* intended to use any distributions from the business to support community health care and indigent care.[42]

Result: The IRS concluded that in Situation 1, hospital *A* could retain its exempt status because it continued to operate exclusively for a charitable purpose and only incidentally benefited from the for-profit's private interests. The IRS looked specifically at the governing documents for *C*, which committed *C* to: (1) providing health care services for the benefit of the community; and (2) giving charitable purposes priority over maximizing profits. The service also focused on the fact that the board structure of *C* gave hospital *A*'s members voting control, through which the hospital could ensure that its assets and the activities which it conducts via *C* will be used for exempt purposes.[43]

In Situation 2, however, the Service found that hospital *D* violated section 501(c)(3) qualification requirements because it failed to establish that it will operate exclusively for exempt purposes after contributing its operating assets to the LLC. The IRS focused on the governing documents which, in this situation, do not require *F* to serve charitable purposes and provide that hospital *D* shares control of *F* with corporation *E*. The IRS interprets this as meaning that the hospital will not be able to initiate programs with *F* to serve new community health needs without first obtaining the agreement of at least one governing board member appointed by *E*. Additionally, the IRS cited the fact that the appointed CEO and CFO had prior relationships with corporation *E* and that the management company may enter into all but "unusually large" contracts without board approval.[44] Once again, "control" became a factor. One problem regarding the IRS decision in Situation 2 is the fact that the Service did not consider actual control, deciding to focus on the theoretical control outlined in the governing documents. The IRS did not look through the formalities to see if in actuality, the venture would be controlled differently than its governing documents indicate. This type of focus intimates that the drafting of the governing documents for a JOA must be precisely written in order to pass IRS scrutiny.[45]

Issues In Creating a Tax-Exempt/For-Profit JOA

As evidenced by the decision in Rev. Rul. 98-15, "control" emerged as a major factor in creating a joint venture between a tax-exempt and for-profit entity.[46] Virtually all of the issues

[41] Rev. Rul. 98-15, *supra* note 1.

[42] *Id.*

[43] *Id.* and Louthian, *supra* note 39.

[44] Carolyn D. Wright and Fred Stokeld, "Practitioners React to Whole Hospital Joint Venture Rev. Rul.," *98 TNT 43-4*, March 5, 1998; *see also* derivative article in *The Exempt Organization Tax Review*, April 1998, p. 9.

[45] *Id.*

[46] Griffith, *supra* note 37.

concerning JOAs involve the concept of "control." These issues are discussed below:

Revenue Sharing

A JOA like a joint venture involves revenue sharing between the partners or members.[47] A joint venture, however, is considerably more integrated because it requires an actual exchange and sharing of assets in addition to sharing of revenue.[48] Utilizing a JOA instead of a joint venture agreement allows the for-profit partner to gain a foothold in the tax-exempt entity's operations without donating assets or making a capital investment.[49] The only creation is a JOC, which merely serves as a vehicle to divide revenue between the partners to the JOA.[50] Thus, just as it was in Rev. Rul. 98-15, the structure and purpose of the JOC becomes critical in a JOA. The JOC must properly allocate revenues to avoid the risk of creating a private economic benefit for the tax-exempt member of the JOA.[51] This is where "control" becomes a factor. If the tax-exempt entity has majority control of the JOC it could potentially change its direction if danger of a private benefit occurring is imminent. If it does not, then its tax-exempt status is at the mercy of the for-profit entity. It is this type of "control" arrangement that the IRS rejected in Situation 2 of Rev. Rul. 98-15.[52]

If the tax-exempt entity has no majority, it may consider drafting an escape clause. An escape clause is a provision in an agreement granting the tax-exempt entity the ability to terminate the agreement if its tax-exempt status may be jeopardized, particularly if there is danger of a private economic benefit.

