Exempt/Non-Exempt Joint Ventures: Furthering Exempt Purpose Through Partnerships With For-Profit Companies

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Exempt/Non-Exempt Joint Ventures: Furthering Exempt Purpose Through Partnerships With For-Profit Companies

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FURTHERING EXEMPT PURPOSE THROUGH PARTNERSHIPS WITH FOR-PROFIT COMPANIES
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Providing legal services in the areas of public, non-profit and for-profit general corporate law, health and education law, real estate development, finance and property management, public and private civil litigation, labor and employment law, and social services law.

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About this presentation

- Rev. Rul. 98-15 and the IRS position on exempt/non-exempt joint ventures
- Criteria for documenting exempt organization control over joint venture operations
- Available structures for exempt/non-exempt joint ventures
- Alternative approaches to affiliation
- UBTI rules as applied to joint ventures and other affiliations
- Structuring suggestions
Rev. Rul. 98-15 and the IRS Position
Introduction to Joint Ventures

- Healthcare
- Low income housing
- New markets tax credits
- Other
Classification of Joint Ventures

Some alternatives:

- Whole (whole hospital) v. ancillary
- TE–TE v. TE–FP
- Operating joint venture v. investment joint venture
- Tax-exempt income v. unrelated business taxable income v. disqualification from tax-exempt status
- Contractual joint venture v. LLC or partnership
Before Rev. Rul. 98-15: The History

- **Plumstead Theatre Society, Inc. v. Commissioner**, 74 TC 3124 (1980), aff’d 675 F. 2d 244 (9th Cir. 1982) – tax exempt organization may serve as general partner in a theatre partnership.

- **Housing Pioneers v. Commissioner**, 65 T.C.M. (CCH) 2191 (1993), aff’d, 49 F.3d 1395 (9th Cir. 1995), amended 58 F.3d 401 (9th Cir. 1995) – organization serving as co-general partner of housing partnership not eligible for tax-exempt status.
Before Rev. Rul. 98-15: The History

- The two-part test
  - Does participation in the joint venture further TE’s exempt purpose?
  - Does the joint venture permit TE to further its exempt purpose, despite its obligations to FP?
Revenue Ruling 98-15

Basic elements

- Tax-exempt hospital joint venture with for-profit corporation
- Whole hospital joint venture – all tax-exempt assets contributed to joint venture
- Two contrasting scenarios
Revenue Ruling 98-15: Scenario 1

- Proportionate ownership and distributions
- Both members approve amendments
- TE chooses 3 directors, FP chooses 2 directors
- Majority approval of key decisions
- TE appoints community leaders, not hospital staff
- The duty to further charitable purposes overrides any duty to operate for financial benefit
- 5-year management agreement with unrelated party, renewable by mutual consent
- No conflicts of interest
Proportionate ownership and distributions

Both members approve amendments

TE chooses 3 directors, FP chooses 3 directors

Majority approval of key decisions

TE appoints community leaders, not hospital staff

No duty to further charitable purposes that overrides any duty to operate for financial benefit

5-year management agreement with FP subsidiary, renewable by FP subsidiary

TE appoints FP employees to serve as CEO and CFO
Revenue Ruling 98-15: IRS Analysis

SITUATION 1: TE continues to be operated for exempt purposes

SITUATION 2: Private benefit to FP not incidental; TE will not be operated for exempt purposes

- Joint venture does not have a binding obligation to serve charitable purposes, and might deny care
- TE can’t initiate programs to serve health needs without the consent of FP
- CEO and CFO have relationship with FP
- FP subsidiary management company has broad discretion, controls renewal
Subsequent History (Disapprovals)

- 1999 denial of tax exemption
  - TE and FP have equal control. TE’s veto rights are insufficient to allow it to affect policy or direction definitively, or to initiate programs that serve new healthcare needs.

