JOINT VENTURES: LEGAL FRAMEWORK

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Introduction: Why Are We Here?

• Changing World
  — Shrinking boundaries between sectors
    1) Rise of mission/impact as a force in the commercial sector
       a) New corporate forms
       b) Increased awareness and notion of corporate responsibility
    2) Charities embracing commercial techniques, processes, etc.
       a) Should we be more like them
       b) It may not be such a bad thing
    3) People
       a) Social entrepreneurs
       b) The commercial sector is not the only destination for business minded people and vice versa
  — Increased awareness brings increased opportunities
Introduction: & Why Do We Care?

• What the IRS thinks about when it thinks about charities
  — Operational fidelity
  — Private Benefit/Private Inurement
  — Limited Commerciality

• What people think about when they think about “charity”
  — Essential Character
  — Halo Effect
  — Public v. Private Purposes

• Fundamental tensions when the for-profit and nonprofit worlds collide or seek to co-exist
Introduction: & Why Do Charities Do It?

• Mechanism to further exempt purpose
• Scale up and/or achieve efficiencies
• Raise needed capital to support a project
• Provide access to expertise and know how
• Good investment opportunity
• Mandated by the structure of specific government programs
  — Tax credit transactions
Introduction: & What Are We So Afraid Of?

• Loss of Essential Character
  — Too much blurring
  — Commerciality

• Charities cannot take care of themselves
  — Charitable focus = lack of business savvy
  — Assumption that charities will always lose out at the expense of private interests

• No real checks and balances

• Disillusionment
What Is a Joint Venture (For These Purposes)?

• An association of two or more persons that undertake a project or activity
  – For profit
  – With a community of interests
  – In the performance of a common purpose
  – With a proprietary interest in the subject matter
  – With a right to govern and direct policy
  – With a duty to share in profits and losses

• For most purposes (in this area) vehicle is a “pass through” or one that mandates attribution of activities to joint venture participants for tax purposes
Joint Ventures in General: Structure

- Joint ventures can take the form of:
  - Limited partnerships
  - General partnerships
  - Limited liability companies
  - Contractual Arrangements
Joint Ventures In General: Threshold Questions

- Ancillary v. whole entity
- What is ancillary?
- Two threshold questions:
  - Does it jeopardize the organization’s charitable purposes?
  - Is income subject to UBIT?
Early History

• Per Se Test
  — Initial IRS position that charity automatically ceases to qualify as tax-exempt when it served as a general partner in a partnership that included for-profit investors.
  — Plumstead Theater Society, Inc. v. Commissioner (9th Cir. 1982)
    1) Arm’s length negotiations
    2) No control over organization by for-profit partners
    3) Plumstead’s assets not at risk
    4) Charitable motive
Early History

• GCM 39005 and Two-Part Test
  — Charitable purpose test
    1) Is the joint venture accomplishing charitable purposes
  — Private benefit test
    1) Does the venture enable the exempt organization to act in furtherance of exempt purposes rather than for the benefit of the profit partners?
    2) Is any benefit to the for-profit partners incidental?
Early History

• Emergence of control as a factor in analysis
  — PLR 9736039
    1) IRS requires organization to amend partnership agreement to clarify that it has sufficient control
    2) Having sufficient control over the venture is connected to the ability of the exempt organization to fulfill charitable purposes
  — PLR 9731038
    1) Control allows the organization to ensure that it is operating for charitable purposes.
Precedential Guidance

• Rev. Rul. 98-15 – whole entity joint venture
  — Control as central motif
    1) Governing body
    2) Charitable purpose
    3) Budget and expenditures
  — Arm’s length management arrangement with entity unrelated to for-profit joint venture participant
  — No inducements
  — Good fact pattern lacks “abuses” (or grey areas)
  — Bad fact pattern – more obvious
Precedential Guidance

  - Effective control in hands of for-profit
    1) Relationship conferred significant private benefit
  - Relevant factors:
    1) No obligation to put charitable objectives over commercial ones
    2) Charity did not have voting control
    3) Charity did not have formal or informal mechanisms to ensure furtherance of charitable purposes
    4) Long term management contract to for-profit
    5) Market advantages to affiliates
Precedential Guidance

• *St. David’s Health Care System* (5th Cir. 2003)
  — Key issue is control
    1) How to ensure charitability
  — Not necessary to control everything
    1) Needs to be sufficient charitable operation and incidental private benefit
  — Lack of formal voting control is not fatal if other, enforceable mechanisms are in place
Precedential Guidance

• 2004-51 – ancillary joint ventures

— Facts

1) Activities insubstantial in light of University’s overall program
2) University kept control of educational and curricular aspects (i.e., what it cared about from a charitability perspective)
3) Joint venture expanded the reach of the offerings
4) Arm’s length, FMV requirement for contracts
5) Venture can’t conduct activities that would jeopardize the University’s exemption
• 2004-51 – ancillary joint ventures

