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JOINT VENTURES WITH FOR-PROFIT ENTITIES: LEGAL LANDSCAPE & REPORTING OBLIGATIONS

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JOINT VENTURES WITH FOR-PROFIT ENTITIES: LEGAL LANDSCAPE & REPORTING OBLIGATIONS

I. INTRODUCTION

Tax-exempt organizations are increasingly being presented with opportunities to participate as co-venturers with for-profit organizations. An exempt organization may desire to proceed because it believes that the joint venture will further its exempt purpose, or the project may simply be an investment opportunity that will generate additional capital or revenues or provide the organization with access to expertise. Whether it is because of the exigencies of accomplishing charitable goals in today's world or for other reasons, the participation by exempt organizations in joint ventures continues to grow, and the rules governing their involvement are constantly evolving.

II. DEFINITION OF A JOINT VENTURE

A joint venture is an association of two or more persons or entities that undertake a project for profit with a community of interests in the performance of common purposes, a proprietary interest in the subject matter, a right to govern and direct the policy in connection therewith, and a duty (which may be altered by agreement) to share in both profits and losses. *See Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949); *Harlan E. Moore Charitable Trust v. United States*, 812 F. Supp. 130, 132 (C.D. Ill. 1993), *aff'd* 9 F.3d 623 (7th Cir. 1993), AOD, CC-1994-001.

Joint ventures between exempt organizations and for-profit organizations take a variety of forms. Joint ventures may be conducted through a limited liability company ("LLC"), a partnership – either general or limited – or through the use of joint venture operating agreements.

A. General Partnership

As defined for federal income tax purposes, a "partnership" includes a syndicate, group, pool, joint venture or unincorporated organization through which, or by means of which, any business, financial operation, or venture is carried on, and which is not, for federal income tax purposes, a corporation, trust or estate. Code Section 761(a).[1] The partners of a general partnership are personally liable for the debts of the partnership.

[1] All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

B. Limited Partnership

A limited partnership is a partnership formed by two or more persons under the limited partnership laws of a state. The partnership must have one or more general partners and one or more limited partners. Revised Uniform Limited Partnership Act Section 101(7). If a partnership complies with the requirements of the applicable state limited partnership statute, the liability of a limited partner for the partnership debts or obligations is limited to the extent of the capital which each partner has contributed or agreed to contribute. In order to maintain this limited liability, the limited partners may not participate in the management of the partnership.

C. Limited Liability Company

An LLC is formed and operated pursuant to state statute. The LLC is a hybrid entity which provides insulation from liability to the same extent as a corporation, but the entity generally is taxed as a partnership. This form of entity also permits members to participate directly in the management of the business without jeopardizing their limited liability.

III. CONSEQUENCES OF PARTICIPATION IN A JOINT VENTURE

When an exempt organization participates in a joint venture with a for-profit entity through a partnership or an LLC taxable as a partnership, the exempt organization faces two threshold questions: First, could its participation in the joint venture jeopardize its tax-exempt status? Second, is the income from the joint venture unrelated business taxable income ("UBTI") subject to the unrelated business income tax ("UBIT") under Code Sections 511-513?

In its CPE Text for FY 2000, the Internal Revenue Service (the "IRS") confirmed the significance of these two underlying concerns, stating "While such [joint venture] arrangements are becoming more sophisticated in terms of participants (such as LLC's . . .), and operations (such as whole hospital joint ventures addressed in Rev. Rul. 98-15, 1998-12 I.R.B. 6), the underlying concerns with regard to these arrangements remain largely unchanged: whether an exempt organization's participation might adversely affect its exempt status, and whether such participation results in unrelated business taxable income ("UBTI") to the exempt organization." *IRS Exempt Organizations CPE Text for FY 2000: Chapter L, UBIT: Special Rules for Partnerships*, 1999 TNT 169-23 (Aug. 31, 1999).

A. Loss of Exemption

There are times when an exempt organization's participation in a joint venture jeopardizes its tax-exempt status because its participation in the venture causes it to fail to operate exclusively for exempt purposes as required by Code Section 501(c)(3). *See* Rev. Rul. 98-15, 1998-12 I.R.B. 6 (March 4, 1998).

B. Unrelated Business Income

A partner in a partnership or a member of an LLC classified as a partnership for tax purposes is subject to tax on the income and loss of the partnership whether or not it is distributed. Code Section 701(a). When an exempt organization receives a Schedule K-1 from an entity taxable as a partnership, the organization will have to determine whether or not the income shown on the Schedule K-1 is subject to UBIT.

Code Section 512(c)(1) provides that partnership income is not taxable as UBTI if the trade or business of the partnership is "substantially related" to the exempt purpose of the exempt organization partner. If the trade or business of the partnership is not substantially related to the exempt partner's exempt purpose, then the income from the partnership generally will be considered UBTI. Treas. Reg. Section 1.512(c)-1. However, the exclusions set forth in Code Section 512(b) (rents, royalties, dividends and interest), are also applicable to partnership income. The rules regarding the treatment of debt-financed income also still apply and may cause partnership income to be UBTI to an exempt partner. Treas. Reg. Section 1.512(c)-1.

IV. EARLY HISTORY OF PARTICIPATION IN JOINT VENTURES BY EXEMPT ORGANIZATIONS

A. Participation as a General Partner

Over the years, the IRS has established strict requirements for exempt organizations that serve as general partners.

1. *The IRS's* Per Se *Position*

Prior to *Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982) (hereinafter, "*Plumstead*"), it was the IRS's position that an exempt organization automatically ceased to qualify as tax-exempt pursuant to Code Section 501(c)(3) when it served as a general partner in a partnership that included for-profit investors as limited partners. *See* GCM 36293 (May 30, 1975). *Plumstead*, discussed further below, triggered the erosion and eventual demise of the *per se* rule.

