

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS

AUSTIN DIVISION

ST. DAVID'S HEALTH CARE SYSTEM, §
INC. §
VS. § CIVIL NO. A-01-CA-046 JN
UNITED STATES OF AMERICA §

ORDER

Before the Court is the above-referenced cause of action. On May 7, 2002 the Court referred this case to the United States Magistrate Judge for findings and recommendations pursuant to 28 U.S.C. § 636(b) and Rule 1 of Appendix C of the Local Rules of the United States District Court for the Western District of Texas. The Magistrate Judge filed his Report and Recommendation (Doc. No. 57) regarding both parties motions for summary judgment (Doc. No. 28 and Doc. No. 31) on May 22, 2002¹. The United States filed its Objections to the Report and Recommendation (Doc. No. 59) on May 24, 2002. Plaintiff St. David's its response on May 31, 2002 (Doc. No. 66).

In light of the Objections, the Court has undertaken a *de novo* review of the entire case file in this cause and finds that the Recommendation should be approved and accepted in part and disapproved and rejected in part by the Court.

¹The United States complains that the Magistrate Judge "issued his report without allowing the United States to file, within the time allowed by the ruled, its Reply to Plaintiff's Response to the United States' Motion for Summary Judgment," The United States filed its Objections to the Report and Recommendation on May 24, 2002 (Doc. No. 59), p. 1, fn. 1, implying that the Magistrate Judge erred by prematurely issuing the report. He did not. The United States apparently misunderstands its rights. Local Rule CV-7(e) gives a party the option of filing a reply to a response to a motion, but states that "the court need not wait for the reply before ruling on the motion." W.D. Tex. Local R. CV-7(e). Furthermore, Local Rule CV-1(e) allows a judge to waive any requirement of the local rules in a specific case. W.D. Tex. Local R. CV-1(e). The fast-approaching trial date would surely justify such a waiver.

FACTUAL BACKGROUND²

Plaintiff St. David's Health Care System ("St. David's") brings this lawsuit to demand a refund of income taxes paid after the revocation of its tax exempt status by the Internal Revenue Service³ in 1996. St. David's first incorporated under Texas non-profit law as a community-owned, not-for-profit hospital in 1925. In 1938, the IRS recognized St. David's as a tax-exempt organization under I.R.C. § 501(c)(3). St. David's charitable purposes were achieved through the ownership and operation of an acute-care hospital in Austin, Texas.

More recently, in 1996, St. David's entered into a limited partnership with HCA, Inc. (formerly known as Columbia/HCA Healthcare Corp.), a for-profit health care company that operates approximately 180 hospitals nationwide. St. David's contributed all of its hospital and medical assets, and HCA contributed its Austin-area hospitals and medical assets. The partnership has two general partners and two limited partners. The two general partners are St. David's and HCA's wholly-owned subsidiary, Round Rock Hospital, Inc. ("Round Rock"). Each general partner holds a ten percent interest, but Round Rock is the managing partner. The two limited partners include St. David's and HCA's wholly-owned subsidiary, Columbia/SDH Holding. St. David's ownership interest in the partnership as both a limited and general partner is 45.9%, leaving 54.1% ownership interest in the hands of the HCA entities.

In October 2000, the IRS issued a decision revoking St. David's tax exempt status retroactive

²Much of this portion of this Order is taken directly from the Magistrate Judge's Report and Recommendation (Doc. No. 57).

³For the remainder of this Order, the Court will use "the United States," "the government," and "the IRS" interchangeably. All uses of the term refer to the same agency of the federal government and defendant in this case.

to the partnership's formation in 1996. The stated reason for the revocation was that when St. David's entered into the partnership with HCA, it was no longer engaging in activities that primarily further a charitable purpose, as required under § 501(c)(3) of the Internal Revenue Code. *See* United States' Motion for Summary Judgment, App. B, Exh. 2, p. 20 (Clerk's Doc. No. 31). Specifically, the IRS ruled that:

St. David's participation in the Partnership does not permit it to act exclusively in furtherance of its charitable purposes and allows for greater than incidental benefits to HCA and its for-profit subsidiaries.

Id. In response to the decision to revoke St. David's tax-exempt status, St. David's has filed this suit.

