

THE IRS VIEW OF JOINT VENTURES INVOLVING TAX-EXEMPTS IN TODAY'S CLIMATE

MICHAEL I. SANDERS

As the U.S. and global economies continue to recover slowly from the Great Recession, charities are receiving less financial support from budget-constrained governmental agencies and fewer contributions from the private sector. Though charitable entities often have fewer funds at their disposal from traditional sources, the needs of the international community have only seemed to accelerate. With natural disasters such as the 2004 tsunami in Asia, the 2010 earthquake in Haiti, the U.S. hurricanes (Katrina in 2005 and Sandy in 2012), and the 2013 earthquake and typhoon that ravaged the Philippines, charities must continue to innovate to conduct their programs. In some cases, this is done by developing new avenues and structures, including joining forces with other nonprofit to accomplish fundraising or program related goals.

Increasingly, however, charities are forging partnerships with for-profit entities to access otherwise unavailable capabilities, capital, and resources. Some examples include universities partnering with for-profit businesses to offer

distance-learning programs, and low-income organizations using Low Income Housing Tax Credits and New Markets Tax Credits programs with for-profit investors to subsidize development.

Over the years, the Service's position has evolved from opposing joint ventures between nonprofit and for-profit entities to acknowledging the various bona fide purposes for entering into a joint ventures, and establishing guidelines for nonprofits to protect their exempt status while engaged in such partnerships. Pursuant to these guidelines, a charity will not jeopardize its tax-exempt status by participating in a joint venture so long as the charity retains sufficient "control to ensure the venture furthers the charity's exempt purposes and prevents impermissible private benefit or inurement from occurring."¹ Although no bright-line test exists for establishing control, having at least 50% voting control of a joint venture in regard to matters relating to a charity's charitable goals is a positive factor. The IRS considers this to be a facts-and-circumstances determination and will not issue rulings except in connection with an application for exemption. It is therefore important to have a joint venture policy in place and to carefully structure ventures pursuant to these guidelines.

Despite the Service's slow acceptance of exempts in joint ventures, many issues still remain unresolved.

MICHAEL I. SANDERS is a partner in the Business Tax Group of the Washington, DC tax department of Blank Rome LLP. The author would like to express his appreciation to Jacob Dean for his research contribution towards this article. Portions of this article have been excerpted from Sanders, Joint Ventures Involving Tax-Exempt Organizations, (John Wiley & Sons, Inc.©, 2013).

Moreover, since the Form 990 was revised in 2008, there are new reporting requirements for nonprofit joint venture participants. Form 990, Part VI, asks the organization if it has a joint venture policy in place. The IRS does not, however, provide a sample joint venture policy as it does with a conflicts of interest policy. Even though the IRS is hesitant to provide a model policy because the structure of a joint venture is based on all of the fact and circumstances, certain basic control principles in reliance upon the *Plumstead* two-prong test can be applied to all ventures between nonprofits and for-profits.²

Background to Section 501(r)

The Treasury Department recently applied the “two-prong” control test to organizations that have an interest in a joint venture that operates a hospital.³

The joint venture control test. In Rev. Rul. 2004-51,⁴ the IRS addressed an ancillary joint venture between a university and a for-profit that conducted interactive training programs. Pursuant to the venture, formed as an LLC, the university would expand its teacher training programs to off-campus sites by using the interactive video technology.

Each partner held a 50% interest in distributions and allocations, and return of capital was proportional to the partners’ respective interests. Each partner selected three directors of the LLC’s governing board, but the university had complete control of all decisions that affected the training program, including selection of the teaching materials, enrolling the participants, selecting the instructors, and establishing the standards for completion of the programs.

The for-profit controlled aspects related to the location at which the video link could be seen and approval of video personnel. There was a representation that the university’s participation in the joint venture constituted an insubstantial portion of its overall educational activities.

In the ruling, the IRS cited *Redlands Surgical Services*,⁵ in which a nonprofit partner was found to lack the control necessary to “ensure furtherance of charitable purposes.” The ruling also cited *St. David’s Health Care System*⁶ in regard to the control issue, and stated that the nonprofit could lose its exempt status if it ceded control to its for-profit partner. In its analysis, the IRS explained that because the LLC is taxed as a partnership, its activities are attributed to the university. The university’s exemption was not jeopardized because the LLC was to operate exclusively for educational purposes and its activities were not a substantial part of the university’s activities.

