St. David's Health Care System v. United States: How Should a Joint Venture Protect Its Tax Exempt Status?

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A tax exempt entity that contributes all or substantially all of its operating assets to a partnership with a non-exempt entity risks losing its tax exempt status unless certain parameters are met. Although the IRS specifically addressed whole hospital joint venture arrangements with for-profit business entities in a guidance document issued in 1998, subsequent judicial decisions have muddied the proverbial waters. Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 WL 89783 (1998). In November 2003, the 5th Circuit remanded the first case regarding this issue, raising new doubts about the meaning and measure of control in a joint venture between an exempt entity and a for-profit organization. *St. David's Health Care System v. United States*, 349 F.3d 232 (5th Cir. 2003).

St. David's Health Care System, originally a charitable organization entitled to tax exempt status, formed a partnership in 1996 with Columbia/HCA Healthcare Corporation ("HCA"), a for profit corporation. In 1998, the IRS audited St. David's and determined that it had lost its tax-exempt status because of its partnership with HCA. St. David's paid taxes under protest and immediately filed an action requesting a refund. The District Court granted summary judgment for St. David's. *St. David's Health Care System, Inc.*, 89 AFTR 2d 2002-2998 (DC Tex. 2002). The Court of Appeals held that a fact issue existed as to whether St. David's had ceded enough control to HCA that it no longer engaged primarily in activities that furthered its charitable purposes. *St. David's*, 349 F.3d at 232.

Non-profit organizations that are "organized and operated exclusively for religious, charitable, scientific… literary or educational purposes" can qualify for a tax exemption under 26 U.S.C.§ 501(c)(3). The burden of proof lies with the party claiming the exemption. *Nationalist Movement v. Commissioner*, 37 F. 3d 216, 219 (5th Cir. 1994).

Traditionally, in order for a non-profit organization to be qualified as tax exempt, it must show that it was organized and operated exclusively for a charitable purpose. 26 C.F.R. § 1.501 (c)(3)-1(a). In order to satisfy the organizational test, the organization must demonstrate that its founding documents limit its purpose to one or more exempt purposes and do not expressly empower it to engage more than an insubstantial part of its activities in conduct that fails to further its charitable goals. 26 C.F.R. § 1.501(c)(3)-1(b). As for the operational test, the entity must show that it (1) engages primarily in activities which accomplish its exempt purpose; (2) that its net earnings do not inure to the benefit of private shareholders or individuals; (3) that it does not expend a substantial part of its resources attempting to influence legislation or political campaigns; and (4) that it serves a valid purpose and confers a public benefit. *Nationalist*, 37 F. 3d at 219-220.

The government contends that because St. David's contributed all of its medical facilities to the partnership, the partnership's activities must be examined to determine if the first element of the operational test has been satisfied. The government argues that St. David's no longer engages primarily in activities that further its charitable goal because of its partnership with HCA. *St. David's*, 349 F.3d at 235. Both parties agree that the other three elements have been satisfied in this case. Id.

IRS Revenue Ruling 69-545 sets forth guidelines for hospitals seeking § 501(c)(3) tax exemption. These guidelines are called the community benefit standard. Factors of compliance include whether the non-profit hospital provides an emergency room open to all persons, regardless of their ability to pay; whether the hospital is willing to hire any qualified physician; whether the hospital is run by an independent board of trustees composed of representatives of the community ("community board"); and if the hospital uses all excess revenues to improve facilities, provide educational services, and/or conduct medical research. Rev. Rul. 69-545, 1969-2 C.B. 117, 1969 WL 19168 (1969); IHC Health Plans, Inc. v. Commissioner, 325 F. 3d 1188, 1197 (10th Cir. 2003). All of the requirements need not be met; rather the hospital must show that based on the totality of the circumstances it is entitled to a tax exemption. *Geisinger Health Plan v. Commissioner*, 985 F.2d 1210, 1219 (3d Cir. 1993). St. David's satisfied the community benefit standard under the IRS from 1938 until 1996. Additionally, the former HCA hospitals now satisfy the community benefit standard as well. David Flynn, CA-5

Remands St. David's But Provides Little Clarification on 'Control' in Joint Ventures, Journal of Taxation 40-54, 44 (Jan. 2004).