ANALYSIS

A party moving for summary judgment has the burden of showing that there is no genuine issue of material fact and that the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56. A genuine issue of material fact exists "if the evidence is such that a reasonable jury could return a verdict for the non-moving party." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248, 106 S. Ct. 2505, 2510 (1986). The court must view all evidence in the light most favorable to the party opposing the motion and draw all reasonable inferences in that party's favor. *Id.*, 477 U.S. at 255, 106 S. Ct. at 2513. As the party moving for summary judgment, Defendant bears the initial burden of showing the basis for the motion, and of identifying the pleadings and evidence which they believe demonstrates the absence of a genuine issue of material fact. *Washington v. Armstrong World Indus., Inc.*, 839 F.2d 1121 (5th Cir. 1988). Once a summary judgment motion is made and properly supported, the non-movant must go beyond the pleadings and designate specific facts in the record showing that there is a genuine issue for trial. Fed. R. Civ. P. 56(e); *Little v. Liquid Air Corp.*,

37 F.3d 1069, 1075 (5th Cir. 1994) (en banc). Although the non-movant may satisfy this burden by tendering depositions, affidavits and other competent evidence, “[m]ere conclusory allegations are not competent summary judgment evidence, and they are therefore insufficient to defeat or support a motion for summary judgment.” *Topalian v. Ehrman*, 954 F.2d 1125, 1131 (5th Cir. 1992). Pleadings are not summary judgment evidence. *Wallace v. Texas Tech Univ.*, 80 F.3d 1042, 1047 (5th Cir. 1996).

As stated by the Magistrate Judge, the requirements for tax exemption under § 501(c)(3) are divided into two major tests: the organizational test and the operational test.

“In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.”

26 C.F.R. § 1.501(c)(3)-1(a). Both sides agree that the organizational test is not at issue, but they disagree as to whether Plaintiff meets the requirements of the operational test. The operational test focuses on how an organization is actually operated, regardless of whether it is properly organized for tax-exempt purposes. This test has four subparts:

- (1) the organization must be operated exclusively for a charitable purpose;
- (2) no part of the organization’s net earnings can inure to the benefit of private shareholders or individuals;
- (3) no substantial part of the organization’s activities can attempt to influence legislation; and
- (4) the exempt organization cannot participate or intervene in any political campaign for or against a candidate for public office.

Because the parties have stipulated⁴ that subparts (2)-(4) are not relevant to this case, the Court will forgo any discussion thereof. However, the parties disagree as to whether St. David's was "operated exclusively for a charitable purpose" during the tax year 1996, as required by subpart (1).

The operational test, as laid out in the Code of Federal Regulations, places three basic requirements on an organization seeking tax exemption under § 501(c)(3). Two of these requirements are not in dispute. The undisputed requirements are that its net earnings may not "inure in whole or in part to the benefit of private shareholders or individuals," 26 C.F.R. § 1.501(c)(3)-1(c)(2), and that it may not be an "action organization" engaged in lobbying or political activities, 26 C.F.R. § 1.501(c)(3)-1(c)(3). The only dispute between these parties centers around the remaining requirement of the operational test, the "primary activities" prong.

"An organization will be regarded as *operated exclusively* for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."

26 C.F.R. § 1.501(c)(3)-1(c)(1) (emphasis in original). Sadly, the last sentence of that section is a horrible amalgamation of negatives arranged like an inside joke prompting laughter only from seasoned and sadistic bureaucrats. In plain English, it means that an organization cannot be exempt while devoting a substantial portion of its activities to non-exempt purposes.

A list of exempt purposes is provided, which includes charity as an exempt purpose. 26 C.F.R. § 1.501(c)(3)-1(d)(1)(i)(b). On the issue of whether or not St. David's has a charitable purpose, the government chooses to avert its eyes when Revenue Ruling 69-545 is raised.

⁴See United States of America's Response to Plaintiff's Motion for Partial Summary Judgment (Clerk's Doc. No. 29).

Specifically, the government turns its eyes to Revenue Ruling 56-185. The government says that “the promotion of health is not per se charitable” and relies on 56-185 for the proposition that an exempt hospital must be “operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay and must not...refuse to accept patients in need of hospital care who cannot pay for such services.” United States of America’s Objections to the Report and Recommendation (Doc. No. 59), p. 5 (internal quotations omitted). However, Revenue Ruling 69-545 states, “In the general law of charity, the promotion of health is considered to be a charitable purpose.” Revenue Ruling 69-545, 1969-2 C.B. 117, 118 (1969). The ruling does go on to say that more is required to be tax-exempt under 501(c)(3), but the promotion of health is clearly a charitable purpose.

