

IRS LETTER RULINGS

Letter Ruling Alert

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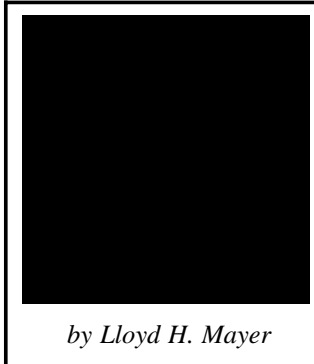
Shades of Revenue Ruling 98-15: Ancillary Joint Ventures Between Tax-Exempt Organizations and For-Profit Entities

Introduction

The issuance of Revenue Ruling 98-15, 1998-1 C.B. 718 (*The Exempt Organization Tax Review*, April 1998, p. 142), led the IRS to curtail its previous practice of issuing private letter rulings on ancillary joint ventures between tax-exempt organizations and for-profit entities. This dry spell has now ended with the issuance of PLR 200041038 (p. 161), in which the Service ruled that such a joint venture neither threatened the tax-exempt status of the section 501(c)(3) participant nor, if certain conditions were met, resulted in unrelated business taxable income. While the facts underlying the ruling parallel in many, although not all, ways the facts found in Rev. Rul. 98-15's "good" example, the ruling is significant not only because it apparently represents the first post-Rev. Rul. 98-15 ruling on such joint ventures but also because it carefully avoids any mention of that revenue ruling, indicating that the Service is still considering to what, if any, extent Rev. Rul. 98-15 should be explicitly applied outside of the "whole hospital" joint venture context.

Facts

A section 501(c)(3) organization formed to preserve, conserve, study, and educate about natural resources requested the ruling. The organization planned to create a limited liability company (LLC) with the private owners of certain forestland to manage the forestland in a more environmentally compatible manner while still allowing selective tree cutting and, therefore, the continued production of revenues for the private owners. The LLC would acquire from the private owners the rights to maintain, conserve, selectively cut and manage, sell (and retain the proceeds therefrom), and replant the trees located on each owner's property (the "Tree Rights"). The governing document for the LLC, the LLC Agreement, would expressly provide that the LLC's purposes are: (a) to conserve forestland to maintain ecological features and natural processes, and (b) to manage such lands, forest, and associated resources to provide economic and financial benefits. The Agreement would also provide that in the event of a conflict between these two purposes, the first purpose would control, and that the LCC must be operated to advance these purposes without regard to whether these purposes or the activities of the LLC would earn a profit for the LLC or its



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members. The LLC's income would come only from forest harvesting activities conducted in a manner consistent with these purposes; such activities could therefore be motivated solely by conservation purposes or by a combination of conservation objectives and other factors, including revenue production, but not by revenue production objectives alone. Pursuant to the Agreement, the LLC would not elect to be classified as a corporation for federal income tax purposes.

The section 501(c)(3) organization would make an initial capital contribution to the LLC sufficient to fund the initial activities of the LLC and would receive a membership interest in return. The organization would have no further obligations to make capital contributions to the LLC, although it would have the option of making such contributions if it chose to do so.

The private owners would contribute easements to the LLC, granting the LLC their Tree Rights, thereby prohibiting the private owners from allowing any development or use of the property inconsistent with the preservation and protection of the forest conservation values of the property. The private owners would receive in exchange membership interests with a face amount equal to the fair market value of the Tree Rights; each membership interest would also provide for an annual minimum return to the private owner set at a percentage of the fair market value of the Tree Rights. The manager of the LLC could also, at its discretion, make distributions to the private owners in excess of their annual minimum return if the LLC's operations produced excess cash flow. A private owner would be allowed to freely transfer that owner's membership interest, and could withdraw the invested amount at any time after a year had passed from the owner's contribution of the easement. The section 501(c)(3) organization represented that the membership interests would be considered an equity interest in the LLC for federal income tax purposes and not a debt instrument issued by the LLC.

Under the terms of the LLC Agreement, the section 501(c)(3) organization would serve as the manager of the LLC, with authority regarding the maintenance, conservation, logging, and selling of forest covered by the contributed easements. As manager, the organization would provide the full-time employees who would actually carry out the business affairs of the LLC.

