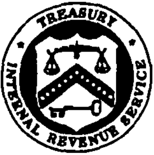

OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

JUN 28 2000

CC:TEGE:EO2:SLCaden
FREV-107236-00

MEMORANDUM FOR DIRECTOR
T:EO EXEMPT ORGANIZATIONS

FROM: Chief, Exempt Organizations Branch 2
Office of Division Counsel/Associate Chief Counsel (TE/GE)
Attn: Rick Darling

SUBJECT: [redacted]

This memorandum responds to your request dated March 30, 2000 that we review [redacted] section 501(c)(3) application. As its principal activity, the applicant has entered into a joint venture with a for-profit entity. You have concluded that the organization qualifies for section 501(c)(3) status based on the level of control it has over the activities of the joint venture, and the likelihood of community benefit purposes being served. We believe that the current partnership agreement and operations fail to satisfy Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd 674 F.2d 244 (9th Cir. 1982).

## Background

[redacted] is a [redacted] not-for-profit corporation, incorporated as a for-profit corporation in [redacted] and then as a not-for-profit corporation in [redacted] It was created by four unrelated exempt hospitals (two have since merged), and is organized exclusively for charitable, benevolent, educational and scientific purposes. Specifically, [redacted] is organized to provide home care infusion services and related home health services, together with educational instruction and related business activities that are in furtherance of its charitable purpose. [redacted] is a for-profit corporation that specializes in providing and administering home intravenous therapy, home uterine activity monitoring, and related services.

[redacted] entered into a partnership with [redacted] to provide home infusion and home uterine activity monitoring for individuals receiving home health care. [redacted] contributed $[redacted] for [redacted]% ownership interest in the partnership, and [redacted] contributed $[redacted] for [redacted]% ownership interest. The ownership interests of each partner are proportional to the amount contributed to the partnership. Profits and

losses of the partnership and cash distributions are allocated in proportion to the partnership interests held by each partner.

The partnership agreement provides that the partnership be managed by a management committee consisting of five individuals from [redacted] and two individuals from [redacted] A quorum for any meeting shall require three [redacted] designees and one [redacted] designee. The partnership agreement enumerates [redacted] management responsibilities, which include establishing overall business policies, preparing and presenting budgets to the management committee, and implementing approved marketing strategies. The partnership agreement also enumerates which decisions relating to the partnership's operations require unanimous approval of the management committee. These decisions are:

a. Operating or capital expenditures in excess of budgets;
b. Incurring of expense or indebtedness by the partnership other than ordinary trade payables, or any actions by the partnership outside the ordinary course of business;
c. Entry of the partnership into a new business (excluding home infusion and home uterine activity monitoring);
d. Sale or other disposition of all or substantially all of the assets of the partnership other than in connection with a liquidation authorized by other provisions of the partnership agreement;
e. Recommendations of voluntary termination or dissolution of the partnership as provided in the partnership agreement;
f. Leasing or purchase of real property by the partnership;
g. Acceptance and execution by the partnership of any contract, agreement, lease, or other instrument involving expenditures by the partnership in excess of $[redacted] or having a duration in excess of [redacted] months;
h. Adding of new partners to the partnership;
i. Agreement to accept cost per day for early release patients outside the parameters agreed to the partnership agreement;
j. Requiring additional capital contributions from the partners in excess of the $[redacted] set forth in the partnership agreement;
k. Termination of [redacted] as manager of the business and operator of the partnership except in connection with a termination of the partnership.

The partnership provides its services to the general public, although approximately half of the patients are referred by the exempt hospitals or their affiliates. The partnership agreement does not state that the partnership has a duty to promote the health of a broad cross section of the community, but it does contain what [redacted] refers to as a charity care policy in section 8, called the "Early Release Program." The Early Release Program provides that the partnership will provide home intravenous services to Medicaid, Medicare, non-insured and underinsured

patients of the member hospitals at the discretion of the member hospitals. The partnership agreement provides a fee schedule to be used in calculating the charge to the member hospitals for servicing Early Release patients. The fee schedule is to be adjusted quarterly by a majority vote of the management committee, and the charge per day will never be greater than $ or less than $ (excluding costs drugs and supplies) without the unanimous vote of the management committee. The costs of providing these services are absorbed by the member hospital that refers the patient to the partnership up to a nominal set fee. Currently, the set fee is $ per day. Any excess costs over that fee (e.g., if a patient needs care in excess of days) are absorbed by the partnership.

The partnership agreement does not state that in the event of a conflict between the community benefit standard and the maximization of profits, the partnership will satisfy the community benefit standard without regard to profitability. In the event of a deadlock on an issue that requires unanimous approval, the parties agree to meet and negotiate in good faith. A stalemate under the partnership agreement is not cause for liquidation or termination.

The partnership agreement provides that shall make the day-to-day management decisions of the partnership. For these duties, receives a fee of $ per month. states that this fee is reasonable and comparable to other similar arrangements around the country. The term of the partnership agreement is four years, automatically renewable for successive two-year periods unless notice of non-renewal is given. The terms were negotiated by unrelated parties as part of the original partnership negotiations. will continue to have general management responsibility unless the partnership is terminated, or the management committee unanimously votes to terminate status as manager of the partnership.

states that none of officers, directors, or key employees are related to the member hospitals, and that the partnership agreement and management contract were negotiated at arm's length.

**Law and Analysis**

Section 501(c)(3) provides, in part, that organizations shall be exempt from federal income tax if they are organized and operated exclusively for charitable purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual. Treas. Reg. §1.501(c)(3)-1(d)(2) provides that the term "charitable" is used in section 501(c)(3) in its generally accepted legal sense.

In Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd 675 F.2d 244 (9th Cir. 1982), the Tax Court held that a charitable

organization's participation as a general partner in a limited partnership did not jeopardize its exempt status. The organization co-produced a play as one of its charitable activities. Prior to the opening of the play, the organization encountered financial difficulties in raising its share of costs. In order to meet its funding obligations, the organization formed a limited partnership in which it served as general partner, and two individuals and a for-profit corporation were the limited partners. One of the significant factors supporting the Tax Court's holding was its finding that the limited partners had no control over the organization's operations.

Revenue Ruling 98-15, 1998-1 C.B. 718, provides additional guidance on joint ventures between tax-exempt and taxable health care organizations. The revenue ruling describes two whole-hospital joint venture transactions. In Situation (1), the joint venture is governed by a majority of members appointed by the exempt organization who have no economic interest in the venture. A management company is contracted to provide day-to-day management services for a five-year period, but major decisions relating to management of the joint venture operations are retained for the governing board. The governing board members are under a duty to operate the joint venture in a manner that furthers charitable purposes by promoting health for a broad cross section of the community, and that duty overrides any duty they may have to operate the joint venture for the financial benefit of its owners. In Situation (2), the joint venture is governed equally by members appointed by the exempt organization and by the for-profit entity. The management company hired to provide day-to-day management services is a wholly-owned subsidiary of the for-profit entity, and is renewable at the subsidiary's discretion. The joint venture is not bound by the governing documents to serve charitable purposes or otherwise provide its services to the community as a whole. The revenue ruling concludes that in Situation (1), the joint venture qualifies for exemption under section 501(c)(3), and in Situation (2), it does not because the benefit has more than incidental private benefits flowing to the for-profit entity.

In Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), appeal pending (9th Cir.), an adverse determination was upheld with respect to a subsidiary of a section 501(c)(3) health care organization whose sole purpose was to enter into a partnership with a for-profit management company to provide outpatient surgical services. The Tax Court held that the subsidiary had ceded effective control over the operations of the surgery center to private parties, conferring impermissible private benefit. The Tax Court based its findings on (1) the lack of obligation that charitable purposes be put ahead of economic objectives, (2) the lack of voting control on management issues, and inability to guarantee charitable objectives will be placed ahead of economic objectives, and (3) the lack of informal control or influence over the partnership's activities.

You have concluded that ████ meets the criteria for exemption under section 501(c)(3). We disagree that ████ has sufficient control over the

partnership's operations to ensure the partnership benefits the community as a whole. Only with substantial modifications to its partnership agreement will meet the control requirements of Plumstead.

1. Control Over Partnership Decisions

In Plumstead, the Tax Court looked to the exempt partner's ability to ensure that the partnership furthered charitable purposes. In this case, the partnership agreement gives majority control over some management decisions, but the material decisions, such as operating in excess of budget, selling substantially all the assets of the partnership, and entering into a new business, are made only with unanimous approval of the management committee. See Revenue Ruling 98-15. We do not believe this structure offers the type of control over the partnership's activities that was contemplated in Redlands. All decisions requiring a unanimous vote nullify majority on the management committee by conferring veto power to designees. veto power over these decisions may interfere with ability to ensure that the partnership furthers charitable purposes. This arrangement fails to demonstrate that has effective control over the manner in which the partnership conducts its activities. Without majority control over material decisions, does not have the ability to initiate charitable actions without the consent of See Redlands Surgical Services v. Commissioner, 113 T.C. 47.

Recommendation:

2. Community Benefit

We question whether the community benefit test is satisfied, and whether Early Release Program furthers charitable purposes. As you point out, the partnership agreement does not state that the partnership or management committee has a duty to promote the health of a broad cross section of the community or that charitable purposes take precedence over profit maximization. argues that it is not necessary to state these provisions in the partnership agreement because the partnership agreement contains a charity care policy in section 8, which expressly binds and to provide charity care regardless of any conflict with profit maximization.

It is unclear whether the Early Release Program constitutes charity care as defined in Rev. Rul. 56-185, 1956-1 C.B. 202. The Early Release Program

provides a fee schedule for treating charity care cases. It does not state how many charity care patients it will serve other than to state that the partnership will treat charity care patients at the discretion of the member hospitals. [redacted] has not provided the charity care policy of the member hospitals. Further, it appears that the cost of serving indigent patients through the Early Release Program is principally borne by the exempt hospitals, not by the partnership or [redacted] Charitable activities of other organizations cannot serve as the basis for [redacted] exemption. See University Medical Resident Serv., P.C. v. Commissioner, T.C. Memo. 1996-251. Rectifying this shortcoming would require restructuring the partnership agreement.

Recommendation: [redacted]

We also question the partnership's lack of a charitable purposes and community benefits statement, and [redacted] reluctance to state that in the event of a conflict between the community benefit standard and the maximization of profits, the partnership will satisfy the community benefit standards without regard to profitability. A charitable purposes statement is an imperative part of the agreement. Without an express and legally enforceable charitable purpose of the partnership, if [redacted] designees pursue charitable purposes over the objections of [redacted] could be liable for breaching its fiduciary duty to [redacted] as a partner. Since there are no provisions for arbitration and the agreement states that in the event of a stalemate on an issue requiring unanimous approval of the management committee (including material amendments to the Early Release program fee schedule), the partners are not required to resolve issues based on charitable purposes. Having a charitable purposes statement and majority control over material partnership decisions resolves these issues by creating an obligation to place charitable purposes ahead of profit maximization.

Recommendation: [redacted]

The partnership agreement does not state how amendments are to be made to the partnership agreement. It is unclear, therefore, if the purposes section or Early Release Program can be amended to not further charitable purposes, or not comply with the community benefit standard.

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Recommendation:

If you wish to discuss this matter with us or have any questions, please contact me or Stephanie Caden at (202) 622-6010.

ELIZABETH PURCELL