Tuesday, October 26
11:00am-12:30pm

607 - Joint Ventures, Co-ventures, Hybrids and Other Unusual and Creative Ideas for Increasing Visibility and Raising Revenue

Timothy Phillips
Senior Counsel
American Cancer Society

Gary Rindner
General Counsel & Chief Operating Officer
Per Scholas, Inc.

William Sherman
Partner
Holland & Knight

Session 607

Faculty Biographies

Timothy Phillips

Timothy Phillips is senior counsel for the National Home Office of the American Cancer Society, Inc. He specializes in the areas of taxation, nonprofit governance, risk management, compliance, employee benefits and executive compensation, grant reviews, vendor contracts and collaborative efforts with foreign cancer fighting entities.

Prior to joining the American Cancer Society, Mr. Phillips was in private practice in the Atlanta office of Troutman Sanders LLP, where he focused on advising tax-exempt entities.

Mr. Phillips is a past president of the Atlanta Volunteer Lawyers Foundation. He also serves on the boards of the Navy SEAL Warrior Fund (secretary), the Naval Academy Alumni Association -- Atlanta Chapter, the Atlanta Bar Association's Section of Taxation (chair), and the Pro Bono Partnership of Atlanta (advisory).

He received his BS from the US Naval Academy then served as a commissioned officer with the US Navy's SEAL Teams. He earned his JD degree from the University of Virginia.

Gary Rindner

Gary Rindner is the Chief Operating Officer and General Counsel of Per Scholas. Per Scholas is a nonprofit organization headquartered in the South Bronx which is committed to breaking the cycle of poverty by providing education, technology and economic opportunities to individuals, families and communities. Mr. Rindner's responsibilities include the computer asset recovery and Access programs that Per Scholas operates in support of its mission. Mr. Rindner began working with Per Scholas in 2006 as its Vice President of Special Projects.

Prior to joining Per Scholas, Mr. Rindner was a corporate attorney with Cadwalader, Wickersham & Taft in New York City and then served as General Counsel of Man Group USA Inc., a global trading and financial services firm. He has over twenty years of experience handling a full range of legal and business matters.

Mr. Rindner is a director of Brooklyn Workforce Innovations, a Brooklyn based nonprofit which provides workforce development training programs. Mr. Rindner graduated from Vassar College with a Bachelor's Degree and received his law degree from Boston University School of Law.

William Sherman

William B. Sherman, chair of the firm's tax team, is a partner at Holland & Knight LLP concentrating his practice in the area of domestic and international taxation. He has provided sophisticated tax planning for mergers and acquisitions, restructurings, joint ventures and investments for clients in diverse industries, such as hospitality, petrochemicals, aluminum, tobacco, real estate, transportation, telecommunications, retailing, investment management, pharmaceuticals, and numerous others. In addition, Mr. Sherman has experience in a broad range of transactions involving US investment overseas, foreign investment in the US, as well as international, federal, state, and local taxation issues involving structuring investment management funds, corporate reorganizations, partnerships, equipment leasing, Subchapter S, executive compensation, stock options, and trusts and estates.

Mr. Sherman is a well-known lecturer, chairing the New York University's Summer Institute in Taxation's Introductory and Advanced International Tax Seminars; and its Institute on Federal Taxation International Tax Program. He has served on numerous panels for organizations such as the ABA and Florida Bar and is the chair elect of the ABA's Tax Section Committee on US Activities of Foreigners and Tax Treaties. He also is an adjunct lecturer of tax law at the University of Miami School of Law.

Mr. Sherman received a BA, cum laude, from Brooklyn College of The City University, an LLM in taxation from the New York University School of Law, and received his law degree from Brooklyn Law School, with honors.

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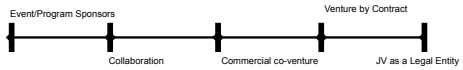
The Venture Spectrum



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The Venture Spectrum

- Every deal is different
- More than one way to skin the cat
- Each structure provides its own mix of risk and reward

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Joint Venture-The Definition

- The term Joint Venture can have different meanings to different persons
- Important to analyze and properly characterize the legal relationships created

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Forms of Joint Venture

- Traditional form-co-ownership of a legal entity
  - Partnership-general or limited
  - Limited liability company
  - Corporation
- Other forms-generally contractual relationship
  - License agreement
  - Agency relationship
  - Joint operating agreement

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Tax Issues to the Tax Exempt Participant

- Does the venture cause a loss of tax exempt status
- Does the Tax Exempt Participant have unrelated business taxable income ("UBTI")

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History: per se loss of exemption

IRS original position

- any partnership of a tax-exempt organization and private investors, where the tax-exempt organization was the general partner was contrary to tax exempt status
  - Called the "per se rule"
  - Resulted in automatic revocation of exemption
  - Furthering or advancing a charitable objective was not a factor to be considered

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The "per se rule" challenged

- Plumstead Theatre Soc'y, Inc. v. Comm'r, 74 T.C. 1324 (1980)
  - Exempt theatre company formed limited partnership with investors to fund production. IRS challenged and lost. Court found venture furthered exempt purposes and exempt organization sufficiently controlled venture's activities.
- Abandoned in 1983-Gen. Couns. Mem. 39005
  - IRS stated that it was possible for a charitable organization to participate as a general partner in a limited partnership without jeopardizing its tax exemption

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Current Law Three Part Test

1. Whether the charitable organization's participation in the partnership is serving a charitable purpose
2. Whether the charity, under the particular facts and circumstances, is insulated from the day-to-day responsibilities as general partner
3. Whether or not the limited partners are receiving an undue economic benefit from the partnership

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Case Study

Per Scholas Inc.(South Bronx) is an environmentally responsible nonprofit organization committed to breaking the cycle of poverty by providing education, technology and economic opportunities to individuals, families and communities

Redemtech Inc. (Columbus) offers TCM (Technology Change Management) services that enable organizations to shift from mass technology refresh programs, which are inefficient and disruptive, to a lean, on-demand model for technology deployment, reutilization, remarketing and retirement.

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Problem or Opportunity?

- Assess your current situation and needs
- Evaluate recent and future trends
- Solve a problem or exploit an opportunity
- Set clear and realistic objectives
- **Per Scholas**: Refurbishing computers in our facility with own staff became more challenging and expensive, trends were unfavorable, not core to mission.
- **Redemtech**: Establish refurbishing facility in New York region with experienced staff and strong client base, broaden Serious Good philanthropic program.

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Per Scholas-Redemtech Partnership

- Per Scholas continues to source and distribute used computers for its digital inclusion mission
- Per Scholas leases production facility to Redemtech
- Redemtech upgrades and operates facility after hiring Per Scholas production staff
- Redemtech expands presence and client base in New York region and reinforces philanthropic commitment
- Per Scholas obtains more refurbished computers at lower costs due to economies of scale
- Establish platform for broadening partnership
- Embedded in contractual relationship

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Finding the Right Partner

- List and evaluate your competitors or vendors
- Research- trade publications, news reports, IRS filings
- Attend relevant industry events/ trade shows
- Review funders/contributors
- Geographic overlap or expansion
- Track record– prior involvement with nonprofit sector
- Compare working environments and cultures
- Seek senior level commitment– measured by time and focus on the partnership

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Forging the Deal

- In person meetings at each other's offices—confirms level of commitment while observing other's operations
- Openness and flexibility are critical—similar businesses may have contradictory business models
- Financial modeling potential outcomes is essential
- Set a deadline on reaching agreement
- Minimize participation by third parties such as attorneys, accountants and consultants
- Matching counterparts–President-to-President, CFO-to-CFO, Sales-to-Business Development

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Documenting the Deal

Documentation will likely consist of:

- Mutual Non Disclosure Agreement– ensure open sharing of information between parties
- Letter of Intent/Memorandum of Understanding– non binding, plain english, structure and timing of transaction, share with relevant stakeholders
- Master Agreement– substantive terms of transaction– might be Partnership Agreement, Joint Venture, LLC
- Ancillary Agreements-- Lease Agreement, Service Level Agreement, Joint Marketing Plan, etc.
- Control drafting but use familiar documents

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Structuring the Deal

Every transaction will be unique but consider

- Transition Period- after signing and before closing, start transition to new arrangement if feasible
- Trial Period- fixed period during which parties ensure goals are realistic, chance to revisit if necessary
- Exclusivity—impact on other aspects of operation
- Provision for friendly unwind if not working
- Term- Fixed or open ended, duration
- Preserve right to modify form of partnership
- Simple dispute resolution mechanism

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Employee/Cultural Issues

- Working environment and management styles differ
- Fear of layoffs
- Hiring standards --"interviews" v. "assessments"
- Clarify reporting lines/ responsibilities
- Motivating former nonprofit employees after being distanced from mission
- Transition to new roles while working with former colleagues
- Compensation structure/inconsistencies
- Matching salary, benefits, vacation, hours—seniority

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Client/Competitive Issues

- Sharing client or proprietary data before signing
- Drafting procedures for new and shared clients or sales territories/coverage
- Coordinating sales/business development activities and marketing approaches
- Form of disclosure to clients-managing reaction
- Consider unwind/restructure if not accepted by clients
- Managing new expectations from clients
- Client connection to nonprofit may be more complex and harder to untangle

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Operational Issues

- Legacy—managing old commitments while switching to new systems, may impact finance, inventory, etc.
- Communications– more formalized, different language used by each organization
- Systems– may require adjusting to new systems to do same job, significant time requirement
- Training– retraining tougher than training from scratch
- Disruption– throughout operation, may need to pull from one department to staff another one
- Timing– begin during a slow period if at all possible

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Conclusions

- Every nonprofit should focus on what it does best and seek opportunities to partner on non-core aspects of its business
- Be creative and flexible for maximum value
- Find a partner which shares the nonprofit's ideals and mission and will be supportive
- Prepare all your employees for change—both immediate and over the long term
- Seek more touch points between the organizations to strengthen ties and benefit of partnership

Rev. Rul. 79-222, 1979-2 C.B. 236

Unrelated business income; employees' trust as limited partner. The investment of an exempt employees' trust as a limited partner in a partnership carrying on an unrelated trade or business may result in unrelated business taxable income within the meaning of section 512 of the Code.

Advice has been requested whether, under the circumstances described below, investment activity by an exempt employees' trust may result in unrelated business taxable income within the meaning of section 512 of the Internal Revenue Code of 1954.

An exempt employees' trust became a limited partner in a partnership that was created under the laws of a state which recognizes such interests. The limited partners do not participate in the management of the partnership and their liability is limited to the amount of their contributions. The partnership regularly carries on a trade or business.

Section 511 of the Code imposes a tax on the unrelated business taxable income of certain organizations, one of which is an exempt employees' pension profit-sharing or stock bonus trust.

Section 513(b) of the Code defines 'unrelated trade or business' to mean, in the case of an exempt employees' trust, any trade or business regularly carried on by such trust or by a partnership of which it is a member.

Section 512(c) of the Code requires that an exempt employees' trust shall include, in computing its unrelated business taxable income, its share of the gross income of the partnership of which it is a member derived from a trade or business regularly carried on by the partnership which, with respect to such organization is an unrelated trade or business regularly carried on by it and its share of the partnership deductions directly connected with such gross income.

Section 512(c) of the Code uses the term 'member' of a partnership without qualification. In setting forth special rules applicable to members of partnerships in computing their unrelated business taxable income, section 512(c) makes no distinction between general and limited partners. See also S. Rep. No. 1402, 85th Cong., 2d. Sess. 2 (1958), 1958-1 C.B. 656, at 657 which states that, under existing law, income from a partnership interest held by a charitable organization-whether the partnership interest is that of a general partner or that of a limited partner-is unrelated business income except to the extent that the income received by the partnership is specifically excluded as dividends, interest, royalties, and the like.

Accordingly, the exempt trust's investment as a limited partner in a partnership carrying on an unrelated trade or business may result in unrelated business taxable income within the meaning of section 512 of the Code.

Section 501.—Exemption From Tax on Corporations, Certain Trusts, Etc.
26 CFR 1.501(c)(3)–1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals. (Also §§ 170 and 509.)

Tax consequences of participation by hospitals described in section 501(c)(3) of the Code in joint ventures with for profit entities. This ruling provides examples illustrating whether nonprofit hospitals that participate in joint ventures with for-profit entities continue to qualify for exemption as organizations described in section 501(c)(3) of the Code.

