PUBLIC HEALTH, WELFARE & SAFETY
Exhibit No. 2
Date 2-18-2009
Bill No. SB 446

MHA

AN ASSOCIATION OF MONTANA HEALTH CARE PROVIDERS

Senate Bill 446
Testimony before the Senate Committee on Public Health, Welfare and Safety
Robert W. Olsen, MHA Vice President

MHA, An Association of the Montana Health Care Providers supports adoption of Senate Bill 446, including adoption of the friendly amendments introduced today by Senator Story.

MHA has consistently opposed licensure for physician-owned specialty hospitals. We believe that studies show medical service utilization increases and that the addition of a specialty hospital increases the overall cost of health care services without providing a corresponding benefit for the community.

However, the time has come when lawmakers must establish a public policy for specialty hospitals in Montana. MHA has worked with hospitals, physician groups, the Department of Public Health and Human Services and others, to find common ground for the future development of specialty hospitals.

Senate Bill 446 proposes to lift the moratorium on specialty hospitals and provide for a path to licensure in Montana. The sections of Senate Bill 446 include:

Section 1: Definitions. On page 4, lines 26-27, SB 446 amends the definition of a hospital to make clear that a hospital must be prepared to provide full time emergency care to its patients at the hospital. SB 446 does not require that a hospital have an emergency room. Rather, the amended statute requires that a hospital maintain medical staff necessary to provide emergency treatment at the hospital within the scope and ability of the medical staff. This amendment is intended to prevent any hospital from routinely transferring its emergency medical care to another hospital by using a 9-1-1 service.

There is an amendment to this section proposed by Shodair Hospital, and supported by the Montana State Hospital, to clarify that a psychiatric hospital is not required to provide emergency care beyond the scope of practice of its medical staff.

Section 2, page 8. Hospital Discrimination Based Upon Ability to Pay Prohibited. A major criticism alleged against specialty hospitals is the practice of providing care to those able to pay, or the well-insured, but declining access for uninsured or low income patients. SB 446 states that a hospital may not discriminate against a patient based upon their ability to pay. Simply put, this means that a hospital must have a consistent and equitable policy to provide access to care regardless of the patient's ability to pay. SB 446 states that a hospital is required to have a written charity policy, but the bill does not specify what that policy must include. Finally, the bill prohibits the transfer of patients solely based upon the patient's ability to pay.

This section of SB 446 is not intended to impose additional responsibility on a hospital to provide any and all care requested by a patient. Nor is it intended to require State investigation of patient complaints about the amount charged for care. It is intended only to provide an even playing field among hospitals, and assure reasonable access to care for patients.

Section 3, page 9: Transfer of Hospital Patients. A troubling practice has developed in states with existing specialty hospitals whereby specialty hospitals rely solely on a 9-1-1 service to transfer patients with emergency conditions or medical complications. In one notorious case in Texas, a man died while being transferred from a specialty hospital to a community hospital, perhaps unnecessarily, and using only a 9-1-1 service.

Hospitals in Montana believe that the appropriate safety, treatment and transfer of patients include clear communication between hospitals. SB 446 requires that a specialty hospital alert a receiving hospital that it is transferring a patient, that the reasons for the transfer are known, and that needed records accompany the patient.

This section of SB 446 addresses those conditions when federal regulations that govern patient transfer do not apply. Federal rules apply to most emergency transfer situations, but may not apply to the transfer of a patient receiving care at the hospital for a scheduled surgery, or to inpatients at the specialty hospital.

Section 4, page 9. Specialty Hospital Standards, Licensure and Repeal of the Moratorium. Beginning on line 11, SB 446 provides the Department rulemaking authority and time needed to establish its procedures and guidelines for processing a specialty hospital application. Subsection 5, beginning on line 18 provides that a specialty hospital can meet the requirement for emergency care required in Section 1 of the bill if it has an agreement to provide that care with another hospital in the same service area. This language reflects the practice in Kalispell where the specialty hospital shares an emergency room with Kalispell Regional Medical Center.

Subsection 6, line 21, provides that applicant specialty hospital have a written charity policy and, either a joint venture relationship with a hospital, or evidence that a good faith opportunity for joint venture was provided, but declined by a nonprofit hospital.

