Redlands Surgical Services v. Commissioners of Internal Revenue Service

113 T.C. 47 (1999), aff'd, 242 F.3d 904 (9th Cir. 2001)

Thornton, Judge.

* * *

Petitioner is a California nonprofit public benefit corporation with its principal place of business in Redlands, California. It is a wholly owned subsidiary of Redlands Health Systems, Inc. (RHS), a California nonprofit public benefit corporation that has been recognized as exempt under § 501(c)(3) of the Code and as a public charity. . . . RHS is the parent corporation of three subsidiaries in addition to petitioner, namely Redlands Community Hospital (Redlands Hospital) and Redlands Community Hospital Foundation (Redlands Foundation), both of which are California nonprofit public benefit corporations that have been recognized as exempt under § 501(c)(3); and Redlands Health Services, a for-profit corporation.

. . . [I]n 1990 RHS became co-general partner with a for-profit corporation, Redlands-SCA Surgery Centers, Inc. (SCA Centers), in a general partnership formed to acquire a 61-percent interest in an existing outpatient surgical center in Redlands, California, two blocks from the Redlands Hospital facility. This general partnership in turn became sole general partner in the California limited partnership that owns and operates the surgical center. Under a long-term management contract, SCA Management Co. (SCA Management)—a for-profit affiliate of SCA Centers—manages the day-to-day operations of the surgical center, in return for a percentage of gross revenues. Several months after forming the general partnership, RHS formed petitioner to succeed to its interest in it.

Petitioner has no activity other than its involvement with the partnerships. The question is whether petitioner is operated exclusively for exempt purposes within the meaning of § 501(c)(3). . . .

. . .

Redlands Hospital has its own outpatient surgery program within the hospital facility. It also maintains a 24-hour emergency room that provides emergency medical services for all patients regardless of their ability to pay. It maintains an open medical staff and is governed by a community-based board of directors. It does not discriminate on the basis of race, gender, age, color, national origin, or disability.

Since its inception in 1983, the Inland Surgery Center Limited Partnership (the Operating Partnership) has operated a freestanding ambulatory surgery center (the Surgery Center) in a 12,000-square foot building within two blocks of Redlands Hospital. During the 1980's, the Operating Partnership was a successful for-profit venture, serving only surgical patients who were able to pay, by insurance or otherwise. Prior to its affiliation with the General Partnership, the Operating Partnership comprised Beaver Medical Clinic, Inc., and some 30 physician partners,
who were also physicians on the medical staff of Redlands Hospital.

The Affiliation of Redlands Hospital
With the Surgery Center

Before 1990, Redlands Hospital desired to increase its outpatient surgery capacity but lacked the capital resources and experience to develop and operate its own freestanding outpatient facility. In addition, such a facility would have been in competition with the existing Surgery Center, and there was concern that the Redlands community could not sustain both.

On March 1, 1990, RHS and SCA Centers entered into a general partnership agreement to acquire jointly a 61 percent general partnership interest in the Surgery Center. The partnership is known as Redlands Ambulatory Surgery Center (the General Partnership).

SCA Centers is a for-profit, wholly owned subsidiary of Surgical Care Affiliates, Inc. (SCA), a publicly held corporation based in Nashville, Tennessee, and specializing in owning and managing ambulatory surgery centers. Prior to formation of the General Partnership, neither SCA nor any of its affiliated entities had any relationship, contractual or otherwise, with RHS or any of its affiliated entities, or with the Surgery Center.

RHS contributed $1,131,289 to the General Partnership, borrowing $796,829 from SCA and the balance of $334,460 from Redlands Hospital. SCA Centers contributed $1,946,993 in cash and stock to the General Partnership. In return for its approximately 37 percent capital investment, RHS received a 46 percent interest in profits, losses, and cash-flows of the General Partnership. In return for its approximately 63 percent capital investment, SCA Centers received a 54 percent interest in profits, losses, and cash-flows of the General Partnership.

