
CHAPTER 1

Introduction: Joint Ventures Involving Exempt Organizations

- 1.1 Introduction 1
- 1.2 Joint Ventures in General 3
- 1.3 Healthcare Joint Ventures 6
- 1.4 University Joint Ventures 8
- 1.5 Low-Income Housing and New Market Tax Credit Joint Ventures 11
- 1.6 Conservation Joint Ventures 14
- 1.7 Joint Ventures as Accommodating Parties to Impermissible Tax Shelters 15
- 1.8 Rev. Rul. 98-15 and Joint Venture Structure 16
- 1.9 Form 990 and Good Governance 20
- 1.10 Ancillary Joint Ventures: Rev. Rul. 2004-51 21
- 1.11 Engaging in a Joint Venture: The Structural Choices and Role of the Charity 21
- 1.12 Partnerships with Other Exempt Organizations 24
- 1.13 Transfer of Control of Supporting Organization to Another Tax-Exempt Organization 25
- 1.14 The Exempt Organization as a Lender or Ground Lessor 26
- 1.15 Partnership Taxation 28
 - (a) Overview 28
 - (b) Bargain Sale Including “Like Kind” Exchange 30
- 1.16 UBIT Implications from Partnership Activities 31
- 1.17 Use of a Subsidiary as Participant in a Joint Venture 33
- 1.18 Limitation on Preferred Returns 35
 - (a) Debt-Financed Property 35
 - (b) The Fractions Rule 36
 - (c) Tax-Exempt Entity Leasing Rules 36
- 1.19 Sharing Staff and/or Facilities: Shared Services Agreement 38
- 1.20 “Intangibles” Licensed by Nonprofit to For-Profit Subsidiary or Joint Venture 39
- 1.21 Private Inurement and Private Benefit 40
- 1.22 Limitation on Private Foundation’s Activities that Limit Excess Business Holdings 44
- 1.23 International Joint Ventures 45
- 1.24 Other Developments 46

1.1 INTRODUCTION

The participation of tax-exempt organizations in partnerships and joint ventures with taxable entities and other nonprofits is an area of continuing

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

growth and interest.¹ Joint ventures allow nonprofits to utilize the resources of other organizations in the pursuit of their charitable goals.

While charitable giving rises at critical times, including natural disasters such as Hurricane Sandy, and tragedies such as occurred on September 11, 2001, nonprofit groups face steep competition for donor funds, particularly in the aftermath of the 2008 recession. In addition, there is increasing likelihood that the charitable deduction will be modified when the Internal Revenue Code is revised either in connection with a resolution of the so-called fiscal cliff or as part of a subsequent, comprehensive revision of the Code. As a result, charitable entities are looking to nontraditional means to attract donors, increase revenues from their mission-related activities, and make the contributions that they have received work more effectively.

Numerous legislative and economic factors in the United States have led to the growth of joint ventures. Changes in the healthcare field, including mergers between nonprofit hospitals and for-profit chains, have been driven by the growth of managed care along with the Medicare shift from a cost-based to a “fixed fee per case” system. Ancillary joint ventures among healthcare organizations have also proliferated, particularly with the creation of accountable care organizations (ACOs) and Consumer Operated and Oriented Plans (CO-OPs), as well as the approval of regional health insurance exchanges (RHIOs) by the IRS. Nonprofit organizations devoted to the arts have been impacted by decreased government funding as well as by the record number of mergers of for-profit corporations. The successor entities often alter the charitable giving strategies of their predecessors, with decreased corporate support of the arts as an unfortunate by-product.² In addition, stock market fluctuations have impacted the endowments of large nonprofit institutions such as colleges and universities.³

At the same time, the technology revolution has created a new stage and marketplace for nonprofits, as well as offering them new opportunities for joint venture activities. Universities and colleges have been at the forefront of creative planning to raise revenues, which often involves joint

¹ See M. Sanders, C. Roady, and S. Cobb, “Partnerships and Joint Ventures: Alive and Well or Endangered Species?” NYU Eighteenth Conference on Tax Planning for §501(c)(3) Organizations (1990). Portions of this chapter are based on research from the authors’ NYU article.

² Irvin Molotsky, “Corporate Medici Lost to Mergers, Arts Groups Fear,” *New York Times*, B1 (Jan. 5, 1999).

³ Judith H. Dobrzynski and Geraldine Fabricant, “Passing On the Pain at the Met, As Charitable Funds Drop, Museum Visitors Pay More,” *New York Times*, B1 (April 14, 1999).



1.2 JOINT VENTURES IN GENERAL

ventures—for example, affinity credit cards (whereby the nonprofit allows a commercial credit card issuer to use the organization’s logo on its cards), travel tours, and corporate “sponsorship,” where a company pays a fee for use of its logo or name at sporting events.⁴ The newest joint ventures involve MOOCs, massive open online courses that make college courses available to millions of students.

The book focuses on nonprofit organizations that qualify for exempt status under the Internal Revenue Code (IRC or “the Code”)⁵ and that most commonly participate in joint ventures. A foundational analysis of §501(c)(3) “charitable organizations” and the statutory and common law requirements pertaining thereto, a necessary predicate to a study of exempt organization participation in joint ventures, is provided in Chapter 2.

1.2 JOINT VENTURES IN GENERAL

A joint venture is an association of persons or entities jointly undertaking a particular transaction for mutual profit.⁶ A partnership is defined as an association of two or more persons to carry on, as co-owners, a business for profit⁷ and can be structured as a partnership or, as is increasingly more common, a limited liability company (LLC).⁸ A partnership is treated as a pass-through entity and is, therefore, not subject to taxation; the partners are liable for income tax in their individual capacities.⁹ The various items of partnership income, gain, loss, deduction, and credit flow through to the individual partners and are reported on their personal income tax returns.¹⁰ A joint venture is treated as a partnership for federal income tax purposes,¹¹ but unlike a partnership, a joint venture does not entail

⁴ See discussion in Section 1.4 and Section 13.7.

⁵ All section references are to the Internal Revenue Code of 1986 as amended and the regulations promulgated thereunder, unless otherwise noted, and will hereinafter be referred to by section number and cited as “§.” Treasury Regulations will be cited as “Reg. §.”

⁶ *Black’s Law Dictionary* 839 (6th ed., 1990); *Harlan E. Moore Charitable Trust v. United States*, 812 F. Supp. 130 (CD. Ill. 1993), *aff’d*, 9 F.3d 623 (Nov. 3, 1993), *acq. in action on decision*, 95-3953 (Apr. 14, 1995) (Issues 1 and 2).

⁷ Uniform Partnership Act, §6(1); *Black’s Law Dictionary* 120 (6th ed., 1990); see also §7701(a)(2).

⁸ See Chapter 6 for a detailed discussion of limited liability companies.

⁹ §701; Reg. §1.701-1

¹⁰ §702; Reg. §1.702-1.

¹¹ §761(a); Reg. §1.761-1(a); §7701(a)(2).



INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

a continuing relationship among the parties. Courts have described joint ventures as follows:

A joint venture contemplates an enterprise jointly undertaken; it is an association of such joint undertakers to carry out a single project for profit; there must be a community of interest in the performance of a common purpose, a proprietary interest in the subject matter, a right to direct and govern the policy in connection therewith, a duty, which may be altered by agreement, to share both in profit and losses. One member of the joint venture is liable to third parties for acts of the other venturer, especially payment of debts.¹²

Current economic and social conditions present exempt organizations with significant opportunities to further their charitable purposes through participation in joint ventures.¹³

EXAMPLE

An exempt organization, whose purpose is to provide food and shelter to homeless individuals as a significant part of its charitable and religious purposes under §501(c)(3),¹⁴ seeks to better serve these individuals. To accomplish this objective, the exempt organization plans to operate a farm. The farm will be used to grow produce and raise livestock for use exclusively as provisions for the homeless shelter. However, the exempt organization, by itself, does not have sufficient capital resources to purchase the farm. Therefore, the exempt organization forms a limited liability company in which it will serve as the managing member. The other members will provide the necessary capital for the venture, and the exempt organization will operate the farm.

This illustration exemplifies the creative strategies utilized by exempt organizations that seek to expand and diversify their activities while furthering their exempt purposes.¹⁵

Exempt organizations are also becoming more entrepreneurial as government funding for the nonprofit sector has decreased and rate

¹² *Harlan E. Moore*, 812 F. Supp. at 132 (citations omitted), *aff'd*, 9 F.3d 623 (Nov. 3, 1993), *acq. in action on decision*, 95-3953 (April 14, 1995) (Issues 1 and 2).

¹³ A joint venture vehicle that is rapidly becoming the entity of choice is the limited liability company, which offers many of the benefits of a partnership while providing limited liability to all of its members. In fact, the most important ruling in the joint venture area, Rev. Rul. 98-15, 1998-1 C.B. 718, involved two limited liability companies as the joint venture vehicle. For an in-depth discussion of limited liability companies, *see* Chapter 6.

¹⁴ §501(c)(3); Reg. §1.501(c)(3)-1.

¹⁵ *See generally* PLR 9308034 (Nov. 30, 1992).

1.2 JOINT VENTURES IN GENERAL

reductions have made it more difficult to attract contributions from the general public.¹⁶

EXAMPLE

X, an exempt organization under §501(c)(3), whose fundamental purpose is to expand access to scientific, educational, and literary information, engages in a joint venture with Z, another exempt organization under §501(c)(3), to produce an electronic journal. The electronic journal is intended to complement the traditional print publications and to facilitate rapid delivery of information. The exempt organization also enters into agreements with libraries to allow access to its database. This activity is seen as furthering the exempt organization's charitable purposes. Furthermore, the fact that the information is furnished to both exempt and nonexempt libraries does not detract from the educational value of the information and, hence, does not affect the charitable purpose.¹⁷

The IRS has recognized the entrepreneurial, elemental change in the way many exempt organizations operate, particularly in the hospital context:

[T]he joint venture arrangements... are just one variety of an increasingly common type of competitive behavior engaged in by hospitals in response to significant changes in their operating environment... [T]he marked shift in governmental policy from regulatory cost controls to competition has fundamentally changed the way all hospitals, for-profit and not, do business.¹⁸

Of course, while the IRS has recognized many ways in which an exempt organization may participate in joint venture with a for-profit industry and not jeopardize its tax-exempt status, the Service has also provided important and illustrative guidance where an exempt organization may either lose or severely compromise its exempt status in the areas of down payment assistance programs and healthcare joint ventures.

¹⁶ See, e.g., PLR 9249026 (Sept. 8, 1992).

¹⁷ The example is based on the factual situation presented in PLR 9249026 (Sept. 8, 1992); see also Rev. Rul. 81-29, 1981-1 C.B. 329 (computer network for libraries furthered exempt purpose even if offered to nonexempt libraries). Rev. Rul. 81-29 amplified Rev. Rul. 74-614, 1974-2 C.B. 164.

¹⁸ Gen. Couns. Mem. 39,862 (Nov. 21, 1991); see also Monica Langley, "Hospitals and Doctors Fight for Same Dollars in a Louisiana Town," *Wall Street Journal*, A1 (Nov. 25, 1997).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

In one Revenue Ruling,¹⁹ the IRS provided guidance to organizations that provide down payment assistance to homebuyers. The ruling was significant for establishing that down payment assistance programs that are not seller-funded can further exempt purpose by assisting low-income home buyers or by combating community deterioration. The ruling makes it clear, however, that organizations providing seller-funded down payment assistance will not qualify for exemption. This ruling is notable for all joint ventures, as it provides insight into what types of activities the Service will view as charitable when deciding if the nonprofit party to the venture is engaging in an exempt activity.

None of these criteria is essential in every case, but rather, an overall facts and circumstances analysis is used to determine qualification, including the use of §501(c)(3) requirements such as operating for the benefit of the public and avoiding individual private benefit, political campaign involvement, and excessive lobbying.

1.3 HEALTHCARE JOINT VENTURES

Nonprofit hospitals and other healthcare institutions are historically high-profile participants in joint ventures.²⁰ Rev. Rul. 98-15,²¹ which was released in March 1998 and remains to date the most significant ruling in the field, involved “whole hospital” joint ventures. In these ventures, both the charity and the private entity contribute one or more hospitals to an operating limited liability company. Often, because the charitable hospital is worth considerably more than the private hospital contributed by the for-profit entity, the for-profit will also contribute cash, which is distributed to the charity, to make up for the inequity in values. Thus, after the transaction, the charity has a membership interest in an LLC and a significant sum of cash. These arrangements can raise questions under the private inurement rules, the intermediate sanctions provisions, and Rev. Rul. 98-15, particularly if the operation of the hospital was the charity’s sole or primary charitable activity or lucrative “golden parachute” arrangements are offered to members of the hospital board.²²

¹⁹ Rev. Rul. 2006-27, 2006-21 I.R.B. (May 22, 2006).

²⁰ See Gen. Couns. Mem. 39,862 (Nov. 21, 1991) and Rev. Rul. 98-15, 1998-1 C.B. 718. For an in-depth analysis of joint ventures involving the healthcare industry, see Chapter 11. For a decision involving the formation of an LLC, see PLR 9517029 (Jan. 27, 1995) (joint venture through an LLC by two hospitals approved by IRS).

²¹ See *id.*

²² Whole hospital joint ventures and other healthcare developments are discussed extensively in Chapter 12.

1.3 HEALTHCARE JOINT VENTURES

This trend toward joint ventures is due in great part to the 1983 shift in Medicare reimbursements from a cost-based to a fixed, per case system, a shift subsequently made by many private insurance companies. These Medicare changes radically altered the financial incentives of hospitals, in that higher reimbursement revenues were no longer linked to extended hospital stays but to increased numbers of patient admissions and outpatient services. During the same time period, the healthcare industry shifted toward “managed care.” Thus, the end of the century saw an expansion of activity in the healthcare area, coinciding with rapid changes in the economic and regulatory environment, including reduced federal funding, increased competition, deregulation, and cost containment efforts by employers and private insurers.²³ To survive in such an environment, exempt healthcare organizations have been compelled to test the legal limits and to “venture” into broader, more businesslike activities.²⁴

There are multiple reasons for healthcare organizations to engage in joint ventures and other sophisticated financial arrangements with physicians or other entities. The most frequently stated reasons include the need to raise capital; to grant physicians a stake in a new enterprise or service, thereby gaining physician loyalty and patient referrals; to bring a new service or medical facility to a needy area; to share the risk that is inherent in a new enterprise; to pool diverse areas of medical expertise; to attract new patient admissions and referrals; to persuade physicians not to refer patients elsewhere; and to ensure that physicians do not establish a competing healthcare provider.²⁵ To further these ends, hospitals, clinics, and other healthcare entities have begun to form more complex business structures. This book discusses these structures, the evolving rules governing their activities, and the potential effects of these changes on the tax-exempt status of the involved entities.²⁶

The issue of whether a nonprofit retains “control” in a joint venture is a major issue in regard to joint ventures in general and healthcare

²³ See Gen. Couns. Mem. 39,862 (Nov. 21, 1991). The IRS notes that “the marked shift in governmental policy from regulatory cost controls to competition has fundamentally changed the way all hospitals, for-profit or not, do business.” See also PLR 9308034 (Nov. 30, 1992); PLR 9221054 (May 22, 1992).

²⁴ See generally Gen. Couns. Mem. 39,862 (Nov. 21, 1991).

²⁵ Gen. Couns. Mem. 39,862 (Nov. 21, 1991). These reasons have all been offered to the IRS by healthcare organizations that are seeking IRS approval for joint venture arrangements. See generally, “Hermann Hospital Closing Agreement,” *Exempt Organization Tax Review* 10 (Nov. 1994), 1035–1041; proposed physician recruitment guidelines, Ann. 95-25, 1995-14 I.R.B. 11 (discussed in Section 12.4); final physician recruitment guidelines, Rev. Rul. 97-21, 1997-1 C.B. 121 (discussed in Section 12.4).

²⁶ See Chapter 12.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

joint ventures specifically. The IRS's lead guidance on the issue of whole hospital joint ventures, Rev. Rul. 98-15,²⁷ and its guidance on ancillary joint ventures, Rev. Rul. 2004-51, set forth the factors that will be examined when determining if a venture jeopardizes an organization's exemption or will generate UBIT (unrelated business income tax). Ultimately, these are facts and circumstances determinations, providing opportunity for careful planning.

The Patient Protection and Affordable Care Act of 2010 (PPACA) contained several provisions applicable to charitable hospitals. Because of the criticism that nonprofit hospitals were operating no differently than for-profit hospitals, Congress enacted Internal Revenue Code §501(r) (and related provisions), which impose new, additional requirements that nonprofit hospitals must satisfy in order to remain tax exempt under §501(c)(3) and/or avoid imposition of substantial monetary fines. At the heart of these provisions are metrics for evaluating whether a hospital is meeting the "community benefit" standard. As discussed in Chapter 12, these new statutory provisions and related IRS guidance present complex issues, especially as they relate to nonprofits operating more than one charitable hospital as well as those operating hospitals through joint ventures.

In addition, the PPACA created two new joint venture vehicles in the healthcare field, Accountable Care Organizations and Consumer Operated and Oriented Plans (CO-OPs), both of which are discussed in Chapter 12. The enactment of §501(r) may be the first step toward the creation of new categories of §501(c)(3) organizations—not based on income sources as are the categories of private foundations and public charities, but based on the position that they are not spending enough of their resources on charitable activities, which is consistent with the first prong of the IRS's joint venture analysis.

1.4 UNIVERSITY JOINT VENTURES

Like hospitals, universities are natural participants in joint ventures.²⁸ Educational missions are often effectively advanced through association with major corporations and/or with individual members of a university's faculty. In turn, the nonexempt venturer has much to gain through access to the university's vast resources.

²⁷ Rev. Rul. 98-15, 1998-12 I.R.B. 6.

²⁸ *Internal Revenue Manual, Exempt Organizations Examination Guidelines Handbook (7)(10)69*, "Colleges and Universities" (Aug. 1994). There are currently 21 colleges and universities under CEP audit.

1.4 UNIVERSITY JOINT VENTURES

A threshold issue confronting university joint ventures is the IRS's position, originally developed in the hospital context, that a nonprofit serving as general partner could jeopardize its §501(c)(3) exemption if the venture conducts an "unrelated" commercial activity and the venture constitutes all or substantially all of the assets and/or activities of the nonprofit. In the university context, however, it is unlikely that the assets contributed to a joint venture would be material relative to the university's total resources. Thus, where a joint venture does not further a university's exempt purpose, the issue of UBIT will arise under the rubric of Rev. Rul. 98-15.²⁹

In perhaps the most significant development in the field, the IRS issued Rev. Rul. 2004-51,³⁰ which analyzed an ancillary joint venture between a §501(c)(3) university and a for-profit entity to offer teleconference courses. The ruling, which is discussed at length in Chapters 4 and 14, is significant for its discussion of bifurcated control by the exempt entity in an ancillary-type venture.

Universities are "pioneering," by forming ventures with for-profit companies to provide distance-learning opportunities over the Internet. Rather than watch their professors and students depart to experiment with distance learning elsewhere, many universities have entered into ventures in hopes of keeping control and participating in the anticipated rewards. The year 2012 witnessed the growth of Massive Open Online Courses (MOOCs). Unlike traditional classroom experiences, MOOCs are available online to millions of people who chose to participate. They are currently tuition free, but do not offer credit as commonly offered to a student who completes the requirements of a traditional classroom course. While they appear to be expanding in terms of availability, there are currently more questions than answers about them. Two of the major ventures are for-profit, so that key personnel can be rewarded with stock options and other forms of equity ownership. It remains to be seen, however, if the for-profit structure will pose disadvantages in the long run.

Almost all large colleges and universities conduct supported or sponsored research, funded by private firms or the federal government. Often, these research activities are structured as a joint venture between the university and the sponsor, and the relatedness of research to the university's scientific or educational purposes is a common theme regardless of whether the taxpayer is a university, whether the relationship is structured as a partnership, or whether the issue involves the basic exemption or unrelated business income tax (UBIT). Therefore, regulations, cases, and

²⁹ See Section 4.7 and Chapter 14.

³⁰ Rev. Rul. 2004-51, 2004-22 IRB 974.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

rulings on the exempt status of separate research organizations, and UBIT for universities, are relevant.

The IRS concerns here are, in theory, similar to those in regard to any other joint venture arrangement involving an exempt organization: The venture must be related to the university's charitable purpose, whether scientific or educational; the venture must allow the university to further exclusively its charitable purposes; the venture arrangement must provide adequate protection for the university's exempt assets; and the venture must comply with the prohibitions against private inurement and private benefit.³¹

Another area of university joint ventures that has received attention in recent years is university-sponsored educational travel tours.³² Generally, such tours involve a joint venture between a university and a travel agency whereby the university provides the students, professors, itinerary, and educational curriculum, and the travel agency books and arranges the trip, while making a tax-deductible contribution to the university. Profits are sometimes shared with the university, either directly or in the form of free travel for the university professors.

Travel tours present a potential UBIT problem for universities unless they are substantially related to such universities' educational purpose. The IRS has often found the requisite educational content lacking in travel tour arrangements³³ and has both officially³⁴ and unofficially³⁵ identified the travel tour area as a major focus of upcoming IRS audits of colleges and universities. In April 1998, the IRS issued proposed regulations on travel tours,³⁶ which were subsequently finalized in 2000.³⁷ The proposed regulations provide illustrations of tours that satisfy the educational requirements and those that do not. The final regulations for travel tour arrangements were published in February 2000. They are similar to the proposed regulations, with three additional examples to illustrate educational content and relation to the educational purpose of the university.³⁸ To satisfy the

³¹ See generally Chapters 4, 5, and 14.

³² University-sponsored travel tours are discussed in detail in Chapter 14.

³³ See, e.g., Rev. Rul. 78-43, 1978-1 C.B. 164; TAM 9027003 (Mar. 21, 1990).

³⁴ *Internal Revenue Manual, Exempt Organizations Examination Guidelines Handbook (7)(10)69, "Colleges and Universities"* (Aug. 1994), §42(14)(2)(e).

³⁵ See Fred Stokeld, "Owens Briefs EO Reps on Guidance, Other Developments," *97 Tax Notes Today* (Sept. 26, 1997): 187-3.

³⁶ Reg. §1.513-7. See Section 8.5(e).

³⁷ Fred Stokeld, "Keep Records of Travel Tours, Owens Advises," *Exempt Organization Tax Review* (April 1999): 21.

³⁸ See Section 8.5(e).

1.5 LOW-INCOME HOUSING AND NEW MARKET TAX CREDIT JOINT VENTURES

guidelines of the regulations, it is crucial that organizations institute a record-keeping system at the initial planning stage so that they can establish on audit that their tours have an educational purpose and therefore do not generate UBIT.³⁹

The IRS is also examining incentive compensation paid by universities.⁴⁰ The IRS sent a questionnaire to 300 colleges and universities in 2008. As discussed in Chapter 14, the IRS has issued an Interim Report⁴¹ and is continuing to conduct audits and assess information reported on revised Form 990.

1.5 LOW-INCOME HOUSING AND NEW MARKET TAX CREDIT JOINT VENTURES

Tax-exempt organizations that desire to develop a low-income housing project typically need to obtain an allocation of low-income housing tax credits (LIHTC) for the project. Most of the low-income housing developed by tax-exempt organizations is financed, at least in part, with LIHTC.⁴² Because nonprofits are tax-exempt entities and do not usually owe tax, the LIHTC is of little use to them. However, the nonprofit can “sell” the credits to a for-profit investor, which can use the credits to offset its tax liability. This is done by syndicating the project, that is, by selling an ownership interest in the project to the investor.

Because widely held C corporations are not subject to either the passive loss or the at-risk rules, these corporations are the most likely investors in tax credit projects. Corporations invest in tax credit projects either directly or through syndicated equity funds. These funds, which are sponsored by such national organizations as the Enterprise Foundation and Local

³⁹ *See id.*

⁴⁰ Carolyn Wright and Fred Stokeld, “Reconstructed EO Function Means More Help for Exempts, Owens Says,” *Exempt Organization Tax Review* (April, 1999): 21.

⁴¹ “IRS Exempt Organizations Colleges and Universities Compliance Project—Executive Summary of Interim Report (May 2010),” available at www.irs.gov.

⁴² The provision of low-income housing offers an excellent opportunity for exempt organizations to provide an invaluable social service in conjunction with taxable entities. This arrangement works well for partnerships that apply for the low-income housing tax credit provided in §42. Generally, §42 provides a tax credit annually for a period of 10 years based on the construction or rehabilitation cost of the project and the portion occupied by low-income tenants. For a detailed discussion of joint ventures involving low-income housing opportunities, *see* Chapter 13; *see also* PLR 9240011 (July 1, 1992) (§42 tax credits allocated to an exempt organization and one of its subsidiaries); PLR 9148047 (Sept. 5, 1991); PLR 9349032 (July 29, 1993). *See* Section 4.2(d) and Section 13.12 for a discussion of the final low-income housing safe harbor guidelines.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

Initiatives Support Corporation, have been organized to assist corporations to invest in projects that qualify for LIHTC.

Corporate equity funds are structured as limited partnerships or LLCs in which the sponsor or its affiliate is the general partner or managing member and the corporate investors are the limited partners or nonmanaging members. The funds may invest in local entities that own projects eligible for LIHTC. These local partnerships (which acquire, construct, own, and manage the low-income housing projects) are commonly referred to as operating or project partnerships/LLCs.

Operating entities generally consist of a local tax-exempt organization or its wholly owned for-profit subsidiary, which serves as general partner/manager or as a manager of an LLC, and an equity fund (or a single corporate investor), which is admitted as a partner or member. The equity fund or other investor generally receives a 99 percent or more interest in entities profits, losses, deductions, and credits (including LIHTC) in return for its capital contribution. The tax-exempt or wholly owned for-profit subsidiary typically retains a 1 percent or less interest.

In most cases, additional financing is necessary; it consists of a first mortgage loan and one or more "soft" mortgage loans that are subordinate to the first mortgage loan. The first mortgage loan is generally provided by a commercial lender or by a state or local agency. The soft mortgage loans are provided by state or local agencies or by one of the federal housing programs, such as the Community Development Block Grant Program, HOME Investment Partnerships Program, Hope VI Public Housing Revitalization Program, or the Federal Home Loan Bank's Affordable Housing Program.

Changes in federal law emphasize the significant role of exempt organizations as social providers.⁴³ Although hospitals, universities, and low-income housing organizations are well-known participants in joint ventures, new types of nonprofit organizations have been created in response to economic and societal needs. Nonprofit entities of recent creation include local economic development corporations (LEDC) and community development corporations (CDCs).⁴⁴ These organizations

⁴³ See generally Small Business Investment Act, 15 U.S.C. §681(d); Hearings Before the Subcommittee on Housing and Urban Affairs of the Committee on Banking, Housing, and Urban Affairs, United States Senate, 102d Cong., 2d Sess. (Mar. 25, 1992) (hearings held to explore the origins of distressed public housing and ways to end its destruction and impact on families, communities, and potential for affordable housing agenda).

⁴⁴ See M. Cerny, "Tax-Exempt Organizations and Economic Development," Exempt Organizations Panel, ABA Section on Taxation (Feb. 7, 1993). See also Rev. Rul. 74-587, 1974-2 C.B. 162; Rev. Rul. 76-419, 1976-2 C.B. 146 (nonprofit formed to assist in community development).

1.5 LOW-INCOME HOUSING AND NEW MARKET TAX CREDIT JOINT VENTURES

exemplify the partnership between the government, nonprofits, and private enterprise necessary to combat societal ills. Two other types of organizations that may qualify for exempt status under §501(c)(3) are the small business investment company (SBIC) and the minority enterprise small business investment company (MESBIC).⁴⁵

New federal programs may further accelerate the growth and activity of such ventures. The Bush administration established an Office of Faith-Based and Community Initiatives to strengthen religious and community groups engaged in social welfare projects. The Community Renewal Tax Relief Act of 2000 authorized expansions of housing and community development programs based on tax credits and tax-exempt bonds. The bill extended the provisions of the Empowerment Zone program; created a new Renewal Communities program that grants a collection of tax incentives to employers and developers in poor urban and rural areas; and increased the amount of low-income housing tax credits. The New Markets Tax credit, also a part of the bill, was designed to encourage investment in businesses located in low-income communities.⁴⁶

In addition to the LIHTC, the New Market Tax Credit (NMTC), created by the Community Renewal Tax Relief Act of 2000, provides incentive for for-profit organizations to partner with exempt organizations to invest in communities that traditionally have had poor access to economic resources. The NMTC provides tax credits to for-profit equity investors in Community Development Entities (CDE). These investments, which are made to CDEs, allow the CDE organization to use the funds to finance economic development in eligible low-income areas. An exempt entity may serve (through a for-profit subsidiary) as a CDE, or be a leveraged lender in a project, or as a Qualified Active Low-Income Community Business (QALICB).

Under the NMTC, the CDE applies for and receives a NMTC allocation from the Treasury Department under a highly competitive application process. Upon receiving an allocation, the CDE then markets the Credit for-profit entities. These investors then make an equity investment in the CDE in return for the NMTC, which totals 39 percent phased in over seven years. With the proceeds from the NMTC, the CDE then makes loans or investments in business and community development projects in low-income communities.

Since the NMTC program's inception, the CDFI Fund has made 664 awards allocating a total of \$33 billion in tax credit authority to CDEs through a competitive application process. This \$33 billion includes \$3 billion in Recovery Act Awards and \$1 billion of special allocation

⁴⁵ Small Business Investment Act, 15 U.S.C. §681(d). *See also* Rev. Rul. 81-284, 1981-2 C.B. 130; Gen. Couns. Mem. 38,841 (Apr. 22, 1981); Gen. Couns. Mem. 38,497 (Sept. 18, 1980).

⁴⁶ *See* Chapter 13, *supra*, for new developments in this area.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

authority to be used for the recovery and redevelopment of the Gulf Opportunity Zone. Under the recently passed American Taxpayer Relief Act, the program has been extended through 2013.

The impact of these joint ventures, NMTC partnerships between exempt CDEs and for-profit investors, has expanded economic investment and revitalization in historically impoverished communities. In addition to rejuvenating notoriously poor areas, the NMTC has proven an effective means to respond to areas ravaged by natural disasters.

In addition, exigent natural disasters have increased the availability of special funding set-asides aimed at low-income housing and New Market Tax Credit ventures. The Gulf Opportunity Zone Act of 2005, signed into law by President Bush on December 21, 2005, contains \$1 billion in economic incentives to rebuild the Gulf Coast, as well as to attract new investments to the affected areas. Modeled after the New York Liberty Zone incentives created for parts of lower Manhattan after the September 11 tragedy, these incentives are intended to stimulate rapid growth. Private investment within the Gulf Opportunity Zone (GO Zone) within the window of time provided.

Finally, the chapter discusses the Federal and State Historic Investment Tax Credit along with an analysis of the recent Third Circuit decision in the *Historic Boardwalk* case.

1.6 CONSERVATION JOINT VENTURES

Environmental concerns such as the greenhouse effect, global warming, deforestation, and commercial overdevelopment have resulted in an increase in the numbers of nonprofit organizations organized and operated to promote conservation and energy awareness. Relying on IRS pronouncements dating back to the 1960s and 1970s, many of these organizations have obtained federal income tax exemption on the basis that such conservation or preservation activities are charitable, educational, or scientific. However, while the environmental concerns prompting the creation of these charities have not, on the whole, improved, funding for these entities has decreased, particularly in light of terrorist attacks and natural disasters.

Despite funding challenges, however, conservation organizations are among some of the largest and most prominent charities in the country. In coping with the need for funding, however, some of these charities have turned to unique joint venture paradigms with for-profit partners, such as the setting up of conservation easements over forestlands that have come under IRS and Congressional scrutiny. Areas currently under scrutiny include in-kind property fundraising strategies, joint ventures, and similar arrangements with for-profit landowners and others,

1.7 JOINT VENTURES AS ACCOMODATING PARTIES TO IMPERMISSIBLE TAX SHELTERS

and ongoing monitoring and enforcement of conservation easements and similar restrictions to assure that the restricted property remains perpetually dedicated to its conservation purpose.

Notwithstanding the scrutiny of certain program strategies, conservation organizations, including those determined to be exempt under §501(c)(3) and (c)(4), as well as state and local government agencies, increasingly must rely on joint ventures and similar arrangements to raise needed financial capital and obtain private market technical and transactional expertise to further exempt purposes.

Chapter 16 is dedicated to these unique joint venture arrangements, and pays particular attention to the Senate Finance Committee's investigation of several joint ventures entered into by The Nature Conservancy, one of the most prominent conservation groups operating in the United States. The chapter also offers an overview of the various venture structures and reporting guidelines for these unique partnerships as well as the IRS focus on valuation of property contributed for conservation purposes.

1.7 JOINT VENTURES AS ACCOMODATING PARTIES TO IMPERMISSIBLE TAX SHELTERS

While a concerted focus on tax-exempt organizations as a whole has been one of the IRS's top service-wide priorities for several years, recently the Service has focused its examination on parties using nonprofits to assist in tax-avoidance or tax shelter transactions.

In Notice 2004-30,⁴⁷ the IRS examined the use of tax-exempt organizations by S corporations that structured joint venture transactions to improperly shift taxation away from themselves to a nonprofit party for the purpose of deferring or altogether avoiding taxes. This Notice was a significant first step in the IRS's focus on nonprofits' roles in tax avoidance transactions, as it specifically designated a nonprofit entity as a participant in an abusive tax-avoidance, or "listed," transaction.

The Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA) added another dimension to the issue of the use of tax-exempt entities in prohibited transactions. Before TIPRA, tax-exempt organizations could engage in prohibited transactions without any penalty to the organization. Now, tax-exempt entities and their managers must comport with a stringent set of reporting rules provided by TIPRA and if they do not, both the organization and its manager may be subject to penalty taxes. The final regulations under §4965 that clarify what qualifies as a "prohibited tax shelter

⁴⁷ IR-2004-30 (April 1, 2004).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

transaction” and the definition of an “entity manger” were published in 2010. A chapter of this book has been devoted to these latest developments.

1.8 REV. RUL. 98-15 AND JOINT VENTURE STRUCTURE

There are numerous structural techniques that an exempt organization may utilize in expanding its activities. A joint venture arrangement can be formed with taxable or exempt entities. Historically, when it was prudent or necessary to create a new entity for a venture, a limited partnership was the first choice; when the project furthered an organization’s exempt purposes, the organization could serve as a general partner, with operational responsibilities for the project.⁴⁸ Now that all 50 states (and the District of Columbia) have adopted limited liability company (LLC) statutes,⁴⁹ the LLC has become the entity of choice because it combines the corporate advantage of limited liability with the pass-through tax treatment of partnerships.⁵⁰ The important ruling in the area of joint ventures, Rev. Rul. 98-15,⁵¹ involved two scenarios of hospital joint ventures between for-profit and nonprofit entities; both used an LLC as the venture entity.

In Rev. Rul. 98-15, the IRS employs criteria similar to the double-pronged test of *Plumstead*⁵² to analyze whether joint ventures would jeopardize the exempt organization’s tax-exempt status. The IRS will closely scrutinize the structure of an LLC joint venture arrangement to determine whether the exempt organization’s duty to operate exclusively for exempt purposes conflicts with any duties it may have to advance the private interests of the LLC’s for-profit members.⁵³ To determine whether the exempt organization’s assets benefit the LLC’s for-profit members,

⁴⁸ See *Plumstead Theatre Society v. Commissioner*, 675 F.2d 244 (9th Cir. 1982) (per curiam), *aff’g* 74 T.C. 1324 (1980). See also Rev. Rul. 68-655, 1968-2 C.B. 213 (development of low-and moderate-income housing as a means of lessening neighborhood tensions and combating neighborhood deterioration is a charitable purpose); Gen. Couns. Mem. 39,005 (Dec. 17, 1982); PLR 9148047 (Sept. 5, 1991). *But cf.* Gen. Couns. Mem. 36,293 (May 30, 1975) (IRS prior position effectively overruled by later rulings).

⁴⁹ See Section 3.4(a).

⁵⁰ See Section 3.4(a).

⁵¹ Rev. Rul. 98-15, 1998-12 I.R.B. 6. See also “Whole Hospital Joint Ventures,” *Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 1999* (hereinafter “1999 CPE”), and Statement of IRS Exempt Organizations Division director Marcus Owens, “Exempt Organizations Get Plenty to Chew On in L.A.,” *Tax Notes* at 829 (Nov. 16, 1998). For details on how the two-pronged test applies to LLC joint ventures, see Section 4.2 and Chapter 6.

⁵² See Section 4.2.

⁵³ See Gen. Couns. Mem. 39,005 (June 28, 1983).

1.8 REV. RUL. 98-15 AND JOINT VENTURE STRUCTURE

the IRS will carefully examine any guarantees, capital call provisions, the management and control of the LLC, and, for private foundations, excess business holding issues.⁵⁴

Alternatively, because the IRS has established strict requirements for charitable organizations that serve as general partner or managing member of an LLC,⁵⁵ the exempt organization may instead form a subsidiary or affiliate to serve in the aforementioned roles.⁵⁶ In other cases, particularly when a venture does not further the organization's exempt purposes, it may serve as limited partner or non-managing member.⁵⁷ Finally, the exempt organization's role may be limited to that of a lender or lessor, with or without some participation in the profits of the venture.⁵⁸

The IRS guidelines for determining whether a tax-exempt organization jeopardizes its exempt status by participating in a joint venture are contained in Rev. Rul. 98-15.⁵⁹ The IRS acknowledges that an exempt organization's participation in a joint venture does not necessitate a per se denial of tax-exempt status.⁶⁰ However, the IRS has stated that any partnership or other joint venture arrangement between a §501(c)(3) organization and one or more for-profit entities requires "close scrutiny" to determine whether the potential conflict between the exempt organization's duty to operate exclusively for exempt purposes and any duty it

⁵⁴ Remarks of Marcus Owens, Meeting of the ABA Tax Section (Aug. 5, 1995).

⁵⁵ Gen. Couns. Mem. 39,862 (Nov. 21, 1991); Gen. Couns. Mem. 39,005 (Dec. 17, 1982). See Section 4.2.

⁵⁶ See generally *California Thoroughbred Breeders Ass'n v. Commissioner*, 57 T.C.M. (CCH) 962 (1989). A tax-exempt organization, pursuant to §501(c)(5), replaced its joint venture horse auction operation with a for-profit subsidiary. The change in structure from a joint venture arrangement to a taxable subsidiary was made because the exempt organization was "at a crossroads" with the joint venturer, and the taxable subsidiary was the best alternative available. Previously, the tax-exempt organization, whose exempt purpose was to "encourage, assist, regulate, and protect the raising and breeding of thoroughbred horses," had entered into a joint venture with a for-profit auction company. The Tax Court held that the joint venture auction activities were "substantially related" to the tax-exempt purpose. See also Gen. Couns. Mem. 39,598 (Jan. 23, 1987); Gen. Couns. Mem. 39,646 (June 30, 1987).

⁵⁷ See PLR 9207033 (Nov. 20, 1991). As a limited partner, the exempt organization may be subject to the unrelated business income tax on income from the partnership's business activity that is unrelated to the exempt organization's exempt purposes. See generally §§511-513.

⁵⁸ See PLR 9112013 (Mar. 22, 1991).

⁵⁹ The Ninth Circuit Court of Appeals confirmed the position of the IRS in *Redlands Surgical Serv. v. Commissioner*, 242 F.3d 904 (9th Cir.), (Mar. 15, 2001). See Section 4.2(f).

⁶⁰ See, e.g., PLR 9709014 (Nov. 26, 1996) (IRS stated that exempt hospital's partnership arrangement with for-profit partners does not "per se" endanger its exempt status).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

may have to advance private interests, places the organization's exempt status in question. Thus, the initial focus is on whether the organization is serving a charitable purpose. Once charity has been established, the venture arrangement itself is examined to determine whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption was granted, and not for the benefit of the for-profit parties to the venture.⁶¹

Charitable is defined in the regulations in its generally accepted legal sense.⁶² Whenever a charitable organization engages in unusual financial transactions with private parties, the arrangements must be evaluated in light of the tax law and other applicable legal standards.⁶³

Notwithstanding an established charitable purpose, conflicts with an organization's charitable goals can arise when an exempt organization participates in a joint venture, because the organizational documents could impose certain obligations upon the joint venture entity that would benefit the for-profit participants to the detriment of the nonprofit.⁶⁴ Those obligations include an assumption of liabilities by the general partner or managing member, which exposes the general partner's or managing member's personal assets to partnership debts and liabilities, as well as a basic profit orientation in furtherance of the interests of the investors.⁶⁵ Thus, it is important that the venture be structured so as to give the exempt organization effective control over daily activities. Day-to-day control demonstrates to the IRS that the exempt organization can ensure that the joint venture is serving a charitable purpose; lack of control suggests the possibility of private benefit.⁶⁶ With respect to an LLC, this

⁶¹ Gen. Couns. Mem. 39,005 (Dec. 17, 1982); *see also* PLR 9349032 (July 29, 1993). There is a debate as to the applicability of Rev. Rul. 98-15 in regard to ancillary joint ventures, that is, those ventures where a nonprofit contributes only a portion of its assets. For a detailed discussion of the exempt organization as a general partner, or member of an LLC, *see* Chapters 4 and 6.

⁶² Gen. Couns. Mem. 39,005 (Dec. 17, 1982); Gen. Couns. Mem. 39,862 (Nov. 21, 1991).

⁶³ Reg. §1.501(c)(3)-1(d)(2); §501(c)(3).

⁶⁴ *See* Uniform Limited Partnership Act, §9 (approved by the National Conference of Commissioners on Uniform State Laws in 1916); Revised Uniform Limited Partnership Act, §403 (approved by the National Conference of Commissioners in 1976); *See generally* *Mery v. Universal Sav. Ass'n*, 737 F. Supp. 1000 (S.D. Tex. 1990) (general partner jointly and severally liable for partnership acts); *Betz v. Chena Hot Springs Group*, 657 P.2d 831 (Alaska 1982) (general partner personally liable on debts even after retirement from partnership).

⁶⁵ Gen. Couns. Mem. 39,005 (Dec. 17, 1982). *See also* Uniform Limited Partnership Act, note 54; *see also* Revised Uniform Limited Partnership Act, note 54.

⁶⁶ *See* 1996 CPE Housing Article, Part II, Topic B, Part II.6.

1.8 REV. RUL. 98-15 AND JOINT VENTURE STRUCTURE

means that except in rare circumstances,⁶⁷ the charitable organization should always be a managing member, although not necessarily the only managing member.

An example of how a joint venture may be structured to preclude a conflict of interests between the tax-exempt organization's obligations and its charitable purposes⁶⁸ can be found in a general counsel memorandum involving a government-financed housing project for disabled and elderly persons. The venture averted significant conflict for the following four reasons:⁶⁹

1. Only the for-profit general partners were obligated to protect the interests of the limited partners.
2. Other general partners reduced the exempt organization's risk of exposure of its charitable assets.
3. The exempt organization had no liability on the mortgage, which was nonrecourse.
4. Housing and Urban Development (HUD) income guidelines restricted the partnership's pursuit of private profit.⁷⁰

The IRS has also applied Rev. Rul. 98-15 and its reasoning to ancillary ventures in healthcare and other fields. Six private letter rulings describe appropriate structures in healthcare and nonhealthcare organizations. For example, a limited liability company (LLC) composed of a conservation organization and owners of forestland was approved to manage the timber rights of a number of small owners, primarily for improved

⁶⁷ In certain situations, however, it may be acceptable for the charity to be a non-managing member. For example, in the case of an exempt organization that brings retail franchises to the inner city through the provision of financial support to individual minority entrepreneurs, who have substantial experience in such development, the project will provide jobs to the poor and underprivileged and serve to encourage minority business development. Under the circumstances, it may be important for the minority entrepreneur to be the managing member. Under this fact pattern, the IRS is likely to allow the charity to participate in a non-managing role, because substantial charitable purposes are being furthered by the activities of the LLC and the success of the project is dependent on the charity acting as a passive investor. (Note that this fact pattern closely resembles a program-related investment, discussed in Section 6.5.) *See also* Section 4.3.

⁶⁸ *See* Reg. § 301-7701-2(d)(2) (structuring limited partnership agreement to shield general partner). However, if the general partner is completely shielded from liability, the entity may be viewed as something other than a partnership. Gen. Couns. Mem. 39,546 (Aug. 15, 1986).

⁶⁹ Gen. Couns. Mem. 39,005 (Dec. 17, 1982).

⁷⁰ *See Id.*

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

conservation of the forest environment and secondarily for income. The exempt conservation organization was to be the managing member in what could be termed an ancillary joint venture.⁷¹ In another private letter ruling, the IRS explicitly relied on Rev. Rul. 98-15 to approve an ancillary joint venture between two exempt healthcare organizations.⁷²

Joint venture arrangements between for-profit and exempt organizations can be structured within the framework set up by Rev. Rul. 98-15. This book examines the viability of and consequences to exempt organizations participating directly and indirectly in joint ventures with taxable and exempt entities. In particular, it reviews how participation in a joint venture, by itself or through a subsidiary, may affect an organization's exempt status.⁷³ Advice on how to retain sufficient control and protection of the charitable partner's purpose and assets is contained in Section 4.2(h).

1.9 FORM 990 AND GOOD GOVERNANCE

To create transparency and facilitate oversight of the nonprofit sector, the IRS released revised Form 990 in 2008. Because the form now seeks significantly more information on many topics, nonprofit organizations must devote additional resources to it in terms of both finances and manpower. For example, in recognition of the level of joint venture activities now engaged in by nonprofit organizations, Form 990 requests a considerable amount of information about them. It also asks nonprofit organizations to focus on what it calls "good governance." Former TE/GE Commissioner, Sarah Hall Ingram, has explained that, in her opinion, while principles of good governance are not expressly contained in the Internal Revenue Code, they actually derive from the fundamental requirements for tax exemption. To facilitate compliance, the IRS has released a Guide Sheet concerning good governance issues for its revenue agents to use when conducting audits. There are questions about governing documents, corporate policies and governing practices such as whether an organization's board actually met the number of times required by its governing documents.⁷⁴ In addition, Form 990, Part VI, Section B, line 16 asks whether an organization has adopted procedures and policies regarding participation in a joint venture

⁷¹ PLR 200041038 (July 20, 2000). *See* Section 4.2(e).

⁷² PLR 200102053 (Oct. 2000). *See* Section 12.3(d).

⁷³ *See* Chapter 4 for a detailed discussion of the impact on its tax exemption of an exempt organization's participation in a partnership or joint venture.

⁷⁴ Governance Check Sheet available at http://www.irs.gov/pub/irs-tege/governance_check_sheet.pdf; www.irs.gov/pub/irs-tege/governance_practices.pdf



1.11 ENGAGING IN A JOINT VENTURE: THE STRUCTURAL CHOICES AND ROLE OF THE CHARITY

or similar arrangement with a taxable entity. In October 2011, House Ways and Means Oversight Subcommittee Chairman Charles Boustany sent the IRS a letter asking whether revised Form 990 has in fact aided transparency and the IRS's ability to monitor compliance with applicable laws.

1.10 ANCILLARY JOINT VENTURES: REV. RUL. 2004-51

In Rev. Rul 2004-51,⁷⁵ the IRS issued long-awaited guidance on the income tax consequences of the participation by tax-exempt entities in "ancillary" joint ventures with for-profit partners. The ruling involved a tax-exempt university that formed a limited liability company with a for-profit company to provide interactive video training courses. The university's primary purpose in forming the partnership was to grow its existing curriculum of teacher-training courses by offering them at off-site locations.

Under the facts, the ownership and the governing board of the partnership was equally divided between the for-profit and exempt parties; however, the operating documents granted the university an exclusive right to approve all of the aspects of the courses, including the curriculum and the hiring of the faculty. The for-profit corporation retained control of all administrative functions associated with holding the courses off-site, including the choice of venue and the types of equipment used. All other decisions required the mutual consent of both parties. In concluding that the activities entered into by the university were not a substantial part of its operations and therefore, not significant enough to jeopardize its tax-exempt status, the IRS appeared to condone the exempt organization's concession of control over *all* of the aspects of the partnership where the exempt party expressly retained control over the educational aspects of the venture. The ruling is discussed at great length later in this book.

1.11 ENGAGING IN A JOINT VENTURE: THE STRUCTURAL CHOICES AND ROLE OF THE CHARITY

Chapter 6 is a new chapter that explores the different paradigms that have evolved over the years to combine tax-exempts, government agencies, for-profit entities, and philanthropists who seek novel solutions to current crises. The trends are not limited to conventional partnerships and LLCs, but include the recent adoption of alternative structures such as the

⁷⁵ Rev. Rul. 2004-51, 2004-22 IRB 974.



INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

L3C (a low-profit limited liability entity formed to engage in socially beneficial activity), as well as social benefit or flexible purpose corporations. In addition, in 2012, the IRS released the first modifications in 30 years to the Treasury Regulations governing program-related investments by private foundations. The chapter describes the various approaches that can be taken by §501(c)(3) organizations to achieve their objectives, beginning with the traditional joint venture vehicle, the LLC.

Because an exempt organization's involvement as a general partner or managing member can often jeopardize its exempt status, it may prefer to invest in a limited partner capacity or in a nonmanaging member role. The exempt organization's role, in this instance, would be as a passive investor.⁷⁶

EXAMPLE

An exempt university becomes aware of the need for off-campus housing suitable for student living. To facilitate the construction of the housing, the institution forms a limited partnership with a local construction firm. The university will serve as a limited partner, contributing necessary monetary resources to capitalize the partnership. In return, the university receives a limited partner profits interest in the partnership. The construction firm serves as general partner with day-to-day responsibility for constructing and managing the housing. Under this arrangement, the university is acting solely as a passive investor in the housing project.

As a limited partner or nonmanaging member, the exempt organization and its assets would not be exposed to unlimited liability. Furthermore, the exempt organization would not have a statutory or fiduciary obligation to maximize the profits for the investors. However, there may be tax consequences for the exempt limited partner or member, depending on the type of activity, charitable or for-profit, engaged in by the partnership. If the activity furthers the charitable purposes of the exempt

⁷⁶ With the growing popularity of LLCs, the question as to whether an exempt organization may invest as a nonmanaging member has arisen on a frequent basis. Although, as a general rule, a charitable organization should be the managing member of the LLC in which it is involved, it is arguable that the nonmanaging member role can be analogized to that of a limited partner. Whether the analogy will be respected by the IRS will depend on the activity of the LLC, the reasons for the charity's nonmanaging role, the degree to which the charity participates in the operations of the LLC despite its "passive" position, and the apparent control it exercises through contractual or operational restrictions. See Section 4.3 for a more in-depth discussion of the exempt nonmanaging LLC member.

1.11 ENGAGING IN A JOINT VENTURE: THE STRUCTURAL CHOICES AND ROLE OF THE CHARITY

organization, the income received by the exempt limited partner would not constitute UBIT.⁷⁷

EXAMPLE

A limited partnership is comprised of 10 limited partners, all hospitals, exempt under §501(c)(3). X is one of the exempt limited partners. The general partner is a for-profit entity. The limited partnership was formed to provide unique mobile medical services to a rural community. Because these medical services are needed, unique, and otherwise unavailable, the partnership is viewed as furthering exempt charitable purposes, the same charitable purposes shared by X and the other limited partners. The participation by X as an exempt limited partner will not jeopardize X's tax-exempt status. Furthermore, the income received by X as a limited partner will not constitute UBIT, because the business activity of the limited partnership has a substantial causal relationship to the exempt purposes of X.⁷⁸

An exempt organization may also invest, but only to an “insubstantial” degree, in real estate and other commercial ventures that have no charitable purpose.⁷⁹ In that event, the exempt limited partner or member will be subject to UBIT on income derived from the activity.⁸⁰

EXAMPLE

If an exempt educational institution serves as a limited partner in a partnership that operates a factory, the exempt organization must include, in computing its unrelated business taxable income, its share of the items of income, deduction, gain, and credit from the operation of the factory.⁸¹

⁷⁷ PLR 9109066 (Mar. 1, 1991) (exempt organizations served as limited partners in limited partnership and the limited partnership was a general partner in a partnership that engaged in charitable activities, so the income was not UBIT); PLR 9207032 (Nov. 20, 1991). *See, e.g.*, Rev. Rul. 85-110, 1985-2 C.B. 166.

⁷⁸ This example is based on the factual situation presented in PLR 9109066 (Mar. 1, 1991). *See generally* §513; Reg. §1.513-1(d)(2). Since the adoption of §501(r) by Congress, a determination must also be made as to the applicability of §501(r) and related provisions.

⁷⁹ §513; Reg. §1.513-1.

⁸⁰ §511(a)(1); Reg. §1.511-1.

⁸¹ Reg. §1.512(c)-1.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

This tax is imposed at the applicable corporate or trust rates, depending on whether the exempt organization is classified as a corporation or a trust for tax purposes.⁸²

1.12 PARTNERSHIPS WITH OTHER EXEMPT ORGANIZATIONS

Partnerships composed wholly of exempt organizations must further the exempt purposes of the exempt partners in order for the income derived therefrom to be exempt from taxation.⁸³

EXAMPLE

X, an exempt educational institution, has a large, well-respected communications department on its campus. Y is a tax-exempt public broadcasting organization. X and Y seek to codevelop a national communications center, to be located on X's campus. This project will be formed using a joint venture partnership. The arrangement will entail the construction and sharing of facilities on X's campus. X will also hold a ground lease on the land on which the new facility is situated. Under these circumstances, because the partnership will further the exempt purposes of both exempt organizations, the income will not constitute UBIT to either X or Y.

In the example, the joint venture partnership must further the exempt purposes of both X and Y. If it is not clear that the joint venture arrangement furthers the exempt purposes of both exempt partners, then the partners should consider seeking separate tax-exempt status for the joint venture. In this situation, X and Y should seek a ruling from the IRS on the issue of whether the joint venture furthers the exempt purposes of both X and Y.

Clearly, the IRS is less concerned about joint ventures involving only exempt organizations because the risks of private benefit and inurement are not present. The IRS approved a venture between two charitable healthcare organizations that formed an LLC to jointly operate rehabilitation services. The operating agreement requires the LLC to operate in a manner consistent with the charitable purposes of the two members, and the LLC is equally controlled by the two members.⁸⁴ Another private letter

⁸² §511(a)(2)(A) (tax imposed on entities under §401(a) and §501(c)); and §511(b) (tax imposed on trusts). *See* Reg. §1.511-2.

⁸³ §512(c)(1); Reg. §1.512(c)-1. *See* Section 4.4.

⁸⁴ PLR 200102053 (Jan. 12, 2001). *See* Section 12.8.

1.13 TRANSFER OF CONTROL OF SUPPORTING ORGANIZATION

ruling approved a joint operating entity in the form of an LLC owned by two healthcare organizations. The operating agreement requires the organization to further the exempt purposes of its two members, and they are equally represented on the board. Approval of both members is required for all major decisions and transactions.⁸⁵

However, to the extent that an exempt organization is a partner in a partnership or a member of an LLC that regularly carries on a trade or business that would constitute an unrelated trade or business if directly carried on by the exempt organization, the organization must include its share of partnership income and deductions in determining its UBIT liability.⁸⁶

1.13 TRANSFER OF CONTROL OF SUPPORTING ORGANIZATION TO ANOTHER TAX-EXEMPT ORGANIZATION

It is often difficult to affect the transfer of control of properties used for charitable purposes because of the existence of tax-exempt financing. The transfer of “control” by the tax-exempt parent of its interest in a supporting nonmember corporation that is a general partner or managing member of a partnership to another §501(c)(3) organization presents a novel set of issues. In the context of a deferred sale, an issue arises as to how adequately to protect or secure the interest of the seller that holds a promissory note, because the mechanics do not involve the transfer of title to the property (which is otherwise typical). The transaction would be accomplished by a “change in control” of the board of the existing nonmember supporting corporation. The change of control is documented in the articles of incorporation and/or bylaws of the supporting organizations.

The IRS requires that when a tax-exempt organization amends either its articles of incorporation or its bylaws, it must notify the IRS of the change. The notification can be done at the time the organization files its annual information return (Form 990) for the year in which the change occurred, or the organization can seek an updated determination letter. By simply notifying the IRS at the time the Form 990 is filed, an organization has no protection going forward that the IRS has agreed that the change has no effect on the organization’s tax-exempt status. Therefore, the recommended course would be to request a ruling from the Exempt Organization Determinations Office that the change in the supported organization has

⁸⁵ PLR 200044040, 2000 WL 33122062 (Nov. 3, 2000). *See* Section 12.7(c).

⁸⁶ Reg. §1.512(c)-1.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

occurred but will not have any adverse effect on the tax-exempt status of the supporting organization.

Accordingly, a security interest must be created in the purchaser-debtor's entire right to elect members of the board of the nonmember corporation. The debtor would have to deliver a Uniform Commercial Code financing statement (Form UCC-1); documents would also have to be drafted effecting the substitution of the secured party for the debtor as a person with the power to vote for the election of the members of the board of directors of the nonmember corporation. In addition, an escrow agent would be designated to hold the aforementioned documents pending a default under the note. The documents must prohibit the purchaser-debtor from selling, transferring, or pledging the collateral without the prior consent of the secured party. Moreover, it is essential that the seller give notice to, and negotiate any necessary consents from, lenders, issuers, bond counsel, trustees, and, where applicable, credit rating agencies and bond insurers. Provisions must prohibit the purchaser-debtor from making distributions other than the repayment of the loan unless otherwise agreed to by the seller.

EXAMPLE

S, an exempt organization, develops multifamily housing for low-income persons in the inner city. It structures each project using a single-asset nonmember corporation as a supporting organization under §509(a)(3), thereby electing all its board members. Each supporting organization serves as a general partner in a joint venture with an equity fund or single corporate investor, which is admitted as a limited partner. T, another exempt organization, proposes to acquire the projects by a transfer of the control of the board of each of the existing nonmember supporting corporations. The acquisition price is represented by a promissory note, secured by the right to control the board in the event of default in the payment of the purchase price, all pursuant to a security agreement and the filing of a UCC-1. The security agreement will contain further limitations on T's right to make distributions or otherwise sell, transfer, or pledge the collateral without S's consent.

1.14 THE EXEMPT ORGANIZATION AS A LENDER OR GROUND LESSOR

Exempt organizations are often advised to participate in an activity by lending funds or becoming a ground lessor, rather than taking an equity ownership position in a joint venture. Alternative arrangements may so

1.14 THE EXEMPT ORGANIZATION AS A LENDER OR GROUND LESSOR

closely replicate the economic functions and goals of partnerships, yet provide advantageous tax treatment, that they are frequently referred to colloquially as “joint ventures.”

Precisely because exempt organizations often enter into loans and ground leases as alternatives to equity investments, lenders and ground lessors in such transactions often require a return beyond a flat rate of interest or rent. The yield may consist of two components: a fixed return in the form of interest or rent (but typically at a below-market rate), plus additional compensation, whether dubbed “interest” or “rent,” for the additional risk assumed by the lender or ground lessor.

The second component, commonly referred to as an “equity kicker,” is the major source of tax difficulty for exempt lenders and ground lessors, because as reflected in its name, this form of yield may cause the loan or lease to be viewed in substance as an equity investment—and thus subject to UBIT and the other tax disadvantages. Recharacterization of debt or a ground lease as an equity investment is more likely to occur if the interest or rent is based on net income or profits of the borrower or lessee, and less likely to occur if the interest or rent is based on gross revenue or receipts.

The advantages of a lender-borrower or ground lessee structure include the following:

- The return on a loan or a ground lease comes in the form of interest or rent, both of which are generally excluded from unrelated business taxable income under §512(b)(1) and (3).⁸⁷
- A loan transaction or ground lease may, for the exempt organization, secure the kind of preferred return which, under the tax-exempt leasing rules, is unavailable to an equity investor without loss of depreciation deductions for the taxable venturer and loss of exemption from the debt-financed income rules.⁸⁸
- A true lending transaction or ground lease cannot properly be termed a “joint venture” and thus would not be subject to the IRS position that the tax exemption of the participating exempt organization is jeopardized, unless the joint venture itself pursues a “related activity.”⁸⁹

⁸⁷ See Chapters 8 and 18.

⁸⁸ See *id.*

⁸⁹ See Chapters 4 and 18.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

However, against these advantages must be weighed certain advantages of equity ownership:

- If the exempt organization has UBIT derived from business activities, services, or debt-financed income, the depreciation deductions available to a property owner can be a valuable offset.

If the exempt organization invests in a venture through a corporate subsidiary that is partially capitalized with debt, or otherwise lends money directly or indirectly to a C corporation, the exempt organization must run the gamut of the “earnings stripping” rules of §163(j), resulting in possible loss of deductibility of the interest paid by the borrower corporation.

- If a debt or lease structuring is vulnerable to recharacterization as equity, it may be preferable for nontax reasons to structure the transaction ab initio as an equity investment. If loan or lease documentation is in place and there is then a recharacterization to equity the exempt organization could lose the security position it holds as lender through possessory rights of foreclosure or eviction, while having forgone the protections it would have enjoyed as a party to a partnership agreement.

Generally, a loan or ground lease arrangement is often more advantageous than a joint venture. This book explores these alternative structures and discusses certain guaranty devices, which are largely of financial rather than tax import.

Another way in which an exempt organization (typically a foundation) may act as a lender is through the use of program-related investments (PRIs). PRIs typically take the form of below-market loans to debtors that would likely have trouble securing traditional commercial financing, and are made in furtherance of the organization’s exempt purposes. This book discusses the statutory requirements for PRIs and the circumstances under which PRIs may be most effectively utilized.⁹⁰

1.15 PARTNERSHIP TAXATION

(a) Overview

Because the joint venture structure is typically used in arrangements between exempt organizations and for-profit partners, it is fundamental in

⁹⁰ See Section 6.5 for a discussion of PRIs.

1.15 PARTNERSHIP TAXATION

an analysis of joint ventures to examine the rules of partnership taxation under Subchapter K of the Code. This subject is especially important because substantial funds are channeled into the charitable stream through public and private syndications—for example, low-income housing tax credit syndications. Partnership tax issues also arise under the tax-exempt entity leasing rules⁹¹ and under the §514(c)(9) exception to the “debt financed property” in the UBIT context, which involves qualified allocations,⁹² and “substantial economic effect” under §704(b).⁹³

The partnership itself is nontaxable under §701. The partners, however, are liable for tax in their individual capacities; that is, each member is taxed separately on its distributive share of income, gain, loss, deduction, or credit.

A partner is entitled to deduct its distributive share of partnership losses, if any, to the extent of the tax basis of its partnership interest, which may include its share of partnership liabilities subject to the at-risk and passive activity loss rules.

The first step in the tax analysis of partnerships is determining whether a business enterprise will be classified as a “partnership” for federal income tax purposes.⁹⁴ The term *partnership* includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or a corporation.⁹⁵ If a partnership is treated

⁹¹ See Chapter 11.

⁹² See Sections 9.3, 11.5.

⁹³ See Section 3.6.

⁹⁴ For periods beginning on or after January 1, 1997, the IRS “check-the-box” regulations determine the classification of business entities for federal tax purposes. Under the check-the-box regulations, unincorporated business organizations may generally choose to be classified for federal tax purposes as either partnerships or associations taxable as corporations. The regulations specifically provide that an eligible entity that has been determined to be, or claims to be, exempt from taxation under §501(a) will be treated as having elected to be classified as an association. Reg. §301.7701-3(c)(1)(v)(A). However, this deemed election rule does not prevent a joint venture from qualifying as a partnership merely because the venturers include one or more exempt organizations. For periods beginning before January 1, 1997, prior Reg. §301.7701-2 applies, which provides that the “major characteristics ordinarily found in a pure corporation which distinguish it from other types of organizations are (i) associates, (ii) an objective to carry on a business for profit, (iii) continuity of life, (iv) centralization of management, (v) limited liability for corporate debts, and (vi) free transferability of interests.” However, the prior regulations also provided that characteristics (i) and (ii) are common to corporations and partnerships, and therefore classification issues were determinative on factors (iii)-(vi) inclusive. See also *Morrissey v. Commissioner*, 296 U.S. 344 (1934).

⁹⁵ §7701(a)(2); Reg. §301.7701-3(a); Reg. §301.7701-1(e).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

for federal income tax purposes as an association, the partnership will be taxable as a corporation.⁹⁶ In such a case, tax benefits, including losses and credits, would not flow through to the partners, and cash distributions to partners would be characterized as corporate distributions, some or all of which may be treated as dividends for federal income tax purposes, resulting in taxation at both the corporate and shareholder levels.⁹⁷ State and local taxes may add to this double tax burden.

The IRS issued regulations relating to the merger and division of partnerships, reflecting an increased pace of corporate restructuring.⁹⁸ Consistent with its policy, the IRS confirmed that LLCs owned by multiple exempt owners would be treated as associations rather than partnerships for tax purposes if they apply for separate tax-exempt status.⁹⁹

(b) Bargain Sale Including “Like Kind” Exchange

Partnerships and partners may transfer properties or partnership interests to charitable organizations. Such transfers may be treated for tax purposes as part gift and part sale—that is, a “bargain sale.”¹⁰⁰ A partnership would recognize taxable gain on the sale portion and would be entitled to deduct as a charitable contribution the excess of the property’s fair market value over its sale price.¹⁰¹

Under §1011(b), the partnership’s adjusted basis for determining its gain on the transfer is that portion of the adjusted basis that bears the same ratio as the amount realized by the transferor bears to the property’s fair market value.¹⁰² If property subject to indebtedness is transferred to a charity, the amount of the indebtedness is treated as an amount realized on the transfer, whether or not the charity agrees to assume or pay the indebtedness.¹⁰³

However, from a planning standpoint, the benefits of nonrecognition under the “like kind” exchange rules (including deferred exchanges) may be available to minimize the tax on bargain sales while preserving the advantages of the charitable contribution deduction.¹⁰⁴ No gain or loss is recognized when property held for productive use in a trade or business,

⁹⁶ Reg. §301.7701-2(a)(1).

⁹⁷ Reg. §301.7701-2(a)(3).

⁹⁸ See Sections 3.11(g) and 3.3.

⁹⁹ See Section 4.4.

¹⁰⁰ §170(e), Reg. §1.170(c)(1); §1011(b); Reg. §1.1011-2(a)(1).

¹⁰¹ §170(e), §1011(b); Reg. §1.1011-2(a)(1).

¹⁰² §1011(b); Reg. §1.1011-2(a)(1).

¹⁰³ Reg. §1.1011-2(a)(3).

¹⁰⁴ §1031; Reg. §1.1031(a)-1(a)(1).

1.16 UBIT IMPLICATIONS FROM PARTNERSHIP ACTIVITIES

or for investment, is exchanged solely for property of a like kind and is held for similar use.¹⁰⁵ If the taxpayer receives cash or other property (that is not of like kind), at least part of the gain or loss may be recognized.¹⁰⁶ Nonrecognition provisions will not apply to deferred like-kind exchanges unless the exchange meets a 180-day time limit on the completion of the exchange and a 45-day rule for identification of the property to be received in the exchange.¹⁰⁷

1.16 UBIT IMPLICATIONS FROM PARTNERSHIP ACTIVITIES

Since its inception, the federal income tax law has provided an exemption from taxation for organizations operating “exclusively for religious, charitable, scientific . . . literary, or educational purposes.”¹⁰⁸ Some organizations benefiting from the exemption, however, earn profits through means having little or nothing to do with the purposes for which their exemptions were granted. In this regard, an exempt organization that participates in a partnership or joint venture with taxable or nontaxable entities is subject to taxation on any income it receives from an unrelated business activity.¹⁰⁹ The UBIT is generally applied to the gross income derived from any unrelated trade or business regularly carried on by the exempt organization,¹¹⁰ less allowable deductions that are directly connected with the carrying on of the trade or business.¹¹¹ Income is subject to UBIT if

- It is income from a “trade or business.”¹¹²
- The trade or business is “regularly carried on.”¹¹³
- The activity is not “substantially related” to the organization’s performance of its exempt function.¹¹⁴

¹⁰⁵ §1031(a)(1); Reg. §1.1031(a)-1(a)(1).

¹⁰⁶ §1031(b); Reg. §1.1031(b)-1(a).

¹⁰⁷ §1031(a)(3); Reg. §1.1031(k)-1(b)(2)(i) and (iii).

¹⁰⁸ §501(c)(3); Reg. §1.501(c)(3)-1(a).

¹⁰⁹ §501(b); §511(a) and (b). The UBIT was intended to prevent unfair competition by nonprofit organizations that engage in a commercial activity. *Clarence LaBelle Post No. 271 v. United States*, 580 F.2d 270 (8th Cir. 1978).

¹¹⁰ §512(A)(1); Reg. §1.512(a)-1(a). See generally Chapter 7 on UBIT.

¹¹¹ §512(b); Reg. §1.512(b)-1(b).

¹¹² §513(a); Reg. §1.513(a)-1(b).

¹¹³ §512(a); Reg. §1.512(a)-1(a); Reg. §1.513-1(c)(1).

¹¹⁴ §513(a); Reg. §1.513-1(a); Reg. §1.513-1(d)(1).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

If an exempt organization is a member of a partnership that regularly carries on a trade or business that is an unrelated trade or business, the organization must include its share of the partnership's gross income, less applicable deductions, from these activities in calculating its UBIT.¹¹⁵ The same rule applies to interests held in a publicly traded partnership.¹¹⁶

Section 512(b) sets forth exceptions to the definition of unrelated business income (UBI), which include dividends, interest, rents, royalties, and noninventory sales.¹¹⁷ However, if any of these items (except dividends) are derived from controlled subsidiaries¹¹⁸ or debt-financed property,¹¹⁹ they may not qualify for the UBIT exceptions.

Generally, interest is excluded from the computation of an exempt organization's UBIT unless it is interest from debt-financed property or from a controlled organization.¹²⁰ A payment usually qualifies as interest if it is remuneration for the use of or forbearance of money.¹²¹ However, whether an item constitutes interest is determined by the "facts and circumstances of each case."¹²² For example, in certain cases, an equity kicker may cause a loan to be viewed in substance as a joint venture, thereby subject to UBIT.¹²³

Rent is generally excluded from UBI.¹²⁴ However, the IRS has been challenging the classification of certain lease agreements as joint ventures rather than leases.¹²⁵ The rent from real property is not excluded from UBI if the amount of rent depends, in whole or in part, on the income or profits

¹¹⁵ §512(c)(1); Reg. §1.512(c)-1. Reg. §1.512(c)-1 provides that if an exempt organization is a member of a partnership engaged in a taxable trade or business, then the income received as its share from the partnership is UBIT.

¹¹⁶ §512(c) as amended by §13145(a)(1) of the 1993 Act.

¹¹⁷ §512(b); Reg. §1.512(b)-1. Additional categories of UBIT exclusions include payments with respect to securities loans; gains on the lapse or termination of options on securities; gains or losses from securities options (without regard to whether written by an exempt organization); gains from options on real property; gains from the forfeiture of good faith deposits for the purchase, sale, or lease of real property; and loan commitment fees. §512(b).

¹¹⁸ §512(b)(13); Reg. §1.512(b)-1(I)(1).

¹¹⁹ §512(b)(4); Reg. §1.512(b)-1(I)(1) and (ii).

¹²⁰ §512(b)(1)(a); Reg. §1.512(b)-1(a). *See generally* Chapter 7 on UBIT and Chapter 8 on debt financing.

¹²¹ *Deputy v. DuPont*, 308 U.S. 488 (1940). *See also* Rev. Rul. 69-188, 1969-1 C.B. 54.

¹²² Reg. §1.512(b)-1; Priv Ltr. Rul. 89-05-002 (Oct. 12, 1988).

¹²³ *See* Chapter 18.

¹²⁴ §512(b)(3); Reg. §1.512(b)-1(c)(2).

¹²⁵ *Harlan E. Moore Charitable Trust v. United States*, 812 F. Supp. 130 (CD. 111. 1993), *aff'd*, 9 F.3d 623 (7th Cir. 1993), *acq. in action on decision*, 95-3953 (Apr. 14, 1995) (Issues 1 and 2).

1.17 USE OF A SUBSIDIARY AS PARTICIPANT IN A JOINT VENTURE

derived by any person from the leased property (excluding amounts based on a fixed percentage of the gross receipts of sales).¹²⁶ Furthermore, the regulations governing real estate investment trusts,¹²⁷ which define rents based on income or profits, are incorporated into the UBIT regulations for determining whether the rental exclusion applies.¹²⁸

Rent that is attributable to services other than those usually or customarily rendered in connection with the rental of rooms or other space solely for occupancy is not within the UBIT exclusion for rental income.¹²⁹ Hence, payments for the use of space in parking lots, warehouses, or storage garages are generally treated as payments for services.¹³⁰

Importantly, while previously rents received by an exempt organization from its controlled entity were taxable as UBIT, the Pension Protection Act of 2006 temporarily altered this paradigm to the extent such payments either reduced the controlled entity's net related income or increased its net unrelated loss. Under the Act, and subsequent extenders, the payments of interest, annuities, royalties, and rents received by an exempt organization from a controlled entity were included in the UBIT calculation only to the extent that the payments exceed a comparable fair market value as determined under §482 of the Code.

The UBIT tax is imposed on gross income from any regularly carried on unrelated trade or business, less allowable deductions directly connected with the carrying on of the trade or business.¹³¹ If an exempt organization has UBI from a number of unrelated trades or businesses, the tax is imposed on the aggregate of gross income less aggregated deductions from all unrelated trades or businesses.¹³²

1.17 USE OF A SUBSIDIARY AS PARTICIPANT IN A JOINT VENTURE

As an alternative to direct participation in a joint venture, an exempt organization may form a for-profit subsidiary to participate in the venture. Through the use of a subsidiary, the exempt organization can be

¹²⁶ §512(b)(3)(B)(ii); Reg. §1.512(b)-1 (c)(2)(iii)(b).

¹²⁷ Real estate investment trusts will hereinafter be referred to as "REITS."

¹²⁸ Reg. §1.512(b)-1 (c)(2)(iii)(b), incorporating Reg. §1.856-4(b)(3) and (6)(i).

¹²⁹ Reg. §1.512(b)-1(c)(5).

¹³⁰ Rev. Rul. 69-69, 1969-1 C.B. 159. For a comprehensive discussion of the rental exclusion, see Chapter 8 on UBIT.

¹³¹ §512(a)(1); Reg. §1.512(a)-1.

¹³² Reg. §1.512(a)-1(a).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

indirectly involved in a for-profit activity without jeopardizing its exempt status. Furthermore, because the income of the subsidiary is generally taxable, the parent will not be subject to UBIT on the subsidiary's income.¹³³

Use of a for-profit subsidiary protects the status of the exempt parent and insulates its assets from possible liability. If the exempt parent were to undertake these activities, and if involvement in the activities were more than insubstantial, its tax exemption could be jeopardized.¹³⁴ Furthermore, exempt organizations may choose to place an activity in a separate subsidiary to insulate the parent corporation from legal liability for the activity. A parent corporation is generally not liable for the debts or tortious acts of its subsidiary.

Frequently, investors and creditors will more readily invest or lend capital to for-profit entities than to tax-exempt organizations. The main reason is that in the event of insolvency of the exempt organization, an involuntary bankruptcy cannot be filed against it by creditors.¹³⁵ Furthermore, a for-profit entity has the capacity to raise capital from the general public through a conventional stock issue. With the creation of the MESBIC and the small business investment company (SBIC) programs, these capital sources are reinforced. For example, the MESBIC program involves tax-exempt organizations providing seed capital for the establishment of organizations to serve as catalyst to obtain loans for minority businesses. In this case, the government has guaranteed these funds, permitting further leveraging through financial institutions.¹³⁶

The subsidiary will be viewed as a distinct entity from the exempt parent, thereby preserving the parent's exempt status and limiting the liability of the parent. The use of a subsidiary also allows for growth within the subsidiary, whereas if the parent directly engaged in the

¹³³ See Section 4.2 on exempt organizations as general partner. See also Tesdahl, "Avoiding UBIT with Two Subsidiaries," *Exempt Organization Tax Review* 11 (Mar. 1995): 597.

¹³⁴ A private letter ruling involving the National Geographic Society provides an excellent illustration of the fundamental principles applicable to for-profit subsidiaries. The ruling is discussed in Section 6.3(b)(iii).

¹³⁵ See 11 U.S.C. §303(a), which provides that an involuntary case may be commenced only under Chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed business, or commercial corporation. The Senate Judiciary Committee specifically stated that "eleemosynary institutions, such as churches, schools, and charitable organizations and foundations likewise are exempt from involuntary bankruptcy." S. Rep. No. 95-989, 95th Cong. (1983).

¹³⁶ M. Cerny, "Tax-Exempt Organizations and Economic Development," *Exempt Organizations Panel, ABA Section on Taxation* (Feb. 7, 1993).

1.18 LIMITATION ON PREFERRED RETURNS

activity and the operations were successful, its exempt status might be adversely affected.¹³⁷

1.18 LIMITATION ON PREFERRED RETURNS

Under the tax law, certain preferred returns are unavailable to a tax-exempt equity investor without a limitation on depreciation deductions for the taxable venturer and a loss of exemption from the debt-financed income rules.

(a) Debt-Financed Property

The UBIT exclusions for interest, rents from real property, and so forth, do not apply to the extent that income is derived from “debt-financed property.”¹³⁸ The term *debt-financed property* is defined as “any property which is held to produce income and with respect to which there is an acquisition indebtedness . . . at any time during the taxable year.”¹³⁹ Debt-financed property includes property that was disposed of during the taxable year if there was “acquisition indebtedness” outstanding with respect to such property at any time during the 12-month period preceding the disposition (even though such 12-month period may cover more than one taxable year).¹⁴⁰

Property is not debt-financed property if substantially all of its use is related to the exercise or performance of the organization’s exempt purposes.¹⁴¹ However, income from debt-financed property will be subject to UBIT even if that income is derived from an activity that is not a “trade or business regularly carried on.” In other words, the “trade or business” and “regularly carried on” tests are not relevant when debt-financed property is involved.

Additional limitations are imposed on qualified organizations that invest in real property through partnerships that include as partners both qualified organizations and parties other than qualified organizations. These limitations apply to partnerships as well as to any other pass-through entities, including tiered partnerships.

When a qualified organization is a partner in a partnership that holds real property subject to acquisition indebtedness, the debt-financed portion

¹³⁷ For an in-depth discussion on the use of subsidiaries, see Section 6.3.

¹³⁸ See Chapter 9 on debt-financed property. See also §512(b)(4) and §514.

¹³⁹ §514(b)(l); Reg. §1.514(b)-1.

¹⁴⁰ §514(b)(l); Reg. §1.514(b)-1(a).

¹⁴¹ §514(b)(l)(A).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

of the qualified organization's income from the partnership will be subject to UBIT unless the partnership meets *one* of the following three tests:

1. All partners must be qualified organizations, such as educational institutions and qualified pension trusts.
2. Each allocation to a qualified organization must be a qualified allocation, that is, an allocation that never varies (the "qualified allocations rule").
3. The partnership meets the requirements of the "fractions rule."¹⁴²

These three tests operate to prevent the transfer of tax benefits from a qualified organization to a taxable partner. When all partners are qualified organizations, there is no potential for a transfer to taxable partners. Because allocations never vary under the qualified allocations rule, taxable partners are prevented from receiving any tax benefits in greater proportion than their underlying interest in partnership capital. Under the fractions rule, allocations may vary but only within certain prescribed limits, which under the Proposed Regulations allow reasonable preferred returns and guaranteed payments.

(b) The Fractions Rule

The fractions rule requires the following:

- Allocations of items to any partner that is a qualified organization cannot result in the qualified organization's having a share of overall partnership income for any year greater than the qualified organization's share of overall partnership loss for the year when the qualified organization's loss will be the smallest—that is, a qualified organization can never have income greater than its smallest share of loss; and
- All partnership allocations must have substantial economic effect under §704(b)(2).

The function of the fractions rule is to prevent disproportionate income allocations to qualified organizations and disproportionate loss allocations to taxable partners.

(c) Tax-Exempt Entity Leasing Rules

Increased tax incentives that became available for the for-profit sector in the early 1980s (accelerated depreciation, investment tax credits, etc.)

¹⁴² §514(c)(9)(E).

1.18 LIMITATION ON PREFERRED RETURNS

created new opportunities for nonprofit organizations to raise funds by, in effect, “selling” otherwise wasted tax benefits to for-profit organizations. However, the Deficit Reduction Act of 1984 (the “1984 Act”) contained new rules known as the tax-exempt entity leasing rules, which significantly restrict the tax benefits of leasing property to tax-exempt organizations, as well as the tax benefits available to partnerships composed of taxable and tax-exempt entities.¹⁴³

The tax-exempt entity leasing rules do not apply to any property predominantly used by a tax-exempt organization if the income derived from that property by the tax-exempt organization is subject to tax as unrelated business income. If this exception does not apply, the 1984 Act is applicable to two basic types of transactions. The first category involves direct leases of property by taxable organizations to tax-exempt organizations. The second category involves partnerships with taxable and tax-exempt entities as partners when partnership items of income, gain, loss, deductions, credit, and basis are not allocated to the tax-exempt entity in the same percentage share during the entire period that the tax-exempt entity is a partner. For example, a partnership agreement may allocate only 1 percent of profits, losses, and net cash flow to a tax-exempt partner but may allocate 50 percent of sale and refinancing proceeds to that tax-exempt entity.

In either case—the direct lease to a tax-exempt organization or a partnership composed of taxable and tax-exempt entities—§168(h) severely restricts depreciation deductions for many of these transactions that affect the taxable joint venturer. For example, the depreciation deduction for residential real estate based on a 40-year useful life would be approximately one-third less than under the Modified Accelerated Cost Recovery System (MACRS).¹⁴⁴

These rules were designed to address the perceived abuses of the prior law, namely, that for-profit or taxable lessors indirectly made investment tax incentives available to tax-exempt entities through reduced rents; the Code encouraged tax-exempt entities to enter into sale/leaseback transactions with taxable entities, which resulted in substantial revenue losses, and partnerships that included tax-exempt and taxable entities could allocate all or substantially all of the tax losses to the taxable

¹⁴³ See Chapter 11 on tax-exempt entity leasing rules.

¹⁴⁴ See §168. However, under the Revenue Reconciliation Act of 1993 the depreciation period for nonresidential realty was lengthened from 31.5 years to 39 years. §168(c)(1), as amended by the Revenue Recognition Act of 1993 §1315(a), Chapter 1 of Title XIII of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (Aug. 10, 1993) (hereinafter the “1993 Act”).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

entities, although the tax-exempt entities could share in profits and cash distributions on a more favorable basis.¹⁴⁵

CAVEAT

The 1986 Act, by enacting longer depreciation periods, introducing the passive loss rules, and repealing the investment tax credit, reduced the available tax benefits to individuals and thus reduced the impact of the tax-exempt entity leasing rules. As a result, more joint venture opportunities have become available to tax-exempt entities, especially with corporate investors that are not subject to the passive loss limitations. See Chapter 13 on the low-income housing tax credit.

1.19 SHARING STAFF AND/OR FACILITIES: SHARED SERVICES AGREEMENT

A tax-exempt organization may form a wholly owned for-profit subsidiary to carry out activities that the parent corporation cannot or chooses not to perform itself. Moreover, a tax-exempt organization may share some employees and/or facilities with a for-profit affiliate. In both cases, it is important to provide corporate protection to the tax-exempt entity so the activities and the income of the for-profit subsidiary or affiliate will not be attributable to the nonprofit.

Where there are nonprofit and for-profit affiliates sharing employees and facilities, it is important that there be a Memorandum of Understanding or a Shared Services Agreement setting forth the arrangement. The justification for the Shared Services Agreement should be contained in the document itself, by including “whereas” clauses that include economies of scale reasons, division of corporate functions, and allocation of costs, so as to make the payment a fair value to the appropriate entity. Where payments are based on a cost-reimbursement structure, actual time records or actual costs would be the appropriate supporting documentation, including the actual expense items such as lease agreements, receipts, and the like.

If the exempt organization shares services and/or facilities with more than one entity, it is preferable to have an agreement with each for-profit.

¹⁴⁵ §1301 like-kind exchanges were occasionally used as a tax planning technique to circumvent the application of the alternative depreciation system (ADS)—a key aspect of the tax-exempt entity leasing rules. Regulations, finalized in 1996, essentially foreclose further use of this technique by ensuring that the ADS will be applied to tax-exempt-use property even if a like-kind exchange is made. See Chapter 11 for a more in-depth discussion of the regulations.



1.20 "INTANGIBLES" LICENSED BY NONPROFIT TO FOR-PROFIT

Where lobbying expenses are shared, it is important to note the difference in tax treatment between nonprofits and for-profits and, in particular, to make sure that any lobbying expenses attributable to the nonprofit are truly "lobbying" expenses within the meaning of §501(h) of the Internal Revenue Code. Where there is a shared use of websites, it is important that the cost be allocated appropriately between the two entities, so as to not inadvertently cause an exempt organization to generate income that could jeopardize its exempt status or be treated as unrelated business income tax.¹⁴⁶

1.20 "INTANGIBLES" LICENSED BY NONPROFIT TO FOR-PROFIT SUBSIDIARY OR JOINT VENTURE

An affiliate for-profit entity may use, or plan to use, certain intangible assets of its nonprofit parent or coventurer, including its name, trademarks, logo, donor (or member) database, domain name, and certain content from publications and/or directory of service providers. The licensee would pay a royalty as consideration.¹⁴⁷ (*Note:* The listing of assets is used by means of example only. All of these assets were licensed by a tax-exempt entity to its wholly owned subsidiary in Private Letter Ruling 200225046 [June 24, 2002]).

Section 512(b)(2) excludes from the definition of *unrelated business taxable income* all royalties, whether measured by production or by gross or taxable income from the property. In numerous cases, for example, *Common Cause v. Comm'r*, 112 T.C. 332 (1999), and *Planned Parenthood Federation of America, Inc. v. Comm'r*, T.C. Memo 1999-206, the courts have held that so long as the exempt organization engages only in "royalty-related" activities

¹⁴⁶ See Chapter 5 for a discussion of private inurement, private benefit, and excess benefit transactions and the result of an exempt organization engaging in such transactions, which may be avoided if the exempt organization forms a wholly owned for-profit subsidiary to carry out certain activities that the exempt organization is prohibited from performing. See also Chapter 8 and Section 2.3(c) for discussion of UBIT and lobbying rules, respectively.

¹⁴⁷ In PLR 200225046 (June 24, 2002), the royalty paid by a for-profit subsidiary to its tax-exempt parent was 10 percent of the subsidiary's "gross revenues" (defined in the agreement). The author has reviewed several cases in which the royalty was calculated on 4 to 5 percent of the subsidiary's gross income. We note that for several years, there has been a legislative effort to persuade Congress to amend §512(b)(13), so that no UBIT would be imposed on the exempt parent, if the payment were at fair market value, as required under §482. See discussion in Section 6.3(d)(ii)(B) for new developments.



INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

(i.e., it exercises only quality control over the use of the intangible assets), the characterization of the payment as a royalty will not be challenged. The IRS has stated that it does not intend to litigate in this area, but it will apply an allocation theory, treating the income from any marketing and promotional services as UBIT.

However, royalty payments from “controlled” subsidiaries (i.e., ownership by vote or value of more than 50 percent of the stock of the corporation) may constitute unrelated business taxable income to the exempt parent. Previously, interest, annuities, royalties, or rent (but not dividends) received by an exempt organization from a controlled entity were taxable as unrelated business taxable income (“UBTI”) to the extent such payments either reduced the controlled entity’s net unrelated income or increased its net unrelated loss. Under the Pension Protection Act of 2006, such payments received by an exempt organization during 2006, 2007, or 2008 from a controlled entity will only be included in the calculation of the exempt organization’s UBTI to the extent that the payments exceed a comparable fair market value payment, as determined using the principles of §482.

Given the related-party nature of this royalty arrangement, it is critical that the royalty payment be based on comparable arm’s-length transactions between unrelated parties. This approach is consistent with §482, and should withstand any potential IRS challenge. The nonprofit must retain the services of an independent professional consulting service to conduct a valuation analysis in connection with the implementation of the license agreement.

CAVEAT
We recommend that the royalty arrangement be made prospective, but it may memorialize payments made in prior years, for which no royalty fee was paid.

1.21 PRIVATE INUREMENT AND PRIVATE BENEFIT

The prohibitions against private inurement and private benefit are fundamental to tax-exempt status and are among the key issues on which the IRS focuses in analyzing joint ventures involving exempt organizations. This book explores the parameters of the doctrines of private inurement, private benefit and “excess benefit transactions,” and the types of situations in which these issues may arise.¹⁴⁸

¹⁴⁸ See Chapter 5.

1.21 PRIVATE INUREMENT AND PRIVATE BENEFIT

Some of the most controversial transactions involve nonprofits which provide educational and health services, derive income from television contracts for college sports, and earn income from selling and renting their mailing lists. One issue is whether the activity is too “commercial” and, to the extent the activity generates a profit, who benefits from the profit.

Regardless of the presence of exempt entities as participants in a joint venture, nonexempt partners will face the same traditional issue of reasonable compensation that plagues many commercial entities—deductibility under §162. However, the presence of an exempt organization as a joint venture partner introduces additional key concerns. The first concern is whether any of the financial or nonfinancial arrangements contemplated by the joint venture results in the inurement of any portion of the exempt organization’s earnings to an officer, director, or founder (i.e., an “insider”) of the exempt organization. The second concern is whether the participation of the exempt organization in the joint venture confers a benefit on private individuals and/or nonexempt entities that is substantial and provides evidence that the exempt organization is operating for private benefit rather than for its exempt purpose.

The third concern is whether there has been an “excess benefit transaction” under the intermediate sanctions provisions.¹⁴⁹ The intermediate sanction rules were enacted in response to perceived financial abuses in the world of nonprofit organizations in general and public charities specifically. Until the adoption of §4958, the IRS’s only enforcement tool was revocation of a public charity’s exempt status, a result considered too severe in most circumstances. In addition to the severity of revocation as a penalty, revocation penalized the nonprofit itself; there was no mechanism to punish the wrongdoer in the context of public charities as there was for private foundations in the Chapter 42 excise tax provisions.

Compliance with the guidelines of the intermediate sanctions provisions is particularly important in regard to joint ventures between for-profit and nonprofit organizations. First, such ventures by their nature attract greater scrutiny. Second, engaging in a transaction with one or more for-profit entities inherently raises the potential for impermissible benefit and inurement. Accordingly, this book explains the significant terms and definitions of the intermediate sanctions rules.

Specifically, the regulations apply to public charities that would be described in §501(c)(3) or (4) and exempt from tax under §501(a), as well as any organizations that were exempt from tax under §501(a) and that were described in §501(c)(3) or (4) at any time during the five years preceding

¹⁴⁹ §4958 and regulations thereunder.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

the date of an excess benefit transaction (the “lookback period”).¹⁵⁰ They do *not*, however, apply to private foundations,¹⁵¹ trade associations, or other types of exempt organizations. Foreign organizations receiving substantially all of their support from sources outside the United States also are not subject to §4958, regardless of §501(c)(3) or (4) status.¹⁵²

Compensation is one of the more sensitive and troublesome, yet common, contexts to which these basic proscriptions may apply. The law of exempt organizations has borrowed the nomenclature from the for-profit sector: compensation is said to be “reasonable” when the total compensation package is found to be reasonable relative to the services provided to the exempt organization.

Under the intermediate sanctions regulations, organizations must ensure that their compensation arrangements are “reasonable”—reasonable being that which would be paid for similar services by similar enterprises under similar circumstances. In determining reasonableness, the IRS will consider those circumstances in existence when a contract for services is *made*, unless reasonableness *cannot* be determined from such circumstances, such as when an unspecified performance bonus is to be paid at a later date. Under these circumstances, a determination of reasonableness cannot be made as of the date of the contract, but, rather, will be based on all the facts and circumstances, up to and including the date of payment.¹⁵³

Compensation consists of cash and noncash compensation, including the following:

- Salary, fees, bonuses, and severance payments that are paid¹⁵⁴
- All forms of deferred compensation that are earned and vested¹⁵⁵

¹⁵⁰ With the exception of churches that, per statute, do not have to file Form 1023, only §501(c)(3) organizations that file Form 1023 are subject to the intermediate sanctions. State and local government organizations that would be described in (c)(3) or (c)(4) were they not governmental related are therefore not subject to the intermediate sanction regulations, absent a request for §501(c)(3) status. *See Bernadette M. Broccolo et al., “Rules to Live By: IRS Releases Intermediate Sanctions Regulations,” Exempt Organization Tax Review 21 (1998): 287, 291.*

¹⁵¹ Because private foundations are subject to §4941 excise taxes, it would not be advantageous for a §501(c)(3) organization to seek private foundation status in order to avoid the intermediate sanctions.

¹⁵² Reg. §53.4958-2.

¹⁵³ Reg. §53.4958-4(b)(3)(i).

¹⁵⁴ Reg. §53.4958-4(b).

¹⁵⁵ Reg. §53.4958-4(b)(3)(ii)(B).

1.21 PRIVATE INUREMENT AND PRIVATE BENEFIT

- Premiums paid for liability or other insurance, as well as payments or reimbursement for expenses, fees, or taxes not covered by insurance¹⁵⁶
- All other benefits, including dental, disability benefits, and life insurance plans, as well as taxable and nontaxable fringe benefits¹⁵⁷
- Any other economic benefit provided directly or indirectly (including any benefits through joint venture arrangements)¹⁵⁸

Compensation issues that are particularly relevant to nonprofits engaged in joint ventures and that are encompassed by the intermediate sanctions provisions include incentive compensation, deferred compensation, physician recruitment incentives, and gain sharing.¹⁵⁹

Under the §4958 regulations,¹⁶⁰ persons in a position to exercise substantial influence over a charitable organization will be penalized for receiving from the organization a greater benefit than warranted by the consideration they provided. The definition of *disqualified person* is based on facts that show the person actually had substantial influence over an organization, rather than on the person's title. Notably, the Pension Protection Act of 2006 expanded the definition of "disqualified persons" to include donors to donor-advised funds, and classified disqualified persons in supporting organizations.

The final regulations adopt the view of the Seventh Circuit in the *United Cancer Council*¹⁶¹ case that a person who is an outsider when he or she negotiates a fixed-payment contract is allowed a "first bite." In such a situation, it is assumed that the organization negotiated a fair contract at arm's length, so it will not be subject to penalties under the intermediate sanctions regulations. However, several of the examples appear to restate the Service's position in *United Cancer Council* that an outsider can become a disqualified person through a contract.

Of particular interest to joint ventures, the regulations make it clear that indirectly conferred excess benefits are also prohibited. Thus, a subsidiary or joint venture may not provide excess benefits to a person who is prohibited from receiving them directly from the parent or limited partner.

Another section of particular interest, that on revenue sharing, was withdrawn. The IRS concluded that revenue-sharing arrangements should

¹⁵⁶ Reg. §53.4958-4(b)(3)(ii)(C).

¹⁵⁷ Reg. §53.4958-4(b)(3)(ii)(D).

¹⁵⁸ Reg. §53.4958-4(b)(3)(ii)(E).

¹⁵⁹ See Sections 5.4(c), 12.3(c), and 12.4.

¹⁶⁰ See Section 5.4 for a more complete discussion.

¹⁶¹ See Section 2.3(b)(ii).

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

be analyzed under the general facts-and-circumstances test used for all excess benefit transactions. If the revenue that is shared exceeds the property or services provided in exchange, it will be considered excess. The standards used for valuation are the familiar ones of market value for property and reasonable compensation (within the range of that paid for like services under similar circumstances). Two examples of initial contracts included in the regulations show that the Service will treat revenue-sharing arrangements as reasonable compensation if implemented in the form of fixed-payment contracts.

The regulations provide a rebuttable presumption that gives organizations an assurance that they have not entered into excess benefit transactions as long as they follow designated procedures. The regulations also add specific guidelines and detail on what constitutes corrective action if an excess benefit transaction does occur. These rules are described in detail in Chapter 5.

1.22 LIMITATION ON PRIVATE FOUNDATION'S ACTIVITIES THAT LIMIT EXCESS BUSINESS HOLDINGS

This book focuses primarily on joint ventures involving §501(c)(3) “charitable organizations.” All such charitable organizations are divided into two general categories, public charities (such as churches, nonprofit schools, and publicly supported organizations) and private foundations.¹⁶² Private foundations are charities that receive their primary financial support from a few individuals or corporations, or from income earned by their own large endowments.

Public charities and private foundations are subject to the same general tax law requirements: They must be operated exclusively for public as opposed to private purposes; their assets cannot be used to benefit private persons; and they cannot engage in any political activity. Public charities, however, may conduct an insubstantial amount of lobbying activity.¹⁶³

¹⁶² A private foundation is a §501(c)(3) charitable organization, other than the following four types of organizations: (1) an organization that is a church, hospital, government-supported organization, or educational organization; (2) an organization that receives more than one-third of its annual support from gifts, grants, contributions, membership fees, and receipts from admissions and sales of merchandise; (3) an organization that is operated, supervised, or controlled by an exempt organization; or controlled by an exempt organization; and (4) an organization which is organized and operated exclusively for testing for public safety. *See* §509(a).

¹⁶³ *See* Section 2.3(d).

1.23 INTERNATIONAL JOINT VENTURES

Stringent though these general rules may appear, private foundations are subject to additional limitations. Private foundations must pay a tax on their net investment income, they cannot engage in any lobbying, they cannot undertake the simplest of commercial transactions with certain disqualified persons, they must distribute at least specified amounts to charity each year, their investments must meet strict standards of prudence, their grantmaking procedures must be fair to all prospective candidates, and they must not own more than a minority interest in any business. Infractions of these rules are punished by the imposition of stiff excise taxes, both on the foundation and, in some cases, on the persons who run them. This book examines a foundation's permissible ownership interest in a business enterprise and the consequences of excess business holdings.

Generally, an excise penalty tax of 10 percent is imposed on a private foundation if it has excess business holdings in a business enterprise, including a joint venture.¹⁶⁴ "Excess" business holdings are generally determined with reference to the foundation's own holdings and the holdings of all "disqualified persons." As a general rule, the combined holdings of a private foundation and all disqualified persons in any joint venture, partnership, or corporation that are not substantially related to the exempt purposes of the foundation are limited to 20 percent of the voting stock or profits interest.¹⁶⁵ Furthermore, an additional tax of 200 percent of the value of such excess holdings will be imposed if the excess business holdings are not disposed of within a "correction period."

1.23 INTERNATIONAL JOINT VENTURES

In the modern global community, news of human suffering, poverty, and natural disaster has been brought to the forefront of our attention. Accordingly, over the past 10 years, the United States has seen an increase in the number of domestic charities responding to the needs of other nations and their peoples by expanding their charitable activities into the international arena. This charitable work is often performed in cooperation with the host government, other international organizations, community organizations, private national or international groups, or nongovernmental organizations (NGOs). Current law provides for special rules governing the use and expenditure of charitable assets overseas, and practitioners must exercise care in the structuring of foreign charitable undertakings to

¹⁶⁴ §4943(a)(1); Reg. §53.4943-1. The Pension Protection Act of 2006 amended this section, increasing the penalty tax from 5 percent to 10 percent.

¹⁶⁵ Reg. §53.4943-1.

INTRODUCTION: JOINT VENTURES INVOLVING EXEMPT ORGANIZATIONS

ensure that neither the deductibility of contributions made to the charitable organization nor the organization's tax-exempt status is endangered.¹⁶⁶

This book discusses, in the context of joint ventures, the different methods by which a domestic charitable organization may conduct overseas charitable activity.¹⁶⁷ In addition, the use of (and interaction with) "friends" organizations,¹⁶⁸ the application of foreign law to joint ventures involving domestic participants,¹⁶⁹ and the strict grantmaking provisions applicable to private foundations (major participants in the international charitable arena) are analyzed, as are the newly released regulations adding several examples involving program related investments in foreign countries.¹⁷⁰ As discussed in Chapter 6, some social entrepreneurs are adopting creative approaches to addressing societal needs, including operating without forming a separate nonprofit entity to raise funds for a particular cause, a process which is facilitated by use of the Internet and social media platforms.

The United States and Canada finally implemented a treaty that grants automatic recognition of exempt status to religious, scientific, literary, educational, or charitable entities, provided that they have been recognized as charitable under the laws of the country in which they were organized.¹⁷¹

The United States government has embarked on a series of actions designed to address the use of U.S. charities by international terrorist groups to fund terrorist activities. While some of these actions may create cumbersome procedures for charities, including the use of joint ventures, the need for government intervention to curb instances of fraud and illegal uses of charitable contributions outweighs the need to retain the simplified procedures for obtaining and maintaining nonprofit status. (See Section 17.3 for discussion.)

1.24 OTHER DEVELOPMENTS

As described in Chapter 6, using an LLC to conduct one or more of a nonprofit's programs or activities can now almost be considered a "traditional" joint venture vehicle. A trend spurred by the desire of social entrepreneurs to find new ways to achieve social objectives is the adoption

¹⁶⁶ See Sections 17.2 and 17.9.

¹⁶⁷ See generally Chapter 17.

¹⁶⁸ See Section 17.2(b).

¹⁶⁹ See Sections 17.8 and 17.9.

¹⁷⁰ See generally §§4942-4946 and §170 and the regulations thereunder. See also Section 6.5 and Chapter 17.

¹⁷¹ See Section 17.11(c).

1.24 OTHER DEVELOPMENTS

of state legislation creating so-called hybrid entities. The first such entity was the L3C, a low profit LLC adopted in approximately 11 jurisdictions. The L3C is a modified LLC formed for the purpose of facilitating program related investments by private foundations. While its promoters hoped that the IRS would recognize L3Cs as appropriate PRI vehicles, thereby avoiding the burden of repeatedly having to satisfy the PRI rules, the IRS has not yet granted such blanket approval.

Other hybrid vehicles that have been adopted in some states include social benefit corporations and the flexible purpose corporation, the latter of which has only been adopted in one state, California, as of this writing. These are for-profit organizations that, pursuant to their respective governing laws and corporate instruments, permit their boards to consider specified social causes when making corporate decisions without exposure to liability to shareholders who might be disgruntled about lower profitability.

The growth of the Internet affects many aspects of exempt organization tax law. The IRS is considering the need for additional regulation of advertising, trade shows, lobbying, and political activity on the Internet.¹⁷² For example, the lines between corporate sponsorship and advertising may have to be clarified for a medium that can transport the reader of a sponsorship acknowledgment to a commercial environment with the movement of one fingertip.¹⁷³ The IRS itself increasingly makes use of the Internet to communicate¹⁷⁴ its website has numerous tools, publications and workshops to help taxpayers navigate the processes of applying for and maintaining tax exemption. The new reports required from §527 political organizations may be made entirely electronically and the IRS is working on an electronic submission process for the application for tax exemption (Form 1023). The annual reports of all exempt organizations are now readily available on several sites on the Internet. State charities officials have also made innovative use of the Internet to develop and disseminate recommendations for regulating charitable solicitations over the web.¹⁷⁴ These developments are described throughout the book.

¹⁷² See Section 8.5(g).

¹⁷³ *Id.*

¹⁷⁴ See Section 8.5(g).

