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# The Architecture of Charities' Commercial Activities - Structural Reactions: Basic Structures

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**THE ARCHITECTURE OF CHARITIES' COMMERCIAL ACTIVITIES**  
**STRUCTURAL REACTIONS: BASIC STRUCTURES\***

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I. INTRODUCTION

The diverse assortment of organizations that share the label "nonprofit" are said to inhabit a "sector" of American society, variously described as "charitable," "tax-exempt," "independent," "voluntary," "philanthropic," and the "third" sector.<sup>1</sup> A common assumption underlying this cluttered and often misleading terminology is that nonprofit organizations play a role in American society distinct from government and the for-profit sector. And so they do – most of the time. These special characteristics have influenced the evolution of a body of law that brings both stricter government regulation and generous tax benefits, especially for "charitable"<sup>2</sup> nonprofits.

The government, for-profit and nonprofit sectors do not exist in separate orbits. They overlap considerably, and the boundaries have been blurring for years. As traditional sources from government and private philanthropy declined as a percentage of total revenue, fiscally squeezed nonprofits entered the marketplace. It is now well known that, as a group (and thus the statistics are misleading), charitable organizations in the United States derive the bulk of their support from fees, dues, service charges, and other

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\*\*Parts of this paper have been adapted from other works of the author, including James J. Fishman & Stephen Schwarz, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* (3d ed. 2006); Stephen Schwarz, *Rethinking Nonprofit Joint Ventures* (unpublished manuscript 2006); and Stephen Schwarz, *Federal Income Taxation of Investments by Nonprofit Organizations: Beyond a Primer* (National Center on Philanthropy and the Law, 2000), available at <http://www1.law.nyu.edu/ncpl/libframe.html>.

<sup>1</sup>See generally LESTER M. SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* (2d ed. 1999).

<sup>2</sup>The term "charitable" is used throughout this paper in its broadest tax law sense, encompassing the other § 501(c)(3) exempt purposes such as religion, education, science and the like. For convenience, qualified § 501(c)(3) organizations will be referred to as "charities."

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types of program-service income. In 2005, the last year for which reliable data is available, private contributions accounted for only 12.3 percent of total revenue of public charities that filed Form 990 information returns, as compared to 70.3 percent from fees for services and goods, 9 percent from government, and 8.3 percent from investment income and miscellaneous sources.<sup>3</sup> It is reasonable to assume that most of this program service income comes from activities linked to an organization's (broadly defined) mission. Familiar examples include tuition, charges for health care and other "exempt function" services, admission fees, or income from "substantially related" activities such as gift shops, bookstores, and hospital pharmacies. Some of this nondonative revenue—the precise amount is unknown—comes from “commercial” activity having little or no relationship to the organization's core mission other than, perhaps, to cross-subsidize charitable programs.

The legal structures vary for these profit-seeking pursuits. The most straightforward approach is to conduct the activity directly and report the revenue as program-service income. In other settings, charities employ wholly owned corporate subsidiaries or limited liability companies, or they engage in joint ventures with for-profit firms or private individuals either through formal entity structures or contractual relationships such as licensing agreements, research alliances, corporate sponsorships, ground leases, and the like. In describing these developments, interested observers have identified a pattern of commercialization and competition<sup>4</sup> that is contributing to a convergence of the sectors.<sup>5</sup> This is not a new phenomenon, but the dynamics have changed. More than 50 years ago, with the introduction of higher and more progressive

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<sup>3</sup>KENNETH T. WING, THOMAS H. POLLAK & AMY BLACKWOOD, *THE NEW NONPROFIT ALMANAC 2008*, 143-148 (2008). These statistics are skewed by inclusion of health care and educational institutions, which derive the bulk of their substantial support from program service revenue.

<sup>4</sup>See generally *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* (Burton A. Weisbrod, ed., 1998).