This language is at the heart of the compromise to allow for specialty hospitals. The opportunity for a joint venture addresses hospital concerns about carving up the market into profit centers for specialty providers, and leaving nonprofit hospitals with unprofitable services.

Subsection 7 specifies that when a specialty hospital is partnered with a hospital its physicians hold active privileges with the partner hospital and that the hospital holds at least a 50% ownership interest.

This language is a second key part of the compromise. The requirement for active medical privileges provides the basis for active management of patient care needs across both partnering entities. The ownership requirement for the joint venture hospital assures that a nonprofit hospital is not accused of converting its tax exempt assets to private, for profit activities.

Subsection 8, page 10, line 1 states that the physician partners are not prohibited from managing the specialty hospitals. Management and control of patient care at a specialty hospital is a key issue for physicians.

Subsection 9, line 3 provides that in the case of a joint venture specialty hospital the charity policy of the nonprofit hospital must be used at both entities. 'This is another feature of the model developed in Kalispell that assures that the profits are not moved to one hospital and the losses imposed on the other.

New Section 5. The application process. Section 5 provides a public process that accomplishes two goals. First, the application process provides the opportunity for the creation of a specialty hospital. This is the desired goal of the proponents for development of specialty hospitals. The second goal is that the application process provides for an impact study to be completed before a specialty hospital is licensed. This addresses concerns of those who oppose development of specialty hospital by providing the public information about the impact of such a facility on the community. Simply stated, if Montana policy is to allow specialty hospitals, the development occurs with our eyes wide open.

The key part of Section 5 is the requirement to conduct an impact study. SB 446 specifies that the applicant pay the costs of the study, and that the Department approve the consultant that performs the study. This assures that the Department does not bear any expense for the application process, and that the study is performed by an independent analyst. SB 446 provides an opportunity for public comment and participation in the process.

Subsection 4, beginning on line 20 addresses the scope of the study to include the impact on key community medical services and the operational impacts on existing health care facilities.

Subsection 5 provides for a limited time frame of 180 days from the date the department establishes the scope of the study. This provision assures the applicant that they won't face endless delays.

Subsection 6, line 27 allows the Department to mitigate any adverse impacts on the community by imposing conditions on the applicant. SB 446 also allows the Department to deny an application.

The final two sections provide codification instructions and provide an effective date of July 1, 2009. This date coincides with the expiration date for the current moratorium.

Latest IRS Ruling on Hospital and Physician Joint Ventures
By Don Stuart, for HealthLeaders News, October 18, 2004

In navigating around many of the laws and regulations (Anti-Kickback, Medicare reimbursement, Stark, etc.) impacting hospital and physician investor outpatient facility joint ventures, the additional restrictions imposed by the IRS on these joint ventures where the hospital is tax-exempt will continue to be a challenge. The IRS has issued a new ruling that provides additional insight into structuring such joint ventures in a manner that will pass IRS scrutiny.

In Private Letter Ruling 200436022, a nonprofit, tax-exempt hospital proposed to form a new joint venture structured as a limited partnership to own and operate a freestanding diagnostic imaging center. Units in the limited partnership will be offered to physician investors and related physician groups. If the offering becomes fully subscribed, the joint venture will be structured so that a LLC wholly owned by the nonprofit hospital will serve as general partner and own 1 percent, the nonprofit hospital as a limited partner will own 54 percent, the physician investors will own 40 percent and an independent management company will own 5 percent of the limited partnership. Several issues were addressed by the IRS with respect to the proposed joint venture. The IRS concluded, however, that the joint venture would not adversely affect the tax-exempt status of the hospital, nor would any income received by the hospital from the joint venture be unrelated business taxable income.

The IRS approached the joint venture in the ruling with a now familiar analysis focusing on its "community benefit standard" and the "control" criteria set forth in the IRS's 1998 revenue ruling on whole hospital joint ventures. Although a private letter ruling can only be relied upon by the taxpayer to whom it is addressed, there are several factors that are worth noting in the ruling as tax-exempt hospitals and physicians continue to struggle with structuring joint ventures for outpatient facilities. Also noteworthy was the hospital's use of a single member LLC (a disregarded entity for tax purposes) and the for-profit management company holding an interest in the partnership.