Either of these two adjustments would substantially reduce the risks. As it did in Rev. Rul. 98-15, the IRS will most likely scrutinize the governing documents of the JOA to determine if the tax-exempt entity will not be in jeopardy of losing its tax-exempt status. Unlike in a joint venture, in a JOC assets cannot be restructured to avoid the possibility of private economic benefit, since there are none in the JOC.[53] The JOA is in essence a straight revenue-sharing arrangement that needs to be used to further exempt purposes.[54]

When structuring the JOA to ensure that revenue sharing is in line with the IRS's expectations, the entities creating the agreement need to follow the two-pronged test from *Plumstead*.[55] The test is as follows: (1) the JOA must promote the tax-exempt entity's charitable purpose;[56] and (2) once this purpose is established, the parties must ensure the exempt organization's assets are free from risk and that only incidental benefits will flow from the partnership to the for-profit partner.[57] The first part of this test, the pursuit of a charitable purpose, should be satisfied as long as the JOA expresses a stated goal of promoting health care. Specifically, a joint venture cannot provide health care only to a small portion of the community, i.e. a health plan, or this prong will not be satisfied.[58] It must provide significant charitable care for the entire community as it is defined under the code.[59]

The second prong of the *Plumstead* test is the more difficult portion for the JOA to satisfy.[60] Much of the concern regarding JOAs between tax-exempts and for-profits involves the flow of revenue to the for-profit entity. The possibility of a private benefit accruing to the for-profit healthcare entity, even if unintended by both parties to the agreement, is highly possible.[61] Although JOAs are extremely flexible agreements that allow a great deal of latitude in drafting, a private benefit could still accrue. JOAs are entirely untested, and as such not all possible ways of incurring a private benefit have been identified.[62]

For example, if the nonprofit organization is heavily promoted by its members and the for-profit engaged in a JOA with that hospital sees a large rise in patient admissions,[63] does this constitute a private benefit to the for-profit entity?[64] Without proper guidance, the answer is unknown. Rev. Rul. 98-15 addresses a portion of this question. It appears that as long as there is some way for the nonprofit entity to maintain "control" of the JOA, many of these concerns and issues are mitigated.

Unrelated Business Income Tax

Under section 512(c)(1), a tax-exempt organization is treated as earning its share of all items of partnership gross income, and each item is treated separately in determining whether the organization has unrelated business income tax.[65] The income from the partnership will not be taxable as UBTI if the trade or business of the partnership is substantially related to the tax-exempt purpose of the tax-exempt health care organization.[66] There is no distinction made if a tax-exempt organization is serving as a limited partner as opposed

[47]Smith, *supra* note 6.

[48]Bruder, *supra* note 10.

[49]*Id.*

[50]*Id.*

[51]Louthian, *supra* note 39.

[52]Wright and Stokeld, *supra* note 44.

[53]Bruder, *supra* note 10.

[54]T.J. Sullivan, "Whole Hospital Joint Ventures — Speech Presented at International Business Community Health Care Conference November 20, 1997," *The Exempt Organization Tax Review*, January 1998.

[55]*Supra* note 16. Two-pronged test that emerged from this case was later reaffirmed by decision in Rev. Rul. 98-15.

[56]*Id.* at 245-246.

[57]*Id.*

[58]Bruder, *supra* note 10, *citing* Rev. Rul. 69-545.

[59]I.R.C. section 501(c)(3).

[60]Bruder, *supra* note 10 at 242.

[61]*Id.*

[62]*Id.*

[63]*Id.*

[64]*Id.*

[65]John R. Washlick, "Nonprofit Healthcare Organizations: Federal Tax Issues," *BNA Tax Management Portfolio Number 873* (1996) at A-52, *citing* section 512(c)(1).

[66]*Id.*

to a general partner for UBIT purposes.[67] This standard has been similarly applied to joint ventures structured as partnerships.

Although Rev. Rul. 98-15 involved an LLC, the IRS still applied the partnership standard for UBIT. As long as the tax-exempt organization maintains a charitable purpose, as per the standard in *Plumstead*, when structuring a JOA, the business of the partnership should remain charitable. It remains to be seen how the IRS will interpret the "substantially related" portion of the UBIT definition in the JOA context. The best indicator of how the IRS will potentially rule lies in the private letter rulings for joint ventures. In several PLRs, the IRS ruled that income derived from the following joint venture activities was not UBTI: (1) hospital in a joint venture with a for-profit physician service group in an MRI joint venture;[68] (2) operation of an ambulatory surgery center;[69] and (3) inpatient and outpatient surgical orthopedic services[70] to name a few. If a JOA is structured following these guidelines, the current guidance regarding joint ventures appears to be applicable. Once again, "control" of the entity becomes vital. Even if the purpose of the JOA begins to stray away from a "substantially related" position as it is defined by the Service, the ability for the tax-exempt organization to direct the activities of the JOA provide a safety feature. The tax-exempt entity always has a means of amending the purpose of the JOA in the agreement, changing the purpose of the JOA, or even terminating the agreement.[71]

Intermediate Sanctions

On July 30, 1996, President Clinton signed into law P.L. 104-168, the Taxpayer Bill of Rights 2 (TBOR 2).[72] The new law contains provisions that impose excise taxes known as "intermediate sanctions" on certain individuals who engage in so-called "excess benefit transactions" with certain tax-exempt organizations. An excess benefit transaction, for instance, could result if a tax-exempt organization received less than fair market value consideration from the sale of an asset or paid more than fair market value for compensation. The legislation provides for the following sanctions: (1) a 25 percent excise tax imposed upon the individual who receives an excess benefit, and has substantial influence over the organization ("disqualified person");[73] (2) an additional 200 percent excise tax imposed upon that individual if the excess benefit is not returned within a reasonable amount of time;[74] and (3) a 10 percent excise tax imposed upon an individual who knowingly approves an excess benefit transaction (known as an "organizational manager").[75]

These rules would need to be carefully considered when structuring revenue-based compensation arrangements as well as practice valuation issues within a JOA. Rev. Rul. 98-15 did not address these issues specifically.[76] Although intermediate sanctions are less of a concern in JOAs than in joint ventures, since there is no mixing of assets, where overvaluation of a practice acquisition may occur, it remains to be seen how the IRS will apply these rules. Management contracts and compensation arrangements are still very much at issue in a JOA, as they are in a joint venture.

Governing Documents

Given the level of IRS scrutiny for the two joint ventures analyzed in Rev. Rul. 98-15, properly drafting the governing documents is an extremely important procedure. In drafting these governing documents, extreme care must be taken in drafting the JOA to ensure multiple layers of protection for the tax-exempt entity. Strict adherence to the factors the IRS utilized in its Rev. Rul. 98-15 decision is important.[77] Additionally, the JOA should consider several other factors which the IRS looks to when structuring a partnership agreement. These favorable factors are: (1) limited contractual liability of the exempt partner; (2) limited rate of return on invested capital of limited partners; (3) tax-exempt organization's right of first refusal on sale of partnership assets; (4) presence of additional general partners; and (5) no obligation to return limited partner's capital from the exempt organization's own funds.[78] The JOA should also avoid the following factors, identified as unfavorable by the IRS, when structuring the agreement: (1) disproportionate allocation of profits or losses; (2) commercially unreasonable loans by the tax-exempt organization to the partnership; (3) inadequate compensation for services to be provided by the tax-exempt organization; and (4) most important in light of the decision in Rev. Rul. 98-15, control of the tax-exempt organization by the limited for-profit partners.[79]

Although these factors are by no means guarantees that a JOA will be upheld, they can be perceived as policies that insure the tax-exempt entity will always have a means to control the JOA.

Future Developments

Some have argued that allowing JOAs between tax-exempt and for-profit health care organizations will threaten the ability of tax-exempt health care to survive.[80] There are concerns that for-profit health care organizations will eventually continue their trend of tax-exempt takeovers and force

[67] *Id., citing* Rev. Rul. 79-222, 1979-2 C.B. 236.
[68] LTRs 9122061, 9122062, 9122070, 9024085, and 8917055.
[69] LTRs 9407022 and 8946067.
[70] LTRs 9318033 and 9308034.
[71] Louthian, *supra* note 39.
[72] Section 4958.
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] Carolyn D. Wright, "Analyzing Control in Joint Ventures Isn't Enough, Says Livingston," *The Exempt Organization Tax Review*, April 1998, p. 12.
[77] Louthian, *supra* note 39.
[78] Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal 1986, *supra* note 38.
[79] *Id.*
[80] Bruder, *supra* note 10.

tax-exempts into joint ventures and joint operating agreements.[81] Some even argue that it may force tax-exempt health care to be abandoned altogether in order to effectively compete.[82] Although these are valid concerns, the recent decline in physician acquisitions and increase in financial problems encountered by several high-profile health care organizations, have slowed the pace of joint venturing.[83] Also, the IRS has started conducting audits of whole hospital joint venture agreements.[84] In the future, the Service could very possibly expand its audits to include tax-exempt/for-profit JOAs. Marcus Owens, IRS Exempt Organizations Division Director, commented on this new audit policy in a speech before the Washington D.C. Bar Association's Health Law and Taxation Section in July 1998. He said, "I think any time you have an ownership or contractual *interest in the revenue* or the assets of the charity being created, you automatically have a serious question."[85]

However, there is another side to this argument. Allowing a tax-exempt entity to execute a JOA with a for-profit health care organization gives many independent hospitals and small healthcare systems a chance to compete with larger health care systems.[86] The advantage of a JOA for a health care entity and for the IRS is the degree of independence the tax-exempt entity can maintain in a JOA as compared with joint ventures and practice acquisitions. A small independent hospital, for example, could retain its assets and its independence while benefiting from the shared revenue of a JOA.[87] A small hospital may also be able to offer additional services, enter into new areas of research, and attract better quality medical staff where it would have been financially unable to do so previously.[88]

From the Service's perspective, as long as the tax-exempt entity utilizes the revenue gained in the JOA to further its tax-exempt purpose or to improve its facilities in furtherance of charitable care, the JOA should survive scrutiny. However, to do so, the tax-exempt entity must ensure that it always maintains "control" of the venture and that this control is clearly stated in the governing documents. Additionally, distribution of the earnings, selection of the JOC's key executives, acquisitions of new facilities, changes in hospital service, and renewal or termination of management agreements remain key issues that need to be addressed when structuring the agreement to pass IRS scrutiny.[89] It also remains to be seen whether the IRS will look behind the governing documents to investigate whether the JOA is, in actuality, operating in accordance with the governing documents.

Conclusion

Therefore, in light of the decision in Rev. Rul. 98-15 and the recent IRS decision to begin auditing whole hospital joint ventures, a party seeking to create a JOA should carefully draft its governing documents paying particular attention to the level of "control" maintained by the tax-exempt entity. By drafting these governing documents, with emphasis on revenue sharing, UBIT, and intermediate sanctions, the parties to the JOA help ensure that the agreement will pass IRS scrutiny.

[81]Bruder, *supra* note 10.

[82]T.J. Sullivan, *supra* note 54.

[83]Griffith, *supra* note 37.

[84]Fred Stokeld, "IRS Conducting Audits of Whole Hospital Joint Ventures, Owens Says," *98 TNT 137-5*, July 17, 1998.

[85]Marcus Owens, Speech given July 16, 1998, before the Washington, D.C. Bar Association. Owens spoke about the Ruling in 98-15 and how the IRS is planning to use it in its administration. (emphasis added). Mr. Owens commented that the same level of scrutiny will be applied to revenue sharing agreements, namely JOAs. For a related news story, *see The Exempt Organization Tax Review*, August 1998, p. 163.

[86]Bruder, *supra* note 10.

[87]*Id.*

[88]*Id.*

[89]Rev. Rul. 98-15, *supra* note 1.