2. *Plumstead Theatre Society Inc. v. Commissioner*

Facts: In *Plumstead*, an organization formed to promote and foster the performing arts, applied for, and was denied, tax-exempt status under Code Section 501(c)(3) because its activities as a general partner of a limited partnership that included private investors caused the organization to fail the operational test. Initially, Plumstead co-produced a play with the Kennedy Center in Washington, D.C. Because of financial difficulties, it formed a limited partnership with three private investors, selling them 63.5% of its interest in the play, leaving Plumstead with a 36.5% interest in the partnership's profits and losses.

Analysis: In ruling against the IRS and deciding that Plumstead was organized and operated exclusively for charitable and educational purposes under Code Section 501(c)(3), the Tax Court found that the limited partners had no control over the way the organization operated or managed its affairs; the exempt organization had no obligation to return the limited partners' capital contributions; there was no profit motive exhibited by the exempt organization; and the partnership transaction was arm's length and reasonably priced. The court concluded that Plumstead's participation in the partnership did not result in its being operated for private rather than public purposes. Based on the result in *Plumstead*, the IRS began to acknowledge that the participation of an exempt organization in a partnership as a general partner would not necessarily jeopardize exempt status.

3. *GCM 39005: The Emergence of the Two-Prong Test*

Following the Tax Court's decision in *Plumstead*, the IRS released GCM 39005 (June 28, 1983) in which it enunciated a two-prong test for analyzing whether a tax-exempt organization jeopardizes its exempt status by serving as a general partner in a limited partnership:

a. Charitable Purpose Test: Whether the exempt organization is accomplishing a charitable purpose through the venture; and

b. Private Benefit Test: Whether the arrangement permits the organization to act exclusively in furtherance of its exempt purposes rather than for the benefit of the for-profit partners. An exempt organization cannot further private interests other than incidentally in furthering its exempt purpose. The private benefit must be incidental in both a qualitative and quantitative sense. GCM 37789 (Dec. 18, 1978); GCM 39862 (Nov. 21, 1991).

In general, any partnership or other joint venture arrangement between a Code Section 501(c)(3) organization and one or more for-profit entities requires "close scrutiny" to determine whether the potential conflicts between the exempt organization's duty to operate exclusively for exempt purposes and any duty it may have to advance private interests jeopardizes the organization's exempt status.

While recognizing the statutory obligations of a general partner to its limited or co-general partners, the IRS acknowledged in GCM 39005 that a partnership agreement may be structured so as to preclude a conflict of interest between the tax-exempt general partner's obligations and its charitable purpose. For example, the structure of the partnership arrangement in GCM 39005, involving a government financed housing project for the handicapped and elderly, averted significant tax conflicts for the exempt general partner because: (i) the partnership agreement limited the obligations and responsibility of the exempt general partner; (ii) the presence of other general partners reduced the exposure of the exempt organization's charitable assets; (iii) the exempt organization had no liability for the mortgage, because it was

nonrecourse; and (iv) HUD's income guidelines restricted the partnership's pursuit of private profit.

Subsequent rulings and commentaries by the IRS sorted out other protections for the exempt general partner as important toward meeting this standard: (i) allocations based on capital contributions and assumed risks, GCM 39732 (May 19, 1988); GCM 39862; (ii) the absence of special allocations of items of income, deduction or credit to any partner, GCM 39732; (iii) services and property provided at fair market value, *Id.*; (iv) capital contributions by limited partners are real and substantial, GCM 39862 (Nov. 21, 1991); and (v) non-exempt partners do not receive more than reasonable compensation for the sale of property or service to the joint venture. *Plumstead*, 74 T.C. at 1333; *IRS Exempt Organizations CPE Text for FY 1993: Chapter D: Update on Partnerships and Joint Ventures* 94 TNT 70-18 (Oct. 1, 1992); PLR 8917055 (April 28, 1989)[2] (participation of exempt organization in a partnership did not adversely affect its tax status).

4. *PLR 9731038 (Aug. 1, 1997)*

It is common for a general partner to offer the limited partners certain guarantees and indemnifications in order to induce their participation. Thus, what might seem to be normal business practices, have been of concern to the IRS when an exempt organization is a general partner. The main focus has been whether the exempt organization is putting its assets at risk and whether an impermissible private benefit has been provided to for-profit limited partners. PLR 9731038 suggests that careful structuring may enable an exempt general partner to offer limited partners certain typical guarantees and indemnities without jeopardizing its exempt status.

Facts: In PLR 9731038, a Code Section 501(c)(3) organization was created to provide affordable housing and to rehabilitate a deteriorated downtown area. The organization requested the IRS to rule that its participation in a plan, in collaboration with the city, to revitalize badly deteriorated inner-city areas would not jeopardize its tax-exempt status. The plan involved the formation of several limited partnerships, each of which would own and operate a low-income housing project. The limited partners would be private investors. The provisions of the partnership agreement initially raised IRS concerns because the exempt organization agreed to (i) an environmental indemnification; (ii) credit adjusters and; (iii) a return of capital to the limited partners in the event that the project was not completed by a certain date. These provisions caused the concern that the exempt organization had impermissibly guaranteed the investment of the limited partners.

