The Internal Revenue Service is like any other government agency when it litigates a case. Sometimes it wins. Sometimes it loses. But only rarely does a federal court find the IRS has been "disingenuous" and award the taxpayer fees and costs because the position the IRS has taken is not "substantially justified."

A Federal District Court in Texas ruled in September that the IRS must pay over $950,000 in legal fees, expert witness costs, and other expenses that St. David's Health Care System, Inc., a tax-exempt entity, incurred challenging the IRS's revocation of its exempt status. Section 7430 of the Internal Revenue Code authorizes an award of "reasonable litigation costs" against the IRS when its position is not "substantially justified."

St. David's had contributed all of its hospital and other medical assets to a limited partnership in 1996. The other partner, an affiliate of Columbia/HCA Healthcare Corp., (since renamed HCA, Inc.) contributed to the partnership all of its hospital and other medical assets in the same Austin, Texas market. The partnership agreement allowed an HCA affiliate to manage the partnership's hospitals subject to the ultimate authority of a 50-50 board of directors. The chairman's seat was reserved for a St. David's appointee. St. David's had the power, acting alone, to remove the partnership's CEO. It had the right to dissolve the partnership if it found that the partnership's hospitals failed to operate in accordance with community benefit standards promulgated by the IRS.

The IRS issued a decision in 2000 revoking St. David's exempt status retroactive to 1996, the year the partnership was formed. It ruled that participation in the partnership did not allow St. David's to act exclusively in furtherance of its charitable purposes and conferred more than incidental benefits on HCA and its affiliates, all of which caused St. David's to no longer satisfy the standards of Section 501(c)(3) of the Internal Revenue Code.

The IRS had published Revenue Ruling 98-15 in 1998 to publicize its views on so-called "whole hospital joint ventures" - those in which tax-exempt organizations contributed all of their ownership interest in one or more hospitals to a partnership or joint venture with a taxable entity. The IRS said in Rev. Rul. 98-15 that an exempt hospital organization's participation in
a joint venture governed by a 50-50 board which contracted with an affiliate of its for-profit member for management services would cause the exempt entity to lose its exempt status.

In the St. David’s case, the Board was 50-50 and the HCA affiliate was the sole managing general partner of the limited partnership. The IRS apparently argued that that ended the analysis, and St. David’s should lose it exemption. The District Court agreed with St. David’s that the additional provisions in the partnership agreement requiring the partnership’s hospitals to observe community benefit standards, reserving the Chairman’s seat for a St. David’s appointee, and giving St. David’s the right to remove the CEO and dissolve the partnership if charitable standards were not followed, constituted "exceptional protections" against running the partnership's hospitals "in pursuit of private interests."

The Court did not give concrete examples of the charity care provided by the joint venture or other examples of its activities which a for-profit provider, acting alone, might not be inclined to undertake. Instead, it held that the provisions of the partnership agreement were sufficient not only to support the Court's ruling in favor of St. David’s, but its harsh and expensive rebuke of the IRS. The Court's actions give exempt health care providers participating in joint ventures clear directions regarding provisions which should be included in the ventures’ governing documents.

This Article appeared in the November 2002 edition of Kentucky Medical News.