The March 15, 2001, decision of the Ninth Circuit U.S. Court of Appeals in Redlands Surgical Services v. Commissioner validates the long standing “close scrutiny” analysis applied by the IRS to evaluate participation by a tax-exempt organization (“EO”) in a joint venture with for-profit interests. In particular, it confirms as a prominent factor in that analysis whether the EO is in a position to exert meaningful control over the venture. The decision does not mean that EOs may not participate in joint ventures with for-profit interests; rather, it confirms that they may so participate if the arrangements are properly structured.

The Decision

The Ninth Circuit affirmed the U.S. Tax Court’s 1999 decision denying the petition of Redlands Surgical Services (“Redlands”) for a declaratory judgment overturning the IRS’ 1996 denial of Redlands’ request for recognition of tax-exempt status. Redlands was a wholly-owned subsidiary of a tax-exempt hospital system parent. Redlands’ sole purpose and activity was to hold a partnership interest in, and help govern, a partnership that controlled another partnership operating a freestanding ambulatory surgery center.

Redlands is unusual in that the applicant had as its sole activity participating in the ambulatory surgery center joint venture at issue. Thus, Redlands involved a purportedly charitable organization’s participation in an ancillary joint venture, but presented the exemption question on facts more closely resembling a whole-hospital joint venture.

The IRS denied Redlands’ request because it took on the liability of a general partner but couldn’t exercise control over the use of the assets in the partnership. Accordingly, Redlands could not ensure that the joint venture would not be operated for private benefit. The IRS focused on five factors in reaching its conclusion that the nonprofit organization had no real control over the venture: (1) the lack of any express or implied obligation on the for-profit partners to put charitable objectives ahead of noncharitable ones; (2) Redlands’ lack of voting control over the partnership; (3) Redlands’ lack of formal or informal control sufficient to ensure furtherance of charitable purposes; (4) the long-term management contract giving a for-profit vendor too much control and an incentive to maximize profits; and (5) the important competitive advantages secured by the for-profit partners through their arrangement with Redlands.

Practical Effect

The most important effect of the Redlands decision is that it upholds the analysis applied by the IRS to EO participation in joint ventures announced in Rev. Rul. 98-15, and thus implicitly supports the Ruling.

In Rev. Rul. 98-15, the IRS adopted an analytical approach that was consistent with controlling case law and several IRS internal memoranda relating to EO investment in joint ventures with for-profit entities. Thus, Redlands combines with Rev. Rul. 98-15 to assure that nonprofit hospitals and other EOs will continue to be able to participate in the typical “ancillary joint ventures” (i.e., non whole-hospital joint ventures) without jeopardizing exemption in much the same fashion they have been since the seminal 1980 decision in Plumstead Theatre Society v. Commissioner. This means that EOs and their advisors should continue to analyze ancillary joint ventures pursuant to the two-pronged close scrutiny test (as restated in Rev. Rul. 98-15).

First Prong. Does participation in the joint venture by the EO further exempt purposes? To satisfy the first prong of the close scrutiny test, the EO must be
able to demonstrate that the activity of the joint venture, or the EO’s participation therein, somehow directly furthers the EO’s charitable purposes (i.e., establishing a “relatedness” criterion). Promoting the health of a broad cross-section of the community is the charitable purpose underlying most hospitals’ exemption.

This first prong of the test was clarified somewhat in the health care context by the 1991 issuance of IRS General Counsel Memorandum 39862, which found that three joint ventures involving sale of a net revenue stream from a hospital outpatient service did not further the participating hospitals’ charitable purposes. In so doing, GCM 39862 identified the following examples of bona fide community benefit (for purposes of the relatedness criterion):

- Creation of a new provider of health care services;
- Expansion of community health resources;
- Improvement in treatment modalities;
- Reduction in health care costs; and
- Improved patient convenience and access to physicians.

Second Prong. Does the joint venture arrangement or structure allow the tax-exempt organization to act exclusively in furtherance of its exempt purposes and not (other than incidentally) for the benefit of the for-profit partners? To satisfy the second prong of the close scrutiny test, the EO must be able to demonstrate that the joint venture structure protects the EO’s financial interests (e.g., no exposure to unnecessary risk for the benefit of the for-profit partners) and protects against the non-exempt investors deriving improper financial gain from the venture. Factors supportive of this second prong in the context of an ancillary joint venture include:

- Proportionate allocation of profits, losses, and tax items;
- Fair market value consideration paid by the venture to partners that provide services to it;
- Limited contractual liability of the exempt partners;
- Right of first refusal of the EO on the sale of venture assets;
- Supermajority voting rights/control vested in the representatives of the exempt partner with respect to significant operational matters (e.g., amendments to governing documents, disposition of assets, change in corporate activities); and
- Absence of improper guarantees by the exempt partner of the investment of non-exempt partners.

“Control” and Its Effect on UBIT

A related issue of importance under Redlands and Rev. Rul. 98-15 is whether the revenues received from a particular joint venture are related or unrelated to exempt purposes. Under Code § 512(c), an EO that is a partner in a partnership must examine each item of income and deduction flowing through from the partnership to determine the appropriate reporting of that income on the EO participant’s Form 990 or 990T. As is implicit in Redlands and Rev. Rul. 98-15, joint venture participants may need to take a fresh look at the character of income they receive from joint ventures to determine whether it is related or unrelated. In addition, they should evaluate the desirability of making adjustments in existing and planned joint venture arrangements to (1) obtain majority control or (2) maintain other formal or informal control that is sufficient to ensure that the joint venture conducts its activities in a manner that furthers exempt purposes.

Conclusion

The Redlands decision gives strong support to the IRS’ position that charitable organizations participating in joint ventures with for-profit interests must have formal or informal control over the ventures to rely on venture activities as furthering exempt purposes. Though significant, this case is only the latest development in an emerging trend toward looking carefully at who controls—and who benefits from—the joint ventures in which charities participate.
Due to its unique facts, Redlands is unlikely to signal any threat to exemption for organizations involved in common joint venture activities. It does, however, suggest a need for all tax-exempt organizations to consider whether the structure of their joint ventures with for-profit participants include mechanisms that will support the relatedness of venture activities to charitable purposes so as to avoid treatment of venture proceeds as unrelated business taxable income.

If you have any questions, please do not hesitate to contact Michael W. Peregrine (312-245-8455), T.J. Sullivan (202-408-7157), or any other member of the Gardner, Carton & Douglas Health Law Department.