CONFERENCE NOTES

Exempt Organizations Tax Update

by Marcus S. Owens

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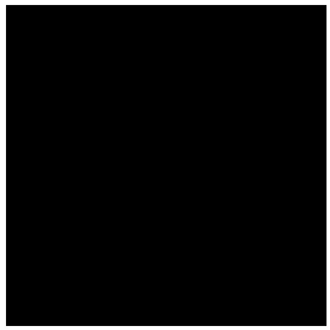
Since joining Caplin & Drysdale, Mr. Owens has been representing a broad range of nonprofit organizations including private foundations, charities, and trade associations.



Marcus S. Owens

Speech Outline for a Presentation at the 2001 AICPA National Not-for-Profit Industry Conference June 14 – 15, 2001

I. Introduction

During the year, the [IRS] Exempt Organizations Division remained in state of transition from the old organizational structure to the new, more centralized arrangement contemplated by the master plan. Despite the interim nature of the organization, there were developments of significance during the year. This topic will review those developments.

II. Administrative Developments

A. Status of the Reorganization

While the overall structure of the new Exempt Organizations Division, with its six geographic area offices in place of the former key district structure, has existed since December 5, 1999, key operational aspects remain works in progress.

1. Personnel

During the year, several key positions were filled; others, however, remained filled on a temporary basis only. A list of the key positions and contact information is attached as Appendix A. IRS officials have also stated that hiring is under way or has occurred for determination specialists (approximately 25) in the Cincinnati applications processing site, for lawyers and CPAs (approximately 10) in the Rulings and Agreements function in the Washington post of duty, and revenue agents (approximately 45) for the examination groups in the EO area offices.

a. Director of Exempt Organizations Rulings and Agreements

The important executive-level position of Director, EO Rulings and Agreements remains unfilled. This position, located in Washington, D.C., is at the top of the hierarchy that is responsible for the processing of applications for exemption and proposed transaction rulings. It is currently filled on an interim basis by Tom Miller.

b. Director of Exempt Organizations Examinations

The executive designated as Director of EO Examinations, Rosie Johnson (formerly Rosie Slaughter), recently completed the IRS Executive Development Program and has assumed her duties overseeing the examination program from Dallas, Texas. Ms. Johnson was formerly the Chief of the EP/EO Division in the old Mid-States Key District.

c. Manager, Customer Education and Outreach

Ms. Roberta (Bobby) Zarin, formerly with the Federal Election Commission, was selected to oversee the customer outreach effort of the new Division. Ms. Zarin will be responsible for publications, conferences, and similar efforts from Washington, D.C.

d. Closing Agreements Coordinator

Ms. Genny Farley was selected as Closing Agreements Coordinator for the Division. The position reports to the Director of EO Examinations and is located in the St. Petersburg, Fla., IRS post-of-duty. This is a new position whose existence reflects the centralized nature of the new organizational structure. Ms. Farley is responsible for overseeing closing agreements in exempt organizations matters and serving as an initial point of contact for organizations seeking to begin negotiations.

e. Mid-Atlantic Area Manager

With the selection of Joanne Dorling as Exempt Organizations Area Manager for the Mid-Atlantic Area, all the exempt organizations area offices now have permanent managers. Ms. Dorling was previously with the Examination function of the IRS.

2. Programs

At various times during the preceding year, IRS officials have publicly indicated that a number of studies or proposals related to the reorganization are under consideration.

a. Plain Language Publications and Closing Agreements

In Announcement 2001-14, 2001 IRB 1, the IRS requested "Ideas for Exempt Organizations Plain-Language Publications and Voluntary Compliance Programs." The Announcement stated that prior plain language publications, such as the Gaming Publication for Tax-Exempt Organizations (Pub. 3079 April 1998 [*Doc 98-12112 (33 pages)*; *98 TNT 71-25*]), the Tax Guide for Veterans' Organizations (Pub. 3386, June 1999), and the Draft Tax Guide for Churches and Other Religious Organizations (Pub. 1828, September 1994), will be models for future efforts. The same Announcement also requested comments on specific areas in which voluntary compliance programs, or closing agreement programs, might be appropriate, such as for organizations that self-identified potential compliance concerns and voluntarily brought them to the attention of the agency. Recent public comments by IRS executives have suggested that a final version of Pub.1828 and a guide for disaster relief organizations may be issued this year.

b. Reevaluation of the Coordinated Examination Program

Steven T. Miller, the Director of the Exempt Organizations Division, has publicly stated that the Gulf Coast EO Area Office is undertaking a reevaluation of the Coordinated Examination Program (CEP). The program began in 1991 and, for its first ten years, maintained a focus on health care organizations and colleges and universities, together with other large, complex tax-exempt organizations. A CEP examination utilizes a team approach to the audit to enable the IRS to assess the flow of funds and overall operations of an economic system composed of a number or organizations or tax entities. Mr. Miller has suggested that the team approach, which has been found to be effective in developing and addressing issues in the context of the larger tax-exempt organizations, might be usefully extended to smaller entities. He has also suggested that the number of CEP audits may be reduced.

c. Electronic Filing of Forms 990 and Applications for Exemption

The Exempt Organizations Division has formed a task force to begin the process of creating a system for the electronic filing of the Form 990 series of returns, and, eventually, applications for exemption. The task force mirrors an effort being undertaken by several state charity offices in conjunction with the National Association of State Charity Officials (NASCO). In their public comments, IRS officials have suggested that electronic filing will be accompanied by a revision of the 990 series forms themselves to make them more electronically friendly.

d. Reevaluation of the Determination Process

References have been made to a large-scale study of the determination letter process, including the use of consultants, to redesign the "front end" of the process. In public comments, the EO Division Director has stated that the focus of the study, at least initially, is the procedure for assignment and processing of applications with a view to improving the timeliness or speed of the processing rather than the quality of the work performed.

e. Issue Resolution Programs

The Exempt Organizations Technical Group Chief with responsibility for health care issues, Marvin Friedlander, has publicly noted that the agency is using a "quick reaction process" as a preliminary step in the technical advice process to ensure that issues arising from audits and requiring headquarters consideration are identified and the facts fully developed before being submitted. He also suggested that the Exempt Organizations Division may consider participating in the IRS program that facilitates early referral of appropriate issues to the Appeals function for resolution.

f. TEAC (Tax Exempt/Government Entities Advisory Committee)

On May 8, 2001, the long-awaited Tax Exempt/Government Entities Advisory Committee came into existence with the announcement of the 18 members. The group is intended to serve as "an organized public forum for the IRS and representatives who deal with employee plans, exempt organizations, tax-exempt bonds, and federal, state, local and Indian tribal governments." The membership is divided between the various sectors represented by the Tax Exempt and Government Entities Division of the IRS.

B. Implementing Guidelines for FY 2001 (Formerly the Workplan)

1. Overview

The Implementing Guidelines for FY 2001 (October 1, 2000 through September 30, 2001) were issued on November 20, 2000. They emphasize that the key priority for the Exempt Organizations function is the completion of the reorganization. They also make it clear that design and implementation work in the areas of customer education and outreach, voluntary compliance, and large case examinations, as well as training, will consume major amounts of time and resources. [Portions of the workplan appear in *The Exempt Organization Tax Review*, January 2001, p. 91; for the full text, see *Doc 2000-31009 (81 original pages)* or *2000 TNT 232-44*.]

2. Determinations Guidelines

The Guidelines contemplated that the number of applications would not increase at an unusual rate — the projected number of receipts was 80,000 (recent public statements by the Director, Exempt Organizations Division, placed the number of new applications at 85,000). Of the 80,000, it was anticipated that approximately 49,000 would be processed by the Cincinnati office with the balance being transshipped to other area offices for processing. The Guidelines note that the average processing time for an application is 81 days.

3. Field Examination Guidelines

The Guidelines indicate that three general types of examinations will be employed — field, office, and correspondence. Field examinations will include both individual revenue agent examinations as well as examinations that require a team of agents. The Guidelines do not specifically identify many discreet areas of compliance concern. However, they do direct agents to verify that fund-raising income and expenses are being properly reported on Forms 990 filed by charities and to consider imposing penalties under section 6652(c) "where appropriate." An additional area of focus directs the field to conduct limited scope examinations of entities that have filed claims for refund of FICA taxes paid on behalf of medical/dental residents.

The Guidelines indicate that the Coordinated Examination Program will continue, however, the document does not specify any particular focus or priorities for the program other than the limited scope audits of claims for FICA refunds (which, curiously, will qualify as CEP audits for field management reporting purposes). CEP audits are expected to comprise between 20 percent and 30 percent of field examination time. The particular array of time reporting codes in the Guidelines suggests that there will be some level of audit interest in health care acquisitions and joint ventures.

III. Precedential Guidance

A. Regulations

1. Temporary Regulations Under Section 4958 (Intermediate Sanctions)

On July 30, 1996, as part of the Taxpayer Bill of Rights 2, section 4958 was enacted into law. The general rule set forth provides for a penalty excise tax on excess benefit transactions, defined as those transactions between a disqualified person and an applicable tax-exempt organization in which the disqualified person receives a benefit that exceeds the value of the consideration provided in return.

On January 10, 2001, the IRS and Treasury released temporary regulations under section 4958. The regulations will expire on January 9, 2004, unless replaced by final regulations before that date. The issuance of temporary regulations provides an additional opportunity for public comment on the rules before final regulations are issued. [T.D. 8920, 66 F.R. 2144-2172; *The Exempt Organization Tax Review*, February 2001, p. 225; *Doc 2001-1185 (29 original pages)*; *2001 TNT 10-96*.]

Key changes from the earlier proposed regulations include an "initial contact" rule designed to address the *United Cancer Council* Seventh Circuit opinion. Under the temporary regulations, section 4958 does not apply to a fixed payment to a person pursuant to an initial contract. The exception also includes a discretionary bonus if made pursuant to an objective formula. Standards for revenue-based compensation, however, were reserved in the regulations.

Important steps for charities and social welfare organizations to take include identifying their "disqualified persons," implementing or reviewing organizational procedures for setting compensation and financial transactions, establishing a conflict of interest policy, and documenting organizational actions.

2. Proposed Regulations Under Section 513 (Corporate Sponsorships)

On March 1, 2000, the IRS and Treasury released, in re-proposed form, regulations under section 513 concerning income from corporate sponsorship arrangements. The latest set of proposed regulations conforms the earlier 1993 regulations to reflect more recent statutory changes. While generally containing few surprises, the regulations do introduce the concept of an "exclusive marketing arrangement" that could reduce or eliminate the exclusion of the corporate sponsorship income from unrelated business income tax. [REG-209601-92, 65 F.R. 11012-11019; *The Exempt Organization Tax Review*, April 2000, p. 133; *Doc 2000-6180 (8 original pages)*; *2000 TNT 44-85*.]

3. Proposed Regulations Under Section 6050S

In June 2000, the IRS and Treasury released proposed regulations regarding the reporting requirements for qualified tuition assistance payments and interest on qualified education loans. [REG-105316-98, 65 F.R. 37728-37738; *The Exempt Organization Tax Review*, July 2000, p. 142; *Doc 2000-16645 (47 original pages)*; *2001 TNT 116-7*.] The proposed regulations set out several reporting dates for colleges and universities regarding payments, reimbursements, and refunds relating to qualified expenses. After receiving a number of critical comments, the proposed applicability date in the regulations was extended in Notice 2000-62. [*The Exempt Organization Tax Review*, January 2001, p. 87; *Doc 2000-30916 (4 original pages)*; *2000 TNT 232-6*.]

