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Joint Ventures with For Profits

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JOINT VENTURES BETWEEN TAX-EXEMPT ORGANIZATIONS AND FOR-PROFIT PARTIES: AVOIDING FEDERAL TAX LAW TRAPS

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INTRODUCTION

The last twenty-five years have seen an explosion in joint ventures between tax-exempt organizations and for-profit parties. Indeed, the recent economic downturn has caused many tax-exempt organizations and for-profit parties to examine ways to consolidate their operations. One of the most common approaches is through a joint venture.

The term "joint venture" has no precise legal definition. In this article we use the term to refer to arrangements in which a tax-exempt organization, such as a university or hospital one or more taxable, for-profit parties have agreed to provide capital or services in a common undertaking, and to share in some manner the income or losses from the undertaking.

Joint ventures involving tax-exempt organizations fall into one of two categories: 1) "ancillary" joint ventures that involve an insubstantial portion of the exempt entity's assets and activities, such as ventures to create ambulatory surgery centers (in the healthcare space) or to acquire and operate certain technologies, and 2) "whole-entity" joint ventures, in which a tax-exempt entity contributes all or a substantial portion of its assets and operations to a joint venture entity in partnership with a for-profit entity that contributes cash and/or assets. Ancillary joint ventures are by far the more common type of joint venture.

The purpose of this article is to identify the major federal tax issues that are unique to joint ventures between tax-exempt organizations and for-profit parties, and to suggest ways that they can be structured to address those issues. Such joint ventures almost invariably also raise significant legal issues in other areas. It is essential that any joint venture structure take these issues into account as well.

SUMMARY OF MAJOR TAX LAW ISSUES

A. Overview.

A nonprofit organization that is qualified for federal tax exemption under Section 501(c)(3)[1] may permissibly engage in a joint venture with for-profit parties, including physicians on its medical staff, without putting its tax exemption at risk, so long as the joint venture structure meets certain parameters.

[1] All Section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations thereunder. All references to Section 501(c)(3) organizations refer to organizations classified as public charities under Section 509(a), including hospitals, medical research organizations and publicly supported organizations. Different rules apply to Section 501(c)(3) organizations that are classified as private foundations within the meaning of Section 509(a).

The biggest concern for the exempt organization is of course preserving its tax-exempt status. The stakes are much higher in the context of whole-hospital joint ventures, in which the exempt organization must ensure that it has sufficient control over the joint venture. In the context of ancillary joint ventures, there is generally not a risk of loss of exemption so long as all transactions are at arm's length and for fair market value.

It is essential that all assets to be contributed to a joint venture be valued appropriately to ensure that each party to the joint venture receives an interest in the venture that is proportionate to its contributions. Any joint venture in which not all transactions are at arm's length and for fair market value may result in either "private inurement" or an impermissible level of "private benefit," and could jeopardize the exempt organization's tax status. The exempt organization's participation in the joint venture may also constitute an unrelated trade or business. From the perspective of the for-profit participant, there is also the possibility of "intermediate sanctions" excise taxes.

B. Private Inurement.

Private inurement occurs when an "insider"[2] with respect to an exempt organization receives a benefit in excess of the fair market value of goods an services provided by the insider.[3] The level of risk to an exempt organization in a joint venture depends to a significant degree on whether any of the other parties involved is considered an insider with respect to the exempt organization. The term "insider" is not precisely defined, but clearly includes members of the organization's board, its officers, and their family members, entities owned by them, and likely others who may have a substantial level of influence over the organization (e.g., a key department head). As a general matter, an exempt organization should ensure that any transactions with for-profit parties are at arm's length and at fair market value. This becomes especially critical when the other party is an insider. The tax law's remedy for private inurement is revocation of the organization's tax-exempt status.[4]

C. Intermediate Sanctions.

Any transaction that results in private inurement may also result in so-called "intermediate sanctions" on the party that received the undue benefit.[5] The intermediate sanctions rules do not impose any liability on the tax-exempt organization itself. Rather, they were designed as an intermediate means of addressing private inurement transactions by penalizing the persons who benefit from such transactions, rather than (or in addition to) revoking the organization's exemption. Specifically, the intermediate sanctions rules authorize the IRS to impose an excise tax on any individual or entity who is a "disqualified person"[6] with respect to the exempt organization and who receives a benefit from the organization that exceeds the value of goods or services that the disqualified person provides. The tax is initially 25% of

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[2] See Treas. Reg. § 1.501(a)-1(c) (defining the terms "private shareholder or individual" present in Section 501(c)(3) as persons having a personal and private interest in the activities of the organization).
[3] See Treas. Reg. § 1.501(c)(3)-1(c)(2).
[4] See Section 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(f)(2)(ii).
[5] See Section 4958.
[6] See Section 4958(f)(1).

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