- Loss of tax exemption - Redlands Surgical Services v. CIR
  - TE and FP have equal control. The management agreement with FP subsidiary is renewable at FP subsidiary’s discretion.
Subsequent History (Approvals)

- Approvals
  - PLR 200118054
  - PLR 200304041
  - PLR 200304042
  - PLR 200304048
  - PLR 200351033
  - PLR 200448048

- TE maintained majority control of the board, majority approval required for key decisions
  - Occasional exceptions — amendment to organizational documents, agreements between TE and joint venture, dissolution
Rev. Rul. 2004-51

- University – Distance Learning Joint Venture
  - Each party appoints 3 board members
  - Joint venture controls advertising, enrollment, facilities, distribution and broadcasting
  - University controls curriculum, training materials, instruction and standards for successful completion
  - FP has exclusive control over location
  - Other actions require unanimous consent

- Approved: No UBIT
Documentation
Documenting the Joint Venture: Key Elements

- Purpose of Joint Venture
  - Joint Venture is obligated to further TE’s exempt purpose
  - TE may terminate agreements if joint venture is not acting to further TE’s exempt purpose
  - Reformation requirement, if law changes
  - No non-competes that prevent TE from fulfilling exempt purpose
Documenting the Joint Venture: Key Elements

- Decision-making controls
  - Voting rights
    - Control over board membership (but at least 50-50)
    - Control by TE over all policies and activities related to TE’s exempt purpose
  - Dispute resolution
  - Evidence that powers are exercised
  - Realistic remedies
  - Exit strategies
Documenting the Joint Venture: Key Elements

- Financial interests
  - Proportionality
    - capital contributions – initial and ongoing
    - right to receive distributions - operating income and liquidating distributions
    - tax consequences – allocations of income, gain and loss
    - risks – indemnities and guaranties
  - Arm’s length FMV agreements
    - Terms & conditions reasonable and market-based
    - Length is reasonable (5 years) and renewal is not automatic
Joint Venture Policy – IRS Form 990

- IRS Form 990
  - Did the organization invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity during the year?
  - If “Yes,” did the organization follow a written policy or procedure requiring the organization to evaluate its participate in joint venture arrangements under applicable federal tax law, and take steps to safeguard the organization’s exempt status with respect to such arrangements?
- No sample policy
Joint Venture Policy – IRS Form 990

- Joint venture - any 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 for federal income tax purposes, or as an association, or corporation for federal income tax purposes.

- Disregard certain investment-type ventures or arrangements.
Model Joint Venture Policy - Checklist

- Does the joint venture further the exempt purpose of TE?
- Does the exempt purpose have priority over the financial interests of the parties?
- What are the financial terms?
  - Proportional allocation of income, loss and distributions
  - All transactions with FP and third parties are arms-length, FMV
  - All transactions with TE, no less than FMV to TE
- What is TE’s potential exposure?
  - Limit contractual liability
  - No obligation of TE to return FP capital contribution; no TE guaranty
- Who controls the joint venture?
  - Governing body controlled by TE, not FP
  - TE has exclusive control over exempt purposes
Model Joint Venture Policy - Checklist

- Conflicts of interest
  - Ensure that board members may not vote on their own compensation

- How is the joint venture terminated?
  - Right of first refusal upon sale of joint venture assets
  - Ensure right to terminate for cause
  - Permit right to unwind for tax and non-tax (economic) reasons

- How are disputes resolved?
  - Any arbitration or dispute resolution provision should require the arbitrators or other decision-makers to take the exempt organization’s exempt purposes into account
Model Joint Venture Policy - Checklist

- Is there a non-compete?
- Prohibited/limited activities
  - Intervention in political activities
  - Lobbying
- Flexibility clauses
  - Permit modification to protect TE’s exempt status in the event of changes in IRS guidance
Exempt and Non-exempt Joint Ventures
## Exempt & Nonexempt Joint Ventures

- **Traditional pass-through relationship**
- **No pass-through relationship**
- **Allocation by source**

### Traditional Pass-through
- **Structure of venture**
  - Limited liability company
  - Partnership
  - Contractual joint venture
- **Tax-exempt or disregarded LLC participates**
- **Tax considerations**
  - Will TE retain exempt status?
  - Will income be taxed as unrelated business taxable income (UBTI)?

### No Pass-Through
- **Structure of venture**
  - Contractual affiliation with no profit-sharing
  - Corporation or LLC taxed as C corporation
- **Tax-exempt or disregarded LLC participates**
- **Tax considerations**
  - Profits taxed
  - Attribution

### Allocation by source
- **Structure of venture**
  - Limited liability company
  - Partnership
  - Contractual joint venture
- **Tax-exempt or disregarded LLC participates**
- **Tax considerations**
  - Is income allocated by source?
  - How would TE be taxed if it participated directly in activity?
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EXEMPT / NON-EXEMPT JOINT VENTURES

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IV. Alternative Approaches to Affiliation
Alternative Approaches to Affiliation

- Disregarded Single-Member LLC Participates in Joint Venture
- LLC or Business Corporation Taxed as a C-Corporation Participates in Joint Venture
- Joint Venture Operated as an LLC Taxed as C-Corporation
- Joint Venture Operated as Business Corporation Taxed as C-Corporation
- Contract-Based Joint Venture
Charity Establishes Disregarded Single-Member LLC to Participate in Joint Venture

• Why set-up a disregarded single-member LLC to participate in the joint venture when there are no tax-exemption issues?
  • Additional liability protection.
  • Branding (name distinction).
  • Separate governance team focused on joint venture project(s).
  • Nontax jurisdictional issues or international privacy/security (beyond Form 990).
  • Unique fundraising opportunities.
    • Single-member LLC can receive charitable donations directly and issue charitable receipts.
    • Must include name and FEIN of sole exempt member. (IRS Notice 2012-52)
What if the proposed joint venture activity to be conducted is nonexempt, commercial activity?

- The LLC could elect to be taxed as a C corporation.
- The parties could organize as a traditional business corporation under state law.
- The charity could establish its own for-profit, taxable subsidiary that would directly participate in the joint venture.
Structures Associated With Non-Exempt Commercial Activity

- Joint Venture organized as an LLC and taxed as a C corporation
  - Protects the exempt organization’s tax status because the LLC conducting the joint venture is now a separate taxable entity whose activities are not attributed to the charity and do not affect the charity’s organizational or operational test.
    - Charity receives dividends which are passive income.
    - Often unattractive to the for-profit partner due to double taxation (dividends not deductible to the C corporation).
Structures Associated With Non-Exempt Commercial Activity

• Joint venture operated as a business corporation under state law and taxed as a C corporation
  • Occasionally, specific activities are not permitted to be conducted by an LLC under state law (e.g., insurance) or a state statute limits an LLC’s ability to effectuate mergers or other transactions with different entities.
  • Some investors prefer traditional corporate form.
  • More extensive and defined laws covering liability protection and corporate veil piercing.
  • Increased corporate formalities.
Structures Associated With Non-Exempt Commercial Activity

• Utilization of a for-profit subsidiary to participate in the joint venture (C corporation for tax purposes structured as an LLC or corporation under state law)
  • Protects the exempt entity’s tax status without imposing double taxation on partner. The joint venture is taxed as a partnership.
  • More complicated structure.
    • More filings (Forms 1120 and 1165).
    • Governance layers and agreements between entities to maintain corporate formalities.
Overarching Considerations for Taxable Entities

- Structuring to avoid attribution
  - Mere instrumentality of shareholder vs. substantive business purpose with independent board, operations, and arms-length, FMV transactions.
  - Key area for attorneys to identify documentation and agreements necessary for flow of resources and activities. This goes beyond cash and covers tangible and intangible property, personnel, etc.
    - Shared services and personnel agreements
    - Intellectual property
    - Office usage and equipment
    - Accounting
- Want more? See *Moline Props. v. Comm'r*, 319 U.S. 436 (1943) and IRS rulings related to independent boards (PLRs 200321021 & 200225046), operations (PLRs 200634039 & 200518081 & 200321021), and arm’s length, FMV dealings (PLRs 200152048 & 200518081).
Overarching Considerations for Taxable Entities

• Capital contributions from charity
  • Investment by charity’s board must meet state law fiduciary standards - is it a prudent investment of charitable assets?
  • Ownership interest must be reasonably apportioned to value of the assets contributed (IRC section 482).
    • Tangible
    • Intangible
  • If a private foundation, IRC sections 4944(a) on jeopardizing investments and 4943 on excess business holdings should be considered.

• Structuring of contributions can impact potential UBI under control rules (discussed below) and debt-financing- IRC sections 512(b) & 514.
Overarching Considerations for Taxable Entities

• Payments and distributions to the exempt organization
  1. Is the payment between the charity and taxable entity an expense reimbursement or is the charity receiving a profit for the services provided?
  2. Ensure income back to the charity does not impact the public support test under IRC sections 509(a)(1) or 509(a)(2).
  3. Must be carefully documented to demonstrate FMV, particularly for shared services and facilities agreements (IRC section 482).
Overarching Considerations for Taxable Entities

• Compensation
  • If the taxable entity is controlled by the exempt entity, compensation is included for disqualified persons for purposes of IRC section 4958 (included in Form 990 reporting as well).

• Liquidation
  • Tax will apply to taxable entity not the charity.
  • A taxable corporation that transfers all or substantially all of its assets to an exempt organization, must recognize gain as if assets were sold at FMV.
    • Treas. Reg. 1.337(d)-4.
    • Exception for assets continued to be used for an unrelated business purpose.
Joint Ventures Beyond the Use of Traditional Partnerships, LLCs, and Corporations

• Utilization of alternative legal entities such as benefit corporations, low-profit LLCs, etc.
  • Many of the same tax issues exist since taxable corporations.
  • Can provide additional branding benefits and help emphasize charitable goals.
  • The benefits must be weighed against state law limitations imposed by the enabling statute.
  • May create additional reporting and regulatory oversight with state attorneys general.
Joint Ventures Structured Through Contractual Agreements

• Examples:
  • Licensing
  • Loans
  • Leases
  • Joint operating agreements
  • Other creative agreements

• PLR 9350044- Educational TV programming for children
Joint Ventures Structured Through Contractual Agreements

• Often a creative way to accomplish joint venture objective and address control limitations, UBI, and other exempt status concerns.

• Ensure the substance of the agreement is consistent with the form intended by the parties for tax purposes. If the agreement is substantively different can be reclassified for tax purposes. For example, a royalty arrangement with services provided or loan with active participation in a venture. If reclassified, can have significant unintended consequences on tax-exempt status and/or unrelated business income.

• Need transaction to be arms-length, FMV, and reasonable for preservation of exemption (look out for excessive compensation issues with profits, etc.).

• Some agreements can trigger commercial co-venture, professional fundraising, and other charitable fundraising compliance considerations.
V. Unrelated Business Income Rules Applied to Joint Ventures
Partnership Income

- A partner in a partnership or a member of a LLC classified as a partnership is subject to tax on the income and loss of the partnership whether or not it is distributed (IRC section 701(a)).

- Exempt organization that receives a K-1 must make a determination whether or not the income is subject to UBIT.

- IRC section 512(c)(1)- If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.
Substantially Related

• Generally a question of whether the income from the trade or business activity is *substantially related* or whether an UBIT exclusion or modification applies.

• Substantially related test: does the activity *contribute importantly* to the charity’s exempt purpose?

• All circumstances must be considered
  • Size and extent of business activity must be proportionate to the contribution to the exempt purposes.

• Fragmentation Rule- unrelated sales or services performed within larger related program are viewed as independent activities (e.g. art museum shop).
Substantially Related

• What steps have you taken to carefully structure the activity?
  • operating agreement
  • board resolutions
  • Contracts

• Is the charity’s purpose for participating clearly articulated and well-aligned with its tax-exempt purposes? Are there applicable safeguards to ensure exempt activity is prioritized?

• Remember control plays a role in relatedness as well as general commerciality considerations.

• FIN 48 Compliance - reporting liability for uncertain tax positions.

• Legal opinion can be very helpful.
Modifications and Exclusions to UBIT

• Lots of exceptions in the UBIT rules
• IRC section 512 – Exception to UBI for passive income-dividends, interest, royalties, rent.
• Rule does not apply if debt-financed
• Special rules for controlled organizations
### Special Considerations With Controlled Entities under IRC sec. 512(b)(13)

<table>
<thead>
<tr>
<th></th>
<th>If exempt organization has 50% or more ownership / control</th>
<th>If exempt organization has less than 50% ownership / control</th>
<th>If entity is taxed as a partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profits</td>
<td>Profits from for-profit subsidiary taxed at the subsidiary level</td>
<td>Taxed at the subsidiary level only</td>
<td>If the LLC generates “unrelated” profits, provides charity with a K-1 and charity files 990-T on its share of income</td>
</tr>
<tr>
<td>Dividends</td>
<td>Not taxable income to the exempt organization but not deductible by the subsidiary</td>
<td>Not taxable income to the exempt organization but not deductible by the subsidiary</td>
<td>Partnerships do not pay dividends</td>
</tr>
<tr>
<td>Royalties</td>
<td>Royalties paid to the exempt organization for IP are taxable income to the charity and deductible by the for-profit entity</td>
<td>Royalties paid to the parent for IP are not taxable to the parent and are deductible by the subsidiary</td>
<td>Royalties paid to the charity by the partnership is taxable if 50% or more control. Charity’s share of deductions is passes through on K-1</td>
</tr>
<tr>
<td>Interest</td>
<td>Interest on a loan to a for-profit is taxable to the charity and deductible to the for-profit entity</td>
<td>Interest paid to the parent is not taxable to the parent and is deductible by the subsidiary</td>
<td>Interest paid to the charity by the partnership is taxable if 50% or more control. Charity’s share of deductions is passes through on K-1</td>
</tr>
<tr>
<td>Rent</td>
<td>Rent payments for real estate leased to the for-profit are taxable to the parent and deductible to the subsidiary</td>
<td>Rent payments from real estate owned by the parent and leased to a for-profit corporation are not taxable to the parent and are deductible by the subsidiary</td>
<td>Rent paid to the charity by the partnership is taxable if 50% or more control. Charity’s share of deductions is passes through on K-1</td>
</tr>
</tbody>
</table>
Changing Landscape - New IRC section 512(a)(6)-UBIT Silo Rules under Public Law 115-97

• Deductibility of expenses, depreciation and similar items must be directly connected with carrying on of unrelated business trade or business (proximate and primary relationship).

• If split facilities or personnel utilized to carry on both, allocation must be made on a reasonable basis.

• Prior to Jan. 1, 2018, an exempt organization would aggregate income and expenses and other deductions from ALL unrelated trades and businesses in determining UBTI.

• Operating losses from one UBI activity could offset UBTI from another activity.

• New paragraph that if organization has more than 1 unrelated trade or business, each unrelated business shall be computed separately with specific deductions and the UBTI with respect to any such trade or business shall not be less than zero.
How will it impact Joint Ventures?

• We don’t know what “one unrelated trade or business” means.
• If joint venture involves distinct activities, computation of UBTI will get very complicated.
• If multiple joint ventures with the same activity, can these be aggregated?
• Dual use activities will grow more complicated as well
• Unclear how to treat specific activities that constitute UBTI by statute.
  • Debt-financed income under IRC sections 512(b)(4) & 514.
  • Payments from controlled corporations under IRC section 512(b)(13).
  • New taxable fringe benefit provisions under IRC section 512(a)(7).
• Adoption of for-profit blocker subsidiary is more attractive if multiple unrelated business lines exist, which allows aggregation.
• Several bills to to repeal IRC sections 512(a)(6) and section 512(a)(7)
  • Lankford, Walker, and Cruz
Permissible Levels of UBI

• Incidental level of UBI is permissible - no bright line test.


• Different methods to determine:

  • Commerciality Doctrine - Case law based factors analyzing how similar is the activity operating to for-profit counterparts?
    • adopting pricing in order to maximize profits
    • engaging in commercial marketing methods
    • generating and accumulating unreasonable reserves
    • using paid staff rather than volunteers
    • discontinuing unprofitable programs
    • selling to the general public as opposed to a discrete charitable class
    • receiving substantial public charitable contributions

  • Commensurate Test - Are the organization’s charitable activities commensurate in size and scale to the organization’s resources? Rev. Rul. 64-182.
IV. Structuring Suggestions and Hypotheticals
Hypothetical #1

IRC section 501(c)(3) public charity is organized to support individuals transitioning from incarceration with job training. Organization wants to partner with local coffee roaster company to open up a new coffee shop that employs individuals during transition period. Requires outside investment to purchase building.
Hypothetical #2

IRC section 501(c)(3) community development organization seeks to enter into a development plan with commercial property investors and grocery store chain to establish new grocery store and retail stores into economically blighted area.
Hypothetical #3

IRC sec. 501(c)(6) trade association has a director that has the technical skills to create an application that will be used by the association to operate certification programs in the industry. The application has significant commercial viability as well. In fact, with some minor modifications, the application can be sold to a wide variety of businesses to train staff. The trade association and director want to enter into a joint venture to create the application, use it for the certification programs, and to sell it to other businesses.
Questions?

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