<sup>5</sup>See, e.g., J. Gregory Dees & Beth Battle Anderson, *Sector-Bending : Blurring Lines Between Nonprofit and For-Profit*, *SOCIETY* 16 (May/June 2003); Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 *SMU L. REV.* 675 (2003); Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 *N.Y.L. SCH. L. REV.* 457 (1996).

income tax rates, investigative journalists began warning that universities, churches and a handful of other charities were being used as tax shelters for business profits.<sup>6</sup> These uncharitable-like activities were seen as threatening the traditional “good works” rationale of tax exemption. Congress eventually responded by enacting the unrelated business income tax (“UBIT”) and denying tax exemption to “feeder corporations,” which previously had been granted exemption on the ground that all their profits were destined for use by one or more specific charities.<sup>7</sup> At the same time, the UBIT, supposedly aimed at unfair competition and protection of the corporate tax base, preserved tax exemption for income from businesses that were substantially related to an organization’s exempt purposes even if they competed with for-profit firms and had substantial net income.<sup>8</sup> Despite statements in the legislative history, a meticulous review of the UBIT’s origins suggests that unfair competition was not the primary motivation for taxing unrelated business income. As Professor Ethan Stone has concluded, a more historically accurate

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<sup>6</sup>Benjamin Fine, *University Dollars Yielding Tax-Free Business Profits*, N.Y. TIMES, Dec. 13, 1948, at A1. See also *The Abuse of Tax Exemption: It Has Got to the Point Where Something Has to Be Done About It*, FORTUNE, May 1950, at 74.

<sup>7</sup>Very generally, a feeder is an organization (usually a corporation) operated for the primary purpose of carrying on a trade or business for profit. A corporation that manufactured and sold salad dressing and distributed its net profits to a designated charity is an example of a feeder. Under § 502, a feeder will not qualify for tax exemption on the ground that all its profits are payable to one or more § 501 organizations. Section 502 was enacted to overturn the destination of income test that permitted feeders to qualify as tax-exempt. See, e.g., *C.F. Mueller v. Commissioner*, 190 F.2d 120 (3d Cir. 1951). For a rare recent case denying exemption to a feeder, see *CRSO v. Commissioner*, 128 T.C. 153 (2007), involving a nonprofit corporation that as its sole activity rented out two parcels of debt-financed commercial real estate and distributed the net proceeds to a charity named in its charter.

<sup>8</sup>More than fifty years of history, experience and endless discussion have not yielded much more than speculation as to whether the stated goals of the UBIT are coherent and, if unfair competition is the culprit, whether the current structure of the tax provides a satisfactory solution. A familiar lament is the lack of any empirical data validating the supposed evils of unfair competition. Periodically, questions are raised as to whether the “trade or business” and “relatedness” tests are appropriate to police inappropriate commercial behavior. The assumption that nonprofit organizations would compete unfairly in their active “business” pursuits without the UBIT, but pose no competitive threat when investing their endowment, renting their real estate, or exploiting their intellectual capital is accepted but lacks a rigorous explanation. Some academic commentary has called for repeal of the UBIT, while others question whether unfair competition is even relevant, preferring to shift the inquiry to economic efficiency and protection of the corporate income tax base. See, e.g., Henry Hansmann, *Unfair Competition and the Unrelated Business Tax*, 75 VA. L. REV. 605 (1989); Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982).

explanation may be political symbolism – i.e., the function of the UBIT was to deter charities from engaging in activities that look bad.<sup>9</sup>

As it approaches its 60<sup>th</sup> birthday, the UBIT, with its porous standards, specialized exceptions, and opportunities for strategic allocation of expenses, has evolved into a modest tax exemption border patrol sentry – a dog with more bark than bite, almost a voluntary tax.<sup>10</sup> The UBIT influences how charities structure or “spin” their business activities but it has not stunted their growth. Headlines appear at regular intervals describing the slick museum shops at suburban shopping malls;<sup>11</sup> the “kept” University, with its profitable research alliances with drug companies and exclusive sponsorship and provider arrangements for athletic gear, soft drinks, credit cards, alumni cabernet, and stadium and even dean naming rights;<sup>12</sup> cause-related marketing deals;<sup>13</sup> Ben and Jerry’s

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<sup>9</sup>See Ethan Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L. J. 1475 (2005). Professor Stone found few complaints about unfair competition in the history preceding enactment of the UBIT and concluded that Congress was responding more to the use of charities by for-profit businesses as tax shelter facilitators.