Analysis: After an examination of all of the facts and circumstances (and the taxpayer's agreement to make changes), the IRS concluded that the organization's charitable

[2] Although private letter rulings apply only to the requesting taxpayer and may not be cited as precedent, they offer insight into the position of the Internal Revenue Service on an issue. Code Section 6110(j)(3).

purpose was furthered by its participation in the plan and that the guarantee, the credit adjusters and the indemnity did not provide an impermissible private benefit. First, the IRS noted that the partnership reduced the risk to the exempt organization by completing a Phase I environmental assessment and amending the partnership agreement to require indemnification by the exempt organization only to the extent losses arising from the recapture of credits were attributable to the gross negligence or willful misconduct of the general partners. Second, an amendment to the partnership agreement provided that any credit adjustment would be treated as a capital contribution by the charitable general partner, rather than a penalty for breach of warranty. Finally, the risk of not completing the projects was minimal because three were in operation, and the organization as the developer was, therefore, in control of the completion date. See Michael I. Sanders, *Hot Issues Affecting Partnerships and Joint Ventures Involving Partnerships*, 98 TNT 75-50 (Apr. 15, 1998) (hereinafter, "*Hot Issues*") for a thorough discussion of this ruling and its implications.

B. Participation as a Limited Partner

1. *Role of Exempt Organization*

Because the IRS closely scrutinizes an exempt organization's participation in a partnership as a general partner, exempt organizations oftentimes elect to participate in joint ventures as limited partners. Most typically, as a limited partner, the exempt organization's role is simply as a passive investor. The exempt organization's assets are not exposed beyond the investment, and the exempt organization does not have a duty, statutory or otherwise, to maximize profits for the investors.

2. *UBTI*

In general, the significant issue that arises is whether any income received by the exempt organization is UBTI. *See generally* PLR 9109066 (March 1, 1991) (exempt organizations that served as limited partners in a limited partnership, where the limited partnership itself was a general partner in a partnership which engaged in charitable activities, did not result in UBTI); PLR 9207033 (Feb. 14, 1992) (exempt organization served as a limited partner in a limited partnership investing in timber and timberland, and its gain from timber-cutting contracts was not UBTI under Code Section 512(b)(5)).

3. *"Prudent" Investments*

It has been said by some practitioners that an exempt organization may invest as a limited partner in any prudent investment. *See, e.g., Hot Issues*. Query, however, whether the answer changes if the exempt organization contributes a significant portion of its charitable assets to the limited partnership. *See IRS Exempt Organizations CPE Text for FY 2000: Chapter D*, 1999 TNT 169-15 (Sept. 1, 1999) ("There is no factual significance [in the comparison of Situations 1 and 2 of Rev. Rul. 98-15] in the fact that an LLC is the joint venture arrangement rather than a *limited partnership* or general partnership.") (emphasis added); PLR 9319044 (May

14, 1993) (IRS ruled on whether an exempt parent organization's participation as a limited partner, as well its subsidiary exempt-organization's participation as a general partner, in the same limited partnership with a for-profit co-venturer jeopardized the exempt status of either the parent or the subsidiary).

C. Use of Limited Liability Companies Rather Than Partnerships

1. *Structure and Advantages of LLC*

An LLC is formed pursuant to state law and provides limited liability to all owners while permitting flow-through tax treatment for all "members." Code Section 7701; Treas. Reg. Section 301.7701-1(a). Advantages of LLCs over partnerships include elimination of personal liability for entity level debt and the opportunity for all members to participate in the management of the entity. For some time, exempt organization participation in LLCs has been analyzed similarly to participation in a partnership and the IRS early on applied the two-prong test of GCM 39005 to LLCs. *See* Rev. Rul. 98-15.

2. *PLR 9517029 (April 28, 1995)*

Facts: An exempt supporting organization of a university and a for-profit corporation that owned two hospitals established an LLC to own and operate the two hospitals. Prior to the establishment of the LLC, the two privately-owned hospitals served as the university's primary teaching hospitals. The LLC was created as a result of serious disagreements between the university and the for-profit corporation over the operations of the hospitals, and the intervention of a court-ordered mediator.

Analysis: The IRS approved the proposed LLC arrangement, stating that it did not jeopardize the tax-exempt status of the exempt subsidiary of its university parent, because: (i) the hospitals would continue to provide medical services in a manner consistent with Code Section 501(c)(3) requirements; (ii) teaching requirements of the university parent would continue to be met by the operation of the hospitals; and (iii) there were no disproportionate allocations of joint venture profits or losses under the LLC operating agreement. The IRS also held that the distributive share of the LLC's profits and losses was income from a trade or business that was substantially related to the exercise or performance of the university's exempt educational and research purposes and, thus was not subject to UBTI.

V. EMERGENCE OF THE "CONTROL" REQUIREMENT

A. Laying the Foundation for "Control" Analysis

Two letter rulings in the second half of the 1990s pointed the way to the analysis later adopted by the IRS.

1. *PLR 9637050 (Sept. 13, 1996)*

The IRS ruled that the ownership and operation of a joint venture LLC formed by two exempt entities to provide outpatient dialysis services would further the charitable purposes of the exempt health care organization member.

Facts: Initially, the LLC was owned by physicians, none of whom were officers or directors of the two exempt organizations. The LLC proposed to construct a new dialysis center and offered the exempt organizations the option to purchase a 62.5% membership interest. One of the exempt organizations operated an acute care hospital and the other was a health care system that operated two hospitals. All financial arrangements between the physicians and the exempt organizations were to be negotiated on an arm's length basis and based on fair market value. Contributions to the LLC and allocations of profits, losses, and distributions from it would be proportionate to the interests of the members, and members would be proportionately liable for LLC debts and obligations.

Analysis: In ruling that participation in the LLC would not have an adverse effect on the tax-exempt status of the exempt organization and that its distributive share of the profits and losses would not be UBTI, the IRS found that the exempt organizations' control of the LLC, and the policies and guidelines for the operation of the LLC dialysis center, assured their continued operation exclusively in furtherance of the exempt entities' charitable purposes with only incidental benefits to the physicians.