B. Revenue Rulings, Revenue Procedures, and Announcements

1. Revenue Ruling 2000-49, 2000-44 IRB 1

The revenue ruling, released in October, provided implementing rules for compliance with the new reporting and disclosure rules under section 527 for certain political organizations, including certain separate segregated funds maintained by tax-exempt organizations. The revenue ruling complements the new reporting forms, the Form 8871 (filed within 24 hours of the entity's formation) and Form 8872 (filed periodically to disclose the donors and expenditures of the entities). The forms must be filed electronically and are publicly available. [Rev. Rul. 2000-49; *The Exempt Organization Tax Review*, November 2000, p. 176; *Doc 2000-26441 (9 original pages)*; *2000 TNT 199-6*.]

The underlying statute's constitutionality has been challenged in *Mobile Republican Assembly v. U.S.*, (S.D. Al) No. 00-0759-MJ-C.

2. Revenue Procedure 2001-20, 2001-9 IRB 1

At long last, the IRS published procedures for a voluntary compliance program addressing withholding on payments to aliens by colleges and universities, and their charitable affiliates. The program, known as the Voluntary Compliance on Alien Withholding Program or VCAP, will enable the institutions to resolve withholding issues and institute procedures to address future compliance. VCAP is effective February 26, 2001, and will be available for submissions made before March 1, 2002. [*The Exempt Organization Tax Review*, March 2001, p. 498; *Doc 2001-2884 (17 original pages)*; *2001 TNT 20-8*.]

3. Announcement 2000-84, 2000-42 IRB 385

On October 16, 2000, the IRS released an announcement that solicited comments on whether guidance was needed on issues relating to the Internet in the context of tax-exempt organizations. The announcement did not, itself, provide any precedential guidance other than as an indicator that the IRS is aware of the broad impact that the Internet can have on an exempt organization's activities. [Ann. 2000-84; *The Exempt Organization Tax Review*, November 2000, p. 184; *Doc 2000-26524 (3 original pages)*; *2000 TNT 200-14*.]

4. Announcement 2001-33, 2001-17 IRB 1137

Over the years the IRS has periodically announced revisions of tax forms and requested recommendations for adjustments in forms. In Announcement 2001-33, the IRS is asking for comments on the reporting of the identities and compensation paid to "out-sourced" officers, directors, trustees, or key employees. In 1999, the Form 990 instructions were expanded to state "If you pay any other person, such as a management services company, for the services provided by any of your officers, directors, trustees or key employees [or foundation managers for private foundations], report the compensation and other items as if you had paid them directly." The change was made to address concerns that excessive compensation to key executives of charities was being funneled through management services contracts with neither the executives nor the amounts of compensation being reported on the Form 990. The IRS is now soliciting comments on alternative methods of reporting such information, including whether reporting should be limited to only the name of the management company and the aggregate compensation paid.

C. Future Guidance (IRS/Treasury 2001 Guidance Priorities)

The IRS and Treasury released their guidance publication priorities list on April 27, 2001. [See *The Exempt Organization Tax Review*, June 2001, p. 477; *Doc 2001-11987 (31 original pages)*; or *2001 TNT 84-36*.] The list contains nine items directly related to exempt organizations and at least two other items that have a close relationship. The list also identifies some future items. The items are:

- Guidance on section 501(c)(4) organizations.
- Guidance under section 501(c)(12).
- Guidance under section 507 regarding termination of private foundation status.
- Final regulations under section 513(i) regarding corporate sponsorship payments received by exempt organizations.
- Guidance under section 514 regarding the investment of proceeds of qualified 501(c)(3) bonds.
- Final regulations under section 529 regarding qualified state tuition programs.
- Guidance on split-interest trusts.
- Announcement requesting comments on updates to private foundation regulations.
- Final regulations under section 4958 for certain excess benefit transactions.
- Guidance on charitable contributions to disregarded entities.
- Guidance on discount stock option arrangements for exempt organization executives.
- At some future time, guidance regarding group rulings under section 501(c)(3).
- At some future time, guidance regarding simplifying the advance ruling process for public charities under section 509(a).
- At some future time, guidance regarding allocating deductions in computing UBIT.
- At some future time, a private foundations regulations update.

IV. Litigation

A. Court Decisions

1. *Branch Ministries and Dan Little, Pastor v. Rossotti*, 40 F. Supp. 2d 15 (D. D.C. Mar. 30, 1999), *aff'd* No. 99-5097 (D.C. Cir. May 12, 2000)

In *Branch Ministries*, the appellate court, while upholding the prohibition on political campaign intervention by section 501(c)(3) organizations, including churches, set forth a path for charities to participate in political discourse. The court cited *Regan v. Taxation with Representation*, 461 U.S. 540 (1983), for the view that a church could, within the parameters of the federal tax rules, create an affiliated section 501(c)(4) organization that could, in turn, create a section 527 political organization. The court set out two conditions that must be met: (1) the related section 501(c)(4) organization must be separately incorporated, and (2) records must be maintained that demonstrate that no tax-deductible contributions to the church were used to support the political activities conducted by the section 501(c)(4) organization's political arm. The court suggested that the existence of the preceding option was necessary for a finding that the section 501(c)(3) prohibition was constitutional. [*Branch Ministries Inc., el al. v. Commissioner*, *The Exempt Organization Tax Review*, June 2000, p. 552; *Doc 2000-13770 (13 original pages)*; *2000 TNT 95-17*.]

2. *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), *aff'd* 9th Cir., No. 99-71253 (March 15, 2001)

This case involved a fact pattern similar to the adverse example of a joint venture between a charity and a for-profit health care provider in Rev. Rul. 98-15. The IRS prevailed in the Tax Court and the Ninth Circuit affirmed the lower court decision in a one paragraph *per curiam* opinion that referenced the Tax Court's finding of impermissible private benefit. Redlands has asked for a rehearing. [*Redlands Surgical Services v. Commissioner*, *The Exempt Organization Tax Review*, April 2001, p. 182; *Doc 2001-7736 (2 original pages)*; *2001 TNT 52-11*.]

3. *U.S. v. Estate Preservation Services, et al.*, 38 F. Supp. 2d 846 (1998), *aff'd* 202 F.3d 1093 (9th Cir. 2000)

The Ninth Circuit affirmed the issuance of a preliminary injunction enjoining the defendants from rendering tax-shelter advice on a finding by the lower court that the defendant's literature made false statements advocating the deduction of non-ordinary and unreasonable expenses, as well as fraudulent charitable deductions involving donor-directed funds. The case is related to the pending Claims Court case of *New Dynamics Foundation v. Commissioner*. [*U.S. v. Estate Preservation Services, et al.*; *Doc 2000-2857 (23 original pages)*; *2000 TNT 19-7*.]

4. *Nationalist Foundation v. Commissioner*, T.C. Memo 2000-318

This decision utilizes the "educational methodology test" to find that an organization does not qualify for exemption. In doing so, the Tax Court reviews the factual record, including information from the organization's Web site. This is thus one of the first cases involving tax-exempt organizations and an administrative record that includes information that was disseminated electronically. It appears that the Web site information was printed out or otherwise transcribed into hard copy format for inclusion. Information referenced on the Web site, but not reduced to hard copy for inclusion in the record, was noted but not included in the evaluation beyond noting that it was not provided to the IRS. [*Nationalist Foundation v. Commissioner*; *The Exempt Organization Tax Review*, November 2000, p. 204; *Doc 2000-26284 (14 original pages)*; *2000 TNT 198-10*.]

5. *Arkansas State Police Association Inc. v. Commissioner*, T. C. Memo 2001-38.

The Tax Court provided a counterpoint to the series of decisions involving royalty income and mailing lists in the context of the publication of a journal containing paid advertising. The court found that the section 501(c)(5) organization had sufficient active involvement in the production of the journal, which was produced under contract with a publishing company, that the income from advertising was subject to unrelated business income tax. In doing so, the court distinguished the *Sierra Club* line of cases. [*Arkansas State Police Assn. v. Commissioner*; *The Exempt Organization Tax Review*, March 2001, p. 591; *Doc 2001-5201 (12 original pages)*; *2001 TNT 35-7*.]

B. Pending Litigation

1. *Sta-Home Health Agency Inc. of Granada, Miss. v. Commissioner*, Tax Ct. Dkt. No. 14711-99

This is one of a series of related cases involving the application of the section 4958 penalty excise taxes on excess benefit transactions and revocation of exemption based on inurement. As the second tier excise taxes were assessed, the dollar amount (approximately $42 million) of the potential tax liability is significant. These cases will likely be the first judicial interpretation of section 4958.

2. *IHC Care Inc. v. Commissioner*, Tax Ct. Dkt. No. 14601-99, and *IHC Group v. Commissioner*, Tax Ct. Dkt. No. 14599-99

The IRS denied the two health maintenance organizations' applications for exemption on the grounds that they were not operated exclusively for the charitable purpose of promoting health and were not integral parts of two section 501(c)(3) organizations, Intermountain Health Care, Inc., and IHC Health Services, Inc. The IRS also found that a substantial part of IHC Care's activities consisted of providing "commercial-type insurance" within the meaning of section 501(m).

3. *St. David's Health Care System Inc. v. United States*, (W. D. Texas), 01-CV-46

This recently filed case involves a challenge to a revocation of exemption of a health care system that entered into a partnership with Columbia/HCA. The IRS position is based on Revenue Ruling 98-15. St. David's has requested a jury trial.

4. *Fund for Anonymous Gifts v. Internal Revenue Service*, D. D.C. No. 95CV1629

The Fund had sought a declaratory judgment that it qualified under section 501(c)(3) as a charitable fund that gives donors a vehicle for making anonymous charitable contributions. The U.S. District Court for the District of Columbia granted the IRS summary judgment on April 15, 1997. The Fund filed a timely appeal. During the pendency of the case, the appellate court permitted the Fund to amend "any transfers subject to a condition or power within the meaning of Income Tax Regulations section 170A-1(e) and comparable provisions contained in the federal gift and estate regulations." The court of appeals then concluded that the amendment removed any rationale for the Service's objections to granting exemption.

5. *New Dynamics Foundation v. Commissioner*, Cl. Ct. Dkt. No. 99-197T

This case presents the courts with the distinction between a donor-advised fund and a donor-directed fund. The IRS contends that the funds operated by the Foundation served private rather than public interests and that the organization's net income inured to the benefit of private individuals.

V. Significant Rulings, Technical Advice, and IRS Counsel Memoranda

A. Private Letter Rulings and Information Letters

1. PLR 200051049/PLR 200101036

The IRS is establishing a rulings position that the operation of exercise facilities and health clubs, under certain circumstances, constitute a related activity for section 501(c)(3) organizations.

This evolving IRS position has attracted criticism from the fitness club industry in a manner similar to the opposition several years ago to travel tours operated by tax-exempt organizations.

2. PLR 200103083

In this ruling, the IRS approves, as a charitable activity, the apparent donation or bargain sale of a building, containing asbestos and owned by a hospital, to an unrelated for-profit company that will renovate the structure and remove the asbestos.

3. PLR 200103084

Anticipating the *Branch Ministries* appellate decision, the IRS approved the existence of a section 501(c)(3) organization that has an interlocking board of directors with a section 501(c)(6) entity that, in turn, has a political action committee described in section 527. The basis for the finding was that the three entities are separate organizations and the charity's funds are not used for section 527 purposes.

4. PLR 200104031

The IRS concluded that income from the leasing of space on a television and radio antenna tower is not excludable from unrelated business income tax as rent from real property because a broadcasting tower is specifically considered personal property under section 1.48-1(d). The ruling reverses an earlier ruling on the same facts (PLR 9816027). [*The Exempt Organization Tax Review*, March 2001, p. 490; *Doc 2001-2611 (3 original pages)*; *2001 TNT 19-32*.]

5. PLR 200118054

The IRS approved a community health care system's participation in a joint venture that will operate an ambulatory surgery center. The ruling provides insight into the types of arrangements that the IRS is comfortable approving under Rev. Rul. 98-15.