If the LLC failed to pay the minimum annual return due to the private owners for any two consecutive years, the

organization could be replaced as the manager of the LLC by a two-thirds vote of the owners of the outstanding interests in the LLC. Any replacement manager, would, however, be required to be a section 501(c)(3) organization with the primary purpose of conserving forestland, would be required to acknowledge and agree that such conservation purposes take precedence over any fiduciary duty the manager would otherwise have to earn a profit for the owners of the membership interests, and would be required to assume all of the obligations of the previous manager. There, apparently, was no other consequence for a failure to meet the minimum annual return requirement.

The organization requested three rulings. First, that its participation in the LLC, including as the LLC's manager, would not impair its status as an organization described in section 501(c)(3). Second, that the LLC's activities would not constitute the conduct of an unrelated trade or business for purposes of section 513. Third, that the membership interests provided in exchange for the Tree Rights would not constitute acquisition indebtedness under section 514(c)(1).

IRS Conclusions and Rationale Exemption

The Service first determined that since the LLC would not elect to be taxed as a corporation, it would be treated as a partnership for federal income tax purposes under reg. section 301.7701-3(b)(1). Citing *Butler v. Commissioner*, 36 T.C. 1097 (1961), *acq.* 1962-2 C.B. 4, the Service concluded that the activities of the LLC would therefore be attributed to the section 501(c)(3) organization.

The Service then noted that the organization's activities, including the activities attributed to it from the LLC, would continue to focus on the conservation of natural resources. Relying on Rev. Rul. 76-204, 1976-1 C.B. 152 (ruling that an organization formed to preserve the natural environment qualified for exemption under section 501(c)(3)), the Service concluded that such activities furthered an exempt purpose under section 501(c)(3). The organization's activities, including its role as manager of the LLC, would therefore not adversely affect its status as a section 501(c)(3) organization.

Unrelated Trade or Business

The Service next examined whether the activities of the LLC would constitute the conduct of an unrelated trade or business for the section 501(c)(3) organization. The Service first noted that gains from the sale of property are normally excluded from the definition of unrelated trade or business income under section 512(b)(5). The Service further noted, however, that although taxpayers can elect under section 631(a) to treat the cutting of timber as a sale or exchange of timber, and therefore any gain as capital gains income (assuming the right to cut the timber had been held for a year or more), section 512(b)(5) and reg. section 1.512(b)-1(d)(1) explicitly provide that the section 512(b)(5) exclusion does not apply to the cutting of timber considered a sale or exchange of timber under section 631(a).¹

The Service then concluded that if the cutting and selling of timber by the LLC was motivated solely by long-term conservation objectives, it would constitute a related trade or business and therefore the revenue from such activities would

not be subject to the unrelated business income tax. The Service also concluded, however, that if the cutting and selling of timber by the LLC was motivated solely by revenue objectives or by revenue objectives and only incidentally by conservation objectives, such activity would constitute an unrelated trade or business, assuming that such activities were regularly carried on. The facts as presented indicated that conservation objectives would never be only incidental, although revenue objectives might also be taken into account, but the Service was apparently not willing to provide a flat-footed ruling that the LLC's planned activities would never constitute the conduct of an unrelated trade or business.

Debt-Financed Property

Under section 514(b)(1), debt-financed property includes any property held to produce income and with respect to which there is an "acquisition indebtedness." Section 514(c)(1) defines acquisition indebtedness in relevant part as the unpaid amount of indebtedness incurred by an organization in acquiring or improving debt-financed property.

Assuming without ruling that the section 501(c)(3) organization's representation that the membership interests in the LLC constituted equity interests and not debt instruments for federal income tax purposes was correct, the Service concluded that the LLC (and therefore the organization) did not incur indebtedness to acquire the Tree Rights. The membership interests therefore did not represent an unpaid amount of indebtedness, so the membership interests did not constitute acquisition indebtedness. The result is that the easements did not constitute debt-financed property.