2. *PLR 9736039 (Sept. 5, 1997)*

Facts: A Code Section 501(c)(3) organization formed to provide low-income housing proposed to develop a multi-unit, single-room-occupancy facility. The facility was to be partially funded with low-income housing tax credits that had been allocated to a limited partnership of which the charity was the managing general partner. The charity had only a .15% general partnership interest, and a for-profit co-general partner who served as developer held a .85% general partnership interest. Investors held the remaining 99% interest in the partnership. Under the partnership agreement, the managing general partner (*i.e.*, the exempt organization) was responsible for the day-to-day operations. The charity and the developer were to jointly control certain substantive functions, such as compliance with resident qualifications and rental restrictions. However, the developer's partnership interest gave it effective control over qualification and substantive operation of the partnership. The partnership agreement obligated the developer, as co-general partner, to return funds to the investors if specified contingencies occurred, including (i) an allocation differential in which the projected credits exceeded the allocated credits, (ii) a tax credit shortfall in which rejected credits exceeded the actual credits, or (iii) a tax credit recapture. The charity did not agree to any similar guarantees. However, the charity had entered into a pledge and security agreement, pledging its entire partnership interest to secure a default under the partnership agreement, which included the developer's failure to return funds to the investors or acquire the investors' entire interest.

Analysis: The IRS was concerned under these facts that the charity, because of its minority interest, lacked control over the partnership's substantive obligations. Thus, it concluded that the charity was not in a position to cause the partnership to carry out its exempt charitable objectives. In order to meet this concern, the partnership agreement was amended (i) so that the charity was delegated substantive authority formerly reserved jointly to the general partners and (ii) the parties terminated the pledge and security agreement which eliminated the IRS's concern that charitable assets would be at risk for the benefit of for-profit persons. After the modifications, the IRS held that the charity's acquisition and retention of the general partnership interest would not adversely affect its tax-exempt status, and that income derived from its participation in the partnership and the development and operation of the apartment complex would not constitute UBTI.

B. Whole Entity Joint Ventures Versus Ancillary Joint Ventures

The genesis of the whole entity joint venture was driven by the changing needs of the health care industry, in general, and hospitals, in particular. Hence, the original nomenclature: "whole-hospital joint venture." The whole hospital joint venture created new questions and uncertainties for exempt organizations that chose to enter into these transactions. The term "whole hospital joint venture" describes a transaction between an exempt organization and a for-profit entity, where one of the venturers contributes a hospital to a joint venture and the other joint venturer contributes funds or other assets.

These joint ventures led to further focus by the IRS on the control possessed by exempt organizations that participate in joint ventures.

1. *PLR 9308034 (Feb. 26, 1993)*

The IRS approved a joint venture where a for-profit acute care hospital and a tax-exempt organization that operated three acute care hospitals formed a partnership to own and operate the for-profit's hospital.

Facts: The for-profit entity contributed the hospital to the partnership, and the exempt organization made a capital contribution in an amount equal to one-half the appraised value of the hospital. Subsequently, the exempt organization also contributed one-half of the working capital needs of the venture. The exempt organization's capital contribution was paid to the for-profit partner, resulting in the sale of the hospital to the joint venture. The joint venture was managed by a six-member executive operating committee consisting of three representatives appointed by each of the venturers. The committee was able to obligate the venturers to contribute capital in an amount equal to their percentage ownership.

Analysis: In analyzing this joint venture, the IRS relied on the two-prong test of GCM 39005 (June 28, 1983). In its favorable ruling, the IRS cited the provisions of the joint venture agreement for equal sharing of capital contributions, profit and loss allocations, distributions and assumptions of liabilities. Importantly, no part of the exempt organization

network was required to place its other assets at risk for the benefit of the for-profit venturer; participation in the joint venture was the subject of arm's length negotiation; and the exempt organization was contributing fair market value to the venture as consideration for its interest. Furthermore, the exempt organization's participation on the joint venture's executive operating committee provided it with influence sufficient to assure a high level of community benefit, even though it would not be involved in day-to-day management of the venture.

C. Revenue Ruling 98-15

Revenue Ruling 98-15 provided the first precedential guidance on joint ventures between exempt organizations and for-profit entities. The revenue ruling described two joint ventures between nonprofit and for-profit health care entities.

1. *Comparison of Situation 1 (good) and Situation 2 (bad)*

In each of the examples, the nonprofit Code Section 501(c)(3) hospital is in need of additional funds in order to better serve its community and it contributes all of its operating assets to an LLC which will be jointly owned by the tax-exempt and the for-profit entities. In Situation 1, a hospital recognized as exempt under Code Section 501(c)(3) forms an LLC with a for-profit corporation that owns and operates a number of hospitals. The exempt hospital contributes all of its operating assets, including its hospital, to the LLC, and the for-profit corporation contributes assets to the LLC. In Situation 2, an exempt hospital owns and operates an acute care hospital and forms an LLC with a for-profit hospital corporation to provide funding for the acute care hospital. The exempt hospital and the for-profit corporation form an LLC to which the exempt organization contributes all of its operating assets and the for-profit entity contributes some of its assets. In both situations each member of the LLC receives ownership interest proportional to its contribution.

Control: In Situation 1, the exempt organization will choose three of the LLC's board members and the for-profit will choose two, and a majority of three board members must approve major decisions. In Situation 2, each co-venturer will choose three of the members of the board, and a majority of four members must approve major decisions. Thus, in Situation 1 the exempt member's appointees to the board constitute a voting majority, thereby giving the exempt member clear control of the LLC.