<sup>10</sup>See MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION* 295 (2004). The author came to this conclusion independently but notes that it was among the themes of a November 1999 conference at the Hauser Center for Nonprofit Organizations at Harvard where the topic was: “The Unrelated Business Income Tax: The Dog That Doesn’t Bite.” Statistics confirm this suspicion. Slightly more than half of the 38,040 exempt organizations (including pension trusts) filing Form 990-T tax returns in 2004 (the latest year for which data is available) reported zero taxable income or a deficit. About 25 percent of the total UBIT tax liability of \$367.7 million in 2004 was paid by pension trusts and § 501(c)(9) voluntary employee beneficiary associations on investment income. Although § 501(c)(3) organizations accounted for about one-third of total returns filed, only 37.7 percent paid any tax, and those organizations reported a collective gross income of \$5.5 billion but collectively paid only about \$192 million of tax. The major sources of gross unrelated business income of § 501(c)(3) organizations were profits from sales and services and advertising, followed by investment income from partnerships and S corporations, and debt-financed income. Margaret Riley, *Unrelated Business Income Tax Returns, 2004*, IRS STATISTICS OF INCOME BULLETIN (Winter 2008). See also Peter Panepento & Grant Williams, *A Question of Calculation: Most Charity Businesses Manage to Avoid Paying Federal Taxes*, CHRON. PHILANTHROPY, Feb. 7, 2008, at 33 (reporting that of 91 large charities scrutinized, 51 percent reported zero or negative taxable income and were able to reduce \$419.1 of gross income to a collective \$3 million deficit after allocation of deductions). The largest tax bill was paid by New York’s Metropolitan Museum of Art, with total tax owed of \$8.1 million on partnership investments, other business services, and retail sales. *Id.*

<sup>11</sup>See, e.g. Helmut K. Anheier & Stefan Toepler, *Commerce and the Muse: Are Art Museums Becoming Commercial?*, in *TO PROFIT OR NOT TO PROFIT? THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* 233-248 (Burton A. Weisbrod, ed. 1998).

<sup>12</sup>See, e.g., DEREK BOK, *UNIVERSITIES IN THE MARKETPLACE: THE COMMERCIALIZATION OF HIGHER EDUCATION* (2003); JENNIFER WASHBURN, *UNIVERSITY, INC.: THE CORPORATE CORRUPTION OF HIGHER EDUCATION* (2005); DAVID L. KIRP, *SHAKESPEARE, EINSTEIN AND THE BOTTOM LINE: THE MARKETING OF*

ice cream franchises operated by job training centers; films and exhibits developed by entertainment and technology companies at nonprofit museums;<sup>14</sup> campus hotels and other real estate developments;<sup>15</sup> nonprofit credit counseling agencies that are indistinguishable from commercial businesses;<sup>16</sup> and the commercialization of venerable nonprofit elders such as the Educational Testing Service,<sup>17</sup> the National Geographic Society,<sup>18</sup> the Nature Conservancy,<sup>19</sup> the Smithsonian Institution<sup>20</sup>, and the National Wildlife Federation,<sup>21</sup> to name just a few.

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HIGHER EDUCATION (2003); Eyal Press & Jennifer Washburn, *The Kept University*, THE ATLANTIC MONTHLY (March 1, 2000). On stadium and dean naming rights, two examples will suffice. The principal indoor athletic venue at Arizona State University, once known as the University Activities Center, is now Wells Fargo Arena. The dean of the Haas School of Business at the University of California at Berkeley, once known as the Dean, is now the BankAmerica Dean. With the consolidation of financial services firms and banks, these monograms are unlikely to last in perpetuity.

<sup>13</sup>"Cause branding" deals are designed to leverage each participant's image and reputation with the dual goals of selling products and raising revenue to support the charity's mission.

<sup>14</sup>See Anna Wilde Mathews, *Entertainment Companies Aim to Thrill Museum Throngs*, WALL ST. JOURNAL, Nov. 25, 2002, at B1; *The Whitney Museum and Intel Announce Innovative Collaboration to Greatly Enhance the Ways People Experience and Learn About Art*, BUSINESS WIRE, Sept. 24, 1998.

<sup>15</sup>See Maureen Milford, *A University Tries Its Hand at a For-Profit Hotel*, N.Y. TIMES, Aug. 16, 2004.