The next issue was whether the university would be subject to UBIT as a result of activities of the LLC. The IRS determined that the manner in which LLC conducted its activities “contributes importantly to the accomplishment of” the university’s exempt purposes, citing Reg. 1.513-1(d)(2), and therefore the university’s share of the LLC’s income would not be UBIT.

The factors enumerated in support of this conclusion were those factors that gave the university control over the substantive aspects of the training program, and the fact that the video presentation format allowed the university to expand its educational programs to people who could not otherwise participate in these programs on the university campus. This analysis is now referred to as the “UBIT plus control” test as it encompasses examination of factors under the UBIT provisions as well as the elements of control of a joint venture’s charitable activities.

Application of the joint venture control test. In 2010, the Patient Protection and Affordable Care Act added Section 501(r) and Section 4959 to the Code, imposing additional requirements on certain hospitals and a tax on the hospitals that fail to meet those requirements.⁷ Section 501(r)(1) provides that a hospital organization will not be treated as described in Section 501(c)(3) unless

¹ See *Plumstead Theatre Soc’y, Inc.*, 74 TC 1324 (1980), *aff’d*, 675 F.2d 244, 49 AFTR2d 82-1390, (CA-9, 1982); Rev. Rul. 2004-51, 2004-22 IRB 974, Rev. Rul. 98-15, 1998-1 CB 718.

² A model joint venture participation policy is provided in Sanders, *Joint Ventures Involving Tax Exempt Organizations*, (John Wiley & Sons, Inc., © 2013), Appendix 4B.

³ Prop. Reg. 1.501(r), REG-106499-12, 2013-21 IRB 1111, 78 Fed. Reg. 20,523 (2013).

⁴ Note 1, *supra*.

⁵ 113 TC 47 (1999), *aff’d*, 242 F.3d 904, 87 AFTR2d 2001-1249 (CA-9, 2001).

⁶ 349 F.3d 232, 92 AFTR2d 2003-6865 (CA-5, 2003).

⁷ Section 6033(b) was also amended.

⁸ See Prop. Reg. 1.501(r); see also Notice 2014-2, 2014-3 IRB 407, Notice 2014-3, 2014-3 IRB 408.

⁹ Prop. Reg. 1.501(r).

¹⁰ If there is a subsequent audit of the venture, the IRS will examine all the facts and circumstances including a number of factors, which are discussed below.

¹¹ See “Come the Revolution,” N.Y. Times, 5/16/14, page A25.

the organization meets the requirements of Section 501(r)(3) through Section 501(r)(6).

The Treasury Department confirmed its continuing interpretation of the two-prong “control” test in its publication of proposed regulations pursuant to Section 501(r) in 2013.⁸ What it means to operate a nonprofit hospital has been an important question, particularly with regard to Section 501(c)(3) organizations that have an interest in a joint venture or other partnership that operates a nonprofit hospital. Under the proposed regulations, if a Section 501(c)(3) organization owns a capital or profit interest in or is a member of a joint venture, limited liability, or other entity treated as partnership for federal tax purposes, and that entity operates a hospital, the Section 501(c)(3) organization will itself be treated as operating a hospital, and therefore will be subject to the regulatory scheme under Section 501(r), unless it meets one of two exceptions.⁹ These two exemptions turn on the aforesaid “control” test.

1. The Section 501(c)(3) organization does not have control over the operation of the hospital sufficient to ensure that the operation of its facilities furthers an exempt purpose described under 501(c)(3) and, thus, treats the operation of the hospital facility, including its provision of medical care, as a unrelated business trade or business, described in Section 513(a), with respect to the hospital organization (the “UBIT without control” test).
2. If the primary business of the Section 501(c)(3) organization is other than operating a hospital and it owns 35% or less in a venture that does operate a hospital, the Section 501(c)(3) organization will not be deemed to be operating the hospital if, in fact, it does not have control over operation of the hospital—either through powers delegated under a partnership or similar agreement or by virtue of its position as a general partner, managing member, or similar role (the “percentage of ownership and control” test).