[A lengthy description of the partnership agreement is omitted.]

Effective April 30, 1990, the General Partnership entered into an amended and restated agreement of the Operating Partnership in accordance with the Revised Limited Partnership Act of the State of California. Pursuant to this agreement, the General Partnership acquired, for approximately $3 million, a 61 percent general partnership interest in the Operating Partnership. As part of the purchase price, the General Partnership agreed to contribute $1,598,495 by delivering to the limited partners (with the exception of Beaver Medical Clinic) shares of SCA common stock with an equivalent market value.

To determine the General Partnership’s investment, the Operating Partnership was valued at four to five times earnings. No formal appraisal was acquired; rather, the valuation was determined based on SCA’s experience and knowledge of the market and by a review of historical records. An unrelated bidder (a for-profit company, not otherwise identified in the record) was offering the Operating Partnership a higher purchase price based on approximately six times earnings. The existing partners of the Operating Partnership agreed to the offer made by the General Partnership due to the desire to have an affiliation with Redlands Hospital for quality control review and other reasons, such as to supervise the teaching and maintenance of up-to-date surgery methodologies.

The General Partnership is the sole general partner of the Operating Partnership. There are 32 limited partners. Except for Beaver Medical Clinic, Inc., the limited partners are all physicians who are also on the medical staff of Redlands Hospital. Two of the limited partners are board members of Redlands Hospital and RHS. The amended Operating Partnership agreement contains no statement of charitable purpose and imposes no requirement that the Operating Partnership operate for a charitable purpose.

[A summary of the operating partnership agreement is omitted.]

. . . [O]n April 30, 1990, the Operating Partnership entered into a contract with SCA Management, whereby SCA Management was retained “for the purpose of rendering management, administration and purchasing services and support, and all other management support needed for operation and, in the best interest, of the [Surgery] Center.” The management agreement is signed on behalf of both the Operating Partnership and SCA Management by David E. Crockett, in his capacities as secretary and vice president, respectively, of these two entities.

Pursuant to the management contract, SCA Management has wide-ranging authority for operational management of the Surgery Center, except that it has
“no power or authority to make any decision relating to
the care or treatment of patients or other medical mat-
ters,” this power and authority being specifically re-
served to the Operating Partnership’s Medical Advisory
Committee. SCA Management is authorized to enter
into contracts relating to the affairs of the Surgery Cen-
ter, subject to certain exceptions, requiring express
authorization of the Operating Partnership. These ex-
ceptions include lease or contractual obligations requir-
ing payments in excess of $50,000 in any 12-month
period, and obligations to a related party in excess of
$5,000.

[A summary of the management agreement is
omitted.]

Quality Assurance Agreement

Paragraph 13 of the General Partnership agree-
ment, supra, requires SCA Management to enter into a
quality assurance agreement with RHS whereby RHS
will agree to perform “certain managerial and supervi-
sory quality assurance duties” in connection with the
operation of the Surgery Center. The General Partner-
ship agreement provides that the quality assurance
agreement is to continue from year to year unless ter-
minated by either of the parties.

Effective April 30, 1990, SCA Management and
RHS entered into a quality assurance agreement. The
agreement states that SCA Management “retains RHS
for the purpose of the management and supervision of
quality assurance programs for the [Surgery] Center
and to oversee its affairs, and for providing additional
services as SCA [Management] may reasonably
request.”

The quality assurance agreement recites as one of its
premises that SCA Management “desires to reimburse
RHS for certain services, including without limitation
management and the supervision of quality assurance
programs with respect to the [Surgery] Center.” . . .

On September 30, 1990, RHS transferred its obli-
gations and rights under the Quality Assurance Agree-
ment to petitioner.

By its terms, the quality assurance agreement was
to continue from year to year unless terminated by ei-
ther SCA Management or petitioner. The quality assur-
ance agreement was to terminate automatically,
however, if the number of surgical cases performed at
the Surgery Center was less than 4,225 during any year.
The agreement states that if it is terminated for any
reason, the parties agree to negotiate in good faith an
agreement on substantially the same terms.