<sup>16</sup>See Jennifer Bayot, *Not-for-Profit Credit Counselors Are Targets of an I.R.S. Inquiry*, N.Y. TIMES, Oct. 14, 2003, at A1; Statement of Hon. Mark Everson, Testimony Before Senate Finance Committee (April 5, 2005), available at <http://www.irs.gov/pub/irs-tege/metest040505.pdf>. Tax exemptions for credit counseling organizations are now regulated by detailed statutory requirements. I.R.C. § 501(q).

<sup>17</sup>Tamar Lewin, *Testing Group Ends Effort to Make Profit on Web Site*, N.Y. TIMES, Jan. 24, 2003, at C2 (reporting on the Educational Testing Service's diversified corporate structure and the related College Board's decision to abandon a commercial online venture).

<sup>18</sup>Jane Levere, *National Geographic Buys Stake in iExplore*, N.Y. TIMES, Aug. 21, 2000, at C1.

<sup>19</sup>David B. Ottaway & Joe Stephens, *Nonprofit Land Bank Amasses Billions*, WASH. POST, May 4, 2003, at A01; Joe Stephens & David B. Ottaway, *How a Bid to Save a Specifies Came to Grief*, WASH. POST, May 5, 2003, at A01; Joe Stephens & David B. Ottaway, *Nonprofit Sells Scenic Acreage to Allies at a Loss*, WASH. POST, May 6, 2003, at A01.

<sup>20</sup>See, e.g., Edward Wyatt, *Smithsonian-Showtime Deal Raises Concerns*, N.Y. TIMES, March 31, 2006, at A11; Jacqueline Trescott, *Smithsonian Investigating Its Sales Division's Salaries*, WASH. POST, April 19, 2006, at C01; Edward Wyatt, *House Panel Challenges Smithsonian*, N.Y. TIMES, May 11, 2006, at A14.

<sup>21</sup>Elizabeth Schwinn, *Constructing a Marketing Deal: Home Depot Venture Could be a Sign of the Future*, CHRON. PHILANTHROPY, Aug. 7, 2003, at 24 (describing an arrangement under which Home Depot stores will offer "backyard habitat" products bearing the national Wildlife Federation's logo).

The sector-bending trend cuts both ways. For-profit firms have staged their own competitive march into traditional nonprofit turf. The most obvious example is the emergence and, in some markets, domination of for-profit hospitals and clinics. For-profit companies also have become major players in online education, hospice care, day care, affordable housing, rehabilitation services, and even social welfare and charitable giving through donor-advised funds.<sup>22</sup> The Apollo Group, a large publicly traded for-profit education company that operates the University of Phoenix, had \$2.3 billion in gross revenue in 2005 and 315,350 enrolled students.<sup>23</sup> Law students who wish to receive their J.D. online can now enroll at for-profit Concord Law School, a subsidiary of the Kaplan educational empire. Where historically for-profit firms complained about unfair competition from tax-favored nonprofits, now nonprofits that have long enjoyed a monopoly are concerned about for-profit companies shrinking their market share.

A byproduct of the "new commercialism" is the active encouragement of a culture of social entrepreneurship.<sup>24</sup> This admirable-sounding movement has been promoted by a coalition of wealthy, mostly younger, "venture philanthropists" and their academic concierges who oversee programs at elite business schools and public policy centers. Prototypes include the National Center on Nonprofit Enterprise,<sup>25</sup> the Harvard Business

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<sup>22</sup>See Dees & Anderson, *supra* note 5; Lester M. Salamon, *THE RESILIENT SECTOR: THE STATE OF NONPROFIT AMERICA* (2003). Examples include the Edison Schools, the University of Phoenix, Nobel Learning Communities, VITAS (hospice care), and even defense contractor Lockheed-Martin (social welfare) and financial giant Fidelity Investments (donor-advised funds). Dees & Anderson, at 17; Salamon, *supra*, at 23.

<sup>23</sup>Sam Dillon, *Online Colleges Receive a Boost from Congress*, N.Y. TIMES, Mar. 1, 2006, at A1. Despite their initial popularity, some for-profit universities have come under siege and become subjects of inquiries about aggressive marketing, poor job placement, excessive fees, and other abusive practices. See John Hechinger, *Inquiry Into Florida For-Profit University Widens*, WALL ST. J., June 22, 2006, at A12 (reporting on the woes of Corinthian Colleges and an investigation of its sales tactics by the Florida attorney general).