It is clear that Treasury is continuing to apply the *St. David's* control test in the development of the Section 501(r) regulations.

As previously explained, the IRS has a “no rulings” policy regarding joint ventures. What does this mean practically? The IRS will not issue a private letter ruling (except in connection with a determination letter at the formation of a new Section 501(c)(3) organization) as it considers this a “facts and circumstances” determination. Accordingly, in the case of com-

plex joint ventures, this inaction effectively requires the board of the charity to obtain an opinion of counsel.¹⁰

Hot areas in ancillary joint ventures

Two areas involving ancillary joint ventures are growing in popularity.

Massive open online courses. With the growth of technology and the spread of high-speed wireless and Internet, smart phones, Facebook, the Cloud, and tablet computers over the last few years, educational joint ventures have grown in popularity. Massive Open Online Courses (MOOCs), which are college courses open to millions of people worldwide through the Internet, are one such example. Three major enterprises have driven the development of MOOCs: edX, a nonprofit run out of MIT and Harvard with other universities participating as “partners”; Coursera, a for-profit founded by two Stanford University professors with 33 university partners, which has received \$22 million in investor funding; and Udacity, a for-profit program.

MOOCs are courses that were developed in response to concerns raised by social entrepreneurs that traditional colleges and foundations move too slowly to make big innovations without a significant “push.” Since a generation has grown up relying upon technology to provide learning, this new structure allows for interaction with professors through online platforms. This interactive platform could allow the best schools in the world not only to offer a wide range of free course lectures online, but also a system of testing, grading, student-to-student help, and the award of certificates of completion, all for a relatively low costs. The largest enrollments in MOOCs are in the United States, Britain, Russia, India and Brazil. The thought is that high-quality learning platforms could benefit community colleges that typically have strained budgets. Such platforms would allow the best lecturers in the world on any subject to be “downloaded,” while the colleges’ own professors could concentrate on working directly with the students.¹¹

Companies such as Coursera obviously need old-fashioned universities to be their partners, but initially, many believed that Coursera had been pushing disruptive changes that could threaten traditional revenue streams for these same partners. The new companies seek to change the way colleges do business rather than simply sell what

colleges already do. However, major MOOC providers have recently distanced themselves from attempting to “reshape” higher education. Coursera’s new chief executive, former Yale University President, Richard Levin, has recently reiterated that the company’s moves should be thought of as “additive to what universities are doing, not disruptive.”¹²

It is important to have a joint venture policy in place and to carefully structure ventures pursuant to IRS guidelines.

Since this type of distance learning is still evolving, there is no formula as to how students will be charged or how they will receive credit for the particular courses. Will they receive certificates of completion? What are the mechanics for evaluating student participation? Could a university’s participation generate UBIT even though this is a new methodology for offering distance learning?¹³ These are questions that still need to be answered and are a reason that the topic of MOOCs is particularly of note.

The new market tax credit structure—a subsidy for charities operating in a qualified census tract. The New Markets Tax Credit (NMTC) program was enacted by Congress as part of the Community Renewal Tax Relief Act of 2000. The program is intended to spur investment in low-income communities, with the hope that jobs will be created and lives improved in those communities. The program was initially funded with a \$40 billion allocation from Congress through 2013 (which includes a billion-dollar allocation in the Gulf Opportunity Zone).¹⁴ The CDFI Fund has made 836 allocation awards. To date \$31.1 billion in credits have been invested in low-income communities through FY 2012. The expectation is that

the program will be renewed by the end of 2014 for a minimum of two years, if not permanently.¹⁵

The program allows investors, through an ancillary joint venture, to subsidize or provide “gap” financing for improvements to property or to expand businesses that are located in a qualified census tract. In return, investors receive a 39% tax credit over seven years provided the parties involved comply with the statutory provisions of the program outlined in Section 45D. Investors, typically large financial institutions, can also leverage their investment, which may provide an after-tax return in excess of 9-10%. NMTC projects have provided financing to a number of projects around the country, including food processing facilities, a food bank, manufacturing facilities, and a biomedical office park. The University of Arizona’s medical school received \$25 million in NMTC allocation, which was a key element in the strategy for revitalizing downtown Phoenix. The project led directly to permanent and construction jobs, as well as spurring follow-on investment.