The community benefit standard is relied upon by the IRS to determine whether a tax-exempt hospital "promotes health in a charitable manner," and focuses on a variety of factors in weighing whether the hospital benefits the community as a whole or benefits private interests. At issue in the ruling was whether the hospital's participation in the joint venture created undue private benefit to the physician investors or any other private party. The IRS initially noted that after the formation of the joint venture, the charitable purposes of the hospital (providing healthcare to the community) will continue to be the same as prior to the formation of the joint venture. The more critical analysis for the IRS, however, arose with the activities of the joint venture since the IRS will deem the activities of any partnership in which a tax-exempt hospital owns an interest to be the activities of the hospital itself in determining whether the hospital furthers charitable purposes. The IRS, after reviewing the partnership and management agreements and other factors, determined that the hospital's participation in the joint venture furthers its exempt purposes and the proposed structure of the joint venture would not generate any undue private benefit.

Key factors that the IRS found favorable included the following:

The hospital's wholly owned LLC, acting as general partner, will have effective control over major decisions of the joint venture which will ensure that the imaging center will be operated in a charitable manner (i.e., promoting health for a broad cross section of the community) regardless of ability to pay. (The LLC's board members are elected by the hospital. No management rights were given to any other parties.)
The partnership agreement specifically provides that the duty of the general partner is to operate the partnership in a manner that furthers charitable purposes and overrides any duty to operate the partnership for the financial benefit of anyone else. (The general partner LLC could only be removed by the limited partners holding more than 80 percent of the sharing ratios of all partners.)
The imaging center will have an open medical staff and utilize the charity care policy of the hospital. (Physician privileges were not dependent on owning an interest in the joint venture. The charity care policy will be advertised to patients and the center's radiologists are required to treat all members of the community, including Medicare, Medicaid and indigent patients.)
The LLC's board members will be representative of the community. (The board was made up of community leaders with experience in health care matters, including officers and board members of hospital.)
Contributions to the partnership and allocations of profits, losses, and distributions from it will be in proportion to the interests of the partners. (No special allocations of income or loss were permitted.)
The management agreement will require the manager to operate the center for charitable purposes, with charitable purposes taking precedence over any profit motive. All fees paid are subject to a ceiling amount that will not exceed fair market value. (The IRS did not have any objection to the management fee that was based on a percentage of funds collected in payment of patient services. The term of the management agreement was for two years and renewable for one additional two year term. A "for cause" termination provision was also included.)
In determining that the joint venture would not result in unrelated business taxable income to the hospital, the IRS was satisfied that the hospital's charitable purposes will be furthered by participation of the hospital's wholly owned LLC in the joint venture. This enabled the hospital to expand and improve healthcare services to the community. (Most of the imaging services to be provided at the center were not currently available in or around the local area.) The IRS again emphasized the importance that these charitable purposes override any duty to the members to maximize profits.
The hospital's "control" over the joint venture in the ruling, as reflected in the partnership and management agreements, was sufficient for the IRS to approve of the hospital's participation in the joint venture without any adverse tax consequences. If such a "control" structure is acceptable to a tax-exempt hospital and physicians contemplating such a joint venture for an outpatient facility, similar provisions should also be utilized in the arrangement. However, in certain cases such "control" provisions for the hospital may not find enough support among the physician investors who may opt for a more balanced representation and authority over the joint venture. In such situations, there may still be flexibility for the governing provisions to be tailored to satisfy the parties while minimizing the tax risks to the hospital.

(The opinions expressed in this bulletin are intended for general guidance only. They are not intended as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance.)

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Seven years ago, the IRS published a Revenue Ruling expanding these rules, and the Court in St. David's analyzed this Revenue Ruling. In that Revenue Ruling, the IRS stated that a tax-exempt organization can demonstrate control by showing some or all of the following: (1) that the founding documents of the partnership expressly state that it has a charitable purpose and that the charitable purpose will take priority over all other concerns; (2) that the partnership agreement gives the non-profit organization a majority vote in the partnership's board of directors; and (3) that the partnership is managed by an independent company (an organization that is not affiliated with the for-profit entity). The foregoing factors 2 and 3 may have been relaxed by an IRS Revenue Ruling in 2004. What is clear, however, is that formal and effective control must remain with the tax-exempt organization in order to avoid the potential loss of the tax-exempt entity's tax-exemption.