Medical Advisory Group

Pursuant to paragraph 9.6 of the Operating Part-
nership agreement, supra, all questions regarding medi-
cal standards and policies at the Surgery Center are
determined by a Medical Advisory Group, which also
reviews procedures being performed at the Surgery
Center. The Medical Advisory Group is composed of
six physicians who are all limited partners of the Oper-
ating Partnership. The managing directors of the Gen-
eral Partnership select three members of the medical
advisory group; Beaver Medical Clinic—which is a lim-
ited partner in the Operating Partnership—selects the
other three members. Prior to the affiliation of the
General Partnership with the Surgery Center, the Medi-
cal Advisory Group was inactive.

Redlands Surgical Services (Petitioner)

On August 1, 1990, 5 months after entering into
the General Partnership agreement, RHS incorporated
petitioner as a California nonprofit public benefit cor-
poration. On September 30, 1990, RHS transferred its
interest in the General Partnership to petitioner.

RHS formed petitioner with the intent that peti-
tioner’s sole planned activity would be its efforts with
respect to the Operating Partnership. The decisions to
incorporate petitioner as a separate corporate entity and
to transfer the interests in the General Partnership to
petitioner were made to protect Redlands Hospital and
Redlands Foundation from potential creditors of the
Surgery Center and to keep petitioner’s and the Surgery
Center’s activities free of the debt covenants of Red-
lands Hospital.

. . . .

Petitioner’s bylaws limit membership to one mem-
ber. The sole member is RHS, which has the right to
elect, remove, and fill vacancies in petitioner’s Board of
Directors. Petitioner’s bylaws provide that the directors
must be among those persons serving as members of
the Enterprise Committee of petitioner’s parent corpo-
racion RHS.
Petitioner’s sole source of financial support is its share of the revenues from the Operating Partnership. Petitioner has no paid or salaried employees. The president of Redlands Hospital serves concurrently as petitioner’s president.

The Surgery Center’s Operations
The Surgery Center operates on a nondiscriminatory basis both as to doctors and patients. There are no restrictions as to whether a surgical patient can be operated on at the Surgery Center, other than a review as to the appropriateness of conducting the surgical procedure in an outpatient setting and the overall medical condition of the patient. There is practically a 100-percent overlap between surgeons who operate at Redlands Hospital and at the Surgery Center.

Between 1990 and 1995, the number of surgical procedures performed at the Surgery Center increased 10 percent. Over the same period, the number of outpatient surgeries performed at Redlands Hospital decreased from 2,239 to 1,864.

Procedures Authorized To Be Performed at the Surgery Center

The General Partnership agreement generally provides that, unless otherwise approved by the managing directors, the Surgery Center will not perform new surgical procedures until they are available on a non-hospital, outpatient basis at a majority of freestanding outpatient surgery facilities in the area. If the managing directors deadlock over approval of new procedures, the arbitration provisions of the partnership agreement do not apply to break the deadlock.

Petitioner’s appointees to the managing directors have successfully blocked various proposals by SCA Centers that additional surgical procedures be conducted at the Surgery Center.

Payment for Services
The Surgery Center’s charges are determined on the basis of customary and usual charges for similar services provided by other organizations in the area. The Surgery Center offers no free care to indigents and has no emergency room or certification to treat the emergency patient population. For persons who are unable to pay, an effort is made to provide all necessary services and to assist the patient in qualifying for appropriate medical coverage including Medi-Cal. The Surgery Center also provides payment plans for patients to make payment for procedures more affordable.

Since the General Partnership acquired its interest in the Operating Partnership, the Surgery Center has accepted more managed care (i.e., care provided by health maintenance organizations (HMOs)).

For the last 6 months of 1993, Medicare accounted for about 12 percent of total Surgery Center invoices. Because greater medical risks attend surgery of older patients, such as the typical Medicare patient, most Medicare surgeries are performed in a hospital setting, rather than in a surgery center.