<sup>24</sup>See generally J. GREGORY DEES, JED EMERSON & PETER ECONOMY, *ENTERPRISING NONPROFITS: A TOOLKIT FOR SOCIAL ENTREPRENEURS* (2001). For an overview of the legal issues, see Robert A. Wexler, *Social Enterprise: A Legal Context*, 54 EXEMPT ORG. TAX REV. 233 (2006).

<sup>25</sup>See NCNE's web site at <http://www.nationalcne.org>. NCNE's mission is to help nonprofit organizations and leaders make "wise economic decisions" to ensure that their organizations effectively and efficiently serve their constituencies.

School Initiative on Social Enterprise,<sup>26</sup> Stanford Business School's Center for Social Innovation,<sup>27</sup> the Center for the Advancement of Social Entrepreneurship at Duke's Fuqua School of Business<sup>28</sup> and, at one time, the Yale School of Management/Goldman Sachs Foundation Partnership on Nonprofit Ventures.<sup>29</sup> Proponents of this "new view" of nonprofit culture believe there is nothing objectionable about nondonative revenue if the activity itself is consistent with an organization's social mission or if the profits are used to subsidize charitable "investments" (the hip term for grants). They applaud "partnering" with for-profit firms as a means of attracting new capital and expertise to support a charity's socially desirable goals, and tout the intangible benefits from "synergies" between the sector. Social entrepreneurs see themselves as bold and innovative change agents who apply their business acumen to improve society.<sup>30</sup> One academic observer, not necessarily a social entrepreneur, has gone so far as to say that since "greed is good" the nonprofit sector should not be penalized for joining the bandwagon.<sup>31</sup>

One critical response is the familiar complaint about unfair competition that supposedly influenced Congress to enact the UBIT. Wistful traditionalists, many of whom are older than the UBIT, express a fuzzier concern that as charities behave more like

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<sup>26</sup>See <http://www.hbs.edu/socialenterprise>.

<sup>27</sup>See <http://www.gsb.stanford.edu/csi/>.

<sup>28</sup>See <http://caseatduke.org>.

<sup>29</sup>The Partnership was created "to respond to a growing interest in income generation among nonprofit organizations." See Nicole Wallace, *Charities Venture Into Business*, CHRON. OF PHILANTHROPY, May 15, 2003. It conducted its final competition in 2005.

<sup>30</sup>Examples of social entrepreneurship include Kick Start, which distributes technology in Africa to stimulate economic development (<http://www.approtec.org>), Juma Ventures, which uses business enterprises for job training (<http://www.Jumaventures.org>), Grameen Foundation, a pioneering microfinancier which seeks to alleviate poverty (<http://www.grameenfoundation.org>), Ecotrust, a Pacific Northwest environmental group dedicated to preserving Salmon Nation (<http://www.ecotrust.org>), and Pioneer Human Services, a Seattle-based nonprofit that runs nine businesses to support its social service activities (<http://www.pioneerhumanservices.org>).

<sup>31</sup>See, e.g., Darryl K. Jones, *The Greedy and the Good in Nonprofit/For-Profit Partnerships*, 111 TAX NOTES 1155 (June 5, 2006).

businesses—as they "hock their halos" to "milk the cash cow"<sup>32</sup>—they do so at the peril of abandoning core values. This mission drift is said to divert charities from their original *raison d'être* by shifting emphasis from public service to the most lucrative pursuits (that often fail), resulting in a less distinctive sector that eventually will weaken from loss of social impact and declining public respect and support.<sup>33</sup> Critics also lament the invasion of the corporate culture, with its gaudy compensation packages and preoccupation with the bottom line, and its fostering of “managers” and “dealmakers” rather than visionary institution builders.<sup>34</sup> Government regulators worry that charitable assets are being diverted and fiduciary duties neglected or violated as the pursuit of profit takes precedence over public benefit. Legislators and tax collectors periodically vent about the “commerciality” problem, but they rarely act because the problem, if it is one, is complex and not susceptible to a simple fix.