Charitable Purpose: In Situation 1, the governing documents specifically require the LLC to operate in a manner that furthers charitable purposes by promoting health for a broad cross-section of the community, and this stated purpose overrides any duty of the board to operate the LLC for the financial benefit of its owners. In Situation 2, the governing documents do not mention an overriding duty to operate the LLC in a charitable manner.

Board Approval: In Situation 1, the governing documents specifically require board approval for decisions regarding contracts in excess of certain dollar amounts per year, the acquisition or disposition of health care facilities, changes in the types of services offered by the

hospital or the renewal or termination of management agreements. Those in situation 2 do not have this requirement.

Management Agreement: In both Situations, the LLC will enter into an agreement with a company to manage the day-to-day operations of the LLC. However, in Situation 2, the management services will be provided by an entity related to the for-profit member, and the renewal provision of the agreement does not seem to reflect an arms length negotiation because the management company can unilaterally decide to renew the contract.

Inducement: In Situation 1, none of the exempt organization's officers, directors, or key employees who were involved in forming the LLC were promised any inducement to approve the joint venture. In contrast, in Situation 2, the nonprofit agreed to approve the selection of two individuals as the chief executive officer and the chief financial officer, both of whom worked for the for-profit member.

2. *IRS Analysis*

Analysis of Situation 1: The IRS ruled that the exempt organization in Situation 1 will retain its exempt status, even though it contributed all of its assets to the LLC. The IRS noted that the governing documents of the LLC commit the LLC to providing health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits. Furthermore, the board's structure gives the exempt organization voting control so that the exempt organization can ensure that the assets it owns through the LLC and the activities it conducts through the LLC are used primarily to further exempt purposes. The exempt organization can also ensure that the benefit to private parties will be incidental to the accomplishment of charitable purposes. Finally, the exempt organization's principal activity will continue to be the provision of health care (once the LLC begins operations) and its secondary activity will be providing grants for services to the indigent. Therefore, it will continue to be classified as a "hospital" under Code Section 509(a)(1) and as an organization described in Code Section 170(b)(1)(A)(iii).

Analysis of Situation 2: Based on "all the facts and circumstances," the IRS concluded that the exempt organization did not establish that the activities it will conduct through the LLC will further exempt purposes; and the private benefit to the for-profit resulting from the activities conducted by the exempt organization through the LLC will not be incidental to the furtherance of an exempt purpose. Thus, the ruling holds that the tax-exempt co-venturer will fail the operational test by forming the LLC and contributing all of its operating assets. The IRS seemed to stress the absence of a binding obligation in the LLC's governing documents for the LLC to serve charitable purposes or otherwise meet the community benefit standard of Rev. Rul. 69-545, 1969-2 CB. 117.

Consequences of the Rev. Rul. 98-15: After Rev. Rul. 98-15, it was clear that an exempt organization may participate in an LLC treated as a partnership for federal income tax purposes without necessarily jeopardizing its tax-exempt status. Control was the central motif of

the IRS's analysis in the ruling. The ruling suggests that a board structure where the exempt organization appoints 3 members to the board and the for-profit entity appoints 3 members (a "3/3 board structure") in Situation 2 is not acceptable. The ruling left open the question of whether all the favorable factors it noted in Situation 1 must be present in all joint ventures (whether whole entity or ancillary) and, specifically, whether majority control was required in all cases.

D. *Redlands Surgical Services v. Commissioner*

In *Redlands Surgical Services v. Commissioner*, 113 T.C. No. 3 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001) (hereinafter, "*Redlands*"), the IRS denied exemption to a hospital subsidiary on the ground of impermissible private benefit.

Facts: Redlands Surgical Services ("RSS") was a corporate subsidiary of Redlands Health Systems Inc. ("RHS"), a Code Section 501(c)(3) corporation with two other tax-exempt subsidiaries (Redlands Community Hospital and Redlands Community Hospital Foundation) as well as a for-profit subsidiary (Redlands Health Services).

In 1990, RHS became co-general partner with a for-profit corporation, Redlands-SCA Surgery Centers Inc. ("SCA Centers"), in a partnership, Redlands Ambulatory Surgery Center ("RASC"), formed to acquire a majority interest in an outpatient surgical center. RASC held 59% as a general partner of another partnership, Inlands Surgery Center, L.P. SCA Centers was a subsidiary of Surgical Care Affiliates Inc. ("SCA"). SCA Management, a for-profit affiliate of SCA Centers, managed the center's day-to-day operations. RHS formed RSS to succeed to its partnership interest as co-general partner. RSS's sole purpose and activity was to hold the partnership interest in and help govern RASC, the controlling general partner of Inlands Surgery Center, L.P.

Analysis: The Tax Court rejected RSS's arguments that it had retained control over the partnership and concluded that RSS had "ceded effective control" over its activities, conferring a "significant private benefit" on its for-profit partner. The Court stated "It is no answer to say that none of petitioner's income from this activity was applied to private interests, for the activity is indivisible, and no discrete part of the Operating Partnership's income-producing activities is severable from those activities that produce income to be applied to the other partners' profit." The Court found a significant profit-making objective present in the operations of the partnership. The Court further found fault with the fact that the partnership is locked into a management agreement with SCA Management for at least 15 years with the contract renewable at the vendor's sole discretion for two additional five-year periods. The Court also found that the record did not support RSS's contention that the management contract was negotiated at arms length.

