IRS Sticking to Strict Ruling on Nonprofit/For-Profit Hospital Joint Ventures

As tax-exempt hospital systems attempt to compete for managed care contracts and contain costs, they increasingly are entering into joint ventures with for-profit hospital corporations. In what is known as a whole-hospital joint venture, the nonprofit hospital contributes all or substantially all of its assets to the joint venture and receives a partnership interest or a membership interest in a limited liability corporation. The for-profit hospital contributes assets or cash to the joint venture in exchange for its interest. In Rev. Rul. 98-15, 1998-1 C.B. 718, the IRS provided guidance on these transactions by describing a good venture, in which the tax-exempt hospital retains its exempt status, and a bad venture, in which the tax-exempt hospital loses its exempt status.

Practitioners have criticized the revenue ruling for only describing situations that are either black or white, while in real life the facts do not fit neatly into one basket. In the ruling, the IRS takes the position that an exempt hospital will lose its exempt status unless all of the following exist:

- the exempt entity controls the governing body of the joint venture, without regard to its percentage interest in the joint venture
- the management company and the joint venture’s executives are completely independent of the taxable partner
- the members of the joint venture’s governing body have a legally enforceable duty to promote charitable purposes that overrides their duty to operate the venture for the benefit of its owners.

From the taxable partner’s perspective, that means that it can invest its capital in the joint venture, but it cannot acquire or even share control of the joint venture or provide it with management expertise. The IRS says that in the absence of a legally enforceable obligation in the joint venture agreement to serve charitable purposes, the joint venture could deny care to certain segments of the community (such as the indigent), and, because control over the joint venture is shared equally by the tax-exempt and taxable members, the tax-exempt member could not cause the joint venture to initiate new programs to meet community needs.

The two cases that have been decided since Rev. Rul. 98-15 indicate that the IRS intends to adhere to its strict position. In Redlands Surgical Services, 113 TC 47 (1999), an exempt hospital and a for-profit operate the venture for the benefit of its owners.

Prompt-Pay Laws: Good in Theory, Poor in Practice

In recent years, state legislators and regulators have sought to combat chronic problems of delayed payments by insurers to health care providers through “prompt-pay” laws.

While prompt-pay laws hold out much promise in theory for remedying chronic late payments, in practice they often fail to deliver results for providers. Prompt-pay laws have two main problems: providers often do not have private rights of action under them and, more importantly, a “good faith” dispute about the amount owed eliminates the insurer’s prompt-pay obligations. Insurers can often avoid the consequences of prompt-pay violations by simply disputing providers’ bills.

In practical terms, the most effective remedies for insurer payment failures are the traditional common-law actions for breach of contract, unjust enrichment, and pre-judgment interest. A small but growing body of case law supports a provider’s right to recover payment from an insurer under the common law, even when the parties have no written agreement and the provider is non-participating.

The first problem with prompt-pay laws is enforcement. State regulators have initiated several large prompt-pay enforcement actions, but these don’t always provide
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medical group formed a general partnership to operate an ambulatory surgical center. Redlands owned 46 percent and the private party owned 54 percent of the partnership, which was controlled equally by representatives of the parties. A 15-year management agreement was entered into with a subsidiary of the private party. The IRS denied Redlands’ application for exempt status, deciding that Redlands had ceded effective control over its sole activity, which was participating as a co-general partner in the partnerships that owned and operated the surgery center, to its for-profit partner and the affiliated for-profit management company.

The Tax Court ruled in favor of the IRS, citing the totality of the following factors:

• the lack of any obligation of the for-profit parties to put charitable objectives ahead of non-charitable objectives
• Redlands’ lack of voting control
• Redlands’ lack of sufficient formal or informal control to ensure furtherance of charitable purposes
• the long-term contract giving the private party management control over day-to-day operations
• the marketing advantages and competitive benefits secured by the for-profit affiliates as a result of this arrangement.

The Tax Court did not cite Rev. Rul. 98-15, but its decision closely tracks the ruling. This decision was upheld by the Ninth Circuit on appeal, 242 F. 3d 904 (2001).

In St. David’s Healthcare System, Inc., 89 AFTR 2d 2998 (W.D. Texas 2002), St. David’s is an exempt hospital that entered into a limited partnership with HCA Inc., a for-profit company that operated 180 hospitals nationwide. In general, St. David’s contributed all of its hospital and medical assets and HCA contributed its Austin-area hospitals and medical assets. St. David’s ownership interest in the partnership as the limited and general partner was 45.9 percent, with 54.1 percent owned by the HCA entities. The IRS attacked St. David’s exempt status by alleging that St. David’s was not operated exclusively for charitable purposes and that the community benefit standard had not been met.

In concluding that St. David’s should retain its exemption, the court focused on whether St. David’s operated exclusively for charity and whether it operated for the community interest and not for the private interest of HCA. The court answered yes to both questions, primarily based on Rev. Rul. 69-545, 1969-2 C.B. 117, which used a facts and circumstances test to determine if a hospital deserves exempt status. The court addressed the IRS’s view that the lack of a community board at St. David’s was significant to the determination. The court found that having a community board is an important factor, but not an absolute requirement, under Rev. Rul. 69-554.