The mandate for this paper narrows the inquiry to a prosaic aspect of nonprofit sector commercialism: the “basic structures” employed by nonprofits for their “commercial” activities. Other papers will explore “complex” and hybrid structures. To narrow the scope and eliminate some variables, we assume that “commercial” is to be distinguished from “investment” and thus many income-producing activities that straddle the line (primarily real estate) are not discussed. The line between structures that are “basic” and those that are “complex” (e.g., on which side of the line are joint ventures and L3Cs?) is difficult to pinpoint, and so this “basics” paper may poach on the others at the margin. The goals are to be informative (what *are* the basic structures and what agendas drive the choice of form), policy-oriented (what are the implications and trouble spots, with an emphasis on federal tax policy), and anthropological (what is the impact, if any,

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<sup>32</sup>See A.L. Spitzer, *Milking the Cash Cow—Commercial Activities Undertaken by Nonprofit Organizations: Analysis and Recommendations*, in CONFERENCE: DEFINING CHARITY—A VIEW FROM THE 21ST CENTURY (N.Y.U. School of Law, Nat'l Center on Philanthropy & the Law, 2002), available at <http://www.law.nyu.edu/ncpl/libframe.html>. Spitzer, despite his respect for tradition, is not among those expressing fuzzy concerns; he is cited for his colorful metaphors and critical thinking.

<sup>33</sup>See Dees & Anderson, *supra* note 5, at 21-24.

<sup>34</sup>See, e.g., Pablo Eisenberg, *Solving the Nonprofit Leadership Crisis Will Take Much Work*, CHRON. PHILANTHROPY, Dec. 9, 2004.

on nonprofit culture) . Since the author was awarded tenure many years ago and is now enjoying a defined benefit pension for past academic service, he does not feel obligated to formulate any grand thesis but only to make a few observations that flow from this inspection of the architecture. For those social entrepreneurs and other readers whose flights are about to land and may not make it to the end of the paper, please be assured that the remarks to follow are not intended to condemn activities that advance an organization's reasonably defined core mission, or to stifle innovation, responsible business planning, market efficiency, constructive synergy, or all the other wonderful things that are fostered by entrepreneurial nonprofits. Indeed, many mission-driven social enterprises yield greater benefits than expensive fundraising campaigns. Rather, this is a simple termite inspection, interspersed with occasional expressions of caution over the implications of an unchecked invasion of the for-profit culture and its well documented excesses into the nonprofit sector, the negative impact on public perceptions and respect for charities, and the potential adverse reaction in the form of another orgy of regulatory recrimination as the borders continue to blur.

## II. DEFINITIONAL DILEMMAS AND DOCTRINAL DISARRAY

The theme of this conference presents some definitional dilemmas that most of us have discussed before. For example, what do we mean by “commercial” and to what extent does that term embrace mission-related, substantially related, and unrelated activities? Conversely, what is charity?

From the perspective of modern state law, it is not difficult to qualify as a charitable trust or nonprofit corporation. An organization willing to include the obligatory language in its governing document, adhere to the nondistribution constraint, and comply with a few operational formalities can easily obtain “nonprofit” and even “charitable” or “public benefit” status.<sup>35</sup> Harder line-drawing questions are raised under federal tax law. For example, what distinguishes a tax-exempt “charity” from a taxable

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<sup>35</sup>Qualification for state property tax exemption may be an exception, at least in states that have begun to view some commercial activities of charitable nonprofits with skepticism.

“business” and does the choice of structure matter? Federal tax doctrine does not answer these questions with much certainty. There is no bright line test or even a safe harbor to determine whether and when the conduct of a revenue-generating activity jeopardizes qualification for exemption under § 501(c)(3).<sup>36</sup> The statute merely requires an organization to be organized and operated “exclusively” for one or more exempt purposes. The operational test regulations provide that an organization will not qualify for exemption “if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.”<sup>37</sup> Although they offer no guidance on what types of activities do or do not further an exempt purpose, the regulations seem to leave some leeway for insubstantial business activity, whatever its motivation. They later elaborate by providing that an organization will qualify for § 501(c)(3) exemption “although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in Section 513.”<sup>38</sup> An organization’s primary purpose is to be determined by all the facts and circumstances, “including the size and extent of the trade or business and the size or extent of the activities which are *in furtherance of* one or more exempt purposes” (emphasis added).<sup>39</sup>

The regulations are susceptible to varying interpretations. The conventional wisdom is that an otherwise qualified § 501(c)(3) organization does not lose its exemption by engaging in insubstantial business activities, even if they are unrelated to its exempt purposes. Substantial business activities also are permissible if they are “in furtherance of”

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<sup>36</sup>For illuminating discussions of the doctrinal disarray and some proposed solutions, see, e.g., John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 FORD. L. REV. 667 (2007); John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487 (2002); Jessica Pena & Alexander L.T. Read, *A Call for Reform of the Operational Test for Unrelated Business Activity in Charities*, 76 N.Y.U.L.REV. 1855 (2001).