The Court listed the following five factors as leading to the conclusion that RSS was not entitled to exemption: (i) a lack of any express or implied obligation of the for-profit parties involved in the partnership to put charitable objectives ahead of noncharitable ones; (ii)

RSS's lack of voting control over the partnership; (iii) RSS's lack of other formal or informal control sufficient to ensure furtherance of charitable purposes; (iv) the long-term management contract giving the for-profit vendor control over day-to-day operations and an incentive to maximize profits; and (v) the market advantages secured by the SCA affiliates as a result of their arrangements with RSS. It should be noted, however, that while the Court was troubled by RSS's overall lack of control over the ventures, it nevertheless stated that it did not "view any one factor as crucial." 113 T.C. at 92.

E. *St. David's Health Care System v. United States*

In *St. David's Health Care System v. United States*, 2002 WL 1396536 (W.D. Tex. 2002), the District Court for the Western District of Texas granted summary judgment in favor of St. David's Health Care System ("St. David's"), which had challenged the IRS's revocation of its exempt status. In 2003, the Fifth Circuit vacated that decision and remanded the case to the district court for further proceedings. 349 F.3d 232 (5th Cir. 2003). In 2004, a jury returned a verdict upholding St. David's exemption. 2004 WL 555095 (W.D. Tex. March 18, 2004).

Facts: In 1996 St. David's contributed substantially all of its assets to a limited partnership, for which it held both general and limited partnership interests and a 45% ownership interest. An affiliate of Columbia/HCA Healthcare Corporation ("HCA"), a for-profit corporation, held a general partnership interest and was the managing general partner, while another affiliate of HCA had a limited partnership interest; together the two affiliates had a 54.1% ownership interest. St. David's appointed one-half of the partnership's governing board, and the HCA affiliates appointed one-half of the governing board. St. David's had the power to remove the CEO of the partnership, and the partnership agreement required that all hospitals owned by the partnership operate in accordance with the community benefit standard of Revenue Ruling 69-545. Should they fail to meet that standard, St. David's had the unilateral right to dissolve the partnership. Finally, every hospital in the partnership provided emergency care without regard to the patient's ability to pay.

IRS Determination: In 1998 the IRS revoked St. David's tax-exempt status on the basis that participation in the joint venture prevented St. David's from acting exclusively in furtherance of its charitable purposes. The IRS found that St. David's did not exercise a sufficient degree of control to ensure that those charitable purposes were followed, and that the venture conferred significant private benefit on HCA.

District Court Summary Judgment Opinion: The District Court found, by contrast, that there was sufficient control by St. David's. The Court stated that the law was concerned with control, "regardless of whether it springs from a majority or a corporate structure," and found that the partnership agreement sufficiently protected the charitable purposes of St. David's. It placed emphasis on the fact that every hospital provided emergency care without regard to the patient's ability to pay. The Court also found with respect to the IRS's private

benefit concern that the voting rules and ability of St. David's to remove the CEO gave sufficient control to St. David's.

Fifth Circuit Decision: The Fifth Circuit vacated the District Court's decision because it found fault with the lower court's focus on whether the actual operations of the hospitals were charitable. The Fifth Circuit found that the key issue was one of control—and was not just whether St. David's was charitable now but also whether it could ensure charitability in the future. It stated that "even if St. David's performs important charitable functions, St. David's cannot qualify for tax-exempt status . . . if its activities via the partnership substantially further the private, profit-seeking interest of HCA." 349 F.3d at 237. The Court said that in order to determine if non-charitable interests are furthered . . . we look to which individuals or entities control the organization." The issue of control, the Court found, was one of material fact and thus remanded on the narrow issue of whether St. David's had ceded control of its hospital to HCA.

In its ruling, the Fifth Circuit affirmed the analysis of Revenue Ruling 98-15, but made clear that lack of formal voting control of the partnership is not necessarily fatal if the tax-exempt organization has sufficient other factors in place to ensure control of the significant decisions relating to the joint venture's activities.

Ultimate Verdict: Upon remand to the District Court, the jury found that St. David's had not ceded too much control to private interests. This result may help joint venturers make the argument that on a particular set of facts control may exist notwithstanding bifurcated control (*e.g.*, equal representation on a board). Some practitioners have commented, however, that the Fifth Circuit decision is worded more broadly than earlier judicial decisions and administrative pronouncements and, as a result, could be interpreted to mean that control must be found in all joint ventures.

F. Revenue Ruling 2004-51

This Revenue Ruling was long-awaited precedential guidance on ancillary joint ventures – which unlike whole entity ventures do not involve the contribution of all the assets of a charitable organization to a joint venture, but only an insubstantial portion.

Facts: In Revenue Ruling 2004-51, 2004-22 I.R.B. 974 (May 7, 2004), the IRS addresses a situation in which a university exempt under Code Section 501(c)(3) enters into an LLC joint venture with a for-profit corporation to conduct interactive video seminars. The university and the for-profit company each hold a 50% ownership interest in the LLC. The LLC is managed by a board comprised of three directors appointed by the university and three appointed by the for-profit company. Under the governing documents of the LLC, the university arranges and conducts all aspects of the video teacher training seminars, which cover the same content covered in university seminars on its own campus, and the university has the exclusive right to approve the curriculum, training materials, and instructors and to determine the standards for successful completion of the seminars. The for-profit company is granted the exclusive right

to select the locations for the seminars and to approve personnel who would conduct the seminars. The governing documents require that all other actions required the mutual consent of both parties and that all transactions entered into by the parties with others be negotiated at arm's length and be at fair market value. The joint venture is an insubstantial part of the university's activities.

Analysis: The IRS's analysis was quite thin, but emphasized the fact that the university conducts an *insubstantial* part of its activities through the joint venture. The IRS also emphasized that the university alone was in charge of all of the educational and curricular aspects of the seminars, while the for-profit only controlled location and equipment. Further, it noted that the for-profit company's activities expanded the reach of the teacher training seminars. Thus, "the manner in which [the for-profit company] conducts the teacher training seminars contributes importantly to the accomplishment of [the university's] exempt purposes." The IRS mentions but does not address the fact that the university and for-profit share voting control on a 50/50 basis.