Rev. Rul. 98–15
ISSUE

Whether, under the facts described below, an organization that operates an acute care hospital continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code when it forms a limited liability company (LLC) with a for-profit corporation and then contributes its hospital and all of its other operating assets to the LLC, which then operates the hospital.

FACTS

Situation 1
A is a nonprofit corporation that owns and operates an acute care hospital. *A* has been recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3) and as other than a private foundation as defined in § 509(a) because it is described in § 170(b)(1)(A)(iii). B is a for-profit corporation that owns and operates a number of hospitals.

A concludes that it could better serve its community if it obtained additional funding. *B* is interested in providing financing for *A*'s hospital, provided it earns a reasonable rate of return. *A* and *B* form a limited liability company, *C*. *A* contributes all of its operating assets, including its hospital to *C*. *B* also contributes assets to *C*. In return, *A* and *B* receive ownership interests in *C* proportional and equal in value to their respective contributions.

C's Articles of Organization and Operating Agreement ("governing documents") provide that *C* is to be managed by a governing board consisting of three individuals chosen by *A* and two individuals chosen by *B*. *A* intends to appoint community leaders who have experience with hospital matters, but who are not on the hospital staff and do not otherwise engage in business transactions with the hospital.

The governing documents further provide that they may only be amended with the approval of both owners and that a majority of three board members must approve certain major decisions relating to *C*'s operation, including decisions relating to any of the following topics:

A. *C*'s annual capital and operating budgets;
B. Distributions of C's earnings;
C. Selection of key executives;
D. Acquisition or disposition of health care facilities;
E. Contracts in excess of $x per year;
F. Changes to the types of services offered by the hospital; and
G. Renewal or termination of management agreements.

The governing documents require that *C* operate any hospital it owns in a manner that furthers charitable purposes by promoting health for a broad cross section of its community. The governing documents explicitly provide that the duty of the members of the governing board to operate *C* in a manner that furthers charitable purposes by promoting health for a broad cross section of the community overrides any duty they may have to operate *C* for the financial benefit of its owners. Accordingly, in the event of a conflict between operation in accordance with the community benefit standard and any duty to maximize profits, the members of the governing board are to satisfy the community benefit standard without regard to the consequences for maximizing profitability.

The governing documents further provide that all returns of capital and distributions of earnings made to owners of *C* shall be proportional to their ownership interests in *C*. The terms of the governing documents are legal, binding, and enforceable under applicable state law.

C enters into a management agreement with a management company that is unrelated to *A* or *B* to provide day-to-day management services to *C*. The management agreement is for a five-year period, and the agreement is renewable for additional five-year periods by mutual consent. The management company will be paid a management fee for its services based on *C*'s gross revenues. The terms and conditions of the management agreement, including the fee structure and the contract term, are reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals. *C* may terminate the agreement for cause.

None of the officers, directors, or key employees of *A,* who were involved in making the decision to form *C,* were promised employment or any other inducement by *C* or *B* and their related entities if the transaction were approved. None of *A*'s officers, directors, or key employees have any interest, including any interest through attribution determined in accordance with the principles of § 318, in *B* or any of its related entities.

Pursuant to § 301.7701–3(b) of the Procedure and Administrative Regulations, *C* will be treated as a partnership for federal income tax purposes.

A intends to use any distributions it receives from *C* to fund grants to support activities that promote the health of *A*'s community and to help the indigent obtain health care. Substantially all of *A*'s grant making will be funded by distributions from *C*. *A*'s projected grant making program and its participation as an owner of *C* will constitute *A*'s only activities.

Situation 2
D is a nonprofit corporation that owns and operates an acute care hospital. *D* has been recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3) and as other than a private foundation as defined in § 509(a) because it is described in § 170(b)(1)(A)(iii). *E* is a for-profit hospital corporation that owns and operates a number of hospitals and provides management services to several hospitals that it does not own.

D concludes that it could better serve its community if it obtained additional funding. *E* is interested in providing financing for *D*'s hospital, provided it earns a reasonable rate of return. *D* and *E* form a limited liability company, *F*. *D* contributes all of its operating assets, including its hospital, to *F*. *E* also contributes assets to *F*. In return, *D* and *E* receive ownership interests proportional and equal in value to their respective contributions.

F's Articles of Organization and Operating Agreement ("governing documents") provide that *F* is to be managed by a governing board consisting of three individuals chosen by *D* and three individuals chosen by *E*. *D* intends to appoint community leaders who have experience with hospital matters, but who are not on the hospital staff and do not otherwise engage in business transactions with the hospital.

The governing documents further provide that they may only be amended with the approval of both owners and that a majority of board members must approve certain major decisions relating to *F*'s operation, including decisions relating to any of the following topics:

A. F's annual capital and operating budgets;
B. Distributions of *F*'s earnings over a required minimum level of distributions set forth in the Operating Agreement;
C. Unusually large contracts; and
D. Selection of key executives.

F's governing documents provide that F's purpose is to construct, develop, own, manage, operate, and take other action in connection with operating the health care facilities it owns and engage in other health care-related activities. The governing documents further provide that all returns of capital and distributions of earnings made to owners of *F* shall be proportional to their ownership interests in *F*.

F enters into a management agreement with a wholly-owned subsidiary of *E* to provide day-to-day management services to *F*. The management agreement is for a five-year period, and the agreement is renewable for additional five-year periods at the discretion of *E*'s subsidiary. *F* may terminate the agreement only for cause. *E*'s subsidiary will be paid a management fee for its services based on gross revenues. The terms and conditions of the management agreement, including the fee structure and the contract term other than the renewal terms, are reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals.

As part of the agreement to form *F*, *D* agrees to approve the selection of two individuals to serve as *F*'s chief executive officer and chief financial officer. These individuals have previously worked for *E* in hospital management and have business expertise. They will work with the management company to oversee *F*'s day-today management. Their compensation is comparable to what comparable executives are paid at similarly situated hospitals. Pursuant to § 301.7701–3(b), *F* will be treated as a partnership for federal tax income purposes.

D intends to use any distributions it receives from *F* to fund grants to support activities that promote the health of *D*'s community and to help the indigent obtain health care. Substantially all of *D*'s grant making will be funded by distributions from *F*. *D*'s projected grant making program and its participation as an owner of *F* will constitute *D*'s only activities.

LAW

Section 501(c)(3) provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)–1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. In *Better Business Bureau of Washington, D.C. v. United States,* 326 U.S. 279, 283 (1945), the Court stated that "the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Section 1.501(c)(3)–1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. It further states that "to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized and operated for the benefit of private interests . . . ."

Section 1.501(c)(3)–1(d)(2) provides that the term "charitable" is used in § 501(c)(3) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. *See Restatement (Second) of Trusts,* §§ 368, 372 (1959); 4A Austin W. Scott and William F. Fratcher, *The Law of Trusts* §§ 368, 372 (4th ed. 1989). However, not every activity that promotes health supports tax exemption under § 501(c)(3). For example, selling prescription pharmaceuticals certainly promotes health, but pharmacies cannot qualify for recognition of exemption under § 501(c)(3) on that basis alone. *Federation Pharmacy Services, Inc. v. Commissioner,* 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980) ("*Federation Pharmacy*"). Furthermore, "an institution for the promotion of health is not a charitable institution if it is privately owned and is run for the profit of the owners." 4A Austin W. Scott and William F. Fratcher, *The Law of Trusts* § 372.1 (4th ed. 1989). *See also Restatement (Second) of Trusts,* § 376 (1959). This principle applies to hospitals and other health care organizations. As the Tax Court stated, "[w]hile the diagnosis and cure of disease are indeed purposes that may furnish the foundation for characterizing the activity as 'charitable,' something more is required." *Sonora Community Hospital v. Commissioner,* 46 T.C. 519, 525-526 (1966), aff'd 397 F.2d 814 (9th Cir. 1968) ("*Sonora*"). *See also Sound Health Association v. Commissioner,* 71 T.C. 158 (1978), acq. 1981-2 C.B. 2 ("*Sound Health*"); *Geisinger Health Plan v. Commissioner,* 985 F.2d 1210 (3rd Cir., 1993), *rev'g* 62 T.C.M. 1656 (1991) ("Geisinger").

In evaluating whether a nonprofit hospital qualifies as an organization described in § 501(c)(3), Rev. Rul. 69–545, 1969–2 C.B. 117, compares two hospitals. The first hospital discussed is controlled by a board of trustees composed of independent civic leaders. In addition, the hospital maintains an open medical staff, with privileges available to all qualified physicians; it operates a full-time emergency room open to all regardless of ability to pay; and it otherwise admits all patients able to pay (either themselves, or through third party payers such as private health insurance or government programs such as Medicare). In contrast, the second hospital is controlled by physicians who have a substantial economic interest in the hospital. This hospital restricts the number of physicians admitted to the medical staff, enters into favorable rental agreements with the individuals who control the hospital, and limits emergency room and hospital admission substantially to the patients of the physicians who control the hospital. Rev. Rul. 69–545 notes that in considering whether a nonprofit hospital is operated to serve a private benefit, the Service will weigh all the relevant facts and circumstances in each case, including the use and control of the hospital. The revenue ruling concludes that the first hospital continues to qualify as an organization described in § 501(c)(3) and the second hospital does not because it is operated for the private benefit of the physicians who control the hospital.

Section 509(a) provides that the term "private foundation" means a domestic or foreign organization described in § 501(c)(3) other than an organization described in § 509(a)(1), (2), (3), or (4). The organizations described in § 509(a)(1) include those described in § 170(b)(1)- (A)(iii). An organization is described in § 170(b)(1)(A)(iii) if its principal purpose is to provide medical or hospital care.

Section 512(c) provides that an exempt organization that is a member of a partnership conducting an unrelated trade or business with respect to the exempt organization must include its share of the partnership income and deductions attributable to that business (subject to the exceptions, additions, and limitations in § 512(b)) in computing its unrelated business income. *See also* H.R. No. 2319, 81st Cong., 2d Sess. 36, 111–112 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 26, 109–110 (1950); § 1.512(c)–1.

In *Butler v. Commissioner,* 36 T.C. 1097 (1961), *acq.* 1962–2 C.B. 4 ("*Butler*"), the court examined the relationship between a partner and a partnership for purposes of determining whether the partner was entitled to a business bad debt deduction for a loan he had made to the partnership that it could not repay. In holding that

the partner was entitled to the bad debt deduction, the court noted that "[b]y reason of being a partner in a business, petitioner was individually engaged in business." *Butler,* 36 T.C. at 1106 *citing Dwight A. Ward v. Commissioner,* 20 T.C. 332 (1953), *aff'd* 224 F.2d 547 (9th Cir. 1955).

In *Plumstead Theatre Society, Inc. v. Commissioner,* 74 T.C. 1324 (1980), *aff 'd*, 675 F.2d 244 (9th Cir. 1982) ("*Plumstead*"), the Tax Court held that a charitable organization's participation as a general partner in a limited partnership did not jeopardize its exempt status. The organization co-produced a play as one of its charitable activities. Prior to the opening of the play, the organization encountered financial difficulties in raising its share of costs. In order to meet its funding obligations, the organization formed a limited partnership in which it served as general partner, and two individuals and a for-profit corporation were the limited partners. One of the significant factors supporting the Tax Court's holding was its finding that the limited partners had no control over the organization's operations.

In *Broadway Theatre League of Lynchburg, Virginia, Inc. v. U.S.,* 293 F.Supp. 346 (W.D.Va. 1968) ("*Broadway Theatre League*"), the court held that an organization that promoted an interest in theatrical arts did not jeopardize its exempt status when it hired a booking organization to arrange for a series of theatrical performances, promote the series and sell season tickets to the series because the contract was for a reasonable term and provided for reasonable compensation and the organization retained ultimate authority over the activities being managed.

In *Housing Pioneers v. Commissioner,* 65 T.C.M. (CCH) 2191 (1993), aff'd, 49 F.3d 1395 (9th Cir. 1995), *amended* 58 F.3d 401 (9th Cir. 1995) ("*Housing Pioneers*"), the Tax Court concluded that an organization did not qualify as a § 501(c)(3) organization because its activities performed as co-general partner in for-profit limited partnerships substantially furthered a non-exempt purpose, and serving that purpose caused the organization to serve private interests. The organization entered into partnerships as a one percent co-general partner of existing limited partnerships for the purpose of splitting the tax benefits with the for profit partners. Under the management agreement, the organization's authority as co-general partner was narrowly circumscribed. It had no management responsibilities and could describe only a vague charitable function of surveying tenant needs.