6. INFO 20000260

The IRS has begun releasing, in redacted form, the letter it issues in response to requests for general information. In INFO 2000-0260, the IRS states that "an organization that believes that it is described in section 501(c)(4) of the code, but has not sought recognition of exemption from the IRS, must file the Form 990 annually as provided under section 6033. However, neither section 6033 of the code, nor the implementing regulations, requires the IRS to accept such filing. Currently, the IRS does not accept returns filed by organizations that have not filed the Form 1024, or the Form 1023, in the case of organizations claiming they are charitable organizations."

7. Determination Letter for Tompkins Community Charitable Gift Fund, Inc.

On February 15, 2001, the Tompkins Community Charitable Gift Fund was recognized as exempt under section 501(c)(3). The Fund is a donor-advised fund with a close relationship to Tompkins County Trust Company. The initial closeness of the relationship and the planned operation of a pooled income fund led the IRS to issue a proposed denial of exemption. After the Fund agreed to a number of structural and operational changes, the IRS reversed its initial view. The publicly released administrative record contains a copy of the IRS proposed denial letter and reflects the agency's analysis of donor-advised funds that have a close relationship to a financial services company.

B. Technical Advice Memoranda

1. TAM 200044038

The IRS concluded that a section 501(c)(3) organization jeopardized its exempt status on the basis of political campaign intervention when it engaged in joint fund raising with a political candidate. The fund-raising letters were signed by the candidate and discussed his views on issues. [*The Exempt Organization Tax Review*, December 2000, p. 373; *Doc 2000-28328 (31 original pages)*; *2000 TNT 215-12*.]

2. TAM 200047049

This technical advice memorandum contains an extensive analysis of the treatment for unrelated business income tax purposes of income from the development and sale of land, the provision of "municipal-type" services, and operation of a golf course, tennis courts, and boating facilities" by a section 501(c)(3) organization. [*The Exempt Organization Tax Review*, January 2001, p. 73; *Doc 2000-30209 (13 original pages)*; *2000 TNT 228-13*.]

C. IRS Counsel Memoranda

1. FSA 200012051

This field service advice memorandum, as with PLR 200051049 and PLR 200101036, reflects the trend toward holding that the operation of fitness centers is an exempt function activity. The memorandum also analyzes sales to the general public from a bookstore and a convenience store, distinguishing between sales to students, faculty, and staff (exempt from UBIT), and sales to the general public (UBIT). In that analysis, the memorandum draws on Revenue Ruling 68-374 regarding hospital pharmacy sales and the distinction between patient sales and sales to the general public.

2. SCA 200101031

This service center advice memorandum responds to a question raised by the Ogden Service Center which inquired as to the consequences of the failure of a donee charity filing a Form 8282 that omitted the donor's taxpayer identification number. Counsel concludes that such a filing constitutes the filing of an incomplete Form 8282 and triggers a penalty under section 6721 for incomplete information returns.

3. FSA 200110030

Counsel concluded that a hospital's stated policy to provide health care services to the indigent are not sufficient to satisfy the charity care requirement of the community benefit standard unless the hospital demonstrates that such a policy actually results in the delivery of significant health care services to the indigent. [*The Exempt Organization Tax Review*, April 2001, p. 117; *Doc 2001-6950 (6 original pages)*; *2001 TNT 48-45*.]

VI. Joint Committee on Taxation Studies

A. Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998 — January 28, 2000

This Joint Committee study proposed sweeping changes to the general privacy rules in the Internal Revenue Code in the tax-exempt organizations area alone. Virtually all the proposals would have removed the protections that prevent public dissemination of taxpayer information. With the exception of disclosure changes relating to certain political organizations, the proposals have not been incorporated into legislation.

B. Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986

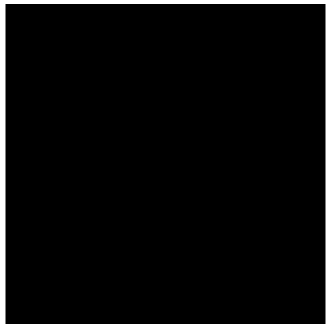
The Joint Committee has recommended two changes that will simplify the federal tax rules applicable to tax-exempt organizations. The first is the elimination of the separate percentage limitation on grassroots lobbying for electing public charities under section 501(h). Electing charities would still be subject to the same overall limit on lobbying expenditures. The second recommended change is the elimination of the section 4940 tax on net investment income of private foundations.

VII. Conclusion

Organizational Structuring

by Michael I. Sanders[1]

Michael I. Sanders is a senior partner in the Washington D.C. office of Powell, Goldstein, Frazer & Murphy, LL.P. He concentrates his practice in the area of taxation, offering particular expertise in matters affecting partnerships, limited liability companies, S Corporations, real estate, and tax controversy. He also has a large practice in the area of exempt organizations involving health care and low-income housing, associations, and joint ventures between for-profits and nonprofits.



Michael I. Sanders

Mr. Sanders is the author of Joint Ventures Involving Tax-Exempt Organizations published by John Wiley & Sons, Inc. He is also an adjunct professor at George Washington University Law Center and Georgetown University Law School teaching Taxation of Partnerships and S Corporations and Tax Treatment of Charities and Other Non-Profit Organizations, respectively.

Speech Given at the 2001 AICPA National Not-for-Profit Industry Conference June 14 – 15, 2001

I. Background and Opening Remarks

The participation of exempt organizations in partnerships and joint ventures is an area of continuing growth and interest. Current economic and social conditions, as well as the issuance of IRS guidance in several key areas has presented exempt organizations with significant opportunities to further their charitable purposes and fulfill their charitable goals through careful and selective participation in joint ventures with for-profit entities.

In the course of its participation in a partnership or joint venture with one or more for-profit entities, the exempt organization may take the role of a general partner or managing member, if certain strict organizational and operational requirements are met.[2] Alternatively, the exempt organization may participate through a single member LLC (which may be disregarded) (see Part II.C.) a subsidiary or an affiliated organization or as a limited partner. Generally, an exempt organization may invest as a limited partner (or a non-managing, nonparticipatory member in the case of an LLC) in any prudent investment.[3] Note that as a limited partner or non-managing member, the exempt organization may be subject to UBIT on any joint venture activity unrelated to the exempt organization's charitable purposes.

This presentation will concern itself primarily with the conditions under which an exempt organization may take on the more formidable role of general partner of a limited partnership or managing member of a limited liability company. After summarizing the history and analysis of joint ventures between tax-exempt and for-profit organizations, generally, it will focus on hot issues in this area, including the following:

- The *Redlands Surgical Services* Tax Court case, recently affirmed on appeal by Ninth Circuit.
- Rev. Rul. 98-15, which focuses on whole hospital joint ventures, but also provides guidance applicable to all joint ventures and partnerships involving charitable organizations.
- The intense scrutiny by the IRS with regard to whether the tax-exempt organization has "control" over the partnership or joint venture.
- The *United Cancer Council* case
- The impact of the temporary intermediate sanctions regulations.

II. History and Analysis of Joint Ventures Between Tax-Exempt and For-Profit Organizations

A. The Early Days: *Per Se* Prohibition

Prior to *Plumstead Theatre Society*,[4] an exempt organization automatically ceased to qualify as tax-exempt under section 501(c)(3) when it served as a general partner in a partnership that included private investors as limited partners, or otherwise shared net profits.[5] The IRS reasoning behind this position was threefold:

1. The limited partnership vehicle served as a means to share profits with private individuals;

[1]Michael I. Sanders is the author of *Partnerships and Joint Ventures Involving Tax-Exempt Organizations* (© 1993, by John Wiley & Sons, Inc. 605 Third Avenue, New York, NY 10158). Significant portions of this article are excerpted from *Partnerships and Joint Ventures Involving Tax-Exempt Organizations*, 1st edition, the 1997 Supplement to the 1st edition, and Sanders, Michael I., *Joint Ventures Involving Tax-Exempt Organizations*, 2nd edition, John Wiley & Sons, Inc. (New York), section 2000.

[2]*See Plumstead Theatre Society v. Commissioner*, 675 F.2d 244 (9th Cir. 1982) *aff'g* 74 T.C. 1324 (1980); GCM 39,005.

[3]*See* PLR 9207033 (Nov. 20, 1991).

[4]74 T.C. 1324 (1980), *aff'd* 675 F.2d 244 (9th Cir. 1982).

[5]*See* GCM 36,293 (May 30, 1975).

2. By agreeing to serve as a general partner, the exempt organization was under a fiduciary duty to further the private financial interests of the limited partners; and

3. As a general partner the exempt organization incurred unlimited liability for the debts of the partnership, and thus exposed charitable assets for the purpose of relieving the private investors from liability. All of the above were deemed, by the IRS, as being incompatible with operating "exclusively" for charitable purposes.

B. *Plumstead Theatre Society* and the Two-Prong Test

The IRS's "per se" opposition to exempt organizations' involvement in joint ventures with for-profit investors was abandoned in 1982, with the issuance of the *Plumstead Theatre Society* decision. In *Plumstead*, a theater company, organized to promote and foster the performing arts, entered into a limited partnership with three for-profit investors to raise revenue needed to produce a stage play. The IRS denied tax-exempt status to Plumstead, on the grounds that it was not operated exclusively for charitable purposes.

The Tax Court, and later the Ninth Circuit Court of Appeals, however, disagreed, holding that Plumstead *was* operated exclusively for charitable (and educational) purposes, and therefore was entitled to exemption. The court based its holding on the safeguards contained in the limited partnership agreement, which served to insulate Plumstead from potential conflicts with its exempt purposes. These safeguards included the following:

1. The transaction was conducted at arm's length, and at a reasonable price;

2. The exempt organization had no obligation to return the limited partners' capital contributions;

3. The limited partners had little or no control over the affairs of the partnership;

4. There was no profit motive exhibited by the exempt organization;

5. None of the limited partners, or any officer or director of a limited partner, was an officer or director of the exempt organization.

The IRS now utilizes a two-prong "close scrutiny" test (based on *Plumstead, Housing Pioneers v. Commissioner,*[6] and GCM 39,005) to determine the permissibility of joint venture arrangements between exempt and for-profit entities. The two-prong test requires (i) that the activities of the partnership further charitable purposes; and (ii) that the structure of the partnership insulates 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.

1. First Prong: Charitable Purpose

a. Introduction

Where an exempt organization seeks to conduct activities through a partnership as general partner, or as a managing member in the case of an LLC, the IRS will scrutinize the arrangement to ensure that the joint venture is operating in furtherance of the exempt's charitable purposes. Generally, charitable purposes include activities that relieve the poor and distressed or underprivileged, advance religion, education or science, erect or maintain public buildings, monuments or works, and lessen the burdens of government.[7]

b. An Example of Operating for Charitable Purposes: Low-Income Housing

One of the most frequent endeavors for joint ventures involving exempt organizations is the ownership and operation of low-income housing. A low-income housing project operated pursuant to a government-sponsored program is likely to be approved by the IRS as in furtherance of charitable purposes.[8] An exempt organization's participation in a non-governmentally sponsored low-income housing project, however, will require a showing that its provision of housing is "charitable." In demonstrating that a particular project meets with charitable requirements (i.e., that it relieves the poor and distressed) an organization may rely upon certain safe harbor provisions established by the Service in Revenue Procedure 96-32, 1996-20 IRB 1.[9]

2. Second Prong: Structure of the Limited Partnership Insulates the Exempt Organization

Even if a charitable purpose or purposes are definitively established by the exempt organization participating in the joint venture, conflict between charitable goals and private interests may arise based on the state statutory obligations of the general partner to the limited partners, or through covenants or provisions contained within the operating agreement or other governing instrument. Among these obligations are an assumption of unlimited liability by the general partner

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[6]T.C. Memo 1993-120 (Mar. 29, 1993), 65 T.C.M. 2191, *aff'd* 49 F.3d 1395 (9th Cir. 1995), *amended* 58 F.3d 401 (9th Cir. 1995). The two standards were applied in *Housing Pioneers* to deny a housing organization's 501(c)(3) exemption. Through the organization's involvement as a co-general partner in limited partnerships, the partnerships took advantage of reduced property taxes and low-income housing tax credits. The Tax Court held that the organization furthered non-exempt purposes and served private interests.