— Analysis

1) Not a substantial activity so exemption not jeopardized
2) Ownership interests proportionate to capital contributions
3) Activities are substantially related (contribute importantly)
   a) University alone approves the curriculum, training materials and instructors and determines the standards for completing the seminars
   b) Similar content to training the university conducts on campus
   c) Expanded reach
Ancillary Joint Ventures: Open Questions

- Ancillary joint ventures
  - Will lack of control result in UBIT if activity is still ultimately “related”?  
    1) Does a “normal” UBIT analysis suffice  
    2) Does structure mandate different approach
  - What is insubstantial?
  - Should not affect tax-exempt status  
    1) Generally a UBIT issue  
    2) BUT… heightened private benefit tensions
Advising Joint Ventures: Mind Frame

- Keep the usual concerns handy
  - Relatedness
  - Private benefit/inurement
- Don’t (you can’t) give up too much
- OK to give up too much in UBIT (not exemption) context
  - Business considerations and calculus
  - Why do backflips?
- Make reasonable judgment calls
  - Document the process and rationale (contemporaneously)
    1) Why are we doing this in this manner
  - Embrace the well crafted “whereas” clause
Advising Joint Ventures

• First question – determine what you have
  — Is it a joint venture?
  — Is it a services agreement?
  — Is it a passive investment?
  — Note that contractual arrangements may be characterized as joint ventures
    1) sharing in profits
    2) exempt organization manager
## Advising on Joint Ventures

- Ensure fair market value and arm’s length transactions
  - Appraisals of non-cash contributions – know the value
    1) I.P., know-how, physical assets
  - Services to venture compensated at fair market value
  - Ownership interests commensurate with contributions of parties
  - Do not place exempt’s assets at risk for benefit of for-profit
    1) Be careful about guarantees, indemnities
  - Fair allocations of income, deductions, taxes, credits

- Articulation of purpose

- Creative (necessary) compensation arrangements
Hospital MRI Venture

- Swampland Hospital is approached by Gator MRI Group to form an LLC that will operate an MRI center in Swampland
- Swampland and Gator will own the new LLC 51/49
- Gator will manage the MRI facilities; Swampland will provide space, some services and facilities
- Gator manages MRI centers at 10 hospitals in region
- Junior lawyer in Gator’s GC office provides Swampland with its standard management and LLC agreements
**Workforce Development Venture**

- WDC, Inc. is a national charity that provides job placement and job skills training for the homeless.
- NSE is a new social enterprise established by a board member of WDC.
- NSE proposes to partner with WDC on a venture to install solar panels and conduct other energy efficiency retrofitting in low and moderate income communities where government subsidies are available.
- WDC will provide and train the workforce and solicit and accept donations to support its involvement in the project.
Workforce Development Venture

- NSE will supervise the workforce
- NSE will make all decisions regarding the communities in which the venture will operate and the services it will provide
- WDC’s name and logo are featured prominently on all marketing materials
- WDC will get a share of the net profits from the venture
Curriculum Joint Venture

- CSN is a charter school network committed to the Fabian-Aquatic Learning Node, a new water-based learning approach developed by CSN’s founder, Jean Fabian, a prominent educator, for use with children with severe learning disabilities.

- CSN is approached by a company that is interested in developing a venture to operate for-profit, fee-based mini-schools and which also provides services to public schools focused on educating children with severe learning disabilities.
Curriculum Joint Venture

- The company would like to use the FALN curriculum and pedagogical techniques developed by CSN in the venture and provide a mechanism for certifying educators in FALN.
- The company has retained Mr. Fabian as a consultant to develop a concept paper for the venture.
- The company and CSN agree to a joint venture run by Mr. Fabian.
- Mr. Fabian is granted a small stake in the venture as an employment incentive.
Ancillary Joint Ventures & Investing

• With ancillary joint ventures the general concern is making otherwise tax-exempt income taxable

• Passive investing does not typically implicate joint venture concerns
  — Lack of control (anyway)
  — Generally passive participation
  — Tax character of income is generally set

• But watch out for “social” investment opportunities that involve a strong participatory component
  — May be more like a joint venture than a passive investment
Ancillary Joint Ventures & Investing

- Returns are taxed under general principles
  - Partnership/LLC investment vehicles
    1) Retains underlying character
      a) Operating businesses
      b) Corporate stock
  - Corporate stock (dividends)
  - Licensing (royalties)
    1) Services
  - Interest
  - Rents
Ancillary Joint Ventures & Investing

• With ancillary joint ventures the general concern is turning otherwise tax-exempt income into taxable income

• Passive investing generally does not implicate joint venture concerns

• Returns are taxed under general principles
  — Corporate stock
    1) dividends
  — Partnership/LLC investment income
    1) Retains underlying character
  — Licensing/royalties
    1) Passive (unless more than incidental services)