Revenue Ruling 2004-51 makes clear that at least in some cases equal ownership of a joint venture by a tax-exempt and a for-profit is acceptable as long as there are other factors supporting the tax-exempt's purposes. Whether this analysis is applicable to whole entity joint ventures is not entirely clear.

Further, prior to Revenue Ruling 2004-51, many practitioners believed that if a joint venture is "ancillary" and involves an insubstantial amount of a tax-exempt participant's assets, the only analysis should be to determine whether income from the joint venture is subject to UBIT or whether the activities of the venture are substantially related such that income from them is exempt from tax.

Following this ruling, some practitioners believe that as long as a joint venture is an insubstantial part of a tax-exempt organization's activities, such participation should not have a negative effect on the status of the organization whether the charitable aspects of the venture are controlled by the tax-exempt entity or not. However, others suggest that while it provides that majority control is not always necessary in a joint venture, it can also be interpreted to mean that the tax-exempt entity must retain some form of control in any joint venture – even if it is an ancillary venture involving an insubstantial part of the tax-exempt organization's assets.

Among the questions that remain or are raised are whether 1) income from a joint venture that conducts activities related to the tax-exempt organization's charitable purpose could be found to be subject to UBIT because the tax-exempt does not possess control over the venture and 2) a joint venture that conducts unrelated activities and is not controlled by the tax-exempt entity could be found to give too great a private benefit to the for-profit joint venturer. It seems that the answer to these questions should be "no," but the revenue ruling is unclear.

G. Private Letter Rulings After Revenue Ruling 2004-51

Many of these private letter rulings do not break new ground, but are nevertheless interesting for their fact patterns.

1. *PLR 200436022 (Sept. 3, 2004)*

Facts: The IRS found that a proposed joint venture limited partnership involving a tax-exempt hospital and its wholly owned LLC, which acted as a general partner in a partnership, would not jeopardize the tax exemption of the hospital. The partnership was formed to expand the scope of available diagnostic imaging services by operating a free-standing imaging center to provide MRIs, x-rays, CTs, ultrasound, and mammography tests in the locale. The LLC owns one general partnership unit representing 1% of the partnership, and the hospital owns one limited partnership unit representing 99% of the partnership. The partnership would offer limited partnership units for sale to eligible physician investors and related physician groups. As general partner, the LLC has the sole right to manage and supervise the partnership's business and property. The partnership agreement also requires the partnership and its facilities to be managed in a manner that promotes the hospital's exempt purposes. The partnership agreement provides that the general partner can only be removed by the limited partners holding more than 80% of the sharing ratios of all partners. The partnership will engage a third party manager to provide all the services necessary to operate the center. The center will follow the charity care policy of the hospital.

Analysis: The IRS found that the LLC, which is a disregarded entity of the hospital, would have "effective control over major decisions under the Partnership Agreement." The IRS also observed that the agreement specifically provides that the partnership must be operated so as to further the hospital's charitable purposes and that the center will use the charity care policy of the hospital. The IRS noted that the fee for the manager, even though based on a percentage, would have a ceiling amount that would be stated to reflect and not exceed fair market value.

2. *PLR 200448048 (Nov. 26, 2004)*

The IRS found that two nearly identical LLC joint ventures between a Code Section 501(c)(3) health services organization and physicians to own and operate equipment to provide certain health care services will not jeopardize the charity's tax exemption. The exempt organization was formed to own and operate certain equipment for treatment of patients in its community and the two joint ventures were the organization's preferred structure for performing certain services. The Code Section 501(c)(3) organization contributed equipment to each joint venture which represented less than 1% of its assets. The IRS found neither joint venture problematic, concluding that the structure of each (in which a majority of the board was appointed by the exempt organization) ensured that the joint venture would act exclusively in furtherance of the charity's exempt purposes and would result in no undue private benefit to the physician members. The IRS cited Situation 1 of Rev. Rul. 98-15 and noted that the charity's

ownership interests in both joint ventures were proportionate and equal in value to what it had contributed, the operating agreements provide that all activities will be in furtherance of exempt purposes, the exempt organization appointed a majority of directors, and contributions, allocations of income, loss and taxes would be in proportion to the members' interests, among other protections.

3. *PLR 200502046 (Jan. 14, 2005)*

The IRS denied exemption to an organization whose for-profit subsidiary would act as one of two general partners (the second for-profit general partner was added later) of a partnership with investors (the "Fund") to encourage private investment in affordable housing. The partnership would participate as the limited partner in other partnerships that would develop, own, and operate housing for low-income tenants and provide Section 42 low-income housing tax credits to their equity investors. The IRS found that the activities of the subsidiary would not qualify as charitable and would substantially benefit the for-profit partners and contractors involved. The IRS cited *Redlands* and Rev. Rul. 98-15 in finding that the organization ceded control over its activity to the for-profit parties involved. The organization seeking exemption gave veto power to the second general partner which was a for-profit entity and acted as the managing general partner. In addition, other for-profit investors had the right to approve or consent to major decisions of the Fund. Furthermore, the partnership agreements of the Fund and partnerships did not give priority to charitable purposes over investor goals. Finally, a third of the directors were affiliated with corporations that will invest for profit in the Fund, creating a conflict of interest. The IRS saw this as a situation clearly warranting denial of exemption.