In *est of Hawaii v. Commissioner,* 71 T.C. 1067 (1979), *aff 'd in unpublished opinion* 647 F.2d 170 (9th Cir. 1981) ("*est of Hawaii*"), several for-profit est organizations exerted significant indirect control over est of Hawaii, a non-profit entity, through contractual arrangements. The Tax Court concluded that the for profits were able to use the non-profit as an "instrument" to further their for-profit purposes. Neither the fact that the for-profits lacked structural control over the organization nor the fact that amounts paid to the for-profit organizations under the contracts were reasonable affected the court's conclusion. Consequently, est of Hawaii did not qualify as an organization described in § 501(c)(3).

In *Harding Hospital, Inc. v. United States,* 505 F.2d 1068 (6th Cir. 1974) ("*Harding*"), a non-profit hospital with an independent board of directors executed a contract with a medical partnership composed of seven physicians. The contract gave the physicians control over care of the hospital's patients and the stream of income generated by the patients while also guaranteeing the physicians thousands of dollars in payment for various supervisory activities. The court held that the benefits derived from the contract constituted sufficient private benefit to preclude exemption.

ANALYSIS
For federal income tax purposes, the activities of a partnership are often considered to be the activities of the partners. *See, e.g., Butler.* Aggregate treatment is also consistent with the treatment of partnerships for purpose of the unrelated business income tax under § 512(c). See H.R. No. 2319, 81st Cong., 2d Sess. 36, 110–112 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 26, 109–110 (1950); § 1.512(c)– 1. In light of the aggregate principle discussed in *Butler* and reflected in § 512(c), the aggregate approach also applies for purposes of the operational test set forth in § 1.501(c)(3)–1(c). Thus, the activities of an LLC treated as a partnership for federal

income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of § 501(c)(3).

A § 501(c)(3) organization may form and participate in a partnership, including an LLC treated as a partnership for federal income tax purposes, and meet the operational test if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for profit partners. *See Plumstead* and *Housing Pioneers.* Similarly, a § 501(c)(3) organization may enter into a management contract with a private party giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets provided that the organization retains ultimate authority over the assets and activities being managed and the terms and conditions of the contract are reasonable, including reasonable compensation and a reasonable term. *See Broadway Theatre League.* However, if a private party is allowed to control or use the non-profit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes. *See est of Hawaii; Harding*; § 1.501(c)(3)–1(c)(1); and § 1.501(c)(3)–1(d)(1)(ii).

Situation 1
After *A* and *B* form *C*, and *A* contributes all of its operating assets to *C, A*'s activities will consist of the health care services it provides through *C* and any grant making activities it can conduct using income distributed by *C*. *A* will receive an interest in *C* equal in value to the assets it contributes to *C*, and *A*'s and *B*'s returns from *C* will be proportional to their respective investments in *C*. The governing documents of *C* commit *C* to providing health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits for *C*'s owners. Furthermore, through *A*'s appointment of members of the community familiar with the hospital to *C*'s board, the board's structure, which gives *A*'s appointees voting control, and the specifically enumerated powers of the board over changes in activities, disposition of assets, and renewal of the management agreement, *A* can ensure that the assets it owns through *C* and the activities it conducts through *C* are used primarily to further exempt purposes. Thus, *A* can ensure that the benefit to *B* and other private parties, like the management company, will be incidental to the accomplishment of charitable purposes. Additionally, the terms and conditions of the management contract, including the terms for renewal and termination, are reasonable. Finally, *A*'s grants are intended to support education and research and give resources to help provide health care to the indigent. All of these facts and circumstances establish that, when *A* participates in forming *C* and contributes all of its operating assets to *C*, and *C* operates in accordance with its governing documents, *A* will be furthering charitable purposes and continue to be operated exclusively for exempt purposes. Because *A*'s grant making activity will be contingent upon receiving distributions from *C, A*'s principal activity will continue to be the provision of hospital care. As long as *A*'s principal activity remains the provision of hospital care, *A* will not be classified as a private foundation in accordance with § 509(a)(1) as an organization described in § 170(b)(1)(A)(iii).

Situation 2
When *D* and *E* form *F*, and *D* contributes its assets to *F, D* will be engaged in activities that consist of the health care services it provides through *F* and any grant making activities it can conduct using income distributed by *F*. However, unlike *A, D* will not be engaging primarily in activities that further an exempt purpose. "While the diagnosis and cure of disease are indeed purposes that may furnish the foundation for characterizing the activity as 'charitable,' something more is required." *Sonora,* 46 T.C. at 525–526. *See also Federation Pharmacy; Sound Health;* and *Geisinger*. In the absence of a binding obligation in *F*'s governing documents for *F* to serve charitable purposes or otherwise provide its services to the community as a whole, *F* will be able to deny care to segments of the community, such as the indigent. Because *D* will share control of *F* with *E, D* will not be able to initiate programs within *F* to serve new health needs within the community without the agreement of at least one governing board member appointed by *E*. As a business enterprise, *E* will not necessarily give priority to the

health needs of the community over the consequences for *F*'s profits. The primary source of information for board members appointed by *D* will be the chief executives, who have a prior relationship with *E* and the management company, which is a subsidiary of *E*. The management company itself will have broad discretion over *F*'s activities and assets that may not always be under the board's supervision. For example, the management company is permitted to enter into all but "unusually large" contracts without board approval. The management company may also unilaterally renew the management agreement. Based on all these facts and circumstances, *D* cannot establish that the activities it conducts through *F* further exempt purposes. "[I]n order for an organization to qualify for exemption under § 501(c)(3) the organization must 'establish' that it is neither organized nor operated for the 'benefit of private interests.'" *Federation Pharmacy,* 625 F.2d at 809. Consequently, the benefit to *E* resulting from the activities *D* conducts through *F* will not be incidental to the furtherance of an exempt purpose. Thus, *D* will fail the operational test when it forms *F*, contributes its operating assets to *F*, and then serves as an owner of *F*.

HOLDING
A will continue to qualify as an organization described in § 501(c)(3) when it forms *C* and contributes all of its operating assets to *C* because *A* has established that *A* will be operating exclusively for a charitable purpose and only incidentally for the purpose of benefiting the private interests of *B*. Furthermore, *A*'s principal activity will continue to be the provision of hospital care when *C* begins operations. Thus, *A* will be an organization described in § 170(b)(1)(A)(iii) and thus, will not be classified as a private foundation in accordance with § 509(a)(1), as long as hospital care remains its principal activity. *D* will violate the requirements to be an organization described in § 501(c)(3) when it forms *F* and contributes all of its operating assets to *F* because *D* has failed to establish that it will be operated exclusively for exempt purposes.

DRAFTING INFORMATION
The principal author of this revenue ruling is Judith E. Kindell of the Exempt Organizations Division. For further information regarding this revenue ruling contact Judith E. Kindell on (202) 622-6494 (not a toll-free call).

Section 509.—Private Foundation Defined
Whether an organization that operates an acute care hospital constitutes an organization whose principal purpose is providing hospital care within the meaning of § 170(b)(1)(A)(iii) of the Internal Revenue Code for purposes of § 509(a)(1) when it forms a limited liability company (LLC) with a for-profit corporation and then contributes its hospital and all of its related operating assets to the LLC, which then operates the hospital. See Rev. Rul. 98–15, page 6.

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Joint ventures. This ruling illustrates the tax consequences for a section 501(c)(3) organization that enters into a joint venture with a for-profit organization as an insubstantial part of its activities.

ISSUES
1. Whether, under the facts described below, an organization continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company (LLC) formed with a for-profit corporation.

2. Whether, under the same facts, the organization is subject to unrelated business income tax under § 511 on its distributive share of the LLC's income.

FACTS
M is a university that has been recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). As a part of its educational programs, *M* offers summer seminars to enhance the skill level of elementary and secondary school teachers.

To expand the reach of its teacher training seminars, *M* forms a domestic LLC, *L*, with *O*, a company that specializes in conducting interactive video training programs. *L*'s Articles of Organization and Operating Agreement ("governing documents") provide that the sole purpose of *L* is to offer teacher training seminars at off-campus locations using interactive video technology. *M* and *O* each hold a 50 percent ownership interest in *L*, which is proportionate to the value of their respective capital contributions to *L*. The governing documents provide that all returns of capital, allocations and distributions shall be made in proportion to the members' respective ownership interests.

The governing documents provide that *L* will be managed by a governing board comprised of three directors chosen by *M* and three directors chosen by *O*. Under the governing documents, *L* will arrange and conduct all aspects of the video teacher training seminars, including advertising, enrolling participants, arranging for the necessary facilities, distributing the course materials and broadcasting the seminars to various locations. *L*'s teacher training seminars will cover the same content covered in the seminars *M* conducts on *M*'s campus. However, school teachers will participate through an interactive video link at various locations rather than in person. The governing documents grant *M* the exclusive right to approve the curriculum, training materials, and

instructors, and to determine the standards for successful completion of the seminars. The governing documents grant *O* the exclusive right to select the locations where participants can receive a video link to the seminars and to approve other personnel (such as camera operators) necessary to conduct the video teacher training seminars. All other actions require the mutual consent of *M* and *O*.

The governing documents require that the terms of all contracts and transactions entered into by *L* with *M*, *O* and any other parties be at arm's length and that all contract and transaction prices be at fair market value determined by reference to the prices for comparable goods or services. The governing documents limit *L*'s activities to conducting the teacher training seminars and also require that L not engage in any activities that would jeopardize *M*'s exemption under § 501(c)(3). *L* does in fact operate in accordance with the governing documents in all respects.

M's participation in *L* will be an insubstantial part of *M*'s activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.

Because *L* does not elect under § 301.7701-3(c) of the Procedure and Administration Regulations to be classified as an association, *L* is classified as a partnership for federal tax purposes pursuant to § 301.7701-3(b).

LAW

Exemption under § 501(c)(3)

Section 501(c)(3) provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of the exempt purposes specified in § 501(c)(3). Activities that do not further exempt purposes must be an insubstantial part of the organization's activities. In *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945), the Supreme Court held that "the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet this requirement, an organization must "establish that it is not organized or operated for the benefit of private interests...."

Section 1.501(c)(3)-1(d)(2) defines the term "charitable" as used in § 501(c)(3) as including the advancement of education.

Section 1.501(c)(3)-1(d)(3)(i) provides, in part, that the term "educational" as used in § 501(c)(3) relates to the instruction or training of the individual for the purpose of improving or developing his capabilities.

Section 1.501(c)(3)-1(d)(3)(ii) provides examples of educational organizations including a college that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on and an organization that presents a course of instruction by means of correspondence or through the utilization of television or radio.

Joint Ventures

Rev. Rul. 98-15, 1998-1 C.B. 718, provides that for purposes of determining exemption under § 501(c)(3), the activities of a partnership, including an LLC treated as a partnership for federal tax purposes, are considered to be the activities of the partners. A § 501(c)(3) organization may form and participate in a partnership and meet the operational test if 1) participation in the partnership furthers a charitable purpose, and 2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for profit partners.

Redlands Surgical Services, 113 T.C. 47, 92-93 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001), provides that a nonprofit organization may form partnerships, or enter into contracts, with private parties to further its charitable purposes on mutually beneficial terms, "so long as the nonprofit organization does not thereby impermissibly serve private interests." The Tax Court held that the operational standard is not satisfied merely by establishing "whatever charitable benefits [the partnership] may produce," finding that the nonprofit partner lacked "formal or informal control sufficient to ensure furtherance of charitable purposes." Affirming the Tax Court, the Ninth Circuit held that ceding "effective control" of partnership activities impermissibly serves private interests. 242 F.3d at 904.

St. David's Health Care System v. United States, 349 F.3d 232, 236-237 (5th Cir. 2003), held that the determination of whether a nonprofit organization that enters into a partnership operates exclusively for exempt purposes is not limited to "whether the partnership provides some (or even an extensive amount of) charitable services." The nonprofit partner also must have the "capacity to ensure that the partnership's operations further charitable purposes." *Id*. at 243. "[T]he non-profit should lose its tax-exempt status if it cedes control to the for-profit entity." *Id*. at 239.