The government also overlooks the final paragraph of 69-545, which expressly removes the requirement of giving care to patients without charge or at rates below cost. The government relies on this requirement as stated in Revenue Ruling 56-185, but this paragraph in 69-545 even cites that prior ruling when removing that requirement. There is therefore absolutely no issue as to whether St. David’s has a charitable purpose, and any argument to the contrary appears at least mildly disingenuous.

Admittedly, the government has cited another court’s opinion that 69-545 did not overrule 56-185, but merely provided an alternative test for determining tax-exempt status. See *Eastern Kentucky Welfare Rights Org. v. Simon*, 506 F.2d 1278, 1290 (D.C. Cir. 1974). However, there are at least two problems with this statement as related to this case. First, 69-545, if it is merely an alternative test, it is far more relevant to this case than the 56-185 test because it is undisputed that St. David’s has a generally accessible emergency room as required by the 69-545 test. The

requirement of providing free or below-cost care is removed in specifically such a case, if not in others also. Second, it is difficult to view 69-545 as anything but an overruling of 56-185 when the later ruling says that “56-185 is hereby modified...”

A later section of these regulations effectively adds a consideration to the primary activities prong of the operational test. It states,

“An organization is not organized or *operated exclusively* for [an exempt purpose, *e.g.*, charity] unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”

26 C.F.R. § 1.501(c)(3)-1(d)(1)(ii)⁵ (emphasis added). By placing the above-quoted section apart from the operational test, the regulations seem to make this a separate consideration from that test in spite of the apparent overlap. The Court’s interpretation is that the operational test requires the organization to operate exclusively for an exempt purpose (in this case, charity), and Regulation 1(d)(1)(ii) requires that the organization benefit the community and not a private interest. However, it is difficult to conceive of an organization that operates exclusively as a charity, but substantially furthers a private interest. Perhaps a case in which the exempt purpose at issue was science or another exempt purpose listed in 1(d)(1), this separation would be less confusing. In any event, the overlap is so significant for this case that the Court will consider them simultaneously.

Thus, the parties’ dispute can be resolved by answering these two overlapping questions: First, is St. David’s operated exclusively for charity, meaning that only insubstantial portions of its activities benefit private, non-exempt purposes? Second, is it operated for the community interest

⁵For brevity and convenience, when referring to this section, the Court will simply call it “Regulation 1(d)(1)(ii).”

and not for a private interest, specifically, HCA? This is consistent with what was conveyed to St. David's by the government when it revoked the tax-exempt status. See quotation in Factual Background portion of this Order, p. 2, *supra*.

As is often the case with statutes and regulations, these are but a starting point. They only begin to take a more definite shape after they have been applied to facts. Fortunately, these regulations have been applied to countless factual situations, and these situations guide the Court's decision. Revenue Ruling 69-545⁶, 1969-2 C.B. 117, is a seminal application of these regulations and is especially relevant to the facts in this case since it involves a similar hospital. It lists several important characteristics of a hospital, imaginatively referred to as "Hospital A," that now comprise what is referred to as the "community benefit" standard. The Court will list these characteristics in the order they appear in the Revenue Ruling, which is not indicative of relative importance.

First, Hospital A has a board of trustees comprised of "prominent citizens in the community." Second, all qualified physicians in the area have medical staff privileges, as the size and nature of its facility allows. Third, Hospital A operates an emergency room that does not deny treatment to anyone requiring emergency care. However, non-emergency care is given only to those who can pay for it, either themselves or via a third party. Those who cannot pay are referred to another hospital in the community that will serve them. Hospital A typically takes in more money than it spends, and that money is applied to expansion and replacement of existing facilities, etc. Finally, and most importantly, this Revenue Ruling holds that Hospital A is exempt from paying federal income taxes.

Having gotten past all of the detached rules and standards governing this case, there appear

⁶This Court is not bound by this Revenue Ruling. However, the Court joins several others in finding that it is a correct and persuasive application of the law.

to the Court two things causing the government to revoke St. David's tax-exempt status. First, the government claims that St. David's is not controlled by a community board. Second, the government claims that HCA receives an impermissible private benefit.