<sup>37</sup>Treas. Reg. § 1.501(c)(3)-1(c)(1).

<sup>38</sup>Treas. Reg. § 1.501(c)(3)-1(e).

<sup>39</sup>Id.

(does that mean "related to"?) exempt purposes. But exemption is denied if unrelated trade or business activities are substantial in relation to charitable activities because at that point the organization's "primary purpose" is a trade or business. Congress, or at least its taxwriting committee staff, recently signaled that it believes this is an accurate statement of current law,<sup>40</sup> although, as discussed below, the legislative history of the UBIT suggests that it may not be.

It follows under this "conventional wisdom" that if an organization's unrelated business activities (including those conducted through partnerships, LLCs, and other joint ventures) are insubstantial, whatever that means, its exemption is secure and the only sanction is possible UBIT exposure. But if unrelated business income or activity exceeds some blurry substantiality benchmark (many advisors assume it is 20 percent of total revenue for planning purposes; some think it is lower, others higher), the organization jeopardizes its exemption, whether or not the revenue is used to subsidize a charitable activity. As we will see, this interpretation of the tax law loosely links the exemption qualification question with the UBIT relatedness standard and causes risk-averse exempt organizations to form taxable subsidiary corporations to conduct any major unrelated business.<sup>41</sup> In many of the cases and IRS rulings, however, the inquiry begins and ends with an amorphous "all the facts and circumstances" smell test that never even mentions the UBIT or the organization's "primary purpose," or whether the activity is "in furtherance of" a charitable purpose. Under this dreary and inconsistent body of "commerciality" jurisprudence, a nonprofit organization that primarily engages in a revenue-generating activity loses its exemption if the activity has a "commercial hue" (e.g., it is too successful) or it appears to the fact finder to be indistinguishable from a for-profit competitor.<sup>42</sup>

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<sup>40</sup>See Joint Committee on Taxation, Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations (JCX-29-05), 51-52 (April 19, 2005).

<sup>41</sup>See *infra* notes 58-77 and accompanying text.

<sup>42</sup>See, e.g., *Living Faith v. Commissioner*, 950 F.2d 365 (7th Cir. 1991) (vegetarian restaurant and health food store not exempt even though it promoted healthy living doctrine of Seventh Day Adventist Church; organization failed to show how it differed from for-profit competitors); compare *Presbyterian & Reformed*

A contrary theory, which is more permissive or restrictive depending on the context, is that current law does not impose any per se limit on the amount of unrelated business income or activity for § 501(c)(3) qualification purposes.<sup>43</sup> Proponents point to a cryptic 1964 published ruling holding that an organization deriving all of its support from real estate rents qualified for § 501(c)(3) exemption because it conducted a charitable grantmaking program "commensurate in scope with its financial resources."<sup>44</sup> The reasoning underlying this ruling apparently (we say "apparently" because the ruling did not contain any reasoning) assumes that Congress, in enacting the UBIT, did not intend to overturn the destination of income test for exemption qualification purposes except in the narrow case of § 502 feeders. It follows that any amount of unrelated business income is permissible provided that the organization's "primary purpose" is charitable, as measured (somehow) by the commensurate-in-scope standard.<sup>45</sup> This theory evolved from an internal IRS debate culminating in a detailed legal memorandum opining that the operational test regulations permit an organization to qualify for exemption despite substantial unrelated business activities if its primary purpose is charitable.<sup>46</sup>

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Publishing Co. v. Commissioner, 743 F.2d 148 (3d Cir. 1984) (upholding exemption for religious publisher) with Scripture Press Foundation v. United States, 285 F.2d 880 (Ct.Cl. 1961) (revoking religious publisher's exemption). More recently, the IