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REPRESENTING AND MANAGING TAX-EXEMPT ORGANIZATIONS
JOINT VENTURE UPDATE: TAX ISSUES FOR ANCILLARY JOINT VENTURES; COMMON STRUCTURING ISSUES

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Charities are receiving less support from budget-constrained governmental agencies and contributions from the private sector. With international natural disasters such as the 2004 tsunami in Asia, the 2010 earthquake in Haiti, and the US hurricanes, Hurricane Katrina, Super Storm Sandy in New York City and New Jersey, and the earthquake in the typhoon ravaged Philippines, charities need to develop new avenues, structures and partners to conduct their programs. In some cases, charities have joined forces to accomplish fund-raising or program related goals.
Increasingly, charities are forging partnerships with for-profit entities to access otherwise unavailable capabilities and capital and resources, e.g., low income organizations using the low income housing and New Markets Tax Credits programs with for-profit investors to subsidize development, and universities partnering with for-profits to offer distance-learning programs.

Over the years, the IRS’ position has evolved from opposition to joint ventures with for-profits to acknowledging the various bona fide purposes and establishing guidelines for nonprofits to protect their exempt status while engaged in such partnerships.
Pursuant to these guidelines, charities will not jeopardize their exemption by participating in a joint venture so long as the charities have sufficient “control” to ensure that the venture will further the charity’s exempt purposes and there will be no impermissible private benefit or inurement.

There is no bright line test, although having at least 50% voting control of a venture in regard to matters that relate to its charitable goals is a positive factor.

- Does charity cede control to for-profit?
- What is relative bargaining position of parties?
- Does the charity have the power to initiate not simply veto, exempt activities? Is there super-majority voting?
• Is the charity board likely to enforce its control rights aside from the language in the agreement?

The IRS considers this to be a facts and circumstances determination and will not issue rulings in connection with an application for exemption. It is therefore important to have a joint venture policy in place and to carefully structure ventures pursuant to these guidelines.
THE IRS’ NO-RULING POLICY REGARDING JOINT VENTURES

• What Does this Mean Practically?
  ● The IRS does not issue private letter rulings (except in connection with the formation of a new section 501(c)(3) organization) as it considers it to be a facts and circumstances determination.
  ● Provides opportunity for careful planning.
  ● In the case of complex joint ventures, this effectively requires the joint venture to obtain an opinion of counsel.
THE CHALLENGE IN STRUCTURING JOINT VENTURES:

Must comply with BOTH:

- IRS’s general legal requirements for nonprofits participating in joint ventures AND
- Specific requirements for the particular program the ventures might be participating in such as
  -- NMTC
  -- Code Section 501(r) and the Treasury regulations, the specific provisions applicable to the operation of nonprofit hospitals (see 2013 proposed regulations and Notice 2014).
Form 990 revisions contain new reporting requirements for nonprofit venture participants:

- IRS Form 990, Part VI

  -- Disclosure: Form 990, Part VI, asks if an organization has a joint venture policy in place

- The IRS does not provide a sample joint venture policy as it does with a conflicts of interest policy

- Why doesn’t the IRS provide a sample policy? Because the structure of a joint venture is based on all of the fact and circumstances, although certain principles can be utilized so that nonprofits can adopt a policy that can be tailored to the circumstances of each venture. See Sanders, Joint Ventures Involving Tax-Exempt Organizations, for a model joint venture policy.
THE IRS' CRITERIA

• The Two Prong Test:
  ● The First Prong: the activities of the partnership must further charitable purposes; AND
The Second Prong: the partnership or joint ventures must be structure in such a way as to:

-- Insulate the exempt organization from potential conflicts between its charitable purposes and its obligations to the venture, minimizing the likelihood that the arrangement will generate private benefit; AND

-- Protect the exempt organization’s assets from exposure to unnecessary risk for the benefit of the for-profit partners.
Nonetheless, given the state of economy and its concomitant fund-raising difficulties, along with appropriate planning, joint ventures present creative avenues to raise funds, expertise and resources for charitable projects.
ANCILLARY JOINT VENTURES: WHERE A SECTION 501(C)(3) ORGANIZATION CONTRIBUTES A PORTION OF ITS ASSETS TO A VENTURE.

• Examples:
  -- Clinical Services - Ambulatory surgery, imaging
  -- Nonclinical Projects - Medical Office Building
  -- Low Income Housing - rental housing, rent restrictions, area median gross income
  -- Distance Learning - educational, university structure (see discussion of MOOCs, infra)
  -- Nonprofit News Organizations
  -- News Markets Tax Credit - charter schools
In Rev. Rul. 2004-51, the IRS addressed an ancillary joint venture between a university and a for-profit that conducts interactive training programs. Pursuant to the venture, formed as an LLC, the university would expand its teacher training programs to off-campus sites by using the interactive video technology.

Each partner held a fifty percent interest and distributions, allocations and return of capital was proportional to the partners’ respective interests. Each partner selected three directors of the LLC’s governing board but the university had complete control of all decisions that impacted the training program including selection of the teaching materials, enrolling the participants, selecting the instructors and establishing the standards for completion of the programs.
The for-profit controlled aspects related to the location where the video link could be seen and video personnel. There was a representation that the university’s participation in the joint venture constituted an insubstantial portion of its overall educational activities.

In the ruling, the IRS cites Redlands Surgical Services (113 T.C. 47(1999), aff’d 242 F. 23d 904 (9th Cir. 2001)) where a nonprofit partner was found to lack the control necessary to “ensure furtherance of charitable purposes.” The ruling also cites St. David’s (349 F.3d, 232 (5th Cir. 2003)) in regard to the control issue, and states that the nonprofit could lose its exempt status if it ceded control to its for-profit partner. In its analysis, the IRS explains that because the LLC is taxed as a partnership, its activities are attributed to the university.
The university’s exemption was not jeopardized because the LLC was to operate exclusively for educational purposes and its activities were not a substantial part of the university’s activities. The next issue was whether the university would be subject to UBIT as a result of activities of the LLC. The IRS determined that the manner in which LLC conducted its activities “contributes importantly to the accomplishment of” the university’s exempt purposes, citing Section 1.513-1(d)(2), and therefore the university’s share of the LLC’s income would not be UBIT.

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

-- Massive Open Online Courses --
college courses that are open to
millions of people worldwide through
the Internet.
Several new programs including:

(a) edX, a nonprofit run out of M.I.T. and Harvard, with other universities participating as "partners."

(b) Coursera, a for-profit founded by two Stanford University professors with many university "partners."

(c) Udacity, a for-profit program.

(d) Minerva School, a new for-profit program.
TAX ISSUES TO CONSIDER AND PITFALLS TO AVOID REGARDING COMPLEX ANCILLARY JOINT VENTURES: ALLOCATIONS OF CONTROL

• Considerations Prior To Entering Into a Joint Venture
  ● What aspects will be controlled and operated by the exempt organization? How are those activities in furtherance of the exempt purposes of the exempt organization?
  ● What aspects will be controlled by the for-profit?
• Operating Agreement

Draft language to require joint venture to operate in furtherance of the exempt purposes, which will override the duty to operate for the financial benefit of the for-profit partners. This protects the exempt organization’s assets from exposure to unnecessary risk for the benefit of the for-profit partners; and minimizes the potential for private inurement or private benefit. Language should provide reasonable and comparable terms for “exit strategy” option in the event the venture is unsuccessful.
• Basic Structuring Considerations.

The venture’s operating agreement should provide the exempt organization, at a minimum, with voting control of those policies and activities of the joint venture related to the exempt organization’s exempt purposes. Board of managers should be at least 50/50 split between the exempt organization and for-profit. It should also require joint venture to furnish the exempt organization with all information necessary to complete its Form 990 in a timely fashion.
• Management Agreement.

The management agreement should include a binding obligation to further the exempt purposes of the exempt organization, within the parameters set forth in the operating agreement. The exempt organization shall have the unilateral right to terminate if the manager is not acting to further the exempt purpose of the exempt organization. The terms and conditions should be reasonable and comparable to similar arrangements in the marketplace. The length of the agreement should be reasonable, e.g., not to exceed 5 year term, and renewal is not automatic.
Assuming that the exempt organization does not have majority control of the board, it needs to retain certain reserved powers including veto and approval rights over key action areas (such as annual budget, amendment to articles, bylaws, sale and refinancing).

The exempt organizations needs to retain the power to initiate exempt activities and build in certain guidance which will be binding on arbitration.

All compensation should be in compliance with Section 4958 excess benefits limitations including the rebuttable presumption.
• Capitalization and Distribution

Ownership interest in the joint venture, for the exempt organization and all for-profit investors, must be proportionate to the value of the assets contributed, which in turn will result in proportionate distribution. Licensing of intangibles, e.g., value of a license agreement to use the logo of the exempt organization would be included in the capital contribution of the exempt organization.

The parties should agree to a comprehensive exit strategy.

For future investors, the amount contributed depends on the valuation of the joint venture at the time of investment.
Section 482

Arm’s Length Transfer. Section 482 and the applicable Treasury Regulations (together, “§482”) allow the Service to reallocate gross income, deductions, credits, and other allowances of related taxpayers in order to prevent tax evasion or to clearly reflect the income of those related taxpayers. Section 482 requires that related taxpayers use an arm’s length standard in their transactions with each other as if they were dealing with unrelated taxpayers in a similar transaction under similar circumstances. For example, a §482 issue may arise if one entity performs serves for another entity without charge or at a charge which does not reflect an arm’s length payment.
Section 482 provides specific methods to calculate a commercially reasonable price, and a taxpayer is required to employ the “best method” (i.e., the method that produces the most accurate result) for such services and/or property. These methods include the comparable uncontrolled price method, the cost-plus method, the comparable profits method and the resale method.
• Shared Services and Facilities Agreement -- For Sharing of Space and Employees Between the Joint Venture and the Exempt Organization.

Such shared services and facilities must be pursuant to an agreement, the term generally not to exceed one year, subject to renewal. Any such agreement must justify the reason for the arrangement, such as economies of scale, division of functions and allocation of costs. And must be at arm’s length negotiation, determining the fair market value of services. The exempt organization can serve as paymaster.

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

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Non-partnership strategic alliance/collaboration: JV?

Nonprofit organization A and for-profit B enter into a “collaboration” agreement:

- A contributes funds and IP
- B contributes development and sales services
- Jointly develop, market and promote the product in poor and distressed regions, and then in other regions.
- B collects funds from sales and pays “royalty” to A
- Collaboration Agreement states: “not intended to be a partnership, employment or agency agreement.”

(hypothetical facts inspired by CCA 201323015)
Reporting non-partnership JVs on 990

Disclose on 990 (Part VI Line 16):

- “joint ownership or contractual arrangement through which
- there is an agreement to jointly undertake
  - a specific business enterprise,
  - investment, or
  - exempt-purpose activity
- without regard to (1) whether the organization controls the
  venture or arrangement, (2) the legal structure of the venture or
  arrangement, or (3) whether the venture or arrangement is
  treated as a partnership . . . .”

(But not including purely (>95%) investment JVs.)
Reporting partnership JVs on 990

Report share of revenue, expenses, assets and liabilities from JVs treated as partnerships.

Joint venture is “Unless otherwise provided, a partnership, limited liability company, or other entity treated as a partnership for federal tax purposes, as described in Regulations sections 301.7701-1 through 301.7701-3.”

Glossary of 990 Instructions
Strategic alliance, collaboration: partnership JV?

1. Parties executed and followed an agreement
2. Both contributed to venture
3. Both shared in the profits and losses; (even though B also paid A “royalty”)
4. Both maintained records of their revenues and expenses for the JV and calculated JV’s profits and losses each quarter.
5. Both had control

These factors support partnership (CCA 201323015)
Other factors supporting partnership

- Business conducted in joint names
- Both parties had control of funds
- Filed partnership returns

Key Principles:
- Parties acting with a purpose to conduct a business enterprise
- Intent to share net profits and losses from the business enterprise

CCA 201323015, Luna 42 T.C. 1067, Culbertson 337 U.S. 69
Open issue from 2004-51

Rev. Rul. 2004-51 suggests that:

- an **ancillary** JV with a for-profit where the EO cedes control does not automatically result in loss of tax exemption, and
- a JV with a for-profit does not automatically result in UBIT to the nonprofit – rather it attributes the activity of the JV to the nonprofit; then normal UBIT analysis applies.

- Is it possible for the activities of the JV to be substantially related to a charity’s exempt purposes even if the charity has significantly less control over the activities of the venture?
Form 990 suggested JV terms to “safeguard exempt status”

- Requirements that the venture or arrangement give priority to exempt purposes over maximizing profits for the other participants.
- The venture or arrangement not engage in activities that would jeopardize the organization's exemption (such as political intervention or substantial lobbying).
- All contracts entered into with the organization be on terms that are at arm's length or more favorable to the organization.
- Control over the venture or arrangement sufficient to ensure that the venture furthers the exempt purpose of the organization.
The purpose of control

“To the extent that petitioner cedes control over its sole activity to

- for-profit parties having an independent economic interest in the same activity and
- having no obligation to put charitable purposes ahead of profit-making objectives,

petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes.” (Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999))
Can activities controlled by for-profit parties be related for UBIT purposes?

Nonprofit organization A and for-profit B enter into a lease and services agreement:

- A provides theatre space and various services
- B produces and manages theatrical production
- A collects revenue from theatrical productions controlled by B

A argued “whether the special events were produced by [A] or [for-profit B] producers, the same tax-exempt purposes resulted. That is, [A] provided to the general public a theatrical event which attracted supporters to the... area.”
Can activities controlled by for-profit parties be related for UBIT purposes? (continued)

- Can A’s revenue from theatre events controlled by third parties be causally related to A's exempt purposes?
- Yes (GCM 39715)
- “we conclude that the leasing of its theaters to professional entertainers, professional producers and to community groups for the presentation of contemporary popular professional entertainment is substantially related to the purposes constituting the basis of [A]'s exemption and does not constitute unrelated trade or business.”
Can activities controlled by for-profit parties be related for UBIT purposes? (continued)

- When do for-profit parties not profit maximize?
  - CSR programs
  - settlements

- Some parties may be merely taxable, but not be profit-maximizing business
  - benefit corporations
  - constituency statutes
Default LLC manager fiduciary duties

- Right to appoint members of the governing board gives the nonprofit control. Or does it?

- What are the fiduciary duties of LLC managers?

  - Default corporate duties for LLC managers (Del. LLC Act §18-1104)
  - eBay v.Newmark (director duty to promote the value of the corporation for the benefit of its stockholders.)
  - = fiduciary duty to maximize profit of the LLC?
Modified LLC manager fiduciary duties

- LLC agreement can expand, restrict, or eliminate traditional corporate fiduciary duties (Del. LLC Act. §18-1101(c))

- Specify the specific exempt purposes of the JV, and specify that the managers have a fiduciary duty to further the exempt purposes of the JV.
Control through participation

- governing body participation
- charitability committee participation
- approve budgets and plans
- approve content of programs/activities
- approve significant actions (distributions, transactions, dollar amount transactions, compensation)
- hire, fire and compensate executives
Control through IP

Can apply to IP licensed to the JV, or developed by the JV
- Review and approval of materials using IP
  - sole discretion to reject
- Prohibit specific problematic uses
  - harm reputation or goodwill of nonprofit
Control through IP

- Make Licensed Products
  - accessible (with respect to cost, quantity, applicability and sustainability)
  - to people in need, or appropriate organizations for non-commercial/charitable purposes

- Progress and Royalty Reports
  - Report First Sale
  - Milestone Reports
  - Patent Prosecution, Marking, Infringement
Control through contract enforcement

- covenants and conditions
  - exempt purpose prevail over profit maximizing
  - not engage in exemption jeopardizing activities (disclose and manage conflicts)
  - use of funds
  - periodic reports
  - funding conditioned on milestones

- enforcement and exit:
  - Terminate and return funds on uncured breach
  - Dissolution method
Ceding JV control to a for-profit

“impermissibly serves private interests” Redlands 242 F.3d at 904.

“the non-profit should lose its tax status if it cedes control to the for-profit entity” St. David’s 349 F.3d at 239.
While a central objective of for-profit corporations is to make money, modern corporate law does not require for-profit corporations to pursue profit at the expense of everything else, and many do not do so. For-profit corporations, with ownership approval, support a wide variety of charitable causes, and it is not at all uncommon for such corporations to further humanitarian and other altruistic objectives.

Dunhill University, a §501(c)(3) educational organization, proposes to form an LLC with Dewey Electronics Corp, a for-profit company that services interactive training programs. The LLC will use the University’s name in its title in order to develop and market interactive technology.
The University will transfer and license software it has developed and make equipment and space available to the LLC on its campus; arrange for its senior staff to support the LLC; allow a link to the LLC on its website and the use of its name and logo by the LLC. However, the for-profit electronics company will be responsible for and have “control” over the future technology research and development, the marketing, advertising and sales. The for-profit will make a cash contribution equal to 25 percent of the total equity although the members agree to share profits and losses 90/10 in favor of the for-profit.
Dr. Duke
Board Member of Dunhill University and CEO of LLC

Consulting contract

Dunhill University §501(c)(3)

Dewey Electronics For-profit Services interactive training programs

Cash

NewCo LLC Known as “Dunhill University Online Technology Institute LLC”

License software developed by University; space lease senior staff support and link to website plus non-profit name and logo
In the event that an independent Nationally recognized tax counsel opines in writing that the arrangement endangers the University’s section 501(c)(3) status, the joint venture may be terminated by the University by returning the for-profit’s capital contribution plus a cumulative 15 percent rate of return on its investment.

The board will be comprised of 4 members, 2 appointed by each member.
The board of the University has offered its Chair, Dr. Duke, a PhD, a consulting contract ($100,000) to negotiate the terms of the LLC and discussed with him a management contract to serve as CEO of the LLC.

Will Dunhill University jeopardize its tax-exemption and/or be subject to unrelated business income tax on income derived from the venture?
1. What community benefit is served by this venture?

2. How does it further the University’s exempt purpose?

3. Who would control the venture? What mechanisms would protect charitable assets?

4. What are the valuation issues involving the name licensing of the IP, equipment, the lease agreement, website and the staff-operational support?
5. Are there any private benefit/private inurement issues for the University? Exit strategy?

6. Does the contract with Dr. Duke raise issues under IRC §4958? Is he a Disqualified Person with respect to the University? Rebuttable presumption standards?

7. Are there potential conflict of interest issues if Dr. Duke is on the Board of the University and also CEO of the LLC?