A. Community Board

In Revenue Ruling 69-545, Hospital A had a community board, and this became a part of the community benefit standard. However, there is some dispute as to whether a community board is an absolute requirement, or just one point in favor of tax-exemption. Furthermore, there is some dispute as to what constitutes a community board. In this case, half of St. David's Board of Governors (the Board) is appointed by St. David's, and half by HCA.

1. Does the Community Benefit Standard Absolutely Require a Community Board?

The Court finds that, as a matter of law, the presence of a community board is a point in favor of exemption, but is not an absolute requirement for exemption. Going back to the original source of the community benefit standard, Revenue Ruling 69-545 never states that any one factor is an absolute requirement for exemption. Indeed, it lists several of the factors repeated here, then states, "These factors *indicate* that the use and control of Hospital A are for the benefit of the public..." Rev. Rul. 69-545, 1969-2 C.B. at 118 (emphasis added). This language suggests that the prongs of the community benefit standard are major factors but also that the absence of one is not absolutely dispositive of the question.

This finding is supported by other applications of the community benefit standard. In *Sound Health Assoc. v. Commissioner of Internal Revenue*, 71 T.C. 158 (1978), the Tax Court found that the HMO's board was made up of prominent members of the community, but they were selected only from the members of the HMO. Furthermore, this particular HMO was owned by its members,

so the board was comprised of owners and was not selected from the community at large.⁷ Nonetheless, the Tax Court found that the HMO satisfied the community benefit standard and qualified for tax exemption.

The government paints itself into a corner with its arguments in its response to the Magistrate's Report and Recommendation. It cites Revenue Ruling 83-157, which held that a hospital that was identical to 69-545's Hospital A in every respect except for the fact that it had no emergency room. 83-157 held that this hospital was tax-exempt in spite of its lack of a generally accessible emergency room because a state agency determined that such an emergency room would unnecessarily duplicate other services provided in the community. The government actually writes that the Internal Revenue Service will "weigh all of the facts and circumstances" and the "absence of particular factors...or the presence of other factors will not necessarily be determinative." The United States Objections to the Report and Recommendation (Doc. No. 59), p.6.

The government later refers to the community benefit standard as "somewhat flexible," stating that "a core ingredient like control vested in a community board may not be omitted unless the presence of other factors render that ingredient unnecessary. The United States filed its Objections to the Report and Recommendation (Doc. No. 59), p. 8. Thus, by the government's own implicit admission, the individual factors of the community benefit standard laid out in 69-545 are not absolute requirements.

The government attempts to rely on *Redlands Surgical Services, Inc. v. Commission*, 113 T.C. 47 (1999), in which the Tax Court held that Redlands was not tax exempt. However, the facts

⁷In *IHC Health Plans, Inc. v. Commissioner of Internal Revenue*, 82 T.C.M. 593 (2001), the Tax Court suggested that the Board in *Sound Health* was chosen from the community at large. As St. David's points out, that is not correct.

of that case are only vaguely similar to this case. In *Redlands*, the surgery center deemed non-exempt operated no emergency room and provided no free care to indigents. As quoted by the government, the Tax Court stated that the surgery center was “largely unfettered by charitable objectives.” *Id.*, 113 T.C. at 92. As described fully below, the structure of this partnership precludes any genuine argument that St. David’s is “unfettered by charitable objectives.”

2. Is St. David’s Run by a Community Board?

Even if a community board is an absolute requirement for 501(c)(3) tax exemption, St. David’s Board satisfies the requirement. Although exactly half of the members are appointed by a for-profit entity, the purpose of a community board is more complex than giving wealthy self-styled philanthropists something to do on the rare occasion that they are not playing golf. The purpose of the community board is to ensure that the community’s interests are given precedence over any private interests. Thus, if a board is structured to ensure such protection, it is clearly a community board.

The error of the government’s position in arguing that St. David’s board is not a community board is that it counts possible votes and discovers that members appointed by a non-profit entity can only tie the members appointed by a for-profit entity, and then end the inquiry. Looking further reveals exceptional protections against running this hospital in pursuit of private interests. The partnership contract requires that all hospitals owned by the partnership operate in accord with the community benefit standard. Should the hospitals fail to meet that standard, St. David’s has the unilateral right to dissolve the partnership. The chairmen’s seat is reserved for a member appointed by St. David’s and therefore great control over the board’s agenda is exercised by St. David’s. Even the day-to-day operations of the partnership are disproportionately impacted by the non-profit entity,

because St. David's has the power to unilaterally remove the Chief Executive Officer.