[7]Reg. section 1.501(c)(3)-1(d)(i). Sanders, Michael I., *Joint Ventures Involving Tax-Exempt Organizations*, 2nd ed., John Wiley & Sons, Inc. (N.Y.) © 2000, Chap. 2.6, pages 51-61.

[8]*See* Rev. Rul. 70-585, 1970-2 C.B. 115.

[9]The safe harbor provisions are intended not only to encourage the leasing or rental of low-income units, but also to provide homeownership opportunities for low-income persons and families. Thus, they will apply to organizations which, while not directly providing low-income housing, facilitate the acquisition of such housing by low-income persons through rent subsidies, or allow for homeownership opportunities through mortgage assistance or guarantees.

for the partnership's debts, an obligation to further the profit interests of the other limited partners or members, and any obligations assumed under certain guarantee or capital call provisions drafted in favor of the private investors.

Essentially, the partnership or joint venture must be structured in such a way as to (i) protect the exempt organization's assets from exposure to unnecessary risk for the benefit of the for-profit partners; and (ii) minimize the potential for private inurement. In its analysis of whether an arrangement adequately shelters the assets of the exempt organization, and resolves, to the greatest degree possible, the statutory obligations of the general partners to the limited partners, certain factors will bear favorably upon the IRS's determination:

- Limited contractual liability of the exempt partner.
- Limited rate of return to the limited (for-profit) partners.
- Exempt organization's right of first refusal on the sale of the partnership assets.
- Lack of control over the partnership by limited partners (e.g., parties are "unrelated" and no limited partner serves as an officer or director of the exempt organization).
- The presence of additional general partners obligated to protect the interest of the limited partners.
- No obligation on the part of the exempt organization to return the limited partners' capital contribution from the exempt organization's funds.
- Profit is not a primary motivation.
- All transactions with the limited partners are made at arms length and are reasonable.
- There is a lack of "negative" or unfavorable factors and/or improper guarantees.

On the other hand, the presence of certain factors will bear unfavorably upon the IRS's determination:

- A disproportionate allocation of profits, losses, or tax items in favor of the limited partners.
- Commercially unreasonable loans by the exempt organization to the partnership.
- Inadequate compensation paid to the exempt organization for services rendered, or excessive compensation paid by the exempt organization for services received.
- Control of the exempt organization (or the activities of the partnership) by the limited (for-profit) partners.
- Abnormally low or insufficient capital contributions by the limited partners, or provisions requiring disproportional capital contributions by the exempt organization.
- A profit motivation by the exempt partner.
- Improper guarantees made by the exempt general partner, e.g., a guarantee of the limited partner's projected tax credits or return on investment to the detriment of the general partner, a guarantee to fund a loss reserve account from its own funds, an agreement to assume responsibility for any tax liability attributable to the limited partners arising from the sale of partnership property, or an agreement to indemnify the limited partners from liability for environmental contamination.
- A lack of positive or favorable factors.

III. Hot Issues Affecting 501(c)(3) Organizations & Joint Ventures

A. Rev. Rul. 98-15[10]

On March 4, 1998, the IRS released a long awaited revenue ruling on whole hospital joint ventures. Rev. Rul. 98-15 incorporates the two-part test from *Plumstead* and *Housing Pioneers* that a joint venture must further a charitable purpose and that the joint venture documents must allow the exempt organization to continue furthering its exempt purpose without benefiting the private parties more than incidentally.[11] Although Rev. Rul. 98-15 focuses on hospitals, it provides significant guidance for all joint ventures and partnerships involving charitable organizations. In fact, IRS spokespersons have indicated that they will apply this ruling outside the hospital joint venture context. As discussed more fully below, the IRS focuses on whether tax-exempt organizations "control" the ventures in which they participate. The IRS reasons that if tax-exempt organizations lack fundamental control, they may also lack the ability to cause the venture to carry out their exempt functions. [Rev. Rul. 98-15: *The Exempt Organization Tax Review*, April 1998, p. 142; *Doc 98-8159 (19 pages)*; *98 TNT 43-8*.]

This rationale has been applied by the IRS in two recent cases, *Redlands Surgical Services v. Commissioner*, and *United Cancer Council v. Commissioner*.[12] Consistent with the foregoing analyses, Rev. Rul. 98-15 confirms that an exempt organization should possess control over a venture to ensure that the arrangement does not jeopardize the charity's exempt status. In general, an organization can enter safely into a venture or management contract if it maintains final control over the assets it contributes and if the terms of the contract are reasonable.[13] The IRS therefore does not intend Rev. Rul. 98-15 to eliminate joint ventures between exempt organizations and for-profit entities.[14] Rather, the ruling simply incorporates existing principles that, in a joint venture, maximization of profits must not override charitable purposes and that the whole community should benefit from

[10]*See* Sanders, 2nd edition, Chapters 4 and 11.

[11]"IRS Exempt Organizations Continuing Professional Education Text for FY 1999: Chapter A, Whole Hospital Joint Ventures" (hereinafter, CPE Text), *98 TNT 156-15* (Aug. 13, 1998), paragraph 49.

[12]*United Cancer Council Inc. v. Commissioner*, 165 F.3d 1173 (7th Cir. 1999). *See* Section III B, below. *Also see* PLR 9736039 which involves a low-income housing partnership.

[13]*See* CPE Text, para. 49.

[14]*See id.* at para. 61.

the services provided by the joint venture.[15] The ruling illustrates the type of facts and circumstances that the IRS considers significant, by presenting two situations, one good and one bad. Key factors include *inter alia*, a long-term management contract; composition of the Board and its fiduciary duty, relative to charitable purpose; related officers including former employees of the for-profit in "day to day" management of the venture. Those situations are summarized below.

1. Example 1 (Good Example)

A section 501(c)(3) public charity (Charity 1), which operated a hospital, contributed the hospital and all of its operating assets to a limited liability company (LLC 1) in exchange for an interest therein. A for-profit corporation (For-Profit 1) that owned and operated several hospitals also contributed assets to the LLC in exchange for an interest therein. The interests in the LLC that Charity 1 and For-Profit 1 received were in proportion to their contributions.

The LLC's Articles of Organization and Operating Agreement (Governing Instruments) provided that its governing board was composed of five individuals, three of whom Charity 1 selected, and two of whom For-Profit 1 selected. Charity 1 intended to select community leaders with hospital experience, but who were not on the contributed hospital's staff and who did not otherwise engage in business transactions with the hospital.

The Governing Instruments could only be amended with both owners' approval. They also required a majority of three members to approve certain major decisions, including the following:

- LLC 1's annual capital and operating budgets;
- Distributions of LLC 1's earnings;
- Selection of key executives;
- Acquisition or disposition of health care facilities;
- Contracts that exceeded a fixed dollar amount per year;
- Changes to the types of services the hospital offered;
- Renewal or termination of management agreements.

The LLC's Governing Instruments required it to operate the hospital in a manner that furthered charitable purposes by promoting health for a broad section of its community. They specifically provided that the duty of its board to satisfy the community benefit standard overrode any fiduciary duty to operate LLC 1 for its owners' financial benefit. They also provided that all returns of capital and all distributions of income must be in proportion to the ownership interests in LLC.

The parties to the transaction also executed a Management Agreement (the Agreement) with a management company that was unrelated to either Charity 1 or For-Profit 1. The Agreement was for five years, and was renewable for additional five-year periods by mutual consent. It compensated the management company based on the LLC's gross revenues, was comparable to other similar arrangements, and could be terminated for cause.

None of the officers, directors, or key employees of Charity 1 who were involved in making the decision to form the LLC were promised employment or any other inducement by the LLC or the For-Profit and their related entities, or had any interest in the For-Profit or any of its related entities. Charity 1 intended to use any distributions that it would receive from the LLC to promote health in the community and to help indigents obtain health care. After forming LLC 1, Charity 1's grantmaking activities and its participation in the LLC constituted its sole activities.

2. Example 2 (Bad Example)

Example 2, like Example 1, involved a section 501(c)(3) exempt organization that operated a hospital (Charity 2), a for-profit corporation that owned and operated hospitals (For-Profit 2), and an LLC which they jointly formed (LLC 2). The facts of Example 2 were virtually identical to those of Example 1, with the following relevant differences:

- **Control**. In Example 2, the LLC's Governing Instruments provided that it was to be managed by a governing board consisting of three individuals chosen by Charity 2 and three individuals chosen by For-Profit 2. In contrast, in Example 1, the Charity clearly controlled the LLC.
- **Purpose and Board's Fiduciary Duty.** In Example 2, the LLC's Governing Instruments lacked a provision comparable to the one in LLC 1's Governing Instruments, which required the LLC to operate in a manner furthering charitable purposes by promoting health for a broad section of its community and explicitly provided that the duty of its board to satisfy the community benefit standard overrode any fiduciary duty to operate LLC 1 for its owners' financial benefit.
- **Management Contract.** The management company in Example 2 was a wholly owned subsidiary of the For-Profit, rather than an independent organization as in Example 1. Moreover, its contract was renewable in perpetuity at the management company's discretion, rather than being renewable by mutual consent. Finally, the Management Agreement was terminable *only* for cause.
- **Related Officers.** In Example 2, the parties agreed that the LLC's CEO and CFO would be two individuals who previously worked for the For-Profit in hospital management, and that they would work with the management company to oversee LLC 2's day-to-day operations. There were no such related key employees in Example 1.
- **Minimum Distributions.** LLC 2's Governing Instruments provided for a minimum level of required distributions, with majority approval of additional distributions required. In Example 1, the Board, which the

[15] *See id.*

tax-exempt organization controlled, was required to approve any distributions.

- **Large Contracts.** In Example 2, LLC 2's Governing Instruments required majority approval of "unusually large" contracts, rather than contracts over a specified dollar amount as in Example 1.

3. IRS Analysis

In Example 1, the Service ruled that Charity 1 would continue to qualify as a section 501(c)(3) tax-exempt organization because its participation in the LLC would further charitable purposes, and it would continue to be operated exclusively for such purposes. The Service stated that after the LLC's formation, Charity 1's activities would consist of the health care services it would provide through the LLC and any grantmaking activities it could conduct using income distributed by LLC 1.

The Service also noted that Charity 1 could ensure that the benefit to For-Profit 1 and other private parties, like the management company, would be incidental to the accomplishment of charitable purposes because LLC 1's Governing Instruments committed it to providing health care services for the benefit of the community as a whole and to giving charitable purposes priority over maximizing profits for its owners. It also noted that Charity 1 could minimize private benefit through (a) its appointment of members of the community familiar with the hospital to LLC 1's board, (b) the board's structure, which gave Charity 1's appointees voting control, and (c) the specifically enumerated powers of the board over changes in activities, disposition of assets, and renewal of the management agreement.

The Service also ruled that because Charity 1's grantmaking activity would be contingent upon its receiving distributions from LLC 1, its principal activity would continue to be the provision of hospital care. Therefore, as long as this remained true, Charity 1 would not be classified as a private foundation.