Discussion

This ruling is significant not so much for its conclusions but for its existence at this time and what it avoids discussing. Its existence is significant because there has been a dearth of rulings on joint ventures between section 501(c)(3) organizations and for-profit entities since shortly before the Service issued Rev. Rul. 98-15. Its silence is significant in that the ruling does not discuss Rev. Rul. 98-15 specifically or the IRS's developing position with respect to joint ventures between section 501(c)(3) organizations and for-profit entities. Nevertheless, the ruling clearly is influenced by the Service's history with such joint ventures, and specifically by Rev. Rul. 98-15.

The history of the Service's positions in this area has been well documented in numerous articles published in previous editions of the *EOTR* and therefore will only be summarized briefly here.² Through the early 1980s, the Service took the position that a section 501(c)(3) organization could not serve as the general partner in a partnership with individuals or for-profit entities and still retain its tax-exempt status. The Service abandoned this absolute prohibition after *Plumstead Theatre Society Inc. v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982). In *Plumstead*, a section 501(c)(3) performing arts organization participated as the sole general partner of a limited partnership, with two individuals and a for-profit corporation as the limited partners; the courts ruled that this role was consistent with the organization's tax-exempt status based on the organization's control over the activities of the partnership and the arm's-length and

reasonable nature of the financial relationships with the limited partners.

In the wake of *Plumstead*, the Service issued a series of general counsel memorandums adopting a two-prong test for determining whether participation in a partnership threatened a section 501(c)(3) organization's exempt status.³ The first prong looked to whether participation in the partnership furthered the organization's exempt purposes. The second prong looked to whether the partnership more than incidentally benefited the individual or for-profit partners. The Service then applied this test to numerous joint ventures for which section 501(c)(3) organizations sought private letter rulings.

Plumstead, and for the most part, the GCMs and the Service's rulings involved "ancillary joint ventures." Ancillary joint ventures are ones in which the section 501(c)(3) organization participates in the joint venture as only one of its activities. In the 1990s, there was growing concern regarding another type of joint venture, commonly referred to as "whole hospital joint ventures."⁴ In these joint ventures, the section 501(c)(3) organization would transfer all of its operating assets, usually one or more hospitals and other health care facilities, to a limited partnership or LLC in exchange for a membership interest and cash. The organization would then have some role in the governance of the LLC and would also usually have a grant making program, which may or may not have been related to health care issues, funded by the proceeds it received from entering into the joint venture. The other partner to the joint venture would normally be a for-profit hospital chain, such as HCA (formerly known as Columbia/HCA) or Tenet.

Responding to concerns about whether the section 501(c)(3) organizations participating in these whole hospital joint ventures could continue to qualify for tax-exempt status when their primary activities had been transferred into the joint venture over which they only had partial control, the Service issued Rev. Rul. 98-15. Rev. Rul. 98-15 clarified that the activities of the joint venture, assuming it was treated as a partnership for tax purposes, would be attributed to the section 501(c)(3) participant. More importantly, Rev. Rul. 98-15 provided two examples (a "good" example and a "bad" example) of when a section 501(c)(3) organization exercised sufficient control over the joint venture to ensure that the organization retained its tax-exempt status, and when it did not. In the months preceding this revenue ruling and since its issuance, the Service has apparently not issued any private letter rulings on either whole hospital or ancillary joint ventures involving section 501(c)(3) organizations and for-profit entities or individuals.

There has been much speculation regarding whether Rev. Rul. 98-15 would apply in the context of ancillary joint ventures. The private letter ruling here suggests that the principles contained in that revenue ruling generally apply, but does not definitively answer this question.

The LLC here resembles in many respects both the joint venture in *Plumstead* and the Situation One (the "good" example) in Rev. Rul. 98-15. The section 501(c)(3) organization here maintains control over the joint venture by serving

as the joint venture's manager, while in *Plumstead* the section 501(c)(3) organization did the same by serving as the sole general partner and in Situation One the section 501(c)(3) organization appointed a majority of the joint venture's board. While not discussed in *Plumstead*, the LLC Agreement here and in Situation One explicitly state the charitable purposes that the joint venture will serve and provide that those purposes trump profit motives.

There are some differences between the current situation and, in particular, Situation One in Rev. Rul. 98-15. In Situation One, the section 501(c)(3) organization controlled the governing board of the joint venture and the manager was an independent company. Here, there is no discussion of a governing board, although it appears that the private members of the joint venture probably control a majority of the membership interests, but the section 501(c)(3) organization serves as the manager and can only be replaced under limited circumstances, and then only by another section 501(c)(3) conservation organization. And Situation One of course involved a whole hospital joint venture, while the current situation involves an ancillary joint venture.

Despite these differences and the fact that the ruling does not mention either Rev. Rul. 98-15 or control, the parallels between the facts cited by the Service here and those found in Situation One indicate that the Service is applying many of the same principles in the context of ancillary joint ventures. First, the emphasis on the control the section 501(c)(3) organization here will exercise over the LLC and the provisions of the LLC Agreement providing explicitly for the preeminence of charitable purposes over profit-seeking purposes, parallels the facts identified as critical in Rev. Rul. 98-15. Second, the Service cited the same case, *Butler*, in Rev. Rul. 98-15, for the proposition that the activities of a joint venture should be attributed to the tax-exempt participant.

The Service is also, however, leaving open the option of not having to completely apply the principles described in Rev. Rul. 98-15 to ancillary joint ventures, and showing some flexibility regarding how control by the section 501(c)(3) participant can be demonstrated. The Service is also indicating that simply because a joint venture is compatible with the exempt status of an organization does not mean that all activities of the joint venture must constitute related trade or business activity; if revenue objectives predominate particular joint venture activities, those activities will, absent an applicable exception and assuming they are regularly carried on, constitute the conduct of an unrelated trade or business, but participation in the joint venture may still be compatible with the organization's tax-exempt status. It is far from clear that such a result would apply in a whole hospital joint venture context, in which a substantial unrelated trade or business activity would presumably be enough to undermine the exempt status of the participating section 501(c)(3) organization because that organization would not have other, substantial activities outside the joint venture to render the unrelated trade or business activity insubstantial.

Conclusion

This ruling represents a first step by the Service toward mapping the post-Rev. Rul. 98-15 landscape for ancillary joint ventures between section 501(c)(3) organizations and for-profit entities. Its conclusions are not surprising, but they do indicate that the Service will look to similar facts as those highlighted in the revenue ruling when deciding whether ancillary joint ventures are compatible with the exempt status of the section 501(c)(3) participants, and whether the activities of the joint venture are related trade or businesses. It is, however, disappointing that the Service was not more explicit regarding the extent to which Rev. Rul. 98-15 will be applied in this context. Hopefully, additional rulings will help to further illuminate this and other important joint venture issues.

Endnotes

¹The Service also noted that disposal of timber that meets the requirements of section 631(b) (primarily by virtue of the seller's retaining an economic interest in the timber) results in capital gains income that is excluded under section 512(b)(5) from unrelated business taxable income.

²See, e.g., Michael W. Peregrine and T.J. Sullivan, "Rev. Rul. 98-15 Confirms Traditional Tax Planning Approach for 'Typical' Joint Ventures," *The Exempt Organization Tax Review*, May 1998, p. 220; Gerald M. Griffith, "Revenue Ruling 98-15: Dimming the Future of All Nonprofit Joint Ventures," *The Exempt Organization Tax Review*, June 1998, p. 405; Gregory A. Petroff, "Whole Hospital Joint Ventures: The IRS Position on Control," *The Exempt Organization Tax Review*, July 1998, p. 19; Jack A. Rosenbloom, "Joint Operating Agreements Between For-Profit and Nonprofit Health Care Organizations: Is There a Future?," *The Exempt Organization Tax Review*, November 1998, p. 263; Phil Royalty and Donna Steele Flynn, "Not-For-Profit/For-Profit Joint Ventures: A White Paper," *The Exempt Organization Tax Review*, July 1999, p. 37.

³See, e.g., GCM 39005 (Dec. 17, 1982); GCM 39444 (July 18, 1985); GCM 39546 (August 14, 1985); GCM 39732 (Nov. 4, 1987).

⁴See, e.g., Robert A. Boisture and Albert G. Lauber, "Caplin & Drysdale Comments on Whole Hospital Joint Ventures," *The Exempt Organization Tax Review*, April 1997, p. 650.