4. *PLR 200528029 (July 15, 2005)*

This is a ruling on what appears to be an ancillary joint venture. The IRS found that the indirect participation by a non-profit unincorporated member association exempt under Code Section 501(c)(6) in an LLC joint venture with an unrelated for-profit corporation to provide an online library for the association's members and members of other associations in the same profession would not result in UBTI or adversely affect the organization's tax exemption. The members of the joint venture LLC were a for-profit LLC holding company formed by the association and a for-profit corporation unrelated to the association. Pursuant to the operating agreement of the joint venture, its board consisted of two representatives from each member (bifurcated control), and action by the board required a majority vote. Furthermore, the association's holding company had the right to purchase certain databases from the joint venture in certain events such as its withdrawal from the joint venture. Without a great deal of analysis, the IRS relied on Rev. Rul. 2004-51 in finding that the association's indirect investment in the joint venture would not jeopardize its exemption or result in UBTI.

5. *PLR 200610022 (March 10, 2006)*

This ruling is interesting because it applies a joint venture analysis to an arrangement between a tax-exempt entity and a for-profit that is arguably not a joint venture at

all, but a sale and license. In this case, the IRS found that the exempt organization's sale of a publication and a one-half interest its a scholarly journal to a for-profit publisher was found not to jeopardize the non-profit's exemption.

Facts: The exempt organization was a literary and educational organization whose principal aim is to honor, preserve, study, and disseminate scholarship about the life and work of a particular author. Although it engaged in other activities, such as organizing educational conferences, its primary activity was publication of a scholarly journal. Under the terms of the agreement, the publisher and exempt organization would retain equal interests in the copyright and subsequent publication revenues; the publisher would provide the journal's editor with an annual stipend each year and would publish and distribute the journal to all subscribers. In return, the exempt organization would provide all the content of the journal, make all editorial decisions, and provide the publisher with a list of subscribers. The publisher would pay the exempt organization a royalty of approximately 15% on revenues from the institutional subscriptions, 25% on non-subscription revenue earned, and 25% on all advertising in the journal.

Analysis: The IRS stated, "The sale and joint publication agreement is similar to a joint venture between [the exempt organization] and [the publisher]." The IRS observed, however, that in contrast to the facts of Rev. Rul. 2004-51, the publication of the literary journal and other activities under the agreement constituted a *substantial* part of the exempt organization's activities. It therefore turned to Rev. Rul. 98-15 and analyzed whether that ruling's two-part test was met. The IRS concluded that the activities under the agreement furthered the charitable purposes of the exempt organization and the exempt organization retained control over the editorial content of the publications. The IRS also found that publisher's benefit was only incidental to the exempt purpose. The IRS stated, "Given the somewhat esoteric nature of the journal content, the limited demand for such material, and the due diligence negotiation for a fair market value agreement, there is realistically no way that the Publisher will obtain substantial monetary benefits." Finally, the IRS found that the royalties received by the exempt organization were excluded from UBTI but that the advertising activities it would conduct were not.

VI. FORM 990 REPORTING IMPLICATIONS

The recently redesigned 2010 Form 990 contains heightened reporting obligations for exempt organizations that participate in joint ventures. The following sections of the new Form 990 implicate joint venture activity:

A. Core Form

1. *Part VI – Governance, Management, and Disclosure:* Question 16 asks whether the organization invested in, contributed assets to, or participated in a joint venture or similar arrangement with a taxable entity. If yes, the organization must state whether it has adopted a written policy or

procedure requiring it to evaluate the arrangements under federal tax law and take steps to protect the organization's exemption with respect to the arrangement.

2. *Part VII – Compensation:* Part VII requires reporting of compensation paid by related entities, which can include joint ventures, to certain persons associated with the filing organization. This includes, among others, the five highest compensated employees, and former officers, directors, and key employees if they have received compensation above a certain threshold. Some of these listed persons, depending on amount of compensation, must be reported on Schedule J.

3. *Part X – Balance Sheet:* Joint ventures might be reported as "investments-other securities" or "investments-program related" or within "other assets." An organization may report the investment as a line item or roll up the individual items of the joint venture in the balance sheet line items. The joint venture may have to also be reported on Schedule D.

B. Schedule R – Related Organizations

An organization must fill out this schedule if answering "yes" to Part IV, Questions 34-35, that ask whether the filing organization owns more than 50% of or otherwise is related to a partnership, corporation, or other exempt organization. An organization must also fill out Part VI of this schedule, for "unrelated" joint ventures, if it answered "yes" to Part IV, Question 37, which asks whether the filing organization conducted more than 5% of its exempt activities through an entity that is not a related organization and that is treated as a partnership for federal income tax purposes.

1. *Part II* (for related exempt organizations): requires name, address, EIN, primary activity, exempt Code section and public charity status (if applicable), direct controlling entity, and whether each related organization is a controlled entity of the filing organization under Code Section 512(b)(13).

2. *Part III* (for related taxable partnerships): requires name, address, EIN, primary activity, legal domicile, direct controlling entity, predominant source of income, share of total income and end of year assets, disproportionate allocations, K-1 UBIT, whether the filing organization is a general partner or managing member of the related partnership, and the filing organization's percentage interest in the profits or capital of the related partnership (whichever is greater).

3. *Part IV* (for related taxable corporations): requires name, address, EIN, primary activity, direct controlling entity, C or S corp., share of total income, and end of year assets, percentage ownership.

4. *Part V* (for transactions with "related" joint ventures): requires filing organization to check responses as to whether the organization entered into certain transactions or arrangements with the joint venture and to report information for such transactions (including the amount involved in the transaction and the method for determining such amount).

5. *Part VI* (for "unrelated" joint ventures): requires name, address, EIN, primary activity, legal domicile, whether all partners are charities, share of end of year assets, K-1, UBIT, general partner or managing member.