In Example 2, the Service ruled that Charity 2 would violate the requirements of section 501(c)(3) when it formed and contributed all of its assets to LLC 2 because unlike Charity 1, it would fail the operational test, pursuant to which it must be operated exclusively for charitable purposes. In support of its ruling, the Service stated that absent a binding obligation in the LLC's governing documents for LLC 2 to serve charitable purposes or otherwise provide its services to the community as a whole, the LLC would be able to deny care to segments of the community, such as the indigent. Moreover, it noted that because it would share control of the LLC with For-Profit 2, Charity 2 would be unable to initiate programs within LLC 2 to serve new health needs within the community without obtaining the agreement of at least one of the governing board members that For-Profit 2 appointed. In this regard, it noted that as a business enterprise, For-Profit 2 would not necessarily give priority to the community's health needs over the consequences for the LLC's profits.

The Service also supported its ruling by stating that the primary source of information for board members appointed by Charity 2 would be the chief executives, who had a prior relationship with For-Profit 2 and the management company, a subsidiary of For-Profit 2. Moreover, it noted, the management company itself would possess broad discretion over LLC 2's activities and assets that may not always be under the board's supervision. To illustrate this, the Service noted that the management company was permitted to enter into all but "unusually large" contracts without board approval, and that the management company could also unilaterally renew the management agreement.

4. Lessons for Joint Ventures Involving Tax-Exempt Organizations

First, as a preliminary note, Example 1 involved a number of facts and circumstances all of which were favorable and Example 2 involved facts and circumstances all of which were unfavorable. Some of the factors may not be comparable to those found in the real world. For example, the management contract in Example 2 allows the management company to continuously renew the contract into perpetuity, while in practice, such a provision may be rare.

> ***Despite its shortcomings, Rev. Rul. 98-15 provides significant guidance for all partnerships and joint ventures involving tax-exempt organizations.***

Second, because there were so many factors in both examples, it was difficult to analyze how far an arrangement may differ from the facts set forth in Example 1 without jeopardizing a charity's tax-exempt status. However, the IRS 2000 CPE text contains an article on health care joint ventures[16] in which it comments on the various criteria of Rev. Rul. 98-15. For example, the 2000 CPE joint venture article states that it is "important" that the terms of the governing documents in Example 1, which require the LLC to be operated for a charitable purpose, are "legal, binding and enforceable under applicable state law."[17]

Another outstanding issue relates to the fact that both of the situations described in the ruling involve whole-hospital joint ventures. As a result, some commentators believe that Rev. Rul. 98-15 should not apply to less than whole-hospital joint ventures. However, others assert that the IRS will apply its analysis to ancillary joint ventures as well.[18] This issue is discussed in Section 5 below.

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[16]M.J. Salins and M. Friedlander, "Update on Health Care Joint Venture Arrangements," 2000 CPE, Section ID (hereafter 2000 Joint Venture Article).

[17]*Id*.

[18]"Rev. Rul. 98-15 Confirms Traditional Tax Planning Approach for 'Typical' Joint Ventures," *98 TNT 102-42* (May 28, 1998) at paragraph 2 ("Nevertheless, nothing in the ruling limits its scope to whole-hospital

(Footnote 18 continued on next page.)

Despite its shortcomings, Rev. Rul. 98-15 provides significant guidance for all partnerships and joint ventures involving tax-exempt organizations.

First, Rev. Rul. 98-15 indicates that control by the exempt organization over the operational and organizational structure of a venture is crucial. To satisfy this requirement, the organizational documents for ventures involving tax-exempt organizations should contain legally enforceable provisions that vest the exempt organizations with control over the venture.[19] The IRS position on this issue should give exempt organizations significant leverage when negotiating joint venture structures with for-profit partners.

In commenting on Rev. Rul. 98-15, Marcus Owens, former director of the IRS's Exempt Organization Division, observed that the there is no bright-line rule (precluding the nonprofit veto) but that the requisite control will be determined based upon the overall facts and circumstances:[20] "[Practitioners should] not assume that the IRS will limit itself to reviewing [joint venture] relationships to the discrete factors mentioned in the ruling. The IRS's message is that it will look beyond the window dressing, beyond the labels, to see what is happening with assets, with the flow of money. The IRS will look to control and the various ways that can be defined."[21]

Historically, after a 50/50 joint venture was formed, the exempt organization board members generally possessed only veto authority over major operational decisions, and had little or no ability to influence staff working conditions, compensation or status.[22] While the exempt organization representatives in a 50/50 joint venture could block (at least temporarily) actions proposed by the for-profit, they are essentially powerless to force the joint venture to take affirmative actions that they consider essential to meet charitable purposes.[23] For example, the exempt organization may be able to block the appointment of a joint venture CEO that it believes may be insensitive to charitable goals, but cannot compel the appointment of a CEO it affirmatively supports.[24]

In Situation 2 of Rev. Rul. 98-15, it is apparent that the IRS also believes that the power to block an action is, in itself, insufficient to demonstrate and promote the exempt purpose.[25] The 2000 CPE joint venture article also emphasizes that "effective control" by the nonprofit partner of the entire decision making process is essential. When answering the question of whether Example 2 could be reformed so that the LLC would not jeopardize the nonprofit partner's exemption, the IRS states that changing one factor alone, such as requiring the LLC to act for the benefit of the community, or to require a set term for renewal of the management contract, would not necessarily be sufficient. Thus, use of a veto as a viable device for preserving exempt organization control in the 50/50 joint venture is suspect, even when coupled with other safeguards.

Management agreements must also be carefully drafted to comply with Rev. Rul. 98-15. The IRS clearly views an independent management company (not affiliated with the for-profit partner) as a positive factor, with terms in the management agreement that allow the exempt organization a "way out." In other words, an agreement that unilaterally permits a management company to renew the agreement is unacceptable, as in Situation 2. The 2000 CPE joint venture article comments that the management agreement in Example 2 is "essentially a perpetual contract" because it was renewable at the sole option of the management company which is run by former employees of the for-profit partner.[26]

Third, exempt organizations must be extremely careful about allowing employees or former employees of for-profit partners to serve in key positions in the partnership. The IRS appears to be primarily concerned that such persons would limit or "package" information flowing to exempt organization partners so that such partners would, as a practical matter, be deprived of some of their control, due to the limited information flow. In the 2000 CPE joint venture article, the IRS explains that even though these officers' compensation is reasonable, the fact that they were employed by the for-profit creates the appearance of a conflict of interest.

Finally, the ruling indicates that other provisions in the partnership agreement that, as a practical matter, limit the exempt organization's control, also will be carefully scrutinized. To illustrate, the Service implied that the provision in Example 2 allowing the management company to enter all but unusually large contracts, combined with the limited flow of information likely to result from employing former employees of the for-profit entity, meant that the exempt organization could not effectively establish that the activities of the venture would further exempt purposes.

In sum, exempt organizations participating in joint ventures with for-profit entities and/or private investors should carefully structure provisions in the agreements to satisfy themselves that they are *not* deprived of control over the operations

(Footnote 18 continued.)

joint ventures, and the Service can be expected to apply the analysis in the ruling to all joint ventures.") (*citing* Kristen Hallam, "IRS May Broaden Ruling," *Modern Healthcare* (March 30, 1998) at 28.). These commentators point out that the factors described in Rev. Rul. 98-15 are entirely consistent with the "close scrutiny" test that came out of *Plumstead*, *Housing Pioneers*, and GCM 39,005, which applies to all joint ventures between exempt organizations and for-profit entities. *See id.* at para. 13.

[19]The law in some states may preclude such a requirement, in which case the partnership or LLC would need to be organized in a different state.

[20]*See* Carolyn D. Wright, "Owens Discusses Newly Released Joint Venture Rev. Rul.," *Tax Notes Today*, Mar. 9, 1998, *98 TNT 45-2*.

[21]*Id*.

[22]R. Boisture & A. Lauber, Jr., "Caplin & Drysdale Comments on Whole Hospital Joint Ventures," *The Exempt Organization Tax Review*, April 1997, p. 650, 655.

[23]*Id*.

[24]*Id*.

[25]*See* Rev. Rul. 98-15 (Situation 2).

[26]The 2000 CPE article does state, however, that Example 1 implies that a management agreement with a nonprofit affiliate of the exempt hospital would be acceptable.

of the partnership, or limited in their ability to ensure that the venture will be operated for charitable purposes.

5. Application of Rev. Rul. 98-15 to Ancillary Joint Ventures

Rev. Rul. 98-15 addresses the tax treatment of nonprofit hospitals involved in whole hospital joint ventures with for-profit entities.[27] The impact of Rev. Rul. 98-15 on ancillary service joint ventures is uncertain. The ruling does not state that it is intended to apply to any venture other than a whole hospital joint venture. However, at least one former IRS representative has informally stated that the analysis in Rev. Rul. 98-15 is not limited to whole hospital joint ventures.[28] Several related private letter rulings also indicate that the IRS will apply the same analysis to ancillary ventures.

The most obvious distinction between whole hospital joint ventures and ancillary service joint ventures is that, in the former, no exempt hospital remains that can independently satisfy the community benefit standard set forth in *Plumstead*. By contrast, with ancillary service joint ventures, the profit conflict standard is far less likely to be implicated because, for example, the hospital would likely continue to meet the community benefit standard through one or more of its retained functions or departments, e.g., an emergency room which is open to the public.

Since the publication of Rev. Rul. 98-15, commentators have questioned whether ancillary joint ventures, in which substantially less than all of a hospital's assets are transferred, are covered by the whole hospital ruling. The 1999 CPE Hospital Joint Venture Article attempts to avoid the issue by commenting that the "scope of this article is limited to a discussion of whole hospital joint ventures and the application of Rev. Rul. 98-15 to such transactions, and does not attempt to analyze the hospital ancillary joint venture."[29] The 2000 CPE text raises the issue by discussing a private letter ruling involving two exempt organizations which form an ancillary joint venture to build a new hospital and ambulatory surgery center to serve the poor in their community.[30]

In the private letter ruling, one partner was the exempt parent of an exempt hospital system which was comprised of two nonprofit hospitals as well as several other nonprofit and for-profit, taxable subsidiaries. That partner contributed the assets of the exempt subsidiaries and the stock of its for-profit subsidiaries, while the other partner contributed cash. The private letter ruling distinguishes this situation from Rev. Rul. 98-15 on grounds that both members of this LLC were nonprofits and therefore nonprofits were exclusively in control of the venture which only served charitable purposes.[31]

The IRS issued two private letter rulings on January 12, 2001 concerning an LLC formed to oversee and operate rehabilitation services. The letter rulings discuss and rely on Rev. Rul. 98-15 and conclude that the two section 501(c)(3) organizations may form and participate in a partnership (including an LLC) if the partnership furthers a charitable purpose and permits the exempt organizations to act exclusively in furtherance of its exempt purpose. The situation differs from that considered in Rev. Rul. 98-15 in that both members of the LLC are nonprofit organizations and because they are contributing only part of their assets to the new LLC. After the formation of the LLC, the two medical organizations will continue to operate hospitals and provide care consistent with the community benefit factors. Participation will not generate unrelated business income because the new organization furthers their exempt purposes by enabling them to expand and improve health care services.

A private letter ruling issued in October 2000 (PLR 200041038) condoned the participation of a conservation organization in an LLC that could be regarded as an ancillary joint venture although it did not mention Rev. Rul. 98-15. The Service ruled that the management role of the organization in the timber management and selling venture would not impair its section 501(c)(3) status because the venture furthered its conservation purposes by managing the timber rights of a number of small holders on a more ecologically sensitive and sustainable basis than the individual owners had done. The operating agreement explicitly provided that in event of a conflict between the purpose of conserving forestland and managing the lands to provide economic benefits to the members, conservation will control. The exempt organization can only be replaced as manager by extraordinary measures (a two-thirds vote of the members after failure to provide for the annual minimum return to the participants for two consecutive years) and then must be replaced by another exempt organization. [PLR 200041038: *The Exempt Organization Tax Review*, November 2000, p. 161; *Doc 2000-26398 (8 original pages)*; *2000 TNT 201-22*.]