The Court concluded that there remained genuine issues of material fact regarding whether the taxpayer had ceded control to the for-profit entity. On remand, a jury found in favor of the taxpayer.

While this suggests that shared control may be sufficient, the safer course would be for the tax-exempt organization to retain clear majority control, pursuant to the parameters set forth in the Revenue Ruling.

Therefore, the following principles are those that should be followed in meeting the IRS tests for a tax-exempt entity's participation in a joint venture with a for-profit entity:

1. The tax exempt organization should maintain formal control over the venture by keeping a majority of voting power in the partnership.
2. The tax exempt organization must, in fact, exercise control over the venture.
3. The venture or partnership agreement must explicitly state its exempt purposes and state an obligation to put these purposes ahead of economic objectives.
4. If state law requires that a general partner assume unlimited liability for the debts of the partnership, the tax exempt organization must contract out of this obligation through insurance or an indemnity agreement.
5. The partnership agreement must contain protections to ensure that benefits conferred on the for-profit partners are incidental to accomplishment of its exempt purposes. For example:

    a. Partnership allocations should be based on capital contributions and assumed risks.
    b. There should be no special allocations of items of income, deductions or credit.
    c. Services and property contributed to the joint venture must be valued at fair market value or, if provided by the exempt organization, at not less than fair market value.
    d. The capital contributions of all the partners should be real and substantial.
    e. The tax-exempt entity should not make any improper guarantees in regard to minimum investment return, return of capital, indemnification, or agreement to fund a loss reserve from its own assets.

As stated above, a tax-exempt organization must not relinquish control in connection with a venture or partnership with a for-profit entity. Prior to any such venture or partnership's inception, the tax-exempt organization should consult the advice of counsel to draft the operative agreement governing the venture, advise the organization as to how the venture must operate, and to ensure that none of the venture's activities will operate to disqualify the organization's tax exempt status.

publications & resources

Legal: Tax-Exempt and Commercial Organization Joint Ventures

ASSOCIATION MANAGEMENT, December 2004

By: *Lauren W. Bright*

The Internal Revenue Service recently provided valuable guidance for tax-exempt organizations regarding joint ventures with commercial business entities.

The Internal Revenue Service recently provided valuable guidance for tax-exempt organizations regarding joint ventures with commercial business entities. In Revenue Ruling 2004-51, the IRS concluded that a tax-exempt organization's participation in a joint venture did not jeopardize the organization's tax-exempt status because the character of the joint venture activity remained consistent with the organization's tax-exempt purpose. Though the ruling cannot be viewed as legal precedent, the analysis provides much-needed clarity to the confusing area of ancillary joint ventures between and among tax-exempt organizations and for-profit entities. In this column, Lauren Bright explains the ruling and its implications. EDITED BY JERALD A. JACOBS

Recent Internal Revenue Service Ruling 2004-51 concluded that the tax-exempt status of a nonprofit organization engaged in a joint venture with a for-profit company is not jeopardized as long as the shared activities are consistent with the tax-exempt purposes of the nonprofit entity. Background information and a discussion of the IRS ruling provide additional information for associations considering--or already engaged in--such activity.

Types of joint ventures

A *joint venture* is essentially a partnership between or among two or more parties whereby each party contributes a portion of its assets, expertise, or activities for the purpose of performing a specific business transaction. Depending on the degree of involvement of the exempt organization, there are four types of joint ventures that may come into play:

1. **Ancillary joint ventures** involve a limited portion of the assets or services of an exempt organization.

2. **Whole joint ventures** involve all or substantially all of the assets of an exempt organization.

3. **Exempt-only joint ventures** involve the assets or services of two or more exempt organizations.

4. **Investment-type joint ventures** involve the participation of an exempt organization in a limited or passive capacity.