The IRS’ decision to deny tax-exempt status to St. David’s was based in part on the makeup of the board of directors, and the agency’s perception that the even split did not give St. David’s enough voting strength to ensure that nonprofit objectives took precedence over for-profit goals. In response, the court stated that the community benefit standard was satisfied because the board was structured to ensure that community interest was given precedence over private interests. The court pointed out that the chairman of the board was appointed by St. David’s, and St. David’s could unilaterally remove the CEO.

St. David’s is on appeal to the Fifth Circuit. The outcome of the case may determine whether the IRS will continue its strict adherence to Rev. Rul. 98-15. In the meantime, exempt hospitals entering into whole hospital joint ventures and ancillary joint ventures must be guided by Rev. Rul. 98-15.

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Pepper in Public
A Roundup of Recent and Upcoming Activities by Pepper Health Care Lawyers

Articles


“Reprieve from Looming Deadline for Electronic Medicare Transactions,” by Steven J. Fox and Rachel H. Wilson, HIPAAAdvisory.com, October 2003 (Steve and Rachel write a monthly Q&A column for HIPAAAdvisory.com, a Web site operated by Pepper client Phoenix Health Systems. For an archive of past columns, visit www.hipaadvisor.com/action/legalqa/archives.htm.)


Upcoming Events

“Health Law Institute,” March 17-18, 2004. Julia D. Corelli and John W. Jones, Jr. will speak at this Pennsylvania Bar Institute event in Philadelphia. Julie will speak on issues involving joint ventures in health care; John will speak on HIPAA’s impact on drug manufacturers, clinical researchers and other non-covered entities engaged in research. For more information, visit our Web site.
immediate relief to providers awaiting payment. And it is unclear that providers can sue to enforce prompt-pay laws. In Pennsylvania, for example, a state and a federal court have split on this issue. Other states expressly exclude a private right of action to enforce prompt-pay violations. Attempts at private enforcement of prompt-pay laws through class action litigation also has been problematic.

So, if the prompt-pay laws do not provide an effective remedy, how can a provider stand up for its rights to be paid? There are two practical alternatives. First, if the provider has a contract with the insurer, the provider should sue for breach of contract.

Second, and more difficult, if the provider and the insurer do not have a contract, the provider may sue for recovery under a theory of unjust enrichment. Here, the provider can argue that by performing a service for an insured, it has rendered a benefit to the insurance company, i.e., the provider has rendered covered services. The insurer is therefore obliged to pay the provider reasonable value for this benefit.

In the past year, the state appellate courts in Tennessee and Pennsylvania have embraced unjust enrichment recovery in the non-contract setting.

Just because a provider sues for unjust enrichment or breach of contract does not mean that the provider is not entitled to interest on the amount owed. In general, in contract cases, plaintiff is entitled to prejudgment interest on liquidated debts from the date of default until payment is made, although such interest may be less than the interest provided by the prompt-pay law.

This article is adapted from a longer article that appeared in BNA’s Health Plan and Provider Report on October 8, 2003. The complete article is available on our Web site at http://www.pepperlaw.com/pepper/publications_article.cfm?rid=397.0.

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Theodore E. Schroeder, a prominent former prosecutor in the criminal division of the U.S. Attorney’s Office in the Eastern District of Pennsylvania, has joined the firm as a partner in the Philadelphia office.

Using his vast experience, Tom will focus his practice on assisting health care and other clients with internal investigations, responding to federal and state regulatory investigations and actions, white collar criminal defense and complex civil litigation.

Tom has investigated and prosecuted a number of high-profile fraud cases, including many in the health care industry. In 1999, he received the Director’s Award from then-Attorney General Janet Reno for his work in investigating and prosecuting health care fraud cases. In October 2003, he received the Chief Postal Inspector’s Award, the agency’s highest award.

Tom was an Assistant U.S. Attorney in Philadelphia from 1995 through October 2003, and was responsible for all aspects of federal criminal investigation and prosecution. He served as the main health care fraud prosecutor in the criminal division in the Eastern District of Pennsylvania from 1998 until his departure.

Tom has investigated and prosecuted numerous complex, multi-defendant white collar criminal matters in a number of industries, including health care, insurance, financial services and defense.

He was the lead prosecutor in the following federal health care fraud cases: the Philadelphia Medical and Rehabilitation Center prosecution (1998); the Keck/U.S. Rehabilitation prosecution (1998); the Inner Health Lifestyle Center prosecution (2001); and the Chavarria (2000), Bomze (2002) and Radbill (2003) investigations and prosecutions.

Tom speaks frequently on white collar crime, health care fraud and trial advocacy at Villanova University School of Law, where he is an adjunct faculty member, and at conferences presented by industry groups such as the Health Care Anti-Fraud Association and the United States Sentencing Commission.
The material in this publication is based on laws, court decisions, administrative rulings and congressional materials, and should not be construed as legal advice or legal opinions on specific facts.