Tax Talk: IRS Issues Ruling on Joint Venture with For-profit

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The Internal Revenue Service (IRS) recently issued long awaited guidance on so-called "ancillary" joint ventures between tax-exempt organizations and for-profits. An "ancillary" joint venture is a partnership between an exempt organization and a for-profit where the activity being conducted by the partnership is not a substantial part of the exempt organization's total activities. The new guidance, Revenue Ruling 2004-51, clarifies that a 501(c)(3) organization can participate in an ancillary joint venture with a for-profit without jeopardizing its exempt status or triggering unrelated business income tax on its share of the income from the venture where participation furthers the organization's tax-exempt purposes and where the organization shares governance and ownership of the venture on a 50-50 basis with its for-profit partner and retains control over those aspects of the venture that relate to its exempt purposes.

Internal Revenue Code Requirements
The Internal Revenue Code requires that a section 501(c)(3) organization be organized and operated "exclusively" for charitable purposes.[1] According to the regulations interpreting section 501(c)(3), the "operated exclusively" requirement means that a 501(c)(3) organization must engage primarily in activities that accomplish its exempt purposes and must limit activities that do not do so to an insubstantial part of its overall activities.[2] Moreover, the 501(c)(3) regulations state that an organization is not organized or operated exclusively for charitable purposes unless it serves a public rather than a private interest.[3] The Internal Revenue Code also imposes unrelated business income tax (UBIT) on income an exempt organization derives from regularly carried on trade or business activities that are not substantially related to its exempt purposes.[4] To be "substantially related," an activity must contribute importantly to the accomplishment of the organization's exempt purposes.[5]

Development of the IRS's Position
The IRS has long been wary of joint ventures between 501(c)(3) organizations and for-profits because of a concern that participation in these ventures can cause 501(c)(3) organizations to benefit private, rather than public, interests. For a long time, the IRS flatly prohibited 501(c)(3) organizations from participating as general partners in partnerships with for-profits because of concerns that the legal duties and unlimited liability imposed on general partners under state law conflicted with the requirement that 501(c)(3) organizations act exclusively to further their own charitable purposes and to benefit public, and not private, interests. Eventually, after losing in court on the issue,[6] the IRS began to permit such participation under certain circumstances – i.e., as long as participation furthered the 501(c)(3)'s exempt purposes and the partnership arrangement permitted the 501(c)(3) to act exclusively

in furtherance of its exempt purposes and only incidentally for the private benefit of its for-profit limited partners.

In 1998, however, the IRS issued guidance focusing, for the first time, on the degree of control exempt organizations have over their joint ventures with for-profits. That guidance, Revenue Ruling 98-15, involved a "whole hospital" joint venture, in which an exempt health care organization transferred all of its hospital assets and operations to a limited liability company (LLC) it formed with a for-profit. In that context, the IRS ruled that, unless the exempt organization controlled the LLC through majority, and not 50-50, board representation, the venture would cause the organization to lose its exempt status. IRS officials indicated that Rev. Rul. 98-15 applied outside of the health care context; what was unclear, however, was whether the ruling applied to ancillary, as well as whole entity, joint ventures. It is now apparent from Rev. Rul. 2004-15 that the IRS will apply a more lenient standard to ancillary joint ventures.

The New Ruling: Facts and IRS Conclusions

Rev. Rul. 2004-15 involves a university whose educational activities include offering on-campus summer seminars to elementary and secondary school teachers. In order to expand the scope of these seminars by offering them at off-campus locations using interactive video technology, the university forms an LLC with a for-profit that specializes in conducting interactive video training programs. The university's participation in the venture is an insubstantial part of its overall activities. The venture is structured so that the university and the for-profit share ownership of the LLC on a 50-50 basis, proportionate to the capital contributions each makes to the venture and, according to the LLC's governing documents, all returns of capital, allocations and distributions are to be made in proportion to each partner's ownership interest. The governing documents of the LLC, which is treated as a partnership for federal tax purposes, also provide that:

- the partners will share governance of the LLC on a 50-50 basis;
- the LLC is not permitted to engage in any activities that would jeopardize the university's tax-exempt status;
- the LLC's activities are limited to conducting the off-campus teacher training seminars;
- the seminars are to cover the same content covered in the university's on-campus seminars;
- the university has the exclusive right to approve the curriculum, instructors, training materials and other educational aspects of the seminars;
- the for-profit is to arrange for all logistical aspects of the seminars and has the exclusive right to choose the location of the seminars and to approve technical personnel, such as camera operators;
- all other actions require the mutual consent of the university and the for-profit; and
- the terms of all contracts and transactions entered into by the LLC must be at arm's length and at fair market value.

At issue in the ruling is whether participation in the LLC will jeopardize the university's exempt status and whether the university will owe UBIT on its share of the income from the LLC. Because the LLC is a partnership for federal tax purposes, its activities are attributed to the university for purposes of analyzing both of these issues. On the exemption issue, the IRS concludes, based on all the facts and circumstances, that because the LLC's activities are not a substantial part of the university's activities, the university's participation in the LLC, taken alone, will not affect its exempt status. On the UBIT issue, the IRS concludes that the university's participation in the LLC is substantially related to its exempt purposes and, therefore, that income the university receives from the LLC will not be subject to UBIT. Key to this conclusion is the fact that the university retains control over all educational aspects of the seminars conducted by the LLC. In addition, the IRS cites the following other facts as demonstrating that the LLC's activities are related to the university's exempt purposes: (1) the LLC's seminars cover the same content as the on-campus teacher training seminars the university conducts itself and expand the reach of the on-campus teacher training seminars; (2) all contracts entered into by the LLC must be at arm's length and fair market value; and (3) returns of capital, allocations and distributions made by the LLC must be proportional to each partner's ownership interest.

Analysis of Rev. Rul. 2004-51

It is clear from Rev. Rul. 2004-51 that an exempt organization may participate in a joint venture with a for-profit entity without jeopardizing its tax-exempt status or generating UBIT where the organization's participation in the venture is an insubstantial part of its overall activities, the organization and its for-profit partner share ownership and governance of the entity on a 50-50 basis, and the venture's activities further the organization's exempt purposes. To ensure that the venture's activities further these purposes, the IRS appears to be requiring that the exempt organization exercise exclusive control over those aspects of the venture's activities that relate to its exempt purposes; however, the for-profit partner may control logistical or technical aspects of the venture's activities. The IRS's statement that the university's participation in the LLC "taken alone" will not affect its exempt status underscores the importance of considering a joint venture in the context of an organization's overall activities.[7]

The IRS's analysis of the exemption issue in Rev. Rul. 2004-51 focuses only on the fact that the university's participation in the LLC is not a substantial part of its total activities and not on whether that participation is related to the university's exempt purposes. Therefore, some commentators have interpreted the ruling to mean that, where participation in a joint venture with a for-profit is an insubstantial part of an exempt organization's activities, that participation, even if unrelated to the organization's exempt purposes, will not affect the organization's tax-exempt status.[8] These commentators note that this conclusion depends on the venture being structured similarly to that in Rev. Rul. 2004-51 – i.e., as a venture between unrelated parties whose governing documents require all contracts to be at arm's length and at fair market value and whose activities are consistent with the governing documents – so as to avoid private inurement and private benefit issues that could jeopardize the organization's exemption.

Clearly, exempt organizations can undertake insubstantial, unrelated activities on their own without jeopardizing their exempt status. They can also participate in insubstantial, unrelated ventures with for-profits as passive investors – either as limited partners or as non-managing, non-participatory members of LLCs. (Where participation in a venture is unrelated to the organization's exempt purposes, the organization's income from the venture will be subject to UBIT unless the venture's activities are not considered a regularly carried on trade or business or qualify for one of the Internal Revenue Code's exceptions to UBIT.) However, given the IRS's historical concerns about the possible private benefit involvement as a general partner in a partnership with a for-profit might produce, even where participation is related to the organization's exempt purposes, it seems unlikely that the IRS would permit an exempt organization to participate as a general partner in an insubstantial, unrelated joint venture with a for-profit.

It is somewhat more likely, but by no means certain, that the IRS would permit an exempt organization to participate in such a venture as a member of an LLC, because of the limited liability such an arrangement would afford. Moreover, it is important to note that while the IRS's analysis of the exemption issue in Rev. Rul. 2004-51 emphasizes only that the university's participation in the LLC is insubstantial and not that the venture is related to the university's exempt purposes, the IRS's conclusion that participation in the joint venture will not affect the university's tax-exempt status because it is insubstantial is a qualified one, "based on all the facts and circumstances," which presumably include the fact that the university's participation in the venture is related to its exempt purposes.

Regrettably but not surprisingly, Rev Rul. 2004-51 does not address some of the more difficult issues that an exempt organization is likely to face in setting up a joint venture in the real world, such as how to determine whether participation in a joint venture qualifies as an insubstantial part of the organization's overall activities and the effect of participation in a venture that is an insubstantial part of an exempt organization's activities but is controlled by a for-profit partner. Note, too, that the ruling applies only to an exempt organization's participation in a joint venture structured as a pass-through entity, such as a partnership or LLC treated as a partnership. It does not apply to an exempt organization's ownership of stock in a corporation. Rev. Rul. 2004-51 provides a blueprint for Community Action Agencies (CAAs) to use in setting up ancillary joint ventures.

As always, however, CAAs considering joint ventures with for-profits should seek professional tax advice to be sure that these ventures are structured so as to avoid jeopardizing the CAAs' tax exemptions and to minimize UBIT. In addition, CAAs involved in existing joint ventures with for-profits may want to review those arrangements with their tax advisers in light of the new ruling.

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[1] See 26 U.S.C. § 501(c)(3).
[2] See 26 CFR 1.501(c)(3)-1(c).
[3] 26 U.S.C. § 501(c)(3); 26 CFR 1.501(c)(3)-1(d)(1)(ii).
[4] 26 U.S.C. §§ 511(a), 512(a)(1), 512(c), and 513(a).
[5] 26 CFR 1.513-1(d)(2).
[6] See *Plumstead Theatre Society v. Commissioner*, 174 T.C. 1324 (1980), *aff'd* 675 F.2d 244 (9th Cir. 1982).
[7] Because Rev. Rul. 2004-51 concludes that the university's participation in the LLC is substantially related to its exempt purposes and because the ruling's facts are carefully chosen to avoid issues of private inurement (i.e., exempt organization insiders receiving economic benefits that exceed the value of benefits received by the organization) and private benefit, it is unclear what aspects of the joint venture arrangement, even when taken together with non-exempt activities, could affect the university's exempt status.
[8] See, e.g., Streckfus Strafes Latest EO Joint Venture Ruling, 104 Tax Notes 313 (July 19, 2004); IRS Ruling Provides Helpful Guidance on Ancillary Joint Ventures with For-Profits, Davis Wright Tremaine LLP Tax-Exempt Organizations Advisory Bulletin (May 2004); and IRS Issues "Ancillary" Joint Venture Revenue Ruling: Rev. Rul. 2004-51 Provides Helpful Guidance, Duane Morris Alert (May 24, 2004),