Voting strength is more than just a numbers game, and these provisions clearly protect the non-profit, charitable pursuits as well as any community board could. The government seems focused on majority control, but the law is more concerned with control, regardless of whether its control springs from a majority or from a corporate structure. Even if it were slightly ambiguous as to whether the board was structured to protect the charitable purpose of the organization, the other factors from the community benefit standard are met with such overwhelming force as to carry the day for St. David's. Every hospital owned by the partnership provides emergency care without regard to the patient's ability to pay.

The government attempts to quibble about how St. David's differentiates between free care that is charity and free care that is bad debt. The Court thinks that is a silly and meaningless distinction for purposes of this case. When all who need emergency care are treated regardless of willingness or ability to pay, the function is charitable regardless of what the accountants discover later. The government uses the alleged fact that St. David's attempts to collect payment from all patients before determining whether the care rendered was charity care or bad debt to show that St. David's actually provides no charity care. This implicitly attempts to require St. David's to determine before rendering care whether to expect payment from that particular patient, a luxury allowed only to those privileged to live in a bubble constructed by theories without the rude pin prick of practicality that so frequently bursts such bubbles. Not surprisingly, the IRS offers no method by which that determination could be made, perhaps it could be based on skin color, the brand name of clothes worn by the patient upon entering the emergency room, or shaking a magic eight ball.

The IRS states that "a hospital does not dispense charity care merely because some of its

patients fail to pay for the services rendered.” The United States filed its Objections to the Report and Recommendation (Doc. No. 59), p. 10. While the Court will not argue with that as a general proposition, this does not preclude attempts at collecting payment before determining the care to be charitable. Knowing that the hospital will not be compensated for much of the care rendered can be sufficient even if it cannot predetermine which patients can pay and which cannot pay. When a hospital operates a generally accessible emergency room, it knows that it will not be paid for much of the care rendered. The statement cited by the IRS is more applicable to non-emergency care.

B. Private Benefit to HCA

The IRS crystallizes the issue and governing standards for a private benefit in Objections to the Report and Recommendation (Doc. No. 59). The Court agrees that not all joint ventures between non-profit and for-profit organizations are either per se exempt or per se non-exempt. Other factors must be considered. The standard under the operational test was set out in *Redlands*, and it focuses on control of the organization. The *Redlands* court stated,

“To the extent that petitioner cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and *having no obligation to put charitable purposes ahead of profit-making objectives*, petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes. In such a circumstance, we are led to the conclusion that petitioner is not operated exclusively for charitable purposes.”

Redlands Surgical Services, Inc. v. Commission, 113 T.C. at 78 (1999) (emphasis added). Since the IRS accepts this as the governing law, the Court will use it for purposes of this case without deciding whether it is in fact the governing standard.

As discussed in detail above, it is difficult to imagine a corporate structure more protective of an organization’s charitable purpose than the one at issue in this case. The purpose stated in

Section 3.2 of the Partnership Agreement make the purpose clear, and the voting rules and rights of the non-profit partner prevent any usurpation of that purpose by HCA. The government essentially argues that these protections are all basically irrelevant, but the truth of the matter is that St. David's has the power to ensure that the manager and CEO are to its liking. That, among other protections discussed above gives the non-profit partner substantially more control than the for-profit partner, despite the facial 50-50 split in voting rights on the Board of Governors.

Upon application of all of these legal tests and standards to the undisputed facts of this case, it is clear that St. David's was exempt from federal income taxes under 501(c)(3) for the tax year 1996 as a matter of law, and therefore summary judgment must be granted.

IT IS THEREFORE ORDERED, ADJUDGED AND DECREED that the United States Magistrate Judge's Report and Recommendation filed in this cause is APPROVED and ACCEPTED IN PART and DISAPPROVED and REJECTED IN PART by this Court.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that the United States Motion for Summary Judgment (Doc. No. 31) is DENIED.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Plaintiff's Motion for Summary Judgment on the Issue of Plaintiff's Tax Exempt Status for the 1996 Tax Year is GRANTED.

SIGNED AND ENTERED this _____ day of June, 2002.

JAMES R. NOWLIN
CHIEF UNITED STATES DISTRICT JUDGE