The Surgery Center has no contract with Medi-Cal directly, although a negligible amount of Medi-Cal coverage is provided for surgeries performed at the Surgery Center pursuant to participating hospital agreements between Redlands Hospital and the Blue Cross of California Medi-Cal Managed Care Program, effective December 1, 1994, and between Redlands Hospital and PacifiCare of California, a California HMO, effective June 1, 1994. For the last 6 months of 1993, the Surgery Center’s Medicaid invoices totaled 18, or less than 1 percent (8/10 of 1 percent) of all its invoices.

Integration of the Activities of Redlands Hospital and the Surgery Center
Since its affiliation with the General Partnership, the Surgery Center has served as a training site for Redlands Hospital nurses in outpatient procedures. Redlands Hospital nursing surgery staff members train at the Surgery Center in circumstances where the frequency of a particular surgery at the Surgery Center makes such training more efficient and economical.

To be a member of the Redlands Hospital physician staff, a physician must be board-certified in his or her specialty and regarded by Redlands Hospital as a capable practitioner. Redlands Hospital uses a “proctor” review process to approve new members of its physician staff. Before the General Partnership acquired its interest in the Surgery Center, no proctoring was conducted at the Surgery Center. Since the affiliation of the Surgery Center with the General Partnership, it is frequently the case...
that, as new surgeons join Redlands Hospital’s staff, the Redlands Hospital proctoring requirements are satisfied, in whole or in part, during surgeries performed at the Surgery Center.

Redlands Hospital has been involved in teaching new procedures to be performed at the Surgery Center. An example is laser arthroscopic surgery, which eliminates incision. These procedures were developed at Redlands Hospital, and the knowledge was shared with the Surgery Center.

The Surgery Center’s Financial Results
The Surgery Center’s profit levels and payor mix are comparable to other ambulatory surgery centers. Its profits are used for equipment additions, replacements, improvements in services, and cash distributions to the partners.

In the first 5-month period after April 30, 1990, when the amended Operating Partnership and the SCA Management contract became effective, the Operating Partnership had net income of $451,430, which was 34.5 percent of gross revenues. SCA Management received $80,458 in fees.

Cash distributions from the Operating Partnership to petitioner, SCA Centers, and the limited partners, expressed as an average rate of return on investment basis for fiscal years 1990-1993, were as follows: [A table of distributions is omitted.]

Upon its Form 1023, Application for Recognition of Exemption, under § 501(c)(3), filed August 7, 1990, petitioner estimated that between 50 and 80 percent of its total annual income would be used to support RHS and Redlands Hospital, which were stated to have total annual losses of $340,544 and $460,595, respectively. Petitioner has used its share of the cash distributions from the Operating Partnership to pay off the note payable to SCA for its initial capital contribution and to make distributions to RHS or Redlands Hospital.

II. Applicable Legal Principles
To qualify for exemption from Federal income tax, an organization must be “organized and operated exclusively for . . . charitable . . . purposes.” [citation to § 501(c)(3)] The applicable regulations provide as follows:

. . . . 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 § 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.

The operational test focuses on the actual purposes the organization advances by means of its activities, rather than on the organization’s statement of purpose or the nature of its activities. To determine whether the operational test has been satisfied, we look beyond “the four corners of the organization’s charter to discover ‘the actual objects motivating the organization.’” (citations omitted)
Although an organization might be engaged in only a single activity, that single activity might be directed toward multiple purposes, both exempt and nonexempt. If the nonexempt purpose is substantial in nature, the organization will not satisfy the operational test.

The fact that an organization engages in a trade or business is not conclusive of a substantial nonexempt purpose and does not, in and of itself, disqualify the organization from exemption under § 501(c)(3), provided the activity furthers or accomplishes an exempt purpose. (citations omitted)

Whether an organization has a substantial nonexempt purpose is a question of fact to be resolved on the basis of all the evidence presented by the administrative record. . . . The burden of proof is on petitioner to demonstrate, based on materials in the administrative record, that it is operated exclusively for exempt purposes and that it does not benefit private interests more than incidentally.

Section 501(c)(3) specifies various qualifying exempt purposes, including “charitable” purposes. The term “charitable” is not defined in § 501(c)(3), but is used in its generally accepted legal sense. In applying this standard, courts have looked to the law of charitable trusts. (citations omitted)

The promotion of health for the benefit of the community is a charitable purpose. As applied to determinations of qualification for tax exemption, the definition of the term “charitable” has not been static. . . . [I]n recognition of changes in the health care industry, the standard no longer requires that “the care of indigent patients be the primary concern of the charitable hospital, as distinguished from the care of paying patients.” Rather, the standard reflects “a policy of insuring that adequate health care services are actually delivered to those in the community who need them.” Under this standard, health care providers must meet a flexible community benefit test based upon a variety of indicia, one of which may be whether the organization provides free care to indigents.

To benefit the community, a charity must serve a sufficiently large and indefinite class; as a corollary to this rule, private interests must not benefit to any substantial degree.

An organization does not operate exclusively for exempt purposes if it operates 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. The private benefit proscription inheres in the requirement that an organization operate exclusively for exempt purposes.

The proscription against private benefit shares common elements with, but is distinct from, the proscription against the inurement of organizational earnings to private shareholders and individuals. . . . The proscription against private benefit encompasses not only benefits conferred on insiders having a personal and private interest in the organization, but also benefits conferred on unrelated or disinterested persons.

The mere fact that an organization seeking exemption enters into a partnership agreement with private parties that receive returns on their capital investments does not establish that the organization has impermissibly conferred private benefit. The question remains whether the organization has a substantial nonexempt purpose whereby it serves private interests.

III. Petitioner’s Claim to Exemption on a “Stand-Alone” Basis

Applying the principles described above, we next consider whether petitioner has established that respondent improperly denied it tax-exempt status as a § 501(c)(3) organization.

A. The Relevance of Control—The Parties’ Positions

Respondent asserts that petitioner has ceded effective control over its sole activity—participating as a co-general partner with for-profit parties in the partnerships that own and operate the Surgery Center—to the for-profit partners and the for-profit management company that is an affiliate of petitioner’s co-general partner. Respondent asserts that this arrangement is indicative of a substantial nonexempt purpose, whereby petitioner impermissibly benefits private interests.

Without conceding that private parties control its activities, petitioner challenges the premise that the
ability to control its activities determines its purposes. Petitioner argues that under the operational test, “the critical issue in determining whether an organization’s purposes are noncharitable is not whether a for-profit or not-for-profit entity has control. Rather, the critical issue is the sort of conduct in which the organization is actually engaged.” . . .

We disagree with petitioner’s thesis. It is patently clear that the Operating Partnership, whatever charitable benefits it may produce, is not operated “in an exclusively charitable manner.” . . . The Operating Partnership’s income is, of course, applied to the profit of petitioner’s co-general partner and the numerous limited partners. It is no answer to say that none of petitioner’s income from this activity was applied to private interests, for the activity is indivisible, and no discrete part of the Operating Partnership’s income-producing activities is severable from those activities that produce income to be applied to the other partners’ profit.

Taken to its logical conclusion, petitioner’s thesis would suggest that an organization whose main activity is passive participation in a for-profit health-service enterprise could thereby be deemed to be operating exclusively for charitable purposes. Such a conclusion, however, would be contrary to well-established principles of charitable trust law.

. . . The binding commitments that petitioner has entered into and that govern its participation in the partnerships are indicative of petitioner’s purposes. 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.

Based on the totality of factors described below, we conclude that petitioner has in fact ceded effective control of the partnerships’ and the Surgery Center’s activities to for-profit parties, conferring on them significant private benefits, and therefore is not operated exclusively for charitable purposes within the meaning of § 501(c)(3).

B. Indicia of For-Profit Control Over the Partnerships’ Activities

1. No Charitable Obligation

Nothing in the General Partnership agreement, or in any of the other binding commitments relating to the operation of the Surgery Center, establishes any obligation that charitable purposes be put ahead of economic objectives in the Surgery Center’s operations. The General Partnership agreement does not expressly state any mutually agreed-upon charitable purpose or objective of the partnership.

After the General Partnership acquired its 61-percent interest, the Operating Partnership—which had long operated as a successful for-profit enterprise and never held itself out as a charity—never changed its organizing documents to acknowledge a charitable purpose . . .

2. Petitioner’s Lack of Formal Control

Under the General Partnership agreement, control over all matters other than medical standards and policies is nominally divided equally between petitioner and SCA Centers, each appointing two representatives to serve as managing directors. (As discussed infra, matters of medical standards and policies are determined by the Medical Advisory Group, half of whom are chosen by the General Partnership’s managing directors.) Consequently, petitioner may exert influence by blocking actions proposed to be taken by the managing directors, but it cannot initiate action without the consent of at least one of SCA Center’s appointees to the managing directors. For instance, petitioner lacks sufficient control unilaterally to cause the Surgery Center to respond to community needs for new health services, modify the delivery or cost structure of its present health services to serve the community better, or, as discussed in more detail infra, terminate SCA Management, if SCA Management were determined to be managing the Surgery Center in a manner inconsistent with charitable objectives.

The administrative record shows that petitioner has successfully blocked various proposals to expand the scope of activities performed at the Surgery Center. Petitioner’s ability to veto expansion of the scope of the Surgery Center’s activities, however, does not establish that petitioner has effective control over the manner in
which the Surgery Center conducts activities within its pre-designated sphere of operations. Nor does it tend to indicate that the Surgery Center is not operated to maximize profits with regard to those activities. Indeed, given that all the partners except petitioner are for-profit interests not shown to be motivated or constrained by charitable objectives, and given that all the limited partners except Beaver Medical Clinic were issued SCA common stock when the General Partnership acquired its interest in the Operating Partnership, and given that SCA Management derives a management fee computed as a percentage of gross revenues, we find, in the absence of evidence to the contrary, that a significant profit-making objective is present in the Surgery Center’s operations. The high rates of return earned on the partners’ investments (including petitioner’s) in the Operating Partnership bolster this finding.

. . . .

. . . .[N]either the General Partnership agreement, the Operating Partnership agreement, nor the management contract itself requires that SCA Management be guided by any charitable or community benefit, goal, policy, or objective. Rather, the management contract simply requires SCA Management to render services as necessary and in the best interest of the Operating Partnership, “subject to the policies established by [the Operating Partnership], which policies shall be consistent with applicable state and Federal law.”

Petitioner argues that the management contract “was negotiated at arm’s length, between parties of equal bargaining strength.” The administrative record does not support this contention. Although the General Partnership agreement was negotiated between RHS and SCA Centers, it contains only a sparse description of several key features to be included in the management contract. The actual management contract is between SCA Management and the Operating Partnership, and contains much more extensive and detailed provisions than are stipulated in the General Partnership agreement.

. . . .

. . . .

The administrative record provides no basis for concluding that, in the absence of formal control, petitioner possesses significant informal control by which it exercises its influence with regard to the Surgery Center’s activities. Nothing in the administrative record suggests that petitioner commands allegiance or loyalty of the SCA affiliates or of the limited partners to cause them to put charitable objectives ahead of their own economic objectives. Indeed, until April 1992, petitioner was in a debtor relationship to SCA. The limited partners (except for Beaver Medical Clinic, Inc.) all became common stockholders of SCA when the General Partnership acquired its interest in the Operating Partnership.

The administrative record does not establish that petitioner has the resources or ability effectively to oversee or monitor the Surgery Center’s operations. Petitioner has almost no resources apart from its assets invested in the General Partnership. The president of Redlands Hospital also serves as petitioner’s president and as one of the four managing directors of the General Partnership.

. . . .

C. Competitive Restrictions and Market Advantages

By entering into the General Partnership agreement, RHS (petitioner’s parent corporation and predecessor in interest in the General Partnership) not only acquired an interest in the Surgery Center, but also restricted its future ability to provide outpatient services at Redlands Hospital or elsewhere without the approval of its for-profit partner. Paragraph 16 of the General Partnership agreement prohibits the co-general partners and their affiliates from owning, managing, or developing another freestanding outpatient surgery center within 20 miles of the Surgery Center, without the other partner’s consent . . .

The General Partnership agreement also restricts the parties and their affiliates from providing outpatient surgery services and procedures that the agreement does not specifically authorize to be provided at the Surgery Center (hereinafter referred to as non-listed services). Under this agreement, Redlands Hospital, but not the co-general partners or any of their other affiliates, is allowed to perform non-listed outpatient services that were currently available to patients in California at the time the General Partnership agreement was executed. By contrast, neither Redlands Hospital nor the co-general partners or their affiliates are allowed to perform non-listed outpatient services that
first become available in California during the term of the General Partnership agreement (i.e., until March 31, 2020), unless the managing directors of the General Partnership approve.

Consequently, RHS effectively restricted its own ability to assess and service community needs for outpatient services until the year 2020. It is difficult to conceive of a significant charitable purpose that would be furthered by such a restriction.

. . . .[T]he Surgery Center had not one but two bidders, the General Partnership, offering four to five times earnings, and another unrelated, for-profit bidder, otherwise unidentified in the record, offering approximately six times earnings. A letter from Ernst & Young to respondent’s representatives, dated July 14, 1992, indicates that the Surgery Center took the General Partnership’s offer instead of the other, higher bid because of a desire to have an affiliation with Redlands Hospital for quality control and other reasons.

Viewed in its totality, the administrative record is clear that SCA and petitioner derive mutual economic benefits from the General Partnership agreement. By borrowing necessary up-front capital from SCA, RHS (petitioner’s predecessor in interest in the General Partnership), overcame a capital barrier to gain entry into a profitable and growing market niche. By forming a partnership with RHS, SCA Centers was able to benefit from the established relationship between Redlands Hospital and the limited partner physicians to acquire its interest in the Surgery Center at a bargain price.

By virtue of this arrangement, petitioner and SCA Centers realized further mutual benefits by eliminating sources of potential competition for patients, as is evidenced by the restrictions on either party’s providing future outpatient services outside the Surgery Center, and by Redlands Hospital’s agreeing not to expand or promote its existing outpatient surgery facility at the hospital. In light of the statement in the record that it is typical for national chains such as SCA to “shadow-price” hospitals in charging for services at outpatient surgery centers, it seems most likely that one purpose and effect of the containment and contraction of Redlands Hospital’s outpatient surgery activities is to eliminate a competitive constraint for setting Surgery Center fees (a matter delegated to SCA Management under the management contract, excluding charges for physicians’ services). Moreover, market consolidation provided petitioner and SCA Centers mutual advantages by eliminating pressures to compete in spending for expensive equipment.

There is no per se proscription against a nonprofit organization’s entering into contracts with private parties to further its charitable purposes on mutually beneficial terms, so long as the nonprofit organization does not thereby impermissibly serve private interests. In the instant case, however, RHS relied on the established relationship between Redlands Hospital and Redlands physicians to enable RHS and SCA affiliates jointly to gain foothold, on favorable terms, in the Redlands ambulatory surgery market. Then, by virtue of their effective control over the Surgery Center, the SCA affiliates have been enabled to operate it as a profit-making business, with significantly reduced competitive pressures from Redlands Hospital, and largely unfettered by charitable objectives that might conflict with purely commercial objectives.

D. Conclusion

Based on all the facts and circumstances, we hold that petitioner has not established that it operates exclusively for exempt purposes within the meaning of § 501(c)(3). In reaching this holding, we do not view any one factor as crucial, but we have considered these factors in their totality: The lack of any express or implied obligation of the for-profit interests involved in petitioner’s sole activity to put charitable objectives ahead of non-charitable objectives; petitioner’s lack of voting control over the General Partnership; petitioner’s lack of other formal or informal control sufficient to ensure furtherance of charitable purposes; the long-term contract giving SCA Management control over day-to-day operations as well as a profit-maximizing incentive; and the market advantages and competitive benefits secured by the SCA affiliates as the result of this arrangement with petitioner. Taken in their totality, these factors compel the conclusion that by ceding effective control over its operations to for-profit parties, petitioner impermissibly serves private interests.
IV. Petitioner's Claim to Exemption
Under the Integral Part Doctrine

Petitioner argues that even if it does not qualify for
tax exemption on a “stand alone” basis, it qualifies for
exemption under the integral part doctrine.

The integral part doctrine is not codified, but
rather is the outgrowth of judicial opinions, rulings, and
regulations. The precise contours of this doctrine are
not clearly defined. . . .

. . . .

In Geisinger Health Plan v. Commissioner, supra,
this Court denied a claim for tax exemption asserted by
an HMO under the integral part theory. We reasoned
that the group-practice line of cases was not controlling
because, unlike the exempt organizations in those
cases, the HMO had a population of subscribers that
did not overlap substantially with the patients of the
related exempt entities. In considering whether the
HMO’s activities would have constituted an unrelated
business if conducted by its affiliate, we noted that sec-
tion 513(a) defines “unrelated trade or business” by
reference to conduct that is “not substantially related”
to the organization’s exempt functions. We stated that
the determination whether conduct is “substantially
related” in this context “considers the degree to which
income is earned from services rendered or sales made
to persons who are not patients of the exempt affiliated
entity.” Noting that entities related to the HMO pro-
vided 80 percent of the hospital services rendered to
the HMO’s patients, we held that the record in Geis-
inger did not justify a conclusion as to whether the
instances in which the HMO’s subscribers were served
by unrelated entities were substantial or insubstantial.
Accordingly, we held that the HMO failed to establish
that its activities comprised an integral part of its affili-
ate’s exempt activities.

Similarly, in the instant case, petitioner has failed
to establish that the Surgery Center’s patient population
overlaps substantially with that of Redlands Hospital.
The record does not reveal what percentage of per-
sons served at the Surgery Center are patients of Red-
lands Hospital. Clearly, however, the Surgery Center
was performing ambulatory surgery on a for-profit
basis for its own patients before petitioner was ever
involved and presumably continued to do so after-
ward.

Even if we were to assume, arguendo, that the pa-
tient populations of the Surgery Center and Redlands
Hospital overlap substantially, this circumstance would
not suffice to confer exemption on petitioner under the
integral part doctrine. In all the precedents cited above
in which courts have applied the integral part doctrine
to recognize a derivative exemption, the organization
has been under the supervision or control of the ex-
empt affiliate (or a group of exempt affiliates with com-
mon exempt purposes) or otherwise expressly limited
in its purposes to advancing the interests of the affili-
ated exempt entity or entities, and serving no private
interests. . . .

By contrast, as previously discussed, petitioner’s
sole activity (the Surgery Center) is effectively con-
trolled by for-profit parties. The operations of the Sur-
gery Center plainly are not dedicated to advancing the
interests of petitioner’s exempt affiliates other than as
those interests might happen to coincide with the
commercial interests of petitioner’s for-profit partners.
Moreover, as previously discussed, petitioner imper-
missibly serves private interests. Petitioner’s activity is
not so substantially and closely related to the exempt
purposes of its affiliates that these private interests may
be disregarded. . . .

[A graphic diagram of the organizational structure of
the hospital and its partners is omitted but was in-
cluded in the court’s opinion.]

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