Tax Challenges for Counsel to Nonprofit Joint Ventures and Alliances

Evaluating Tax Consequences of Entity Structure and Activities, Maintaining Tax-Exempt Status

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TAX CHALLENGES FOR COUNSEL TO NON-PROFIT JOINT VENTURES AND ALLIANCES: 2014

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Excerpted from Joint Ventures Involving Tax-Exempt Organizations, Fourth Edition. Used with permission of John Wiley & Sons, Inc.
Introduction: Joint Venture
-- Overview

Charities are receiving less support from budget-constrained government 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, and most recently in New York and New Jersey, Super Storm Sandy, charities need to develop new avenues and partners to conduct their programs. In some cases, charities have joined forces to accomplish fundraising or program related goals.
Increasingly, charities are forging partnerships with for-profit entities to access otherwise unavailable capabilities, 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. The IRS considers this to be a facts and circumstances determination and will not issue rulings except 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.
• *Plumstead* (1982): IRS unsuccessfully challenges a §501(c)(3) organization serving as a general partner of a partnership with for-profit partners
• **Effect of Plumstead:**
  - Rapid growth in the number of nonprofits and for-profits engaging in joint ventures
  - In many cases, government stimulus now supports the joint venture form previously challenged by the IRS
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 structured in such a way as to:
    • Insulate the exempt organization from potential conflicts between its charitable purposes and its general partnership obligations, and minimizes 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.
Expansion of Two-Prong Control Test: §501(r)

- The Treasury Department has recently confirmed its continuing interpretation of the two-prong “control” test in its publication of the proposed regulations pursuant to Section 501(r) in 2013.

- What it means to operate a nonprofit hospital has been one of the important questions particularly with regard to §501(c)(3) organizations that have an interest in a joint venture or other partnership that operates a nonprofit hospital.
• The regulations provide that a §501(c)(3) organization that owns a capital or profit interest in, or is a member of a joint venture, limited liability or other entity, treated as partnership for federal tax purposes, that operates a hospital, will itself be treated as operating a hospital, and therefore subject to the regulatory scheme under §501(r), unless it meets one of two exceptions.
• These two exceptions turn on the aforesaid “control” test
♦ the §501(c)(3) organization does not have control over the operation of the hospital sufficient to ensure that the operation of its facilities furthers an exempt purpose described under §501(c)(3) and, thus, treats the operation of the hospital facility, including its provision of medical care, as a unrelated business income, described in §513(a) with respect to the hospital organization (the UBIT without control test); or
if the primary business of the §501(c)(3) organization is not operating a hospital and its owns 35 percent or less in a venture that does operate a hospital, the §501(c)(3) organization will not be deemed to be operating the hospital if in fact it does not have control over operation of the hospital, either through powers delegated under a partnership or similar agreement or by virtue of its position as a general partner, managing member or similar role (the percentage of ownership and control test).
• It is clear that Treasury is continuing to apply the *St. David’s* control test in the development of the §501(r) regulations.
• Examples of Areas Where Joint Ventures Occur:
  - Health care
  - Distance learning
  - Low income housing transactions
  - New markets tax credits
The Challenge in Structuring Joint Ventures

Must comply with BOTH:

1. IRS’ general legal requirements for nonprofits participating in joint ventures, AND

2. Specific requirements for the particular program the venture might be participating in such as:
   • NMTC
   • Subsequent to the passage of the PPACA, the specific provision applicable to the operation of nonprofit hospitals

Form 990 revisions contain new reporting requirements for nonprofit venture participants.
Nonetheless . . .

Given the state of economy and its concomitant fund-raising difficulties, joint ventures present creative avenues to raise funds for charitable projects.
JOINT VENTURES

TYPES OF JOINT VENTURES

- WHOLE
- EXEMPT ONLY
- ANCILLARY
- INVESTMENT TYPE
Ancillary Joint Ventures -- 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
- Nonprofit News Organizations
- New Markets Tax Credit – charter schools
Educational Joint Ventures: MOOCs

- Massive Open Online Courses – college courses that are open to millions of people worldwide through the Internet.
- Several major new programs, including:
  - edX, a nonprofit created by M.I.T. and Harvard, with other universities participating “partners”;
  - Coursera, a for-profit founded by 2 Stanford University professors with numerous university “partners”; and
  - Udacity, a for-profit program.
NMTC Structure Ancillary Venture Overview

- Opportunity for nonprofits to subsidize or provide gap financing for developments in a qualified census tract (low income, high unemployment).
- Financial benefits to developers, businesses and charities.
- Major investors such as Goldman, Bank of America, JP Morgan, US Bank or PNC buy credits for cash infusion to the development which may not be paid back at the end of the 7-year compliance period.
- Under leverage structure, investor may receive in excess of 9 to 10% return after tax.
# New Markets Tax Credit – A Government Sponsored Joint Venture Vehicle

**Basics:** $40 billion in NMTC allocated through 2013 round.

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<th>Purpose:</th>
<th>The new markets tax credit (NMTC) serves as a way to provide subsidy or gap financing to real estate developments, business activities, or charitable operations planned in qualified census tracts (high unemployment or poverty rate, low median family income).</th>
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<td>What does it provide?</td>
<td>39% tax credit on the capital invested in a community development entity (CDE), over 7 years (5% in yrs 1-3; 6% in yrs 4-7).</td>
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<td>Who benefits from the credit?</td>
<td>The investor (typically national banks, insurance companies) making an investment in a CDE gets a tax credit of $0.39 for every $1 invested and CRA credit, which under a “leveraged” structure yields in excess of a 10% after-tax return. The CDE directs capital into qualified projects or businesses. The investor is not repaid its equity investment.</td>
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| Eligible Investments: | • Community businesses, including e.g. hospitals, charter schools.  
• Commercial or mixed-use real estate projects (at least 20% of gross income from commercial component). |
| Examples: | • 105-Unit, The Bradford -- $45M affordable housing and ground floor retail space in Bedford-Stuyvesant. Innovative structure allowed HDC and HPD financing to be used, with Goldman Sachs as the equity investor; BRP and Bedford-Stuyvesant Restoration Corp were the development partners.  
• $100M charter high school in Mott Haven, Bronx. Robin Hood Foundation was sponsor; JPMorgan Chase was investor.  
• $25M, University of Arizona’s Medical School revitalizing downtown Phoenix. |
Opportunities for Nonprofits

- Consistent with its charitable purpose, a §501(c)(3) organization may play various roles in NMTC transactions:
  - As CDE;
  - As QALICB;
  - As Leverage Lender.
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. Finally, 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 in regard to the control issue, and states that the nonprofit could lose its exempt status if it ceded control of this issue 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.
The IRS’ No-Ruling Policy Regarding Joint Ventures

• What Does This Mean Practically?
  – The IRS does not issue private letter rulings 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

• What if There is an Audit?
  – The IRS will examine all fact and circumstances
IRS Form 990, Part VI

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

• Is There a Model Joint Venture Policy?
  – The IRS does not provide a sample joint venture policy as it does with a conflicts of interest policy

• Why is There no Model?
  – The structure of a joint venture is based on all of the fact and circumstances, although certain principles can be applied
The Potential Expansion of the Application of the IRS Published Ruling Policy Under Rev. Rul. 2004-51 to Virtual Joint Ventures

- In view of the extensive reach of the IRS published Revenue Ruling 2004-51 to ancillary joint ventures, it may be argued that the rationale could apply in a case where the IRS proposes revocation of an existing §501(c)(3) organization following an examination of its relationship with a for-profit entity (notwithstanding the fact that no formal joint venture agreement exists between the parties).
• Assume a hypothetical case in which an educational or scientific property, such as a magazine, is owned 100 percent by a for-profit business, X, which controls the business and financial operations. A charity, Y, acquires and retains decision-making rights over substantially all of the educational content of the magazine; in effect, an unconventional “upside down” transaction.
• Assume further that the IRS challenges the relationship of Y to X, arguing as a result, that there is impermissible private benefit to the business; in effect, that the charitable organization is operating for a substantial nonexempt purpose and is acting as a “tool” to enhance the sale of products for X, the for-profit entity.
• Even though there is no formal joint venture structure, Y, the §501(c)(3) organization, may be able to defend its exemption by relying upon the bifurcated control test pursuant to Rev. Rul. 2004-51. (This is so even though there is no provision in any agreement dealing with the distribution of net proceeds, but, in fact, all such available funds are reinvested in the trade or business.)
• The question presented by this hypothetical is thus: is the arrangement between Y and X a joint venture or contractual relationship? Indeed, if it is a contractual relationship, a §501(c)(3) organization’s charitable purpose might not be threatened since the two-prong test applies to joint ventures, not a contractual relationship. If a joint venture, Y may argue that the publication is consistent with Y’s educational and scientific purposes, because the charity wants to educate its members, a charitable class, about scientific breakthroughs, knowledge of recent developments and the like.
• It is important to note that on June 11, 2014, the Advisory Committee on Tax Exempt and Government Entities (ACT) urged the IRS to open a regulation project to formalize the “commensurate” test articulated in the Rev. Rul. 64-182 and reject the application of the commerciality test used by the courts and the IRS in determining when certain business activity will preclude exemption for 501(c)(3) and what constitutes unrelated business taxable income. The ACT states that “neither the tax law nor the implementing regulations provide support for a commerciality test.”
Factors To Be Included In A Joint Venture Policy

1. Limited contractual liability of the exempt partner.

2. Limited rate of return to the for-profit members; proportionate allocation of income, loss and distributions, i.e., the nonprofit’s share of economic benefits is proportional to its contributions to the venture.

3. Exempt organization’s right of first refusal upon the sale of venture assets.

4. Exclusive control of the venture’s activities by the nonprofit members as to factors relating to the venture’s exempt purposes.
5. Governing body of the venture vehicle and/or management company is not controlled by members controlled/selected by a for-profit partner.

6. No obligation on the part of the exempt organization to return the for-profit members’ capital contribution from the exempt organization’s funds.

7. Profit is not a primary motivation and the venture’s activities further the nonprofit partner’s exempt purposes.

8. All transactions with the for-profit members and third parties are negotiated at arms-length and at fair market value.
9. Appropriate measures regarding compensation, etc. (e.g., voting members of the governing board who receives compensation are precluded from voting on all matters relating to such compensation) so as to preclude impermissible private benefit, inurement, improper guarantees or violation of §4958.

10. Exit strategy: built-in right to unwind, for tax and non-tax (economic) reasons.

11. Flexibility clauses that allow modification of provisions to protect the nonprofit partner’s status in the event of future IRS guidance.

12. Provisions facilitating the nonprofit’s ability to timely obtain financial and other information required to satisfy its Form 990 reporting obligations, particularly Schedule K-1’s that can serve as the basis of joint venture reporting.
Considerations For An Exempt Organization 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

- Require joint venture to operate in furtherance of nonprofit’s exempt purposes, which will override the duty to operate for the financial benefit of its partners.
  - Protect the exempt organization’s assets from exposure to unnecessary risk for the benefit of the for-profit partners; and
  - Minimize the potential for private inurement or private benefit.
Structured to 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 – 50/50 split between the exempt organization and for-profit.

Require joint venture to furnish the exempt organization with all information necessary to complete its Form 990 in a timely fashion.
Management Agreement

• Binding obligation to further the exempt purpose of exempt organization, within the parameters set forth in the Operating Agreement.

• Exempt organization has the unilateral right to terminate if the manager is not acting to further the exempt purpose of the exempt organization.
• Terms and conditions are reasonable and comparable to similar arrangements in the marketplace.
• Length of the agreement is reasonable, e.g., 5 year term, and renewal is not automatic.
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.

• Future investors: amount contributed depends on the valuation of the JV at the time of investment.
Section 482

- Arm’s Length Transfer

§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.
• §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 services for another entity without charge or at a charge which does not reflect an arm’s length payment.
§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 Joint Ventures and the Exempt Organization Partner

- Must be pursuant to an agreement, the term generally not to exceed one year but can be renewed.
  - Justify reason for arrangement: economies of scale, division of functions, and allocation of costs.
- Must be arm’s length negotiation determining the fair market value of services.
- Exempt organization can serve as paymaster.
• Employees who perform services for both the JV and the exempt organization must keep timesheets, so costs can be allocated.
• Cost reimbursement: must have supporting documentation, e.g., receipts.
• See, PLRs for National Geographic and AARP regarding interaction with a taxable subsidiary: PLR 9542045, PLR 9720036, and PLR 19938041.
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Exempt Organization Concerns and Considerations in Joint Ventures

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Exempt Organization Participation in Joint Ventures – Authorities

• Joint venture (pass-through entity) income is treated as if earned directly by exempt partner (IRC § 512(c))

• IRS and court guidance
  - *Redlands Surgical Services v. Comm’r*, 113 T.C. 47 (1999), *aff’d per curiam*, 242 F.3d 904 (9th Cir. 2001)
  - *St. David’s Health Care System v. United States*, 2003-2 USTC ¶50,713 (5th Cir. 2003)
Exempt Organization Participation in Joint Ventures

• Two issues of concern to EO
  – Is pass-through income UBI?
  – Does participation endanger tax exemption?
Joint Ventures – Is Income UBI?

• Nature of activity
  – Would the activity be related to exempt purposes if conducted directly by exempt partner?
    – Does that depend on specifics of how the activity is conducted?
      – Distance learning
      – Hospitals
      – Low income housing
      – Homes for the elderly
  – If the activity would generate UBI if conducted directly by exempt partner, joint venture doesn’t change that
Joint Ventures – Is Income UBI?

- Control over manner in which the activity is conducted
  - Can the exempt partner ensure that it’s operated exclusively for exempt purposes?
    - In general
  - Exempt owner control over salient aspects of operation
    - The specifics for that activity
Joint Ventures – Exemption Endangered?

• Too much UBI?

• Is the partnership fair to the exempt partner?
  – Capital contributions proportional to ownership interests
  – Preferential distributions or allocations can be tricky
  – Transactions between joint venture and partners must be fair market value
Structuring a Joint Venture – Organizational Document Safeguards

- Charitable purposes of JV
- Charitable override over profit maximization
- JV may not engage in activities endangering EO’s tax-exempt status
- No binding arbitration requirement (on the theory that arbitrator will not decide in favor of charitable purposes)
- No noncompete that prevents EO from fulfilling charitable purposes
- Requirement for reformation of documents if law changes or tax-exempt status affected
Structuring a Joint Venture – Control Rights

• Veto rights
  – Services, strategic plans, budgets, acquisitions, dispositions, and significant contracts
  – Capital calls, distributions, debt, issuance of new units
  – Identity of joint venture executives
  – Renewal or termination of management agreement
  – Amendment of joint venture organizational documents
  – Joint venture merger, dissolution or bankruptcy
Structuring a Joint Venture – Control Rights

• Powers over charity care and community benefit, in case of health care organization
  – Initiation rights?
  – Triggered by not meeting thresholds?

• Limits on term (5 years) and powers of for-profit manager of joint venture operations
Structuring a Joint Venture – Exercising Rights

- Evidence that powers are exercised
- Realistic remedies
- Exit strategies
Joint Venture Policy

• Form 990 asks whether, if the reporting organization had a joint venture interest, it:
  – followed a written policy or procedure
  – requiring the organization to evaluate its participation in joint venture arrangements under applicable federal tax law and
  – took steps to safeguard the organization’s exempt status with respect to such arrangements
Reporting Joint Venture Activity on Form 990

• Form 990 instructions make clear that an organization owning a joint venture interest must report the activities of the joint venture as its own activities to the extent of its proportionate share, including, e.g.:
  – political activity
  – grants

• Proposed Section 501(r) regulations provide that an organization with an interest in a joint venture operating a hospital is treated as a hospital, and is subject to Section 501(r) requirements, unless the organization lacks sufficient control over joint venture and treats income as UBI
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Using Corporate Affiliates in Non-Profit Joint Ventures and Alliances

Elka T. Sachs, Esq.

Presented on Thursday, August 7, 2014
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Partner

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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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Overview

Tax-exempt organizations may participate in joint ventures directly, or indirectly through a subsidiary or affiliate.

- Why use a for-profit subsidiary or affiliate?
- What are the key tax considerations in using a for-profit subsidiary or affiliate?
Why Use a For-Profit Corporate Affiliate?
Why Use a For-Profit Corporate Affiliate?

Tax Considerations

- Segregate activities that do not satisfy the operational test due to:
  - Nature of the proposed activity
  - Manner in which the activity will be undertaken (commerciality doctrine)
  - Scale of the proposed activity (commensurate test)
  - Amount of unrelated business taxable income
- Reporting requirements – IRS Form 1120 is not public.
The Statute: Exclusive Operations

Section 501(c)(3) – Corporations. . . organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes. . . “
“Primary activities - An organization will be regarded as “operated exclusively for one or more exempt purposes only if engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.” Treas. Reg. s. 1.501(c)(3)-1(c)(1).
"Organizations carrying on trade or business - An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. . . In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.” Treas. Reg. s. 1.501(c)(3)-1(e).
SEGREGATING EXEMPT ACTIVITIES

Case Law: A Single Substantial Purpose

- **Better Business Bureau of Washington, D.C., Inc. v. U.S., 326 U.S. 279 (1945)** – “The presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or important of truly educational purposes.”
SEGREGATING EXEMPT ACTIVITIES

The nature of the proposed activity

- Example: Private Benefit
  - Rev. Rul. 69-545 (community benefit standard).
  - Joint Venture Analysis – Redlands Surgical Services v. C.I.R., 242 F.3d 904 (9th Cir. 2001).

- Example: Related Non-exempt Activities
  - Rev. Rul. 96-32 (low-income housing guidelines).
SEGREGATING EXEMPT ACTIVITIES
The manner in which the activity will be undertaken (commerciality test)

- **Commerciality Doctrine**
    - Books were priced to return a profit
    - Distribution and marketing was patterned on standard commercial practice.
    - Large accumulated profits evidence of a commercial character
    - Substantial salaries, and their rapid increase suggest commercial, not non-profit, operation.
    - Direct competition with commercial publishers
    - Pays a royalty and uses dealers using a similar commercial discount.
SEGREGATING EXEMPT ACTIVITIES
The manner in which the activity will be undertaken (commerciality test)

- Commerciality Doctrine (cont.)
  - Living Faith, Inc. v. C.I.R., 950 F.2d 365 (7th Cir. 1991) – Seventh Day Adventist restaurant and food stores not exempt.
    - Purposes may be inferred from manner of operations.
    - The operation of food stores and restaurants is presumptively not exempt.
    - Directly competes with other restaurants, with competitive prices and hours.
    - Informational materials use commercial language: e.g., “World famous restaurant” and “We want to serve you better.”
    - Lack of plans to solicit.
    - Advertising budget size.
    - Lack of profits not determinative in early years of operation.
SEGREGATING EXEMPT ACTIVITIES
The manner in which the activity will be undertaken
(commerciality test)

Commerciality Doctrine (cont.)

- Airlie Foundation v. I.R.S., 283 F.Supp.2d 58 (D.C. 2003) (conference center operations) - “In cases where an organization’s activities could be carried out for either exempt or nonexempt purposes, courts must examine the manner in which those activities are carried out in order to determine their true purpose...”

Major factors:
- competition with for-profit commercial entities
- extent and degree of below cost services provided
- pricing policies
- reasonableness of financial reserves.

Additional factors:
- whether the organization uses commercial promotional methods (e.g., advertising)
- the extent to which the organization receives charitable donations.
The scale of the proposed activity (commensurate test)

- The commensurate test – Rev. Rul. 64-182
  - An organization which owns, maintains, operates, and rents a large commercial office building, and uses the revenue to make grants to charitable organizations is tax exempt, because it carries on a charitable program commensurate with its financial resources.

- Based on Treasury Regulations
  - “In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.” Treas. Reg. s. 1.501(c)(3)-1(e).
  - “Where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are in conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of an unrelated trade or business.” Treas. Reg. s. 1.513-1(d)(3).
The scale of the proposed activity (commensurate test)

- Does not apply to Feeder Organizations under I.R.C. s. 502
  - Rental exemption from feeder status applied to Rev. Rul. 64-182. GCM 32689.
  - Feeder Organization status only applies when revenues are automatically payable (e.g., due to stock ownership), without board discretion. GCM 34682.

- Endorsed by Advisory Committee on Tax Exempt and Government Entities (ACT) 2014 report, which recommended that the IRS open a regulation project to:
  - formalize the commensurate test articulated in Rev. Rul. 64-182.
  - reject application of the commerciality test.
Can an organization lose tax exempt status by generating too much unrelated business income? Some mixed messages:

- Both time and financial data (revenue and expenses) should be considered in determining the extent of nonexempt activities. Although the amount of time was only 10-15%, revenues averaged 29%, and expenditures averaged 30%. Associated Master Barbers & Beauticians of America, Inc. v. C.I.R. 69 TC 53 (1977) (501(c)(6) organization).

- Substantial nonexempt activity when unrelated revenues were 29% - 34%. Orange County Agr. Soc., Inc. v. C.I.R. 893 F.2d 529 (1990)

- No exact standard, but consider the principal source of support. GCM 39108 (501(c)(6) organization).

- Organization is exempt with 98% unrelated revenue, but 41% charitable activities. TAM 9711003.
Why Use a For-Profit Corporate Affiliate?

- Liability shield (subject to veil-piercing)
  - Financial liabilities
  - Liability for third party claims
- Distinct governance
- Branding
- Employee profit-sharing
- Investor preference for corporate form
What are Key Tax Considerations in Using a For-Profit Corporate Affiliate?
Key Tax Issues

What are Key Tax Considerations in Using a For-Profit Corporate Affiliate?

- Structuring to avoid attribution
- Capital Contributions
- Payments and distributions to the tax-exempt parent
- Structuring compensation
- IRS Form 990 Reporting
- Liquidation
Moline Properties v. Commissioner of Internal Revenue, 319 U.S. 436 (1943) – discussed the principle that a corporate form may be disregarded where it is a sham or unreal. (Held: the for-profit corporation was not a mere agent of its sole shareholder).
Attribution factors applicable to for-profit subsidiaries of tax exempts have been developed in private letter rulings:

- **Independent boards** - a majority are not officers or directors of the parent. PLR 200321021; PLR 200225046.

- **Independent day-to-day operations** - should be independent. PLR 200634039; PLR 200518081; PLR 200321021.

- **Arm’s length, fair market value dealings** - between parent and subsidiary. PLR 200518081 (rent); PLR 200152048.

Note: FMV transactions between the parent and subsidiary are also necessary to avoid private benefit, and avoid unfairly reducing the subsidiary’s tax liability.
Payments and Distributions to the Tax Exempt Parent

- Types of payments generally not subject to unrelated business income tax:
  - Dividends - However, net profits generating the dividend will be taxable to the for-profit subsidiary
  - Interest
  - Royalties
  - Rent
Key Exceptions, generating tax:

- **Unrelated debt financed income** – is always taxable, whether dividends, interest, royalties or rent.
- **Controlled corporation interest, royalties and rent**. Control is measured by 50% ownership, by vote or value; the constructive ownership rules of IRC s. 318 apply.
- **Royalty income** is treated as taxable if significant services are provided. *Sierra Club v. C.I.R.*, 86 F.3d 1526 (1996).
- **S Corporation subsidiaries** – items of income, loss and deduction flow through to the tax exempt organization shareholders as unrelated business income.
Public Support Calculations:

- **Section 509(a)(1)** – revenues from a for-profit subsidiary will be included in the denominator, but not the numerator.

- **Section 509(a)(2)** – interest, dividends, rent and royalties will be counted as “investment income”, but not included in the denominator.
Key Tax Issues

Capital Contributions

- State Fiduciary Standards


- Compensation
Structuring Compensation

- **Excess Benefit Transaction** – In determining the reasonableness of compensation paid to a “disqualified person” for purposes of IRC s. 4958, the economic benefits paid by any controlled corporation are taken into account, where control means ownership of 50% of the stock. Constructive ownership rules of IRC s. 318 apply.

- **Equity Compensation** – must be reasonable. See PLR 200225046.

- **IRS Form 990** – include compensation paid to officers, directors, key employees, and highest compensated employees by the tax exempt organization and all related organizations, where “related” includes all 50% controlled stock corporation, by vote or value.
Liquidation

- A taxable corporation that transfers all or substantially all of its assets to one or more tax exempt organizations, must recognize gain as if its assets were sold at fair market value. Treas. Reg. 1.337(d)-4.

- Exception: if the tax exempt organization uses the asset in an unrelated purpose, tax is deferred until the assets is used for an exempt purposes, or sold. Treas. Reg. 1.337(d)-4(a)(4)(b).
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