Thus, the IRS has applied the reasoning of Rev. Rul. 98-15 to ancillary joint ventures, i.e., does the nonprofit have control of the venture and does the venture have a primary charitable purpose?

Until there is further clarification of the effect of Rev. Rul. 98-15 on ancillary joint ventures, the following may be prudent steps for nonprofit entities participating in such ventures:[32]

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[27]Rev. Rul. 98-15, 1998-12 IRB (Mar. 23, 1998), reprinted in *The Exempt Organization Tax Review*, April 1998, p.142.

[28]Comments by Catherine E. Livingston, Former Associate Tax Counsel, U.S. Treasury Department, reported in the *98 TNT 49-6* (1998). *Also see* Sanders, 2nd edition, Section 4.2(e)(i), p. 135.

[29]CPE Text, *supra*.

[30]PLR 199913035 (Dec. 22, 1998).

[31]The ruling also stated that to the extent the for-profit subsidiaries engaged in an unrelated trade or business, that business would be insignificant compared to the exempt activities of the LLC's exempt partners and the exempt subsidiaries. Accordingly, the partner's participation in the LLC would not generate unrelated business taxable income for the partners.

[32]For a more complete discussion of the factors, *see* E. Buchholz, "The IRS's Whole Hospital Joint Venture Ruling: Guidance or Confusion?" *Taxes*, June 1998, p. 20.

- Enter into ancillary ventures that clearly further the organization's exempt purposes.
- Have the exempt organization make a capital contribution proportionate and equal to its percentage interest in the ancillary venture;
- Cash contributions may be less risky than asset contributions;
- The exempt organization should have more than minimal equity ownership even if it otherwise controls the ancillary venture;
- Add an express requirement to the operative documents of the ancillary venture that in case of any conflict between the exempt organization's obligation to satisfy the charitable purpose and furtherance of profit making goals that the former will prevail.[33]
- Limit the exempt organization's obligation to fund future capital contributions to the ancillary venture, and strive to minimize its exposure to liability as a general partner.

It has also been suggested that Rev. Rul. 98-15 raises the issue, albeit implicitly, of whether income received through a joint venture is UBIT if the venture is not consistent with the nonprofit's exempt purposes.[34] The criteria could be particularly relevant in the ancillary joint venture area (where only a portion of a nonprofit's assets are contributed to a joint venture).[35]

B. *Redlands Surgical Services Inc. v. Commissioner*[36]

1. Facts

In a significant case in the health care area, the Ninth Circuit Court of Appeals recently affirmed the Tax Court opinion upholding the denial of IRC section 501 (c)(3) status to Redlands Surgical Services Inc. (Redlands).[37] Redlands, a California nonprofit public benefit corporation, was a wholly owned subsidiary of Redlands Health Systems Inc. (RHS), a charitable organization under section 501(c)(3). RHS was the parent corporation of three other subsidiaries, two of which were also exempt under section 501(c)(3). One of the two exempt subsidiaries was Redlands Community Hospital (Redlands Hospital), a hospital within the meaning of section 170(b)(1)(A)(iii), which provided medical care free of charge or at a discount, and which maintained its own surgery program and emergency room.

In March 1990, RHS became a co-general partner with Redlands-SCA Surgery Centers, Inc. (SCA Centers), a for-profit corporation, in a general partnership formed to acquire a 61 percent interest in an existing outpatient surgical center in Redlands, California. RHS contributed cash and SCA Centers contributed cash and stock to the general partnership. In return for its 37-percent investment, RHS received a 46-percent interest in profits, losses, and cash-flow of the general partnership.

The general partnership agreement provided that the management and determination of all questions relating to the affairs and policies of the partnership were to be decided by a majority vote of the managing directors. The managing directors consisted of four persons — two of whom were appointed by RHS and two of whom were appointed by SCA Centers. In the event the managing directors were unable to agree, either RHS or SCA Centers could submit the matter to arbitration.

The decision of a majority of the arbitrators was to be final and binding.

The general partnership became the sole general partner in Inland Surgery Center Limited Partnership (the Operating Partnership), a California limited partnership that owned and operated a freestanding ambulatory surgery center (the Surgery Center) within two blocks of Redlands Hospital. Prior to the Operating Partnership's affiliation with the general partnership, the Operating Partnership had been a for-profit venture which served only surgical patients who could pay for its services. The partnership agreement of the Operating Partnership did not contain a statement of charitable purpose or a requirement that it operate for a charitable purpose before its affiliation with RHS and it was not amended to include such a provision after its affiliation with RHS. The Surgery Center offered no free care to indigents and it had no emergency room or certification to treat the emergency patient population.

The Operating Partnership entered into a contract with SCA Management Co. (SCA Management), a for-profit subsidiary of SCA, whereby SCA Management would provide management and administrative services for the Surgery Center. With the exception of decisions relating to the care and treatment of patients or other medical policy matters, SCA Management had wide-ranging authority for the management of the Surgery Center.

In return for its services, SCA Management was to receive a monthly management fee of 6 percent of gross revenue from the operation of the Surgery Center. The management

[33] *See* Gregory A. Petroff, "Whole Hospital Joint Ventures: The IRS Position on Control," *The Exempt Organization Tax Review*, July 1998, p. 30, discussing the resolution of disputes through arbitration. However, while such a provision may in theory work, the for-profit member may object because of its vagueness and may insist on the right to either (i) dissolve the venture or (ii) have its interest purchased or exercise a purchase option if resolution of the perceived conflict becomes too onerous to the for-profit member.

[34] T.J. Sullivan, "Unrelated Business Income: Recent Developments, Planning Strategies for Multi-Corporate Entities, and Selected Health Care Issues," *The Exempt Organization Tax Review*, December 1998, p. 447.

[35] The ruling also stated that to the extent the for-profit subsidiaries engaged in an unrelated trade or business, that business would be insignificant compared to the exempt activities of the LLC's exempt partners and the exempt subsidiaries. Accordingly, the partner's participation in the LLC would not generate unrelated business taxable income for the partners.

[36] This discussion is updated and excerpted from Sanders, 2d Edition, Chapter 11.

[37] *Redlands Surgical Services Inc. v. Commissioner*, 113 T.C. 47 (1999), *aff'd* 2001 U.S. App. Lexis 3937 (9th Cir. March 15, 2001).

agreement had a term of 15 years, renewable unilaterally by SCA Management for two five-year extensions. With the exception of bankruptcy or insolvency, the management contract was terminable by the Operating Partnership *only* if SCA Management breached the agreement, and then only after a 90-day notice and a 90-day cure period.

In April 1990, SCA Management entered into a quality assurance agreement with RHS whereby RHS agreed to perform managerial and supervisory quality assurance duties in connection with the operation of the Surgery Center. RHS was to receive a monthly fee after the first year, and it was to be reimbursed for its direct out-of-pocket expenses.

Five months after entering into the general partnership agreement with SCA Centers, RHS incorporated RSS as a California nonprofit public benefit corporation, and transferred its interest in the General Partnership to RSS. RHS also transferred its obligations and rights under the quality assurance agreement to RSS. RSS's sole activity (and its sole source of revenue) was to be its participation in the Operating Partnership.

The IRS argued that RSS was not operated exclusively for charitable purposes because it operated for the benefit of private parties and failed to benefit a broad cross-section of the community. In support of its position, the IRS stated that the partnership agreements and related management contract were structured to give for-profit parties control over the Surgery Center. Moreover, the Surgery Center had never operated with a charitable purpose.

RSS, on the other hand, argued that it met the operational test of section 501(c)(3) because its activities with respect to the Surgery Center further its purpose of promoting health for the benefit of the RSS community, by providing access to an ambulatory surgery center for all members of the community based upon medical need rather than ability to pay, and by integrating the outpatient services of Redlands Hospital and the Surgery Center. RSS further argued that it engaged in arm's-length transactions with the for-profit partners, and that its influence over the activities of the Surgery Center has been sufficient to further its charitable goals. RSS also argued that it performed services that were "integral" to the exempt purposes of RHS, its tax-exempt parent, and Redlands Hospital.

2. The Tax Court Decision

By applying a facts and circumstances analysis, the Tax Court upheld the IRS's denial of RSS's tax-exempt status. The court concluded that RSS had effectively ceded control over the operations of the partnerships and the Surgery Center to private parties, thus conferring impermissible private benefit upon them. In this regard, the court noted that the promotion of health for the benefit of the community is a charitable purpose. However, the community benefit standard also requires that the charity serve a sufficiently large and indefinite class and that private interests not benefit to any substantial degree.

In arriving at its decision that private, rather than charitable, interests were being served, the court examined various factors, similar to the factors the IRS enunciated in Rev. Rul. 98-15 (although it did not reference Rev. Rul. 98-15 and the court did look at more factors than those enunciated in Rev. Rul. 98-15). The court noted, most significantly, that there was a lack of any express or implied obligation of the for-profit parties to place charitable objectives ahead of for-profit objectives. Moreover, after the general partnership acquired an interest in the Operating Partnership, the Operating Partnership failed to amend its organizing documents to include an overriding charitable purpose.[38] In fact, the Operating Partnership explicitly acknowledged the partnership's *non-charitable* objectives, authorizing the General Partnership, for example, to amend the Operating Partnership, but only if the amendments did not alter the economic objectives of the partnership or materially reduce the economic return of the partners.

The court emphasized (as did the IRS in Rev. Rul. 98-15) the relevance of control by the tax-exempt entity. Although RSS had successfully blocked various proposals with respect to expanding the scope of activities performed at the Surgery Center, the court concluded that such veto rights did not establish that RSS had effective control over the manner in which the Surgery Center performed its operations.[39]

Similarly, the court seemed particularly concerned that the general partnership agreement restricted RHS's (RSS's parent corporation) ability to provide outpatient services at Redlands Hospital or elsewhere without the approval of its for-profit partner. As a result, from 1990 to 1995, there was actually a decrease in outpatient surgeries performed at Redlands Hospital and an increase at the Surgery Center. Again, the court did not believe that such a restriction in services served a charitable purpose.

Furthermore, there was no indication that RSS possessed significant "informal" control with respect to influencing the Surgery Center's activities. For example, there was no evidence of Redlands' role in effecting a change in the criteria for procedures performed at the Surgery Center, there was no increase in charity care, and only negligible coverage for Medi-Cal patients due to RSS's involvement in the Operating Partnership.

Finally, the court concluded that the management contract between the Operating Partnership and SCA Management conferred too much management authority to the for-profit

[38]Douglas Mancino, an attorney for Redlands, disputed the court's reliance on this point noting that in an earlier ruling, the IRS had said that the past activities of a hospital which had been sold by a for-profit entity to a nonprofit had no effect on whether the acquiring nonprofit could obtain exemption. Carolyn D. Wright, "IRS Wins First Round in *Redlands*: Exemption Properly Denied," *The Exempt Organization Tax Review*, August 1999, p. 189.

[39]Douglas Mancino also disputes the Tax Court's reliance on a covenant not to compete contained in the general partnership agreement. *Id*. Under the covenant, RHS had agreed not to re-assess and service community needs until the year 2020. The Tax Court stated that it was hard to understand how this type of restriction could further charitable purposes. Mancino commented that such a clause was typical in the health care field. *Id*.

manager. Moreover, SCA Management's fee of 6 percent of the gross revenues, provided it with an incentive to manage the Surgery Center to maximize profits, while none of the operational documents required SCA Management to conduct its activities with the goal of satisfying a community benefit. In addition, the Operating Partnership was virtually "locked into" the management contract which was renewable after 15 years at SCA Management's sole discretion.

