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Nonprofit and For-Profit Collaborations: Mergers, Joint Ventures, and For-Profit Subsidiaries

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I. INTRODUCTION

More and more, charitable organizations – that is, nonprofit corporations that are tax-exempt under Internal Revenue Code[1] §501(c)(3) ("Charity" or "Charities") – seek to collaborate, in one form or another, with for-profit organizations or individual investors.[2] In this paper, we are assuming that the Charity is a public charity and not a private foundation. Private foundations face a host of additional rules that can make collaboration with a for-profit more challenging.

A. Why collaborate? There are several reasons a Charity would want to collaborate with a for-profit organization or individual: to take advantage of investment capital; to take advantage of business expertise; to commercialize a product, service, or item of intellectual property that the Charity has developed as part of its charitable mission (e.g., its name and logo, or a new drug); and/or to share resources.

B. How does a Charity collaborate with a for-profit? There are many ways in which a Charity and a for-profit can collaborate, but in this paper, we will touch on the following:

i. A contractual relationship, for example:

- A simple contract between a Charity and a for-profit where the for-profit is providing services to a Charity for a fee;
- A Charity's license of its intellectual property ("IP") to a for-profit to commercialize something the Charity developed and pay royalties to the Charity;
- A resource sharing arrangement between a Charity and a for-profit, for shared employees, space and equipment.

ii. A "joint venture," by which we mean the formation of a new legal entity that is either:

(1) A limited liability company (or possibly a partnership) into which the Charity contributes a program or programs or some assets and the for-profit contributes money and expertise, or

(2) A for-profit subsidiary to the Charity into which the Charity contributes a program or programs or some assets, and the for-profit contributes money and expertise.[3]

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[1]All references to a section (§) or sections (§§) not otherwise identified refer to the Internal Revenue Code.
[2]Some but not all of the concepts discussed in this paper will apply to trusts, as well.
[3]Technically, the IRS rulings discussed in this paper speak only of LLCs and partnerships as joint ventures, but we have included the discussion of for-profit subsidiaries in this section as well.

iii. The complete acquisition of a Charity by a for-profit or a for-profit by a Charity, either in the form of an asset purchase or a merger, after which one of the entities no longer exists.

In this paper, we first review a few of the general legal principles that arise in these situations. Next, we use the "how" (A (contracts), B (joint ventures), and C (acquisitions) above) to discuss the legal issues.

II. OVERALL TAX PRINCIPLES

In order to evaluate specific transactions, a Charity must be familiar with the basic legal principles, summarized as follows:

A. Tax exemption: Starting with basics, §501(c)(3) uses 133 words to define tax-exempt organizations, as follows:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Put more simply, in order to qualify as a tax-exempt charitable organization, and in order to maintain tax-exempt status, a Charity must satisfy five requirements that can be drawn from §501(c)(3), including two affirmative obligations and three negative conditions. To qualify for exemption, a Charity:

(1) must be organized exclusively for exempt purposes;

(2) must be operated exclusively for exempt purposes;

(3) must refrain from inurement;

(4) must avoid electioneering; and

(5) may not engage in substantial lobbying.

In this paper, we do not focus on the organizational test, electioneering or lobbying. Most of the issues involving for-profit/Charity collaboration tend to involve the operational test and, potentially, private inurement (Requirements 2 and 3). A related issue, the unrelated business income tax ("UBIT"), is discussed below in section D.

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