The first type, the ancillary joint venture, is the subject of the ruling. However, regardless of the type, joint ventures between tax-exempt organizations and for-profit entities are highly scrutinized by the IRS because of the concern that such ventures will not contribute to one or more of the exempt organization's purposes.

Prior rulings on joint ventures

In general, prior rulings addressing joint ventures between tax-exempt organizations and for-profits have indicated that if a tax-exempt organization cedes control to its for-profit partner, the tax-exempt organization will lose exempt status for its share of the income. Indeed, the organization's entire exemption would be at risk if the income is substantial. For example, in a case involving Redlands Surgical Services, the Ninth Circuit Court of Appeals held that a tax-exempt entity must maintain effective control of partnership activities. Examples of such control include majority voting power, independent management of the joint venture, or other measures ensuring that partnership operations are conducted primarily for charitable purposes. If the exempt entity does not maintain control, the activities of the partnership will be deemed to serve private, and not public, interests.

Similarly, in *St. David's Health Care System v. United States*, the Fifth Circuit held that the determination of whether a nonprofit organization that enters into a partnership operates exclusively for exempt purposes is not limited to whether the partnership *provides* charitable services. To maintain tax-exempt status, the tax-exempt entity must have some means of ensuring that the partnership's operations *further* charitable purposes. According to that ruling, an organization will "lose its tax-exempt status if it cedes control to the for-profit entity."

As a result of these rulings, it was long believed that tax-exempt entities could not enter joint ventures with for-profit entities on a 50-50 basis without risking the loss of tax-exempt status. Accordingly, such ventures have traditionally been structured so that the tax-exempt organization maintains a majority of shares in the venture and control over the board of directors. The recent IRS guidance, however, provides tax-exempt organizations increased latitude in structuring such ventures.

Revenue Ruling 2004-51

In Revenue Ruling 2004-51, a tax-exempt university and a for-profit corporation formed a limited liability company to expand the university's teacher training seminars to off-campus locations using interactive video technology. Both the university and the corporation owned an equal 50 percent share of the LLC, and each entity appointed three individuals to the LLC's six-member board of directors. With respect to structure, responsibilities were divided between the two entities. The university had exclusive authority to approve curriculum, training materials, instructors, and the standards for successful completion of the educational programs. The LLC had exclusive authority over all aspects of the video teacher training seminars, including advertising, enrolling participants, selecting program locations, and distributing course materials. The governing documents of the LLC further provided that all contracts and transactions to be entered by the LLC were to be at arm's length and for fair market value, and the LLC was not to engage in any activity that would jeopardize the university's tax exemption under Section 501(c)(3).

Upon review by the IRS, the university's joint venture raised two issues. The primary issue was whether the university jeopardized its tax-exempt status by contributing a portion of its assets to and conducting a portion of its activities through the LLC. The IRS determined that the university's activities conducted through the LLC constituted a trade or business substantially related to the university's exempt purposes and functions. Therefore, notwithstanding the fact that the corporation arranged and conducted the teacher training seminars, the university retained exclusive authority over the educational aspects of the program. Moreover, the video teacher training seminars covered the same content as seminars conducted on the university's campus. As such, the programs were in keeping with the university's exempt purposes, as they merely expanded the scope of the university's current educational activities.

A secondary issue was whether the university would have to pay unrelated business income tax on revenues earned from the LLC. Because it was concluded that the activities of the LLC were substantially related to the university's exempt purposes, the IRS determined that the revenues received by the university from the activities of the LLC were not subject to UBIT.

Implications for associations

Joint ventures between tax-exempt organizations and for-profit entities can lead to unfavorable tax implications for the exempt organization, including disqualification from tax exemption, if the venture is not structured in accordance with IRS rules and regulations. As a result of Ruling 2004-51, it appears that "control" of the entire venture is no longer essential. As such, tax-exempt organizations will now likely have the option of participating in bifurcated joint ventures without jeopardizing tax-exempt status, as long as the exempt organization controls the substantive, exemption-related aspects of the venture. However, notwithstanding the much-needed guidance, tax-exempt organizations should continue to proceed with caution when engaging in joint ventures, partnerships, or similar arrangements with commercial businesses.