With increasing frequency, joint ventures are being formed in the health care industry, usually to operate ancillary services such as MRI facilities and ambulatory surgery centers. This trend began just after the Medicare reimbursement process changed from cost-based to case-based in 1983, thus incentivizing hospitals to reduce costs. The ensuing consolidation within the industry has led to a visible competition for resources, revenues, and alternative strategies for accessing capital.¹

The attraction of joint ventures between exempt hospitals and for-profit enterprises is clear from the business results. One study found that such JVs deliver an average return on assets of 4.22% and exempt hospital not participating in such a JV return only .49%.² As well, the amount of resources devoted to charity care varies between these two groups dramatically. Hospital participating in JVs with for-profit entities average 18.61% charity care while exempt hospitals not in a JV relationship average 79.77% charity care.³

In 1983, the IRS staked out a two part test for joint ventures between tax exempt and taxable organizations:

1. Is participation the joint venture in furtherance of the tax-exempt organization’s charitable purposes?

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³ Id.
2. Does the joint venture agreement permit the tax exempt organization to act exclusively in furtherance of its exempt purposes?\textsuperscript{4}

Subsequently, the IRS published guidance regarding whole hospital joint ventures describing “good” joint ventures and “bad” joint ventures.\textsuperscript{5} In practice, though, few joint ventures fit either of the two situations contemplated in the Revenue Ruling and, so, in 2004, the IRS provided a safe-harbor model for a for-profit LLC to be formed by a non-profit, exempt entity and a for-profit entity. This model contains seven required elements that must be present to protect the tax-exempt entity from losing its exemption or becoming subject to UBIT:

1. The exempt entity must continue to engage primarily in its tax exempt purpose. Accordingly, the business of the LLC cannot occupy more than an insubstantial portion of the activities of the exempt entity.

2. The exempt entity can engage in \textbf{no activities} through the LLC that are not substantially related to its exempt purposes. Any departures from this rule are subject to UBIT.

3. The exempt entity must have control of the LLC sufficient to ensure that all decisions of the LLC associated with the exempt entity’s charitable purpose are controlled by the exempt entity.

4. All agreements entered into by the LLC must be at arm’s length and for fair market value.

5. The LLC’s governing documents should limit the exempt entity’s participation to only those activities consistent with its tax exemption.

\textsuperscript{4} General Counsel Memorandum 39005 (June 28, 1983)
\textsuperscript{5} Revenue Ruling 98-15
6. Ownership interests in the LLC must be proportional to the capital contributions of each member.

7. Returns of capital must be proportional to each member’s proportional ownership interest. It bears note that distributions should be made to the exempt entity and not to any individual to avoid private inurement treatment and consequential loss of exempt status. ⁶

This safe harbor model reduces the risk and allows for more robust participation in capital raising activities by tax exempt entities and provide access to the customer bases of tax exempt hospitals by for-profit enterprises, thereby improving market efficiencies of both. As with any safe harbor in federal tax, its contours must be scrupulously followed for a tax exempt entity to remain within its protection.

⁶ Revenue Ruling 2004-51 (June 1, 2004)