The Court acknowledged that St. David's provided important charitable work to the community, but concluded that the purpose rather than the nature of the hospital's activities must be examined. St. David's, 349 F.3d at 237. The purpose of a partnership between a non-profit and for-profit entity can be ascertained by who has formal or effective control. A non-profit entity loses its tax exemption when it cedes control to a for-profit entity because the assumption is that the non-profit's activities via the partnership are not exclusively or primarily in furtherance of its charitable purposes. *St. David's*, 349 F.3d at 238; *Redlands Surgical Servs. v. Commissioner*, 113 T.C. 47, 75, 1999 WL 513862 (1999); *Redlands Surgical Servs. v. Commissioner,* 242 F. 3d 904, 904-05 (9th Cir. 2001). A non-profit organization can establish control over the partnership by demonstrating some of the following: (1) that the founding documents of the partnership expressly state that it has a charitable purpose and that the charitable purpose will take priority over all other concerns; (2) that the partnership agreement gives the non-profit organization a majority vote in the partnership's board of directors; and (3) that the partnership is managed by an independent company (not affiliated with the for-profit entity). The management agreement should not be for a long term; the IRS suggests a 5 year term subject to renewal by mutual consent of the partners. Rev. Rul. 98-15, 1998-1 C.B. 718 (1998).

In this case, the Court effectively disregarded the community benefit standard in that the partnership's activities were not as important as St. David's ability to legally control the partnership in such a way as to act exclusively in furtherance of its own exempt purposes.
The Court suggested that St. David's was in a weaker bargaining position than HCA because of its financial status and may have been unable to ensure that the partnership's activities provided a public benefit, despite the inclusion of provisions in the contracts protecting St. David's tax exempt status. St. David's also had the power to terminate the management agreement and the CEO, the ability to block proposed action of the Board of Governors (of which half were appointed by St. David's), and the power of dissolution. *St. David's*, 349 F.3d at 241. The Court was not convinced that St. David's had enough actual control over the partnership and remanded the case.

Also of importance is the clarification by the District Court of what qualifies as "charity care." St. David's, 89 AFTR 2d 2002-2998. The District Court determined that the provision of a minimum level of charity care is required in order for a hospital to qualify under Section 501(c)(3) and retain tax-exempt status. The government argued that the inability to pay must be determined prospectively and accepted by the hospital in order to "count" as charity care, as opposed to writing off bad debts because the patient does not pay after services are rendered. The Court disagreed, concluding that when all who need care are treated regardless of payment, the function is charitable regardless of how it is later classified for accounting purposes. Id. This view was not challenged by the Appellate Court. St. David's, 349 F.3d at 237; *See also Maynard Hosp., Inc. v. Commissioner*, 52 T.C. 1006, 1026, 1969 WL 1642 (1969).

When planning an agreement resulting in a hybrid entity, practitioners should avoid a management contract of an excessively long duration or one that does not protect the advancement of exempt purposes via enforceable termination rights for the exempt entity. Non-compete clauses that bind the exempt entity if the dissolution results from a determination by the exempt entity that its charitable interests are not being promulgated should also be avoided. David Flynn at 54. The exempt organization must document its willingness and financial ability to pursue legally enforceable contractual rights that preserve tax exempt purposes. These issues should also be addressed in any ancillary joint ventures to protect exempt status and to avoid unrelated business income, at least until the IRS clarifies its position with regard to ancillary joint ventures. *Id*.

From a policy standpoint, when a formerly tax-exempt entity uses the umbrella of financial security a for-profit partner provides to extend charitable care to the community, it is questionable whether federal taxes should be imposed upon the partnership. On the other hand, for profit companies should not be able to use joint ventures as tax shelters where little charitable care is provided. The IRS and the courts need to provide clarity and guidance in the near future so that the tax status of joint ventures can be relied upon in business, health, and patient communities. Perhaps a new classification should not apply to existing ventures or payment of taxes should be implemented gradually so affected entities have time to adjust their resources and patient care is not disrupted.

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