Tax on Unrelated Business Income

Section 511(a), in part, provides for the imposition of tax on the unrelated business taxable income (as defined in § 512) of organizations described in § 501(c)(3).

Section 512(a)(1) defines "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it less the deductions allowed, both computed with the modifications provided in § 512(b).

Section 512(c) provides that, if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to the organization, in computing its unrelated business taxable income, the organization shall, subject to the exceptions, additions, and limitations contained in § 512(b), include its share (whether or not distributed) of the gross income of the partnership from the unrelated trade or business and its share of the partnership deductions directly connected with the gross income.

Section 513(a) defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501.

Section 1.513-1(d)(2) provides that a trade or business is "related" to an organization's exempt purposes only if the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). A trade or business is "substantially related" for purposes of § 513, only if the causal relationship is a substantial one. Thus, to be substantially related, the activity "must contribute importantly to the accomplishment of [exempt] purposes." Section 1.513-1(d)(2). Section 513, therefore, focuses on "the manner in which the exempt organization operates its business" to determine whether it contributes importantly to the organization's charitable or educational function. *United States v. American College of Physicians*, 475 U.S. 834, 849 (1986).

ANALYSIS

L is a partnership for federal tax purposes. Therefore, *L*'s activities are attributed to *M* for purposes of determining both whether *M* operates exclusively for educational purposes and therefore continues to qualify for exemption under § 501(c)(3) and whether *M* has engaged in an unrelated trade or business and therefore may be subject to the unrelated business income tax on its distributive share of *L*'s income.

The activities *M* is treated as conducting through *L* are not a substantial part of *M*'s activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c) (1). Therefore, based on all the facts and circumstances, *M*'s participation in *L*, taken alone, will not affect *M*'s continued qualification for exemption as an organization described in § 501(c)(3).

Although *M* continues to qualify as an exempt organization described in § 501(c)(3), *M* may be subject to unrelated business income tax under § 511 if *L* conducts a trade or business that is not substantially related to the exercise or performance of *M*'s exempt purposes or functions.

The facts establish that *M*'s activities conducted through *L* constitute a trade or business that is substantially related to the exercise and performance of *M*'s exempt purposes and functions. Even though *L* arranges and conducts all aspects of the teacher training seminars, *M* alone approves the curriculum, training materials and instructors, and determines the standards for successfully completing the seminars. All contracts and transactions entered into by *L* are at arm's length and for fair market value, *M*'s and *O*'s ownership interests in *L* are proportional to their respective capital contributions, and all returns of capital, allocations and distributions by *L* are proportional to *M*'s and *O*'s ownership interests. The fact that *O* selects the locations and approves the other personnel necessary to conduct the seminars does not affect whether the seminars are substantially related to *M*'s educational purposes. Moreover, the teacher training seminars *L* conducts using interactive video technology cover the same content as the seminars *M* conducts on *M*'s campus. Finally, *L*'s activities have expanded the reach of *M*'s teacher training seminars, for example, to individuals who otherwise could not be accommodated at, or conveniently travel to, *M*'s campus. Therefore, the manner in which *L* conducts the teacher training seminars contributes importantly to the accomplishment of *M*'s educational purposes, and the activities of *L* are substantially related to *M*'s educational purposes. Section 1.513-1(d)(2). Accordingly, based on all the facts and circumstances, *M* is not subject to unrelated business income tax under § 511 on its distributive share of *L*'s income.

HOLDINGS

1. *M* continues to qualify for exemption under § 501(c)(3) when it contributes a portion of its assets to and conducts a portion of its activities through *L*.

2. *M* is not subject to unrelated business income tax under § 511 on its distributive share of *L*'s income.

DRAFTING INFORMATION

The principal author of this revenue ruling is Virginia G. Richardson of Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact Virginia G. Richardson at (202) 283-8938 (not a toll-free call).

CInternal Revenue Service (I.R.S.)

General Counsel Memorandum

February 15, 1979

Section 501 -- Exemption From Tax on Corporations, Certain Trusts, etc. (Exempt v. Not Exempt)

501.00-00 Exemption From Tax on Corporations, Certain Trusts, etc. (Exempt v. Not Exempt)

501.03-00 Religious, Charitable, etc., Institutions and Community Chest

PR 7926069

PR 7921018

CC:I-17-79

Br8:DMRoth

JOHN L. WITHERS

Assistant Commissioner (Technical)

Attention: Director, Individual Tax Division

In a memorandum dated January 11, 1979, the Individual Tax Division (T:I) requested our concurrence or comments with respect to a proposed memorandum from that Division to the Assistant Commissioner (Employee Plans and Exempt Organizations), Exempt Organizations Division, Technical Branch (E:EO:T), concerning amendment of a proposed ruling letter in the captioned case.

We have discussed the proposed ruling letter with our Employee Plans and Exempt Organizations Division (CC:EE), representatives of the Office of the Assistant Commissioner (Employee Plans and Exempt Organizations), Exempt Organizations Division (E:EO), and representatives of your Office. As a result of these discussions, it has been decided that a favorable ruling will be issued to the taxpayer in this case using a rationale under which a resolution of the classification issue presented your Office is unnecessary. We understand, therefore, that the Office of the Assistant Commissioner (Employee Plans and Exempt Organizations), Exempt Organizations Division, has withdrawn its request for your advice on the issue.

Accordingly, we are closing this case without further action. The administrative records belonging to the Office of the Assistant Commissioner (Employee Plans and Exempt Organizations) have been forwarded to that Office, and your administrative file is returned herewith.

STUART E. SEIGEL

Chief Counsel

JAMES F. MALLOY

Chief

Branch No. 8

Interpretative Division

Attachment:

Adm. file

CC:EE-18-79

Br2:MAThrasher

February 9, 1979

S. ALLEN WINBORNE

Assistant Commissioner (Employee Plans and Exempt Organizations)

Attention: Director, Exempt Organizations Division

Attached is a copy of a memorandum (O.M. 19057, ***, I-17-79 (Jan. 31, 1979)) from the Interpretative Division to this Division. The O.M. was prepared in regard to a request by the Individual Tax Division (T:I) for Interpretative's concurrence or comments with respect to a proposed memorandum from T:I to your office, which proposed memorandum was prompted by a request from your office to T:I as to the proper classification of an arrangement between the subject organization and a for-profit corporation.

The O.M. takes the position that it is unnecessary to determine the proper classification of the proposed arrangement because, under the particular facts of this case, the *** will not lose its exemption even if the arrangement is classified as a partnership. We think the position stated in the O.M. is correct. Briefly stated, any partnership or other joint venture arrangement between an organization described in section 501(c)(3) and one or more for-profit entities obviously requires careful scrutiny due to the strong possibility of a conflict between the exempt organization's duty to operate exclusively for exempt purposes and any duty it may have to advance the private interests involved in the venture. See G.C.M. 36293, ***, I-214-73 (May 30, 1975). However, such an arrangement does not per se preclude exemption under section 501(c)(3); in some circumstances, there may be no conflict between the charitable and for-profit purposes. See G.C .M. 37259, ***, I-92-77 (Sept. 19, 1977) at 6. It is our belief that, as discussed in the O.M., the arrangement proposed by the *** is one such circumstance.

In view of the foregoing, we suggest that you respond to the *** in accordance with the position outlined in O.M. 19057. For your convenience, we have prepared and attached a revised proposed ruling letter.

STUART E. SEIGEL

Chief Counsel

GEORGE H. JELLY

Director

Employee Plans and Exempt Organizations Division

Attachment

As stated

O.M. 19057

CC:I-17-79

Br8:DMRoth

date: January 31, 1979

to: Director, Employee Plans and Exempt Organizations Division

from: Director, Interpretative Division

subject: ***

In a memorandum dated January 11, 1979, the Individual Tax Division (T:I) requested our concurrence or comments with respect to a proposed memorandum from that Division to the Assistant Commissioner (Employee Plans and Exempt Organizations), Exempt Organizations Division, Technical Branch (E:EO:T), concerning amendment of a proposed ruling letter in the captioned case.

ISSUE

If the proposed arrangement in this case were classified as a partnership for Federal tax purposes, would the participation of the ***, in the arrangement jeopardize its exempt status?

CONCLUSION

The proposed memorandum of the Individual Tax Division (T:I) is concerned with the proper classification of the arrangement in this case for Federal tax purposes. We suggest, however, that consideration of the classification issue might be unnecessary in this case because of our interpretation as to the application of the rationale of G.C.M. 36293, ***, I-214-73 (May 30, 1975).

G.C.M. 36293 concludes that the exempt status of an organization would be jeopardized by its participation in a specified proposed limited partnership with private individuals or institutions. We suggest that the case at hand is distinguishable from the situation considered in G.C.M. 36293 and that the exempt status of the *** should not be

jeopardized by its participation in the proposed arrangement, even if the arrangement were classified as a partnership.

If you agree with our view, we request that you so inform the Office of the Assistant Commissioner (Employee Plans and Exempt Organizations), Exempt Organizations Division (E:EO:T) and that you suggest that they respond to the *** ruling request accordingly.

FACTS

The *** was created by an *** and has been recognized as exempt from Federal income tax under I.R.C. § 501(c)(3). The organization is not a private foundation under section 509(a).

In keeping with a broad range of charitable purposes and with a ***, the *** carries on an extensive program of collecting and processing *** and *** so as to provide them free of charge to the public. The organization has been given the responsibility for meeting the *** of the people ***. The overall *** program includes the carrying on of research in the uses of *** and its ***.

The process by which *** is ***. Various *** have been discovered through *** research to be effective in the *** One type of *** for instance, is given to *** another is used to *** Thus through the process of *** may be used to *** a number of *** with differing needs. As a part of its *** program, the *** supplies *** as well as *** *** free of charge to persons in need.

***. However, *** can be produced economically only by large pharmaceutical facilities. Therefore, the *** currently contracts with commercial pharmaceutical firms and return *** for distribution through its ***.

These arrangements with pharmaceutical firms have not been entirely satisfactory to the *** because the quality of the *** has not always been uniform and the pharmaceutical firms have tended to subordinate the needs of the *** to the firm's own needs, thus leading to uneven supplies and shipping problems. Therefore, the organization has concluded that it should develop its own capacity to ***. Besides allowing increased quality control and more flexible scheduling, the organization's development of its own *** capability would save the organization money and make possible the production of additional needed *** that are not now generally available because of the expense and resulting lack of commercial interest in producing them.

Because the *** does not have the technology or trained personnel to construct and operate a *** facility on its own, it proposes to enter into an arrangement with a commercial pharmaceutical firm and the firm's subsidiary to construct and operate a jointly-owned facility. The commercial firms involved are *** and its subsidiary, ***.

Under a proposed Joint Venture Agreement, *** will locate and purchase, subject to *** approval, a parcel of real estate suitable for construction of the *** facility. *** is then to proceed with the designing, construction, and equipping of the facility, subject to the approval of the *** as to certain aspects. All costs of acquiring the real estate, designing, constructing, and equipping the facility, and providing working capital are to be shared equally by the *** and ***. Furthermore, both the *** and *** are to cause an appropriate number of their technically qualified employees to accept employment with the new *** facility.

To govern the acquisition and operation of the *** facility, the *** and *** will enter into an arrangement formally designated as a 'partnership' called *** Under the proposed 'Articles of Partnership,' both the *** and *** are required to make equal capital contributions limited to *** each. The purposes of the proposed partnership include, among others, providing custom *** services to the *** and *** and performing related research to further medical technology throughout the world 'without regard to the economic benefit of such research to the partnership.'

Under the Articles, the term of the partnership is to be *** years unless dissolved under the terms of the Articles or extended by agreement of the two partners. Dissolution may occur by agreement of the partners, automatically upon completion of the partnership term, or upon the termination of the Joint Venture Agreement between the *** and ***. Furthermore, the Articles provide that the *** shall, upon giving *** years notice to *** have the right at any time after the *** year and before the *** year of the partnership to purchase all of ***'s rights, title, and interest in the partnership at a price essentially equal to ***'s capital contributions less allocable depreciation and to dissolve the partnership.

The Articles state:
It is intended that the partnership shall operate on a break-even basis and shall not sustain a profit or a loss. All costs of operations shall be charged to customers for *** services rendered and retroactive adjustments shall be made in such charges, when necessary, to equate costs and charges in each fiscal year.

Each partner is entitled to one vote. According to the Articles, the complete and sole management of the partnership will be vested in a Board of *** persons. The *** will choose *** members of the Board, including the Chairman of the Board, and *** will choose *** members. The Board will have the power to elect officers for the partnership (except for the Chairman of the Board) and may delegate any of its powers to the officers or to various committees established by the Board. However, the Board may not, without affirmative vote of both of the partners, engage in certain activities, including: (1) the issuance of any debt security, promissory note, or other debt instrument except for certain open account indebtedness for which the partnership has sufficient cash (or projected cash flow) at the time the open account is incurred to pay the debt in the ordinary course; (2) the pledging, mortgaging, or encumbrance of any partnership asset except for certain purchase money security interests and liens that are incurred and paid or released in the ordinary course; and (3) the spending of more than *** percent of gross *** service fees for research and development or the adoption of a budget that provides for expenditures in excess of this percentage. The partners have the power to overrule prospectively any action of the Board, the partnership's officers, employees, and agents, or other persons.

Any inventions, know-how, or other intellectual property made, developed, or conceived by the partnership shall, at a partner's request, be licensed to the partner (or, in the case of ***, its affiliates) without payment. The *** is further empowered to license any such property to others, in the public interest, on a non-exclusive basis and with or without payment of a royalty by the ***.

Separate contractual agreements between the partnership and the *** and between the partnership and the *** are proposes concerning each party's use of the *** facilities. These contracts provide that each party will be entitled to the use of *** percent of the partnership's total capacity for ***. Both contracts provide that the partnership may enter into agreements with other parties to utilize unused capacity. In the case of unused capacity allocable to *** the partnership may only sell unused capacity to the extent that *** notifies the partnership in writing that the capacity will not be used. However, in the case of unused capacity allocable to the *** no similar notification is necessary but all use agreements entered into by the partnership with other parties as to such unused capacity will be subject to the preemptive rights of the ***. If the *** exercises its option under the Articles of Partnership to purchase ***'s interest in the partnership and dissolve the partnership, the contracts provide that ***'s right to use *** percent of the *** facility's capacity will be reduced, and the *** right to use *** percent of the facility's capacity will be increased, by *** percentage points during each of the five years between the time the *** notifies *** of its decision to exercise the option and the time the partnership is dissolved under the Articles. The contracts provide for the payment by *** and the *** to the partnership of the 'actual cost' of the services rendered to them, based on a 'full absorption' method but not including any charge for depreciation or charges for research and development in excess of *** percent of actual cost.

In a letter dated ***, ***, Counselor and Secretary of the ***, reminded ***, Vice President, Secretary, and General Counsel of ***, that ***, Chairman of the ***, and ***, *** Vice President-Finance, had reached an understanding

as to the use of one party's allocable plant capacity by the other party. In accordance with this 'understanding,' the detailed financial plan to govern operation of the *** facility is to provide for either party that utilizes any portion of the plant capacity allocated to the other party to compensate the other party in an amount equivalent to a 'reasonable return' on the party's capital investment in the facility allocable to the portion of the plant capacity used, based on an *** percent capitalization rate. This letter and other submissions of the taxpayer also state that 'there is virtually no likelihood that *** will ever utilize less than its ***% of the plant capacity, in view of the *** recent and projected *** requirements.

As part of the overall arrangement, *** and *** will license to the partnership their rights, respectively, in inventions covered by specified patents and patent applications and in certain know-how relating to the operation of a *** facility. The know-how received from *** will be protected from disclosure under the terms of the proposed license and by the operation of proposed 'Confidential Disclosure Agreements' to be executed by partnership employees. The partnership's rights under the proposed License Agreement will not be assignable except in the case of a dissolution of the partnership pursuant to the exercise of the ***' option to purchase *** interest therein, in which case the partnership will assign its rights to the ***

A memorandum prepared by attorneys for the *** with respect to the proposed joint venture states that *** would begin approximately *** years after creation of the joint venture. According to the memorandum, capacity utilization would be roughly *** percent at that time, increasing incrementally to *** percent in the *** year of the joint venture.

ANALYSIS

The proposed memorandum of the Individual Tax Division concludes that a proposed arrangement between the *** and ***, and its affiliates would not constitute a mere expense-sharing arrangement. However, the memorandum advises revising the proposed ruling letter to say only that the arrangement would not be classified either as an association or as a partnership (joint venture) within the meaning of Treas. Reg. § 301.7701-2(a)(2), without stating that the arrangement would also not be classified as a mere expense-sharing arrangement.

The *** has requested the Internal Revenue Service to rule that the arrangement will not subject the *** to the tax on unrelated business taxable income imposed by sections 511 through 515. The classification question with which the Individual Tax Division is concerned arose because the Exempt Organizations Division was concerned that the exempt status of the *** under section 501(c)(3) might be jeopardized if the *** became involved in a partnership with ***. This concern of the Exempt Organizations Division is based upon the position of the Chief Counsel's Office expressed in G.C.M. 36293, ***, I-214-73 (May 30, 1975), and G.C.M. 37259, ***, I-92-77 (Sept. 19, 1977).

G.C.M. 36293 deals with a corporation organized to provide low and moderate income housing on a nondiscriminatory basis in a predominantly white suburb of a large metropolitan area. The corporation planned to organize a limited partnership to become the owner of the fully developed rental property. Under this arrangement, the corporation would serve as the general partner of the overall venture, would be given credit for a developer's fee equal to approximately *** percent of the total development cost, would raise from *** to *** of equity capital in exchange for the limited partnership interests, and would use such capital in combination with a special *** percent 'subsidy' loan from a state housing authority as a means of acquiring property with an initial cost value (after full development) of approximately ***.

G.C.M. 39293 states that this proposed arrangement is important in determining whether the corporation qualifies for exemption under section 501(c)(3) because the arrangement would make the corporation a direct participant in an income-producing venture involving the sharing of net profits with private individuals or institutions of a noncharitable nature. The G.C.M. emphasizes that this participation would be inherently incompatible with the

corporation's being operated exclusively for charitable purposes within the meaning of section 501(c)(3). In this regard, G.C.M. 36293 states, at pages 15 and 16:

By agreeing to serve as the general partner of the proposed housing project, the Corporation would take on an obligation to further the private financial interests of the limited partners. Since the promotion of those private interests would tend to foster operating and maintenance practices favoring the equity holdings of the limited partners to a greater extent than would otherwise be justifiable on the basis of reasonable financial solvency, the Corporation's assumption of a duty to promote such interests in its capacity as a general partner would necessarily create a conflict of interest that is legally incompatible with its being operated exclusively for charitable purposes. The G.C.M. further indicates that it is immaterial whether the profits of the partnership are distributed currently or whether the profits can only be realized on the sale of the underlying equity interests to third parties.

G.C.M. 37259 is concerned with an educational organization exempt under section 501(c)(3) that produces a motion picture film of educational content and wants to make the film available for public viewing. The issue in G.C.M. 37259 is whether the organization will lose its exemption by entering into an agreement with a commercial distributor to distribute the film for viewing in commercial motion picture theaters throughout the United States. Under the agreement, the organization and the commercial distributor will each receive certain amounts of the gross receipts from the distribution, and each will be responsible for paying certain expenses involved with the distribution. Subject to specified limitations, the organization will retain the television rights to the motion picture. Because of some differences between the facts set forth in the proposed revenue ruling and the facts of the underlying case, there is some question whether the arrangement would be one for sharing gross receipts or one for sharing net earnings.

G.C.M. 37259 concludes that, if the arrangement involves the sharing of gross receipts, it would be analogous to the situation described in G.C.M. 36293. However, G.C.M. 37259 further concludes that there are factual distinctions that might make the rationale of G.C.M. 36293 inapplicable. The primary distinction recognized in G.C.M. 37259 is that the organization considered in G.C.M. 36293 was to be an active member of the partnership and would be faced with a conflict between its duty to dedicate and maximize its earnings for the benefit of its exempt purposes and its duty as the general partner to advance the interests of the private investors in the venture, whereas arguably the educational organization and the distributor in G.C.M. 37259 would have the same goal--to exhibit the film to as many people as possible, albeit for different reasons. The organization, of course, would have an educational purpose in exhibiting the film, whereas the distributor would want to maximize profits. G.C.M. 37259 indicates that there would not be any substantial conflict in such a situation but ultimately concludes that the proposed arrangement would cause a loss of the educational organization's exempt status under section 501(c)(3) on other grounds because of the 'profit-sharing' character of the relationship.

It may be asserted that the arrangement between the educational organization and the commercial distributor considered in G.C.M. 37259 may actually involve an inherent conflict within the meaning of G.C.M. 36293 because the distributor might want to maximize profits by charging more for the distribution of the film than would be necessary to achieve the greatest number of viewers for the film without creating an economic loss for the educational organization--a function of the interrelationship of price and demand. The educational organization would presumably want to achieve the greatest number of viewers economically feasible. However, regardless of the facts of the case considered, it would seem that the position of G.C.M. 37259 that not every joint venture (or partnership) between an exempt organization and a commercial entity would run afoul of section 501(c)(3) is correct and should be followed. Thus, it would seem that, whenever such an arrangement is involved, all the facts and circumstances of the case should be carefully considered to determine whether any real conflict might exist.

Even assuming that the proposed arrangement in the case at hand would constitute a partnership for Federal tax purposes, we suggest that no section 501(c)(3) problem would be created. It would seem that the unique structure of the proposed arrangement would protect the *** from any potential conflict of interests. For instance, although the proposed arrangement calls for the joint purchase of real property and equipment and the joint

management of a technical staff to operate the *** facility, the arrangement would apparently not involve any substantial conflict as to the price to be charged for services rendered and, thus, the amount of profit to be made. The Articles of Partnership specifically call for the operation of the partnership to be on a 'break-even basis' with charges to *** customers essentially being equal to the total costs of operation.

Furthermore, although either the *** or *** (through *** could assign to a third party or to each other their contractual rights to part of the facility's capacity in return for compensation (for instance, an 8 percent return on investment), it would seem that no real conflict between the parties could arise from these transactions within the contemplation of G.C.M. 36293. Each party would be entitled to *** percent of plant capacity, which percentage accords with its relative capital contribution. Whether such capacity were used by the party directly or were transferred to a third person would not affect the other party's right to use or transfer its *** percent of plant capacity. There is no indication that the arrangement itself will ever be used to produce a divisible profit.

The only possible conflict between the *** and *** concerning the operation of the proposed *** facility that might affect the exempt status of the *** under section 501(c)(3) involves the possible sale of the facility to a third party and a division of the gain. Under these circumstances, it could be argued that the *** would be under some obligation or pressure to operate the facility in a manner designed to enhance the facility's marketability and not necessarily to further the exempt purposes of the ***. This potential conflict is apparent from the reasons the *** has given for wanting to establish its own *** facility, including the production of commercially infeasible *** and the establishment of more exacting (and probably more costly) quality control procedures.

We believe that this potential conflict is insubstantial under all the facts of the case. All the evidence seems to show that the *** will exercise its option to purchase *** interest in the arrangement after *** years essentially at book value. There is no indication that either party is interested in developing the facility for future marketability . Furthermore, the facility is not even expected to achieve full capacity until the *** year of the arrangement, thus effectively delaying complete assessment of its success until that time. In sum, we note that it is not the sale of the property and division of the gains that might jeopardize the *** exempt status but, rather, the conflicts that might arise during the active operation of the facility if a sale were contemplated. Therefore, if no sale were intended, there would be no pressures on the *** to operate the facility for other than exempt purposes. We do not believe a sale is contemplated. Moreover, logic dictates that even if a sale at a gain unexpectedly becomes an attractive prospect the *** would certainly block the sale, if possible, until it would be entitled to exercise its option to purchase *** interest and reap all the gains from the sale of the facility.

If our interpretation of the application of G.C.M. 36293's rationale to the case at hand is correct, there is no need to determine whether the proposed arrangement would actually constitute a partnership for Federal tax purposes in order to respond to the taxpayer's ruling request. The exempt status of the *** would not be jeopardized regardless of the classification of the arrangement. Thus, the participation of the *** in the arrangement would be substantially related to its exempt purpose and would not generate unrelated business taxable income for purposes of sections 511 through 515.

If you agree with the position suggested above as to the application of the rationale of G.C.M. 36293, we request that you so inform the Office of the Assistant Commissioner (Employee Plans and Exempt Organizations), Exempt Organizations Division (E:EO:T) and that you suggest that they respond to the *** ruling request accordingly.

The administrative file is attached for your consideration.

JEROME D. SEBASTIAN

Director

JAMES F. MALLOY

Chief

Branch No. 8

Interpretative Division

Attachment:

Adm. file

Dear Sir or Madam:

We have considered your request for a ruling that certain proposed transactions will not subject your organization to the Unrelated Business Income Tax imposed by sections 511 through 515 of the Internal Revenue Code.

The information you have provided indicates that your organization was created by *** and has been recognized as exempt from federal income tax under section 501(c)(3) of the Code. Your organization has been classified as not a private foundation under section 509(a). In keeping with a broad range of charitable purposes, and with ***, your organization carries on an extensive program of collecting and processing *** and *** so as to provide them free of charge to the public. Your organization has been given responsibility for meeting the *** needs of the people of the ***. Your overall *** program includes the conduct of research in the uses of *** and its ***.

You have explained that the process by which *** is *** or *** is generally known as *** various *** have been discovered by *** research to be effective in the ***. One type of ***, for example, is given to ***; another is used to ***. Thus, through the process of *** may be used to *** a number of *** with differing needs. As a part of its *** program, your organization supplies *** as well as *** free of charge to persons in need.

Because your organization lacks the technology for certain *** processes, you indicate that it has been necessary in the past for it to rely on commercial laboratories to *** the ***. You indicate that in the past this commercial *** arrangement has often been unsatisfactory and that the price your organization pays is necessarily higher than what your own cost would be if you did your own *** You therefore initiated a Request for Proposals from commercial laboratories for a 'joint venture' *** facility.

You have proposed to enter into an arrangement with a commercial laboratory for the purpose of acquiring a building site and constructing a *** facility on it. Each party would contribute *** to the costs of acquiring the site and building and equipping the facility . Each party would be a co-owner of the facility on a *** basis. You then propose to form a joint undertaking with the commercial laboratory for the purpose of operating the *** facility and thus supply *** to the parties. Under the proposed agreement the commercial laboratory would share its technological know-how with your organization and would make its own personnel available to work with your employees in operating the facility. At your discretion your organization would be permitted to make any technology acquired from the commercial laboratory or during the operation of the facility freely available to the public. Both parties will share production capacity of the facility on a *** basis. The facility will process separately the *** by each party and deliver the resulting *** to the party that supplied the ***. The facility will not itself directly engage in the sale of the resulting ***. Your organization will use its *** for exempt purposes; the commercial laboratory will deliver its *** to its subsidiary, which supplied it with the *** and that subsidiary will, in turn, sell the *** in its ordinary commercial manner. Sufficient liability insurance will be carried by both the commercial

laboratory and its subsidiary so that the exempt party will effectively be shielded from any third party liability. Finally, after *** years of operation, your organization will have the option of purchasing the commercial laboratory's interest in the facility at a price equal to the commercial laboratory's aggregate capital contributions less one half the accumulated straight line depreciation on the depreciable assets. The transfer of the commercial laboratory's interest would take place over a *** year phase-out period.

The object of this arrangement is that your organization will become self-sufficient in its production of *** and thus be able more effectively to carry out your *** program in furtherance of your charitable purposes.

Collaterally, you have requested and received a Business Review Letter from the Anti-trust Division of U.S. Department of Justice to the effect that the Department has no present intention of filing any type of proceeding or of undertaking any further investigation with respect to the proposed joint undertaking.

Section 511 of the Code imposes a tax on the 'unrelated business taxable income' of organizations exempt under section 501(c)(3).

Section 513(a) defines 'unrelated trade or business' as any trade or business, the conduct of which is not 'substantially related' to the exercise or performance by the organization of the purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that for a trade or business to be substantially related for purposes of section 513, there must be a substantial causal relationship between the conduct of the trade or business and the accomplishment of exempt purposes.

On the basis of the agreements submitted and your representations with respect to the proposed operations of the joint undertaking, we conclude that there is no inherent conflict between the interests of your organization and those of the commercial laboratory. We therefore conclude that your participation in this joint undertaking, as proposed, is not inconsistent with your exempt status under section 501(c)(3).

We further conclude that the arrangement, as proposed, will contribute importantly to your organization's purpose of providing a supply of *** to the public by permitting you to *** more economically and efficiently. We therefore conclude that your participation in this joint undertaking, as proposed, is substantially related to your exempt purpose and will therefore not generate gross income from an unrelated trade or business.

Accordingly, we rule that participation by your organization in the joint transactions and operations, as you have proposed in your ruling request dated *** and in supplementary documents filed in connection with that ruling request, will not subject your organization to the tax on unrelated business income imposed by sections 511 through 515 of the Internal Revenue Code.

We are providing your key District Director with a copy of this ruling and you should keep a copy in your permanent files.

Sincerely yours,

Jeanne S. Gessay

Chief

Rulings Section 1

Exempt Organizations Technical Branch

This document is not to be relied upon or otherwise cited as precedent by taxpayers.

END OF DOCUMENT

C
GCM 39005, 1983 WL 197944 (IRS GCM)

Internal Revenue Service (I.R.S.)

General Counsel Memorandum

Date Numbered: June 28, 1983
Dec. 17, 1982

This GCM relates to a ruling letter that is exempt from disclosure under section 6110(k).

CC:EE-58-82

Br2:JPainter

TO: S. ALLEN WINBORNE

Assistant Commissioner (Employee Plans and Exempt Organizations)

Attention: Director, Exempt Organizations Division

This responds to your memorandum (OP:E:EO) dated May 14, 1982, requesting our concurrence or comments on a proposed ruling letter to the above organization.

ISSUE
Whether a nonprofit organization that enters into a limited partnership as one of several general partners for the purpose of constructing, owning, and operating a federally assisted apartment complex for handicapped and elderly individuals of limited income may qualify as an organization described in I.R.C. s 501(c)(3).

CONCLUSION
An exempt organization may qualify under section 501(c)(3) notwithstanding its participation in a limited partnership as one of several general partners if the partnership arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted. We believe that, in this case, both the federally imposed restrictions and the structure of the partnership agreement are sufficient to protect the nonprofit organization from any potential conflict between its partnership obligations as a general partner and its exempt goals. Accordingly, we agree with your conclusion that the organization may qualify under section 501(c)(3).

FACTS
* * * (the Corporation) was organized in the State of * * * as a not-for-profit corporation on * * *. The Corporation is governed by a * * * member Board of Trustees; * * * selected by the local * * * and * * * selected by area * * *.

The purpose of the Corporation, as recited in its Articles of Incorporation, is:

> To provide for the elderly families and elderly persons on a non-profit basis rental housing and related facilities and services specifically designated to meet the physical, social and psychological needs of the aged, and to contribute to their health, security, happiness, and usefulness in longer living.

To further this purpose, the Corporation has become a general partner in a limited partnership formed to construct, own and operate a federally financed apartment project for the city's limited income handicapped and elderly. There are * * * other general partners, all for- profit entities. There are also numerous individual limited partners who are obligated solely to contribute capital and who will be entitled to a * * * preferential cash distribution on their original cash contribution.

The partnership will participate in a Housing and Urban Development (HUD) Section 8 rent subsidy program. Under this program, the partnership has entered into a Housing Assistance Payments Contract (HAP Contract) through which HUD will make rental assistance payments to the partnership on behalf of qualified tenants. A qualified tenant must be either handicapped or at least 62 years old and meet certain income limitations, thus insuring that only moderate or low income persons will be eligible. Rent will be partially paid by the tenant based on a percentage of adjusted monthly income (not to exceed 25 percent). The difference between the tenant's portion and the contract rent will be paid directly by HUD to the partnership. The project will hold 100 percent of the rental units open to families eligible for Section 8 subsidies.

The HAP Contract is for a term of five years which is renewable by the partnership in five year increments for a maximum period of twenty years. The partnership has indicated that it will renew its HAP Contract for the full twenty year term. The federally insured mortgage on the project, however, will be amortized over forty years. Thus, the housing assistance payments will cease prior to any substantial amortization of the principal amount of the mortgage.

Under the partnership agreement, the Corporation's responsibilities will include marketing and renting units, enforcing leases, supervising maintenance and repairs, and conducting social service programs for residents. All of these activities will be initially carried out with the guidance of a consulting firm, as no trustee in the Corporation has any substantial prior experience in housing, partnership, real estate or financial matters. The Corporation will develop a program to attract minority tenants. The Corporation will be responsible for social service and recreational programs for tenants. Programs with outside agencies such as Meals On Wheels and the Visiting Nurse Program will be developed. The Corporation also indicates that there will be an on-site dining facility to provide meals, a large community room and a bus or van for transportation. The Corporation will be responsible for all tenant-management relations and all on-site management facilities.

The Corporation, and one other general partner have been designated as the managing partners. The agreement provides that the managing partners may allocate duties and responsibilities as they see fit. The Corporation is guaranteed the right of first refusal to purchase the project when it is offered for sale. The Corporation has made only nominal contributions to capital.

Profits, losses and operating cash flow will be allocated * * * to the limited partners and * * * to the general partners. Profits and cash flow from sales or refinancing will be allocated * * * to the limited partners and * * * to the general partners. The general partners' share of profits, losses and cash flow from either operations or from sale, exchange or refinancing will be allocated * * * to the for-profit general partners and * * * to the Corporation. The for-profit general partners have agreed to provide funds to cover any operating deficits until * * *.

For its services in developing the project, the for-profit managing general partner will be entitled to both a development fee from excess capital contribution or other funds and, * * *. For any year in which the for-profit managing general partner is not receiving * * * the consulting firm, which is controlled by the for-profit managing partner, will be entitled to receive an incentive management fee equal to * * * of the project's excess cash flow after payment of the limited partners' * * * cash distribution. However, in consideration of the management duties that will be undertaken by the Corporation, * * * of the fees paid to the consulting firm (including the incentive fee) will be allocated to the Corporation for the first * * *. Thereafter, fees will be allocated in accordance with the responsibilities assigned to each.

ANALYSIS

Section 501(a) and 501(c)(3) of the Code provide for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual.

Treas. Reg. s 1.501(c)(3)-1(d)(2) provides that 'the term 'charitable' is used in section 501(c)(3) in its generally accepted legal sense' and includes 'relief of the poor and distressed' and the 'promotion of social welfare.'

Treas. Reg. s 1.501(c)(3)-1(e) provides that:

> An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.

Treas. Reg. s 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for any of the purposes specified in section 501(c)(3) unless it serves a public rather than a private interest. Thus, to qualify under section 501(c)(3), an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or the creator's family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

In requesting clarification in this area, you noted in your memorandum of May 18, 1982, that it was difficult to reconcile * * *, O .M. 19225, EE-7-80 (March 13, 1980) which permitted an exempt organization to participate as a general partner in a limited partnership established to build and manage a moderate and low income housing project with the denial of exemption to an organization involved in substantially the same activity in * * *, G.C.M. 36293, I-214-73 (May 30, 1975). Although you propose to issue a favorable ruling in this case, you nevertheless expressed concern that participation by an exempt organization in any partnership arrangement would substantially promote the private interests of the limited partners.

As we indicated in O.M. 19225, an exempt organization's participation in a partnership arrangement as a general partner should not *per se* result in denial of section 501(c)(3) status. The partnership arrangement, however, should be closely scrutinized to assure that the statutorily imposed obligations on the general partner do not conflict with the exempt organization's ability to pursue its charitable goals. Thus, in all partnership cases, initial focus should be on whether the organization is serving a charitable

purpose. Once charitability has been established, the partnership arrangement itself should be examined to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted and not for the benefit of the limited partners.

In the instant case, the Corporation's participation in the building and management of a government-financed housing project for the handicapped and elderly serves to further charitable purposes. As a direct result of the Corporation's participation, 100 percent of the units will be held open to elderly or handicapped individuals with limited incomes (although the government subsidy program requires that only 85 percent of the units be made available to these tenants). Moreover, the Corporation will conduct numerous programs to meet the physical, social and recreational needs of this group. The Service has held that an organization which undertakes these activities is operating exclusively for charitable purposes. *See e.g.,* Rev. Rul. 79-18, 1979-1 C.B. 194; Rev. Rul. 79-19, 1979-1 C.B. 195, Rev. Rul. 72-124, 1972-1 C.B. 145.

