Tax-exempt health care systems facing growing operating costs and falling revenues frequently explore creation of ancillary joint ventures (AJVs) as vehicles to raise capital, share risk, expand coverage, and provide care more efficiently, while preserving exempt status and avoiding unrelated business income tax (UBIT). Joint venture activity among tax-exempt entities is robust. However, tax-exempt systems typically are frustrated in their attempts to partner with taxable organizations because of the inadequate current state of guidance from the Internal Revenue Service (IRS) regarding tax-exempt/taxable combinations.

The IRS has not issued sufficiently clear statements of policy or principles to provide the legal guidance that tax-exempt health care systems’ managers and governing body members, and their lawyers, require to proceed prudently with development of such ventures. Consequently, tax-exempt systems face uncertainty regarding whether participation in an AJV will negatively impact their exempt status or lead to UBIT. Tax-exempt systems therefore have had no alternative but to assume they are obligated to require supermajority rights and place limitations on AJV scope that can be unattractive to potential taxable partners and not appropriately meet the needs of either party and the purposes of the AJV. These are constraints that AJVs between tax-exempt entities do not face.

While there may be ample IRS guidance and published court decisions regarding how to organize and operate whole hospital joint ventures or “WJVs” (i.e., joint ventures in which the entire exempt activity is
contributed to the joint venture), the same cannot be said for AJVs (i.e., joint ventures in which the exempt entity transfers a subset of its assets or contributes funds to operate an ancillary service). Rather, the IRS’s only precedential guidance on AJVs leaves open more questions than it answers and does not address concerns related to hospitals or health care more generally (an industry that the IRS consistently treats differently).

Despite this uncertainty, the IRS has stated that it will no longer issue private letter rulings (PLRs) on the tax consequences of AJVs and will not otherwise opine on the issue unless it is presented in an initial application for recognition of exemption. As a result, the IRS is effectively stifling the creativity that would be inspired by changed circumstances and advanced technologies, which arguably would drive the law of tax-exempt entities to keep pace with those circumstances and technologies.

*Download: Ancillary Joint Ventures Involving Taxable and Tax-Exempt Health Care Entities: Addressing the Chilling Effect of IRS Inaction*