

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

- *Redlands Surgical Services v. Commissioner* (T.C. 1999)
 - 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

Precedential Guidance

- 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)