Another example of a successful project was the financing of a charter high school in a major metropolitan area. Financing was provided by leveraging the equity investment with a substantial loan by a third party. The investor received tax credits in excess of its out-of-pocket cash investment, and the project received much-needed financing. Similarly, a 105-unit affordable housing project with ground floor retail space utilized an innovative structure that allowed the project to apply tax incentives offered by local housing agencies. This illustrates how using additional sources of incentive can aid in seeking investment.

¹² Kolowich, “2014: The Year the Media Stopped Caring About MOOCs?” *Chronicle for Higher Education*, 4/14/14, available at <http://chronicle.com/blogs/wiredcampus/2014-the-year-the-media-stopped-caring-about-moocs/51737>.

¹³ See Rev. Rul. 2004-51, *supra* note 1.

¹⁴ See Section 45D(f).

¹⁵ In addition, a number of states have enacted similar programs, which are often “twinned” with the federal program. Although the states’ interest in applying credits is expanding, the programs differ among the states and often have stricter requirements than the federal program. See a map of the state programs at www.novoco.com/new_markets/nmtc/state_nmtc_programs.php.

¹⁶ See Section 45D(a)(1) (allowing a credit to any taxpayer holding a qualified equity investment).

¹⁷ Sections 45D(b)(1)(A)-(C).

¹⁸ Section 45D(d)(1).

¹⁹ Section 45D(b)(3).

²⁰ Note that no UBIT is realized by a nonprofit leverage lender if the project is substantially related to the exempt function of

the organization, such as relief of the poor and underprivileged or relieving the burden of the government.

²¹ Under a typical leveraged structure, the investor will form a single-member LLC, which it will fund with the investor’s equity for the NMTC transaction. The LLC (Fund) will then borrow additional funds from the leverage lender. The Fund, which is controlled by the investor, uses the combined money from the investor and the leverage lender to make a QEI in the CDE. The investor will receive NMTCs based on the amount of the QEI, which combines the investor’s equity with the funds borrowed from the leverage lender. While the leveraged lender may take a security interest in the Fund’s assets, it is not permitted to take a direct security interest in a QALICB’s property. (See Rev. Rul. 2003-20, 2003-1 CB 465.) Loans between the leverage lender and Fund are usually nonrecourse. Because the recapture rules require that an investor (including the Fund) remain invested in the CDE during the seven-year compliance period, leverage lenders will be required to forbear from exercising remedies until the end of the compliance period.

Institutional investors in the joint venture. Although investors in the NMTC program are typically large financial institutions such as Goldman Sachs, J.P. Morgan, and PNC Bank, any taxpayer can be an investor in the program.¹⁶ Investors are defined by the investments they make, not by their corporate form (or lack thereof).

Investors make a qualified equity investment (QEI) in a community development entity (CDE). A qualified equity investment is generally any equity investment in a CDE if the investor obtains the interest at its original issue solely in exchange for cash, substantially all of the cash is used by the CDE to make qualified low-income community investments, and such investment is designated on the CDE's books as a QEI.¹⁷ The CDE must use "substantially all" of the QEI to make a qualified low-income community investment (QLICI). A QLICI includes any equity investment in or loan to a qualified active low-income community business (QALICB), the purchase of a loan from another CDE of a QLICI, financial counseling and other services specified in the regulations to business and residents of

low-income communities, and any equity investment in or loan to another CDE.¹⁸ The safe harbor for "substantially all" of the QEI being used for QLICIs is 85%.¹⁹ A CDE must make QLICIs within 12 months of receipt of the investors' QEIs. Because the credit received by an investor is a percentage of the QEI, there is incentive for the investor to borrow funds from a leverage lender to make the equity investment, which increases the return the investor receives.

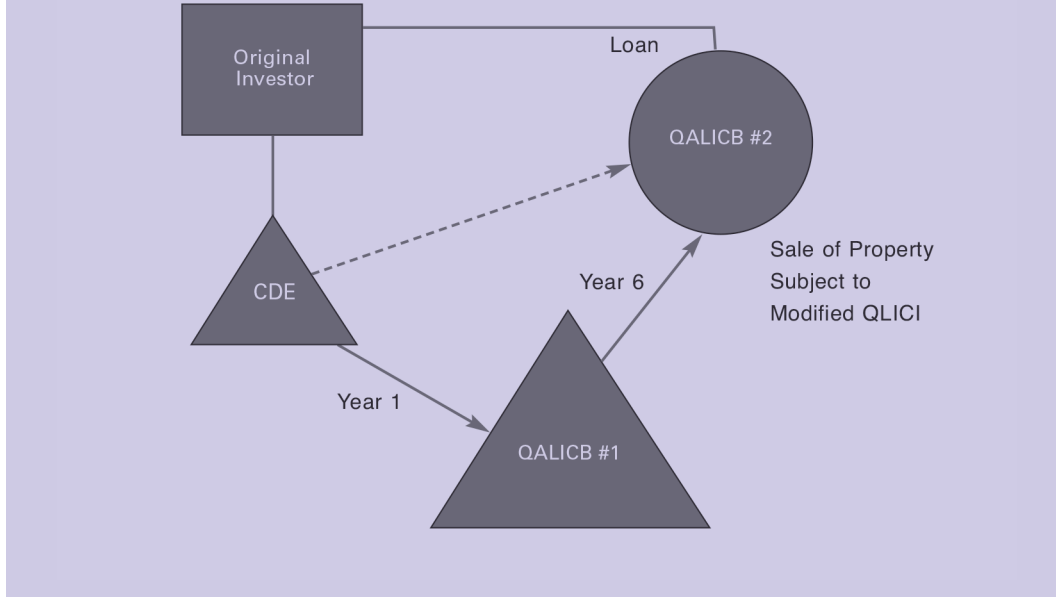
The leverage lender, which is typically unrelated to the QALICB developer (but may be affiliated), must provide bona fide debt to the investor in order to obtain the benefits of a leveraged structure. Examples of leveraged lenders are community banks and charities.²⁰ A lender's loan increases the amount of an investor's cash investment, which in turn leads to a greater credit and results in a benefit to both the investor and the QALICB.²¹

Qualified active low-income community businesses. The ultimate beneficiary of the investment is a QALICB, which is typically a developer or an operating business. The QALICB receives loan proceeds or an equity investment

4 / C AD

EXHIBIT 1

Year-Six Acquisition of Project from QALICB Subject to Modified QLICI Loan (see page 9).



from a CDE and is the entity that generally engages in the community development activity in the low-income community.²²

Exiting and recapture. Once the QEI is made, there is a seven-year compliance period. If any “recapture event” occurs during compliance period, the NMTCs claimed by the investor are recaptured and any future credits are forfeited. “Recapture event” is a statutorily defined term that includes a CDE ceasing to be a CDE, substantially all of the QEI ceasing to be used for investments in QLICIs, and the investment being redeemed by the CDE.²³ At the end of the seven-year compliance period, the investor will have received all the NMTCs for which it is eligi-

ble. At that point the investor and CDE will likely want to unwind the transaction and exit the structure. This is typically accomplished through the use of a “put/call” technique that generates a subsidy or grant equivalent to the QALICB. One version of this technique permits the investor to require the QALICB, over a specified period, to purchase the investor’s interest in the Fund for a specified price (the “put”). If the put is not exercised, the QALICB (or an affiliate) often has the right to purchase the investor’s interest in the Fund over a specified period of time for fair market value (the “call”). The put and call will likely be priced substantially below the investor’s original investment in the Fund.

²² Other options are for the CDE to (1) provide financial counseling and other services to a QALICB or residents of a low-income community directly or (2) make an equity investment in, or loan to, other CDEs, if the other CDE uses the loan in a manner consistent with the qualifications of CDEs. See Reg. 1.45D-1(d)(1)(iii)-(v). The regulations prescribe the parameters of what constitutes a QALICB. For example, a QALICB must derive the majority of its income from the active conduct of a qualified business in a low-income community and must own assets and perform services within a low-income community. (See Reg. 1.45D-1(d)(4)(i).) A low-income community is a statutorily defined term that includes areas where the poverty rate in an area is at least 20%. Section 45D(e)(2) was amended in 2004 to provide that target populations may be treated as low-income communities for statutory purposes. A qualified business generally includes any trade or business, but does not include “sin uses” such as golf courses, racetracks, country clubs, and gambling facilities. The rental of real property is a qualified business only if it is not residential real property and there are substantial improvements to it. (See Reg. 1.45D-1(d)(5)(ii).)

²³ Reg. 1.45D-1(g)(3).

²⁴ In addition, the QALICB’s accountant needs to determine whether COD income may be generated at the time of the “exit.” Under Section 61(a)(12), a discharge of indebtedness constitutes gross income to the debtor. As relevant here, a debtor’s acquisition of its own debt for less than the principal amount of the debt constitutes cancellation of indebtedness and is gross income. Similarly, the Code provides that acquisition of debt by a related party to the debtor is considered to be acquisition of indebtedness by the debtor. Thus, as a NMTC unwinds and notes change hands, the parties must be aware of the COD issue. A QALICB that has operating losses may offset COD ordinary income that it receives, or could pay the note over 25-30 years to defer taxability. However, the QALICB would need to pay interest annually during the life of the note.

²⁵ See note 24, *supra*.

²⁶ See Section 108(e)(4)(A).

²⁷ See Reg. 1.45D-1(D)(4)(i)(E).

²⁸ See Reg. 1.45D-1(d)(6)(ii).

After the investor is removed from the structure, either through the exercise of the put or the call, the QALICB may then take steps to have the Fund, which it now controls, liquidate the CDE. The QALICB will often use the QLICI note previously held by the CDE to repay the leverage lender. The result here is that the structure leaves the QALICB on its own and the leverage lender holding the QLICI note.

It is important to note that the net benefit to the project can then be measured by looking at the amount of the investor's original funds less fees, professional and administrative costs, and the price of the put/call. In the event that the leverage lender is a charity or is controlled by another Section 501(c)(3) organization, it may decide to forgive all or a portion of the loan at the end of the compliance period. However, it must not be legally obligated to do so at inception or intimate that it might do so during the compliance period. Otherwise, the structure may trigger a recapture event if the loan was not true debt.²⁴

Over the last few years, notwithstanding the basic seven-year compliance rule, deal structures have been modified during the compliance period through workouts of existing new market transactions. The basic rules require that the QEI remain in place during the full seven-year period although the investor and CDE may be changed. After the QEI is made, however, the QALICB (as well as the owners thereof) may also be changed within the compliance period. As to the investor, the credit is taken on the date of the initial QEI and on each anniversary date for six years. Prior to the sixth anniversary, to the extent the investor transfers its interest, it will forgo the remaining credits, which will then be taken by the new investor purchaser. After the sixth anniversary, since all credits have been taken, the purchaser will receive only residual cash flow, if any.

A QLICI includes the purchase from another CDE of any loan originally made by the CDE, which is a QLICI (at the time the loan is made or at the purchase). When the new CDE enters the structure, which is permitted, the original CDE needs to reinvest the cash as discussed below. A QLICI includes a loan to any QALICB and any loan to a qualified CDE.

As to the QALICB, the original documents need to be reviewed because they may limit the ability for the owners of the QALICB to transfer their interest, although the documents may

be amended in the ordinary course. If the QALICB repays QLICIs to the CDE, the CDE is required to reinvest such funds within one year. QALICB owners may sell their interest in the QALICB, but a review of existing guarantees and indemnification agreements would be necessary, as it is important that there are no existing defaults.

A new QALICB may acquire the existing project as an alternative, subject to or by assuming the QLICIs and providing substitute guarantees and indemnifications. In the event of the incorporation of a new QALICB, representations and warranties will need to be provided within the agreement confirming that there are no existing recapture defaults. In addition, as previously discussed,²⁵ the QALICB's accountant will need to review the transaction to verify whether there is any potential COD income generated,²⁶ or a modification of the note. There should also be a review of whether a re-examination of the nonqualified financial property test is necessary.²⁷ In most cases, a new QALICB/QLICI/true debt opinion will need to be issued. The CDE's retention of certain control rights at the time of renegotiation may have an impact on the application of the reasonable expectation test.²⁸

Example—A troubled project. Assume a mixed use project including a hotel, residential apartments, and commercial space. The new QALICB #2 borrower will acquire all of Seller-QALICB #1's right to title and interest in property, which is located in a low-income community. The borrower will assume the senior loan (existing QLICI). That loan will be modified by extending it for seven years, with interest payable only for the first five years, and adding a balloon payment at termination. The principal balance of the QLICI loan would be modified by "reducing" the principal 50%, effective immediately prior to closing. It is important that QALICB #2 confirms that the obligation for COD income falls on QALICB #1 and that there are no existing defaults including recapture events during the due diligence phase. The structure of the transaction is illustrated in Exhibit 1 on page 8.

Caveat. Most operating agreements in LLC and partnership agreements have general language relative to the allocation of income, gains, etc., among the partners. In the event that there are partners or members in the QALICB and COD is triggered pursuant to Section 108 upon the exercise of the put or call option

in an unwind, it is recommended that specific language be included in the partnership agreement/operating agreement that specifies exactly how the COD income is to be allocated among the partners.

Virtual joint ventures

In view of the extensive reach of Rev. Rul. 2004-51²⁹ to ancillary joint ventures, it may be argued that the rationale of that ruling could apply when the IRS proposes revocation of an existing Section 501(c)(3) organization following an examination of its relationship with a for-profit entity (notwithstanding the fact that no formal joint venture agreement exists between the parties).

Assume a hypothetical case in which an educational or scientific property, such as a magazine, is owned 100% by a for-profit business, X, which controls the business and financial operations. A charity, Y, acquires and retains decision-making rights over substantially all of the educational content of the magazine—in effect, an unconventional “upside down” transaction.

Assume further that the IRS challenges the relationship of Y to X, arguing that there is impermissible private benefit to the business; in effect, that the charitable organization is operating for a substantial nonexempt purpose and is acting as a “tool” to enhance the sale of products for X, the for-profit entity. Even though there is no formal joint venture structure, Y, the 501(c)(3) organization, may be able to defend its exemption by relying upon the bifurcated control test pursuant to Rev. Rul. 2004-51.³⁰ (This is so even though there is no provision in any agreement dealing with the distribution of net proceeds, but all such available funds are in fact reinvested in the trade or business.)

The question presented by this hypothetical is whether the arrangement between Y and X is a joint venture or contractual relationship. Indeed, if it is a contractual relationship, a Section 501(c)(3) organization’s charitable purpose

might not be threatened because the two-prong test applies to joint ventures, not contractual relationships. If it is a joint venture, Y may argue that the publication is consistent with Y’s educational and scientific purposes because the charity wants to educate its members—a charitable class—about scientific breakthroughs, knowledge of recent developments, and the like.

It is important to note that on 6/11/14, the Advisory Committee on Tax Exempt and Government Entities (ACT) urged the IRS to open a regulation project to formalize the “commensurate” test articulated in Rev. Rul. 64-182³¹ and reject the application of the commerciality test.³² The courts and the IRS use that test in determining when certain business activity will preclude exemption for Section 501(c)(3) status and what constitutes unrelated business taxable income. The ACT stated that “neither the tax law nor the implementing regulations provide support for a commerciality test.”³³

Structuring issues involving complex ancillary joint ventures

While a joint venture with a for-profit entity may well be desirable for a nonprofit organization, for many of the reasons previously mentioned, such a relationship should not be entered into hastily. Prior to entering into an ancillary joint venture with a for-profit company, a tax exempt organization needs to ask basic questions about the relationship. What aspects should be controlled and operated by the exempt organization? How are those activities in furtherance of the exempt purposes of the exempt organization? What aspects may be controlled by the for-profit?

The operating agreement. Language should be drafted to require the joint venture to operate in furtherance of the exempt organization’s purposes, which will “override” the duty to operate for the financial benefit of the for-profit partners. This language will protect the exempt organization’s assets from exposure to unnecessary risk for the benefit of the for-profit partners and minimizes the potential for private inurement or private benefit. Often overlooked, however, the language should provide reasonable and comparable terms for an “exit strategy” option in the event the venture is unsuccessful.³⁴

Basic structuring considerations. The venture’s operating agreement should provide the exempt organization, at a minimum, with voting control of those policies and activities of the joint venture related to the exempt organization’s exempt pur-

²⁹ Note 1, *supra*.

³⁰ *Id.*

³¹ 1964-1 CB 186.

³² Advisory Committee on Tax Exempt and Government Entities (ACT), “2014 Report of Recommendations,” p. 80, available at www.irs.gov/pub/irs-tege/tege_act_rpt13.pdf.

³³ *Id.*

³⁴ See Sanders, *supra* note 2, Chapter 4, Appendix 4B.

³⁵ *Id.*

³⁶ See Rev. Rul. 98-15, 1998-1 CB 718.

³⁷ See Reg. 1.482-4(a).

³⁸ Note 1, *supra*.

poses. The board of managers should be split at least 50/50 between the exempt organization and the for-profit entity. It should also require the joint venture to furnish the exempt organization with all information necessary to complete its Form 990 in a timely fashion.³⁵

Management agreement. The management agreement should include a binding obligation to further the exempt purposes of the nonprofit organization, within the parameters set forth in the operating agreement. The exempt organization should have the unilateral right to terminate if the manager is not acting to further the exempt purpose of the exempt organization. The terms and conditions should be reasonable and comparable to similar arrangements in the marketplace based upon “due diligence.” The length of the agreement should be reasonable, *e.g.*, not to exceed a five-year term, and renewal should not be automatic.³⁶

Capitalization and distribution. Ownership interest in the joint venture, for the exempt organization and all for-profit investors, must be proportionate to the value of the assets contributed, which in turn will result in proportionate distribution. Licensing of intangibles—*e.g.*, the value of a license agreement to use the logo of the exempt organization, would be included in the capital contribution of the exempt organization. For future investors, the amount contributed depends on the valuation of the joint venture at the time of investment.

Section 482—Arm’s-length transfer. Section 482 and the applicable Treasury regulations (together, “Section 482”) allow the Service to reallocate gross income, deductions, credits, and other allowances of related taxpayers in order to prevent tax evasion or to clearly reflect the income of those related taxpayers. Section 482 requires that related taxpayers use an arm’s-length standard in their transactions with each other as if they were dealing with unrelated taxpayers in a similar transaction under similar circumstances. For example, a Section 482 issue may arise if one entity performs services for another entity without charge or at a charge that does not reflect an arm’s-length payment.

Section 482 provides specific methods to calculate a commercially reasonable price, and a taxpayer is required to employ the “best method” (*i.e.*, the method that produces the most accurate result) for such services and/or property. These methods include the compara-

ble uncontrolled price method, the cost-plus method, the comparable profits method, and the resale method.³⁷

Shared services and facilities agreement. Such an agreement is entered into for the sharing of space and employees between the joint venture and the exempt organization. The sharing of services and facilities must be pursuant to an agreement with a term of no more than one year. The agreement should be subject to annual renewal. Any such agreement must justify the reason for the arrangement, such as economies of scale, the division of functions, or the allocation of costs. The agreement must be negotiated at arm’s length, including a determination, also at arm’s length, of the fair market value of services. The exempt organization can serve as “paymaster.”

Employees who perform services for both the joint venture and the exempt organization must keep time sheets so that costs can be allocated between the two. Any cost reimbursements must have supporting documentation—*e.g.*, receipts.

Conclusion

The joint venture structure benefits distance learning; tax credit programs, including the new market tax credit; and health care facilities among other exempt function activities. The IRS has established guidelines that allow tax exempts to protect exempt status and minimize unrelated business income.

Recently, the IRS has reinforced its interpretation of the two-prong control test in the 2013 proposed regulations relative to the operations of nonprofit hospitals. It is important to understand how the potential application of the IRS published ruling policy under Rev. Rul. 2004-51³⁸ could apply as a defense to the IRS proposed revocation of a Section 501(c)(3) organization, in effect establishing a “virtual” joint venture argument.

Finally, charities should adopt joint venture policies and take into consideration a series of operational steps to protect the structure in complex joint venture, including the use of a shared services and facilities agreement and an exit strategy option in the event the venture is unsuccessful. ■