The organization in G.C.M. 36293 could not establish that its participation in the government-sponsored housing project would have actually served a recognizable section 501(c)(3) purpose. First, only * * * of the proposed * * * housing project were designated for low income individuals (* * * units were designated for moderate income tenants). Thus, the project could not be said to be relieving the poor or distressed. Second, the project was to be located in an affluent, predominantly white suburb consisting exclusively of single family dwellings with no indication of decay or community tension. Therefore, the project could not have been characterized as charitable on the basis of combating community deterioration or relieving neighborhood tensions. Accordingly, the organization failed to demonstrate any charitable purpose for its involvement in the partnership.

In contrast to G.C.M. 36293, the organization in O.M. 19225 was formed to foster and develop a government- sponsored low and moderate income housing project in a riot-torn inner city ghetto. The organization demonstrated that its activities would combat community deterioration, juvenile delinquency and neighborhood tensions, all recognized charitable purposes. In addition, federally imposed income limitations were placed on eligible applicants for the housing, indicating that profits were an unlikely motivation for the organization's involvement in the venture.

Notwithstanding an established charitable purpose, however, conflicts with charitable goals can nevertheless arise in a limited partnership situation because certain statutory obligations are imposed upon a general partner. These obligations include an assumption of all liabilities by the general partner and a basic profit orientation in the interest of the limited partners. Thus, unless an exempt organization, acting as general partner, can insulate itself from these obligations, conflicts exist which will preclude exemption.

In G.C.M. 36293, the organization failed to demonstrate that it was so insulated. The organization was to serve as the sole general partner in the project and there was no evidence that its obligations were in any way limited or restricted in the agreement. Accordingly, we stated,

> By agreeing to serve as the general partner of the proposed housing project, the Corporation would take on an obligation to further the private financial interests of the limited partners. Since the promotion of those private interests would tend to foster operating and maintenance practices favoring the equity holdings of the limited partners to a greater extent than would otherwise be justifiable on the basis of reasonable financial solvency, the Corporation's assumption of a duty to promote such interests in its capacity as general partner would necessarily create a conflict of interest that is legally incompatible with its being operated exclusively for charitable purposes.

The partnership agreement may, however, be structured to preclude a conflict of interest between the nonprofit general partner's obligations and its exempt purposes. Both in O.M. 19225 and in this case, the

partnership agreement recognizes that the obligations and responsibility of the exempt general partner are limited. In both cases there are other general partners. The exempt organization has the right of first refusal if the property is offered for sale. Risk is further reduced in the present case because the Corporation has no liability on the mortgage and the mortgage loan is federally guaranteed. The potential for conflict is further reduced because only the other nonexempt general partners have the obligation to protect the interest of the limited partners. Moreover, because of federally imposed income limitations, pursuit of profit cannot be established as a motivating factor for the exempt organization's participation in this venture.

Although it may be argued that a profit-motive is served by the incentive management fee arrangement in which both the consulting firm and the Corporation participate, percentage compensation arrangements are not, in themselves, a bar to exemption. In O.M. 19225, we stated that 'a reasonable percentage compensation agreement is not inconsistent with the pursuit of exempt purposes.' The method of compensation in this case appears reasonable because payments are directly related to services rendered. Moreover, all tenants are of limited means and government guidelines restrict the profits obtainable from the project.

Another potential conflict between the for-profit partners and the Corporation may exist when the rent subsidies and the tax benefits expire. Accelerated depreciation for Section 8 low income housing is provided under section 167(k). However, under section 1250, excess depreciation is subject to full recapture if the property is held for less than 100 months, with recapture decreasing by one percent for each month the property is held beyond 100 months so that there is no recapture after 16- 2/3 years. For the project to qualify as government- subsidized housing for tax purposes, 85 percent of the dwelling units must be held open for occupancy by persons eligible to receive the Section 8 subsidy. After 16- 2/3 years, when the recapture rules are no longer applicable, pressure to sell may be expected. Moreover, after 20 years, the Section 8 subsidies will lapse and pressure to raise rents may be expected. In both O.M. 19225 and here, this pressure is minimized by permitting the exempt organization a right of first refusal on sale of the project.

We believe that under the facts of this case, as in O.M. 19225, the potentials for conflict are minimal. The restrictive provisions of the HUD programs and the structure of the partnership agreement function to permit the Corporation to act exclusively in furtherance of section 501(c)(3) purposes. We therefore concur in the issuance of a favorable ruling.

JAMES F. MALLOY
Director

By:

HARRY BEKER
Assistant Branch Chief, Branch No. 2
Employee Plans and Exempt Organizations Division

Attachment

Adm. file

This document is not to be relied upon or otherwise cited as precedent by taxpayers.

GCM 39005, 1983 WL 197944 (IRS GCM)

END OF DOCUMENT

C
GCM 39825, 1990 WL 698038 (IRS GCM)

Internal Revenue Service (I.R.S.)

General Counsel Memorandum
PARKING LOT REVENUE

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Section 512 -- Unrelated Business Taxable Income (Taxable v. Not Taxable)512.00-00 Unrelated Business Taxable Income (Taxable v. Not Taxable)

512.01-00 Exception, Additions, and Limitations on Unrelated Income

512.01-02 Rent v. Ordinary Business Profits

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By memorandum dated October 10, 1989, the Director, Exempt Organizations Technical Division (E:EO), requested our opinion with respect to a proposed Technical Assistance Memorandum on the application of I.R.C. section 512(b)(3) to parking lot revenues.

ISSUE
Whether an exempt organization's receipt of revenue from either the operation of a parking lot directly or from the lease of a parking lot to a third-party operator constitutes ‘rent‘ which is excludable from unrelated business taxable income pursuant to section 512(b)(3).

CONCLUSION
We agree with the conclusion of the proposed Technical Advice Memorandum that the receipt of revenue from the direct operation of a parking lot by an exempt organization never produces ‘rent,‘ as defined in section 512(b)(3). On the other hand, the receipt of revenue from the lease of a parking lot by an exempt organization to a third-party operator may constitute ‘rent‘ depending on the type of services provided to the third-party lessee in connection with the lease. We also agree that TAM 8445005 (July 11, 1984)

misinterprets Treas. Reg. section 1.512(b)-1(c)(5).

FACTS
The proposed Technical Assistance Memorandum responds to a request from the * * * seeking resolution of conflicts in the definition of 'rent' among four prior Technical Advice Memoranda and a District Office position paper. TAMs 8904002 (Oct. 24, 1988), 8445005 and 7852007 (Sept. 13, 1978), discuss tax exempt organizations which operate parking lots. TAMs 8904002 and 7852007 conclude that the parking lot revenues are not 'rent' because Treas. Reg. section 1.512(b)-1(c)(5) states that payments for occupancy of space in parking lots do not constitute rent from real property. TAM 8445005, citing the same regulation, concludes that such revenues do constitute 'rent' because they are payments for the use of real property and the organization renders no services to the automobile drivers. The District Office position paper accepts the reasoning in TAM 8445005. The organization in TAM 8720005 (Feb. 20, 1987), realizes 'rent' from leasing part of its parking garage to a third-party.

The proposed Technical Advice Memorandum, citing Treas. Reg. section 1.512(b)-1(c) and the legislative history of section 512(b)(3), states that a tax exempt organization which operates a parking lot is conclusively deemed to be providing services 'for the convenience of the occupant' and, therefore, the income received is not 'rent.' On the other hand, net leasing the entire parking lot to a third-party is 'rent.' In the intermediate situation, where the exempt organization leases the parking lot to a third-party operator and also provides services in connection with the lease, the facts and circumstances will determine whether any services provided to the third party are those 'usually or customarily rendered in connection with the rental of . . . other space for occupancy only' or 'primarily for [the] convenience' of the third party. We generally agree with the conclusions of the proposed Technical Advice Memorandum.

ANALYSIS

Section 511(a) subjects organizations described in section 501(c) to a tax on their 'unrelated business taxable income,' as defined in section 512.

Section 512(a) states:

> [T]he term 'unrelated business taxable income' means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 513(a) states:

> The term 'unrelated trade or business' means . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. . . . [FN1]

Section 512(b)(3), enacted by the Revenue Act Of 1950 [FN2] modifies the definition of unrelated trade or business by excepting certain types of rents:

In the case of rents --

> (A) Except as provided in subparagraph (B), there shall be excluded --
>
> (i) all rents from real property (including property described in section 1245(a)(3)(C)), and
>
> (ii) all rents from personal property (including for purposes of this paragraph as personal property any property described in section 1245(a)(3)(B)) leased with such real property, if the rents

attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

(B) Subparagraph (A) shall not apply --

(i) if more than 50 percent of the total rent received or accrued under the lease is attributable to personal property described in Subparagraph (A)(ii), or

(ii) if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). [FN3]

Treas. Reg. section 1.512(b)-1 provides:

> Whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. . . . [I]f a payment termed 'rent' by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or joint venturer, such payment is not within the modification for rents.

Treas. Reg. 1.512(b)-1(c)(5) [FN4] provides:

> [P]ayments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

'Real property' means all real property, including real property defined in section 1245(a)(3)(C) and in section 1250(c) and the regulations thereunder. Treas. Reg. section 1.512(b)-l(c)(3)(i). Section 1250(c) embraces any real property (other than section 1245 property, as defined in section 1245(a)(3)) depreciable under section 167. Treas. Reg. section 1.1250-1(a)(2)(i). Depreciable real property includes leaseholds, buildings and their structural components and all other tangible real property (with certain exceptions). Unimproved land is also real property. Treas. Reg. section 1.1250-1(e)(2), (3). Therefore, whether a 'parking lot' is a field or a parking garage, a parking lot is real property for purposes of section 512(b)(3).

The legislative history of the Revenue Act of 1950 and the Tax Reform Act of 1969 distinguish between the rental of real property and the operation of unrelated trades or businesses, such as parking lots.

The hearings and the committee reports relating to the Revenue Act of 1950 strongly criticize the tax-free operation of 'ordinary businesses' by exempt organizations. Exempt organizations were engaged in the 'active conduct of business' including manufacture of automobile accessories, ceramics, food products, leather goods and china; distribution of petroleum products; operation of theaters, oil wells and cotton gins. Revenue Revisions of 1950: Hearings on H. 8920 Before the Committee on Ways and Means, 81st Cong., 2d Sess. 7-8 (1950) (statement of the Secretary of the Treasury John W. Snyder); 165-167 (statement of Vance N. Kirby, Tax Legislative Counsel); Hearings on H. 8920 Before the Senate Committee on Finance, 81st Cong., 2d Sess. 6-7 (1950) (statement of Secretary Snyder).

The committee reports define an unrelated trade or business which is regularly carried on. One example of an unrelated trade or business is an organization's operation of a public parking lot one day a weak. H. Rep. No. 2319, 81t Cong., 2d Sess. 108, 1950-2 C.B. 458; S. Rep. No. 2375, 81st Cong., 2d Sess. 107, 1950-2 C.B. 559. The House Report then defines the modifications to unrelated business taxable income:

> The tax applied to unrelated business taxable income does not apply to dividends, interest, royalties . . . rents (other than certain rents on property acquired with borrowed funds). . . . Your committee believes that such 'passive' income should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations.
>
> The term 'rents from real property' does not include income from the operation of a hotel but does include rents derived from a lease of the hotel itself. Similarly, income derived from the operation of a parking lot is not considered 'rents from real property.' [Emphasis added]

House Report at 36, 110, 1950-2 C.B. 409, 459. The Senate Report at 30, 108, 1950-2 C.B. 506, 560, reiterates almost verbatim, the language in the House Report. See also, Joint Committee on Taxation Staff, Summary of the Revenue Act of 1950, 81st Cong., 2d Sess. 23-25 (1950); Senate debate, 96 Cong. Rec. 13,274-13,275 (1950). [FN5]

In 1969, the Treasury Department recommended extending the unrelated business income tax to all exempt organizations. U.S. Treasury Department, Tax Reform Studies and Proposals 26-27 (1969). The Joint Committee staff supported Treasury's recommendation, citing its own research into churches' business activities. One of the numerous examples of such unrelated businesses was a church's operation of a parking lot. Joint Committee on Taxation Staff, Tax-Exempt Organizations, 20-21 (Comm. Print 1969). The House committee report from the Tax Reform Act of 1969 incorporates the Joint Committee's examples of proliferating church-operated businesses:

> [N]umerous business activities of churches have come to the attention of the committee. Some churches are involved in operating chains of religious bookstores, hotels, factories, companies leasing business property, radio and TV stations, newspapers, PARKING LOTS, record companies, groceries, bakeries, cleaners, candy sale businesses, restaurants, etc.
>
> . . .
>
> There is inequity in taxing certain exempt organizations on their 'unrelated business income' and not taxing others. [Emphasis added]

H. Rep. No. 413, 91st Cong., 1st Sess. 47 (1969), 1969-3 C.B. 230; S. Rep. No. 552, 91st Cong., 1st Sess. 67-68, 1969-3 C.B. 467 [FN6] Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1969, 91st Cong., 2d Sess. 66-67 (1970).

Congress recognized that exempt organizations had traditionally invested in securities and real estate. The 1950 and 1969 legislation was enacted to tax all other non-traditional, unrelated trades or businesses. The legislative history acknowledges that the distinction between real estate and taxable unrelated businesses rests upon tradition, not upon degrees of 'activity' or 'passivity,' [FN7] not upon any distinction between 'trade or business' and 'investment,' [FN8] and not upon extent or value of organizations' real estate activities. [FN9] Congress twice singled out the operation of parking lots by exempt organizations and twice stated that the operation of parking lots yields unrelated business taxable income and not 'rent' [FN10]

Treas. Reg. section 1.512(b)-1(c)(5) closely tracks the legislative history of section 512(b)(3). The regulation states categorically that parking lot revenues are not rents from real property. [FN11] Therefore, the operation of a parking lot by an exempt organization will never constitute 'rent' as defined in section 512(b)(3). Because the operation of parking lots do not yield 'rent,' we need not inquire whether the exempt organization performs any services primarily for the convenience of the occupant. This inquiry is necessary only for activities which the regulation does not specifically address. [FN12]

On the other hand, the legislative history also shows, by analogy to operating versus leasing a hotel, that leasing a parking lot to a third-party operator may generate 'rent.' GCM 35301. The next step in the lease situation is to analyze any purported 'lease' to ascertain whether the 'lease' creates a true landlord-tenant relationship and not an agency, partnership or joint venture, and whether the landlord-exempt organization performs only the services 'usually and customarily rendered in connection with the rental of . . . other space for occupancy only.'

Accordingly, based upon the above analysis, we concur with the conclusions of the proposed Technical Advice Memorandum.

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Attachment:

Adm. file

FN1. Operation of a parking lot may further an organization's exempt purpose. For example, a hospital's operation of a parking lot for the use of patients and visitors, in an area without adequate parking, contributes to the accomplishment of charitable purpose and is therefore not an unrelated trade or business. Rev. Rul. 69-269, 1969-1 C.B. 160. See also, Rev. Ruls. 79-31, 1979-1 C.B. 206; 76-33, 1976-1 C.B. 169; 69-463, 1969-2 C.B. 131; * * * GCM 39715, EE-178-86 (Apr. 15, 1987).

FN2. Pub. L. No. 81-814 section 301, 64 Stat. 994 (1950), 1939 I.R.C. section 422(a)(3). As enacted, and prior to amendment in the Tax Reform Act of 1969, Pub. L. No. 91-172 section 121, 83 Stat. 537-538 (1969), section 422(a)(3) (1954 I.R.C. section 512(b)(3)) provided:

> There shall be excluded all rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents.

FN3. Assuming that the revenues constitute 'rent' under section 512(b)(3), such rent may nevertheless be taxable as rent received from a 'controlled organization' under section 512(b)(13), or as unrelated debt-financed income under sections 512(b)(4) and 514. This memorandum will address only the modification for 'rent' in section 512(b)(3).

FN4. Treas. Reg. section 1.512(b)-1(c)(5) remains substantially unchanged from its initial promulgation as Treas. Reg. 111 section 29.422-1 in T.D. 5928, 1952-2 C.B. 181, modified in T.D.s 6301, 1958-2 C.B. 226, and 7177, 1972-1 C.B. 159. Treas. Reg. 111, section 29.422-1(b)(3) stated that '[p]ayments . . . for the use or occupancy of space in parking lots . . . do not constitute rentals from real estate.'

FN5. Concerning the history of exempt organizations' tax-favored real estate activities, see, * * * GCM 33604, I-613, I-614 (Aug. 28, 1967) and * * * GCM 33932, I-1049 (Sep. 24, 1968).

FN6. The Senate Report lists many of the same unrelated trades and businesses, including parking lots.

FN7. The discussion during the 1950 Senate hearings highlights conceptual problems that inevitably arise in any active/passive analysis: Is there a true distinction between managing a large office building with 150 tenants and operating a hotel? See, * * * GCM 30873, A-628270 (Sept. 17, 1958). The 1950 committee reports' reference to rents as traditional and proper 'passive income' uses quotation marks around the word 'passive,' to clarify that 'passive income' describes a traditional activity, not an active/passive test.

FN8. Whether or not rental of real property is a trade or business, if the revenues are in fact 'rent,' as defined in section 512(b)(3) they are not income from an unrelated trade or business * * * GCM 32689, I-795 (Oct. 9, 1963.

FN9. * * * GCM 35301 I-978 (Apr. 12 1973) and authorities cited therein at 21; * * * GCM 34034, (Feb. 3, 1969.

FN10. Although the legislative history is conclusive on this question, we also note that patronage of a parking lot is a bailment of personal property and not a lease of real property. See generally, Note, Bailor Beware: Limitations and Exclusions of Liability in Commercial Bailments, 74 Vand. Law Rev. 129 (1988).

FN11. James Eustice, in his treatise on S Corporations, agrees with this interpretation of Treas. Reg. section 1.512(b)-1(c)(5). Treas. Reg. section 1.1372-4(b)(5)(iv), T.D. 6432, 1960-1 C.B. 317 (1954 I.R.C. section 1372 (repealed 1982)), incorporated most of the definition of 'rents' from Treas. Reg. section 1.512(b)-1(c)(5). That regulation also listed 'motels' as an activity that produces no 'rent.' 'By the terms of the regulation, operating a motel does not produce 'rents'. . . .' J. Eustice and J. Kuntz, Federal Income Taxation of Subchapter S Corporations 4-23 (1982).

FN12. Compare Rev. Ruls. 69-178, 1969-1 C.B. 158 (rental of hall); 80-297, Situation 2 1980-2 C.B. 196 (rental of tennis facilities) with Rev. Ruls. 80-297, Situation 1 (operation of tennis school); 80-298, 1980-2 C.B. 197 (lease of stadium together with substantial services to the lessee) and 69-69, 1969-1 C.B. 159 (apartments leased with secretarial and maid service provided).

This document is not to be relied upon or otherwise cited as precedent by taxpayers.

GCM 39825, 1990 WL 698038 (IRS GCM)
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607 - Joint Ventures, Co-ventures, Hybrids and Other Unusual and Creative Ideas for Increasing Visibility and Raising Revenue

A DESKTOP GUIDE FOR THE TAX-EXEMPT VENTURER

Timothy B. Phillips, Senior Counsel, American Cancer Society, Inc.

The following is a by no means exclusive guide to the considerations a tax-exempt organization (and for that matter its potential partner/co-venturer) should take into account when entering into a joint enterprise. This "common sense" checklist is designed to trigger the investigations and inquiries that will assist corporate counsel in managing the various risks associated with such activity, while maximizing opportunities.

Purpose

Furtherance of an exempt purpose is a fundamental component to the engagement in any commercial activity. Will the activity or enterprise contribute importantly to the accomplishment of one or more of your organization's stated purposes? If the answer is "no," then the inquiry must quickly shift to "why, then, should we engage?" and, "are there alternatives to the enterprise which will provide the same outcome, i.e., increase revenues and/or visibility?"

There is a significant degree of risk associated with a nonprofit entity engaging in commercial activities that do not contribute substantially to its mission. Failure to further mission can create: fiduciary risk (the fiduciaries of the organization have a stewardship obligation – duty of loyalty – and must act prudently – duty of care – in the oversight of the organization's affairs and finances); compliance risk (the Internal Revenue Code

provides that exempt entities must operate exclusively in furtherance of exempt purposes and the States Attorneys General are particularly solicitous of charitable entities operating in or under their jurisdiction); financial risk (any investment of an exempt organization's assets, including its employees, must involve a risk/reward analysis); reputational risk (the classic "how would this look on the front page of the Wall Street Journal?" inquiry); and operational risk (will the organization have the resources and acumen to undertake the activity without substantial detriment to other mission critical functions?).

Authority

As counsel to the corporation, you have a duty to ensure that prior to engaging in any venture related activity, management has obtained the appropriate corporate authority. In certain instances, the activity may be purely "operational," and management will be vested with the authority to engage without a formal resolution or consent from the board. In other circumstances, however, especially where a partnership or arrangement treated as such under local laws will be created, it is almost always necessary (if not immeasurably prudent) to obtain the prior consent of the corporation's fiduciaries. This will serve two very important purposes: on the one hand, it will provide the fiduciaries with the appropriate information and visibility into the activity, permitting them to exercise their duty of care; and, on the other, with the exception of deceptive or negligent acts, it will also protect management from the future potential claim of operating outside of their authority.

Tax and Regulatory Compliance

Although mentioned in the "Purpose" section above, this area is of sufficient importance to warrant its own discussion. The tax and regulatory implications for an exempt organization that chooses to engage in venture activity are significant. They range from the tax on unrelated business income (commonly referred to as "UBIT") to state registration requirements. Corporate counsel must consider the realm of tax and regulatory impact on the corporation. Though this may appear at first glance to be daunting, there are some common tips that can facilitate the task:

- If you are not a tax lawyer don't pretend to be. The tax on unrelated business income and the exemptions (also known as "modifications") can quickly become complex. An IRS exam or audit is not the time to discover this. Because your venture partner will have its own tax issues to manage, it is a good practice to engage a tax advisor who is familiar with UBIT beyond what the acronym means.
- Take a look at your state's registration requirements. Is the activity one which would require a separate registration for your organization or that of your venture partner? If a new entity is created, does it need to register?
- Conduct a scan of regulatory entities that may have an interest in your activities? Are there express or implied limitations or reporting requirements attached to any of your existing funding sources that could be triggered by the proposed activity? Are federal funds at risk?
- Carefully review the Instructions to the New IRS Form 990. There are **27** separate disclosures related to exempt organizations that participate in joint ventures.

Brand Dilution/Corruption

Any time an exempt organization engages in an activity in the commercial space, it risks the dilution or corruption of its brand. Of course offsetting this risk is the great reward from establishing the reputation of that brand in a new market. But at the outset, corporate counsel should ask his/her mission partners whether they have considered any dilutive effects of the new venture? Will there be sufficient and apparent differences between the venture and the existing exempt entity to preserve the integrity of the brand? What is the likelihood that venture could swallow the exempt organization as a separate entity in the public's eye?

Partner Due Diligence

For all the right reasons, we must pick our partners carefully. And to quote the Godfather (II): "This isn't personal; it's business." People – our donors, the public, regulators, watchdogs- will judge us by the friends we keep. So we must be solicitous of the venture partners with whom we engage. Has this entity engaged in this type of activity in the past? Does it have any history of social engagement or community benefit activity? Who owns it? What is its financial condition? Has it ever been investigated? These are but a few of the questions any diligent counsel should assure his/her mission partners have considered prior to investing the organization's time, resources and reputation in the enterprise.

Strategic Outlook

Since our objective throughout this year's meeting is to discover ways that corporate counsel can, "Be the Solution," it is fitting to close out this guide with a cautionary note about missed opportunities. Too often we hear the complaint that a transaction or activity could have been great - if only "legal" had approved it. While I am by no means advising the "rubber stamp" approach to commercial ventures, I do encourage my colleagues to consider how to "get to yes" when it makes sense from a mission perspective to engage. The IRS has improved the available guidance in the arena, and though it is not perfect, we at least have some parameters within which to operate. In addition, the public has become more accustomed to the appearance of exempt organizations in the commercial space. From basic cause marketing campaigns in stores to full scale joint ventures in public health and education, the scope of commercial activities involving exempts has expanded to encompass much of our daily activities. So it is important that corporate counsel not loose sight of the big picture when attending to the deal's details. We need to balance our duty to protect the corporation and management with our obligation to further its mission through the creation of opportunity.

Extras from ACC

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