Based on the totality of these factors, the Tax Court concluded that RSS impermissibly served private interests. Although the court did not specifically refer to Rev. Rul. 98-15, *Redlands* buttresses the IRS's authority to enforce Rev. Rul. 98-15 with respect to whole hospital joint ventures and other types of joint ventures involving exempt organizations. Again, the analysis will be based on the totality of all relevant factors, including, but not limited to, the exempt organization's formal and informal control of the day-to-day activities of the venture, as well as a binding commitment of the parties in the operative documents that charitable purposes, as opposed to for-profit purposes, must prevail. Factors that will *mitigate* against charitability are long-term management agreements with a for-profit entity which has the unilateral right to renew the contract, arbitration provisions that do not take into account charitability, and the lack of any evidence of actual charitable operations.

3. Appeals Court Decision

Just 10 days after oral arguments, the Ninth Circuit issued a *per curiam* opinion.[40] The single paragraph "adopted" the Tax Court holding that Redlands had "ceded effective control over the operations of the partnerships and the surgery center to private parties, conferring impermissible private benefit." Because private parties were obtaining substantial benefit, the Surgery Center was not being operated exclusively for exempt purposes. The Ninth Circuit also affirmed the tax court view that private benefit prevented Redlands from claiming exempt status under the integral part doctrine.

The court of appeals had little choice but to affirm the decisions of the Tax Court and the IRS. The Redlands venture incorporated none of the positive factors and many of the negative factors that the Service has discussed in Rev. Rul. 98-15 and elsewhere:

- No charitable purpose in partnership documents (in fact, *profit* motive protected by partnership documents);
- Charity does not have control of the board (equal representation on board);
- No charitable override for deadlocked board or arbitration decisions;
- Management company is a subsidiary of the for-profit partner;
- Long management contract (15) renewable in sole discretion of management company;
- Surgery center did not perform any free medical care even after it formed the venture;
- An agreement restricted the ability of charitable hospital to expand its own ambulatory surgery center; and
- Rate of return on the venture was in excess of 43 percent.

The terse opinion by the Ninth Circuit in *Redlands* disappointed many practitioners who had hoped for a more expansive discussion that would have provided guidance on a broader range of situations. Experienced lawyers believe that Rev. Rul. 98-15 is based on extreme examples that ignore the gray middle area which describes most real life ventures. A for-profit partner is usually reluctant to grant control over a venture to the nonprofit. The exempt partner may be more concerned with attracting the financial support of the for-profit than the details of control.

> ***The terse opinion by the Ninth Circuit in Redlands disappointed many practitioners who had hoped for a more expansive discussion that would have provided guidance on a broader range of situations.***

The IRS is aware of the need for additional guidance, and even before the Ninth Circuit issued its opinion, had tried to provide it through audits and letter rulings. However, it is a difficult subject to address through advance private letter rulings, because the agency policy requires scrutiny of operations as well as organizational structure. The venture must first operate for a period of time, in order for the IRS to be able to rule on both the organizational and the operational aspects of the venture. Only hindsight allows the IRS to rule on a joint venture.[41]

A recently filed case in Texas, *St. David's Health Care System Inc. v. United States*[42] may eventually provide additional guidance for whole hospital joint ventures. A charitable hospital in central Texas entered a partnership with an affiliate of HCA. During an audit two years later, the IRS informed St. David's that it planned to revoke its tax-exempt status because of the partnership. An October 2000 technical advice memorandum (which has not been made public) supported the revocation recommendation. St. David's paid the required back taxes and penalties. The suit seeks a refund and requests a court determination that it is a public charity. The case would have implications for the many similar joint ventures that HCA has entered with other nonprofit hospitals.

[40] *Redlands Surgical Services v. Commissioner of Internal Revenue*, No. 99-71253 (9th Cir. Mar. 15, 2001).

[41] Presentation of Elizabeth Purcell, *Corporate Philanthropic Leadership Summit*, Mar. 17, 2001.

[42] *St. David's Health Care System Inc. v. United States*, W.D. Tex., No. A01CA046, filed Jan. 12, 2001.

4. Commentary — Use of a Subsidiary

It should be noted that RSS's sole activity was participation in the joint venture. If RSS's parent corporation, RHS, had entered into the joint venture instead, there may have been a different outcome because RHS also operated a hospital *inter alia*. In such a case, where a nonprofit conducts extensive charitable activities and devotes some if its assets to a joint venture (a so-called ancillary joint venture) with a for-profit entity, the IRS would likely apply a similar analysis to determine if the venture itself were operated for charitable purposes. If the nonprofit did not have sufficient control of the venture, for reasons such as in *Redlands*, but did conduct independent charitable activities, the nonprofit's tax-exempt status may not be jeopardized if the joint venture did not constitute a major part of its activities. In such a case, the income received by the nonprofit from the venture may be taxable as unrelated business income (UBI).

It is interesting to note, however, that while it is often recommended that a nonprofit create a subsidiary to conduct activities that could be subject to challenge either because it could generate UBIT or threaten the tax-exemption of the parent, it may not always be advisable to do so to participate in a venture. For example, as discussed above, if in *Redlands*, the parent had continued to operate a charitable hospital and had itself participated in the joint venture instead of creating a subsidiary, it may have been found to have received UBIT from the venture but not lose its tax-exempt status. On the other hand, it is sometimes advisable to create a subsidiary in order to limit liability, in which case the parent must observe the required formalities and operational proscriptions However, as *Redlands* demonstrates, creation of a subsidiary will not always be the best route to follow.

At the present time until the IRS provides additional guidance, the following criteria should be applied:

1. The established charity should be the party to the transaction rather than a newly formed subsidiary (single purpose entity) which needs to apply for exemption in its own right. As an alernative a "disregarded" single member LLC should be considered. See IIIC infra.

2. The LLC agreement should explicitly commit the venture to provide health care for the benefit of the community as a whole and give charitable purposes priority over maximizing profits.

3. The activities of the joint venture should be consistent with the charitable purpose of the nonprofit partner.

4. Because requisite control will be determined based upon an overall facts and circumstances, the structure needs to take into consideration as many factors as possible, even if the arrangement is a 50/50 joint venture. For example, the joint venture arrangement could provide the charity certain veto rights or a super-majority vote which would allow the charity to approve the venture's annual capital and/or operating budgets; to amend the venture's governing documents; to approve distribution of earnings and available cash; to approve additional capital contribution calls (protect the exempt organization by assigning it either a pro rata amount or increasing their ownership at the same time); to approve the assumption of additional indebtedness; to approve the venture's acquisition or disposition of the facilities; to approve unusually large contracts involving equipment and other goods and services; to hire key executives (and set their compensation); to insure adequate reserves, etc.

5. The identity of the management company and the details of its contract are of particular importance to the IRS because they demonstrate who controls the day-to-day management of the venture. The management company should be run by unrelated parties if possible, rather than controlled by the for-profit partner. The contract should be for a short term (no more than five years), with Board authority to terminate for cause.

6. It is also important that the composition of the board, committees, and quorum requirements should allow the representatives of the charity to manage the venture. The exempt partner's board members should remain involved and document their participation in written "detailed" minutes of the meetings.

7. The agreement should establish ground rules for arbitration containing a presumption in favor of the tax-exempt that could be overcome only if the for-profit meets a pre-set burden of proof (e.g., preponderance of the evidence or that the charity's position is arbitrary, capricious or unreasonable). For example, if the for- profit partner of a 50/50 shared venture wants to terminate free emergency room service and the tax-exempt vetoes the decision, an arbitrator would have to recognize a presumption in favor of the tax-exempt partner. The for-profit would have the burden of showing the charitable purpose would not be jeopardized or that the charity's position is arbitrary and without merit.

8. Another option would be to create a taxable subsidiary through which the charity would participate in the venture. The new subsidiary must be truly independent.

9. Build-in a right to unwind in the event that the transaction ultimately fails to meet the *Plumstead* dual-prong test.

PRACTICE TIP: The IRS will often apply a more lenient standard on audit than under a request for a private letter ruling because it can examine actual operations as well as the organizational documents. Therefore, it is generally advantageous to use a structure that does not require an advance ruling by the IRS.

C. Limited Liability Companies

Limited liability companies are new legal structures that combine the limited liability of corporations with the federal tax advantages of partnerships. Like a corporation, an LLC shields its owners from personal responsibility for the contractual and tort obligations of the entity. Partnerships do not provide such a shield; even a limited partnership is required to have at least one "general partner" who has unlimited personal liability for the partnership's debts. Further, in order to maintain the limit on their liability, the limited partners must be passive, they cannot take active roles in management of the partnership's affairs. This is not the case in an LLC. All of the members may participate in management without jeopardizing their limited liability. However, like a partnership, an LLC is not subject to taxation at the LLC level. Profits and losses are passed through to the members so that they are taxed only once. The LLC is quickly becoming the entity of choice for joint ventures involving nonprofits in the health care field and others.

The Service is willing to treat both single owner and multiple owner LLCs as exempt organizations under certain circumstances. The IRS recently announced that if an exempt organization is the sole owner of an LLC, the LLC can be treated as a part of the exempt organization for federal tax purposes. (Announcement 99-102, 1999-43 IRB 545.) Such an entity is "disregarded" and would not have to independently satisfy the requirements of section 501(c)(3). However, the owner must treat the operations and finances of the LLC as its own for tax and information reporting purposes, which could generate UBIT.

LLCs with multiple exempt owners may now *separately* qualify for exemption under section 501(c)(3). (So long as the entity is claiming exemption, the IRS will treat it as an association, consistent with its long-standing position that a partnership cannot qualify for exemption.) The IRS has provided informal guidance on the conditions under which multiple owner LLCs may qualify for exemption: where such status is permitted under state law and where the LLCs articles of organization and operating agreements comply with 11 other conditions designed to ensure that the organization is both organized and operated exclusively for exempt purposes. (CPE for Exempt Organizations Technical Instruction Program FY2001, McCray and Thomas.) The conditions include requirements that the organizational language:

- Specifies that the LLC will be operated exclusively to further charitable purposes of its members.
- Requires all members to be section 501(c)(3) organizations or governmental units or instrumentalities.
- Prohibits direct or indirect transfer of membership interest to an entity other than section 501(c)(3) or governmental unit.
- Requires that interests in and assets of the LLC may only be transferred to individuals and noncharitable organizations for fair market value.
- Prohibits the LLC from merging with or converting into a for-profit entity.
- Contains an acceptable contingency plan in the event one or more members ceases to be section 501(c)(3) organizations.

Use of a Subsidiary to Protect the Exempt Parent

If the nature of the activity is such that direct participation by the charitable organization might jeopardize its exempt status, it may be possible to restructure the transaction by participating through a for-profit taxable subsidiary or affiliate.[43] However, for such an alternative structure to succeed, it is preferable for the affiliate's participation to be funded through a source other than the charitable organization, because the IRS may analyze such transactions as if the organization itself were participating directly in the venture to the extent of any funding traceable to it.[44] Even with separate funding, the taxable affiliate must be a bona fide entity separate from the exempt organization.[45] Furthermore, the subsidiary must not be a mere arm of the exempt parent.[46] The subsidiary's independent status is established by:

1. Refraining from active involvement of the exempt parent in the day-to-day business affairs of the taxable affiliate;[47]

2. By forming the affiliate for a real business purpose and not as a mere instrumentality of the parent;[48]

3. By ensuring that the terms of all transactions between the taxable affiliate and the exempt organization are at arm's length;[49]

4. By allocating the cost of any shared assets, services, or facilities according to use; and[50]

5. By maintaining separate minutes and other formal documentation for the affiliate.[51]

In a recent private letter ruling widely known to have been issued to the American Association of Retired Persons (AARP),[52] the IRS set forth a blueprint for the creation of a taxable subsidiary by a nonprofit. By creating a subsidiary, AARP was able to obtain tax-free treatment for royalties and other revenues from the licensing of intangible property rights.

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[43] GCM 39,866 (Dec. 16, 1991); GCM 39,598 (Jan. 23, 1987). *See also* PLR 9308047 (Dec. 4, 1992); PLR 9305026 (Nov. 12, 1992); PLR 9303030 (Oct. 29, 1992).

[44] *See* GCM 39,646 (June 30, 1987); GCM 39,598 (Jan. 23, 1987). *See also* PLR 9303030 (Oct. 19, 1992); PLR 8621059 (Feb. 25, 1986); PLR 8604006 (Aug. 30, 1985). The IRS has held

> that attribution of the activities of a subsidiary to the parent should arise only where the evidence clearly shows that the subsidiary is merely a guise . . . or where it can be proven that the subsidiary is an arm, agent, or integral part of the parent.

GCM 33,912 (Aug. 15, 1968), quoted in GCM 39,598 (Jan. 23, 1987).

[45] *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943); *Britt v. United States*, 431 F.2d 227, 234 (5th Cir. 1970); GCM 39,326 (Jan. 17, 1985).

[465] *Krivo Ind. Supply Co. v. Nat'l Distillers and Chemical Corp.*, 438 F.2d 1098, 1101 (5th Cir. 1973); GCM 39,776 (Feb. 6, 1989); GCM 39,598 (Jan. 23, 1987); GCM 33,912 (Aug. 15, 1968).

[47] GCM 39,326 (Jan. 17, 1985).

[48] GCM 39,598 (Jan. 23, 1987).

[49] GCM 39,776 (Feb. 6, 1989); GCM 39,326 (Jan. 17, 1985); GCM 39,598 (Jan. 23, 1987); PLR 9308047 (Dec. 4, 1992).

[50] GCM 39,598 (Jan. 23,1987).

[51] GCM 39,325 (July 31, 1984); PLR 9305026 (Nov. 12, 1992), PLR 8810082 (Dec. 17, 1987); PLR 8805059 (Nov. 13, 1987).

[52] PLR 199938041 (June 28,1999).

The AARP receives over $150 million per year from the licensing of its name, logos, and endorsements to commercial insurance and other companies. In 1993, the IRS ruled that these license fees were not tax-free royalties because they were not "passive," but "tainted" by marketing services provided by AARP to the licensees. The ruling establishes guidelines for ensuring that the exempt organization's licensing of intangibles is treated as completely passive by the IRS so that payments for such intangibles are tax-free "royalties" under IRC section 512(b)(1). All of the activities that are deemed "services" are placed in the subsidiary that can deduct its expenses against its income, thereby creating a tax-free situation.

The key to the IRS's approval is maintaining the *formal* independence of the subsidiary as outlined above. In the AARP ruling, the IRS lists 25 requirements for establishing independence, but most are typical of those outlined above for any corporation — e.g., separate boards of directors, separate board meetings, and minutes. The key elements of separation in the AARP ruling were:

- A majority of the subsidiary's board of directors or the executive committee cannot be current officers or directors of the exempt parent, but the parent's executive director (or CEO) can serve on the subsidiary's board and its Executive Committee.
- The CEO of the exempt parent cannot also serve as the CEO of the subsidiary and most of the subsidiary's employees must not be shared with the parent (some employees of the subsidiary may be shared with the parent). However, the exempt parent's board, through its CEO, can have the authority to fire any other directors or officers of the subsidiary.
- The exempt parent may provide space and administrative services to the subsidiary, paid for by the subsidiary at the parent's cost.
- The parent may furnish all of the subsidiary's capital as equity contributions so that the subsidiary need not pay interest on the contributions.
- The exempt parent may furnish intellectual property (i.e., mailing lists, know-how, etc.) to the subsidiary as a capital contribution.

As a practical matter, the exempt organization, through its CEO, has absolute policy control of the subsidiary although the formalities of the subsidiary's day-to-day control, through its separate directors and officers, will have to be maintained.

D. Section 4958, Intermediate Sanctions

On January 10, 2001, the Internal Revenue Service issued new regulations, in both temporary and proposed form, expanding the interpretation of the section 4958 Intermediate Sanctions rules. Under the new regulations found in temp. reg. sections 53.4958-1T through 53.4958-8T (hereafter temp. regs.), organizations need to protect their executives by documenting each compensation package or transaction, and by finding comparables and/or an outside expert's opinion that the benefit is reasonable. [T.D. 8920, Temp. Intermediate Sanctions Regs: *The Exempt Organization Tax Review*, February 2001, p. 225; *Doc 2001-1185 (29 original pages)*; *2001 TNT 10-96*.]

These intermediate sanction regulations are particularly important to nonprofits engaged in joint ventures for numerous reasons. First, ventures are being scrutinized by the IRS for excess benefit and inurement issues. Second, compensation issues which may arise in a joint venture context are addressed in these temporary regulations, including a "first-bite" exception for initial contracts.[53] Unfortunately, the temporary regulations do not include specific guidance regarding revenue sharing.[54] However, there are several examples regarding revenue-sharing arrangements within the initial contract exception, discussed below.[55]

The types of excess benefits the IRS is likely to scrutinize include compensation packages of highly paid executives, the sale of assets of the exempt organization to a for-profit entity or individual, leases or other business arrangements, and any other transaction that involves a large asset transfer or outlay of cash by the exempt organization.[56] It should be noted, however, that the individual that is the recipient of the excess benefit must be an insider, i.e., someone with control over the organization's management decisions.

The new regulations provide a rebuttable presumption for organizations as long as several criteria are met. Generally, the independent board must make and document the decision regarding the dollar amounts of the transaction/compensation package, and this decision must be based upon comparable situations entered into by comparable nonprofit and for-profit organizations. The temp. regs. specify that an outside expert is not necessary for valuation purposes, as long as the organization finds its own data on amounts paid by other comparable organizations in the same or similar community for similar services or transactions. The number of comparables is not specified for large organizations, however small organizations with gross annual receipts of $1 million or less will have the protection of the rebuttable presumption if they base their decision on three comparables. The temp. regs. strengthen this presumption of reasonableness by making it difficult for the IRS to rebut the presumption. The IRS must develop sufficient contrary evidence contemporaneous to the transaction date to rebut the probative value of the comparability data relied upon by the organization, should a controversy reach the courts.

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[53]Temp. reg. section 53.4958-4T(a)(3).

[54]Temp. reg. section 53.4958-5T (reserved).

[55]Temp. reg. section 53.4958-4T(a)(3)(vii) Example 5; temp. reg. section 53.4958-4T(a)(3)(vii), Example 7.

[56]The tax that is imposed is based on the amount of the excess benefit. For example, an executive receives a compensation package worth $300,000. The IRS investigates and determines an excess benefit in the amount of $100,000 plus interest. The 1st tier excise tax is 25 percent or $25,000. If the DP timely returns to the organization the $100,000, there is no further tax. However, if the DP does not correct, then there is an additional 200 percent 2nd tier excise tax, *i.e.* $200,000. The IRS may also impose a tax of up to $10,000 per transaction on a manager who approved the transaction, if the transaction is willful.

Unfortunately, the temp. regs. do not specifically cover revenue-sharing arrangements. Instead, revenue-sharing transactions are to be analyzed under the general rules and a facts and circumstances determination as to whether the economic benefits were excessive. Throughout the temp. regs., there is a distinction between compensation arrangements which contain a cap, and those which do not. If the cap is objectively determined and a reasonable amount, the compensation package will be deemed to be reasonable at the time the compensation arrangement is entered into. In that situation, the individual will have the benefit of the rebuttable presumption if the documentation requirements have been met from that earlier date. If, however, the cap is subjective in nature, the reasonableness determination will be made at the time compensation is determined and the rebuttable presumption will attach at that later date, assuming all other criteria are met.[57]

Particularly in a situation in which there has been a joint venture, an individual may be performing services for several entities but may not be receiving compensation from the specific entity for which services are performed. Steven D. Arkin, formerly the Senior Advisor to the Assistant Secretary for Tax Policy and one of the primary authors of these temp. regs., explained that reasonableness is determined by looking at total compensation. The temp. regs. require that the reasonableness of the compensation is determined by a review of 100 percent of the services performed and 100 percent of compensation received on an aggregate basis.[58] For example, if a disqualified person performed services for two or more entities within a joint venture but was paid by only one of those entities, the reasonableness determination is not based upon a pro rata approach, but on an aggregate approach. As long as the total compensation is reasonable for the services performed for all entities, the disqualified person will not be in receipt of an excess benefit and will not be subject to the excise tax.[59] Of course, the private benefit and inurement provisions are applicable to any entity receiving services without paying compensation for those services. Additionally, depending upon the organizational structure, the entity receiving the services might be a disqualified person itself and subject to the section 4958 excise taxes.

There is a broad exception to these rules for initial contracts entered into between the organization and an unrelated person.[60] Essentially any new contract between a previously unrelated person and an exempt organization is not subject to the excise tax. Any amount, even an amount that is outrageously excessive, will not be subject to the excise tax under section 4958. However, the well-established inurement and private benefit rules are still in place, potentially impacting the organization's exempt status if a transaction is egregious.

There are several examples regarding when the initial contract exception will be applicable to revenue-sharing arrangements. Essentially, if the initial contract sets forth compensation as an objective formula applied to gross receipts or some other well defined term, the compensation will be excepted from these rules. However, if the revenue-sharing arrangement is subjectively determined, then the contract will not be within the initial contract exception and the facts and circumstances of the compensation ultimately paid will be determinative of whether an excess benefit was received by the insider. Two specific examples illustrate these concepts:

Example: J is a performing arts organization and an applicable tax-exempt organization for purposes of section 4958. J hires W to become the CEO of J. W was not a disqualified person, within the meaning of the statute, immediately prior to entering into the employment contract with J. As a result of this employment contract, W's duties and responsibilities make W a disqualified person with respect to J. Under the contract, J will pay W $x (a specified amount) plus a bonus equal to 2 percent of the total season subscription sales that exceed $100z. The $x base salary is a fixed payment. The bonus payment is also a fixed payment pursuant to an initial contract because no person exercises discretion when calculating the amount of the bonus payment or deciding whether the bonus will be paid. Therefore, section 4958 does not apply to any of J's payments to W pursuant to the employment contract due to the initial contract exception.[61]

Example: Hospital C is an applicable tax-exempt organization for purposes of section 4958. Hospital C enters into a contract with an unrelated entity, Company Y, under which Company Y will provide a wide range of hospital management services to Hospital C. Because of this contract, Company Y becomes a disqualified person with respect to Hospital C. The contract provides that Hospital C will pay Company Y a management fee of x percent of adjusted gross revenue (i.e., gross revenue increased by the cost of charity care provided to indigents) annually for a five-year period. The management services contract specifies the cost accounting system and the standards to be used in calculating the cost of charity care. The cost accounting system objectively defines the direct and indirect costs of all health care goods and services provided as charity care. Because Company Y was not a disqualified person with respect to Hospital C immediately before entering into the management services contract, that contract is an initial contract within the regulatory exception. The annual management fee paid to Company Y is determined by an objective fixed formula specified in the contract, and is therefore a fixed payment. Accordingly, section 4958 does not apply to the annual management fee due to the initial contract exception.[62]

[57]Temp. reg. section 53.4958-6T

[58]Steven D. Arkin, in remarks made at the D.C. Bar Luncheon on January 31, 2001.

[59]This example is based on temp. reg. section 53.4958-4T(a)(3)(vii) Example 1.

[60]Also, written contracts which were binding on September 13, 1995, are excepted from these rules. State law will be followed in determining what constitutes a binding, written contract, and many times several writings must be combined to establish the intent of the parties and to establish a binding contract.

[61]This example is based on temp. reg. section 53.4958-4T(a)(3)(vii) Example 5.

[62]This example is based on temp. reg. section 53.4958-4T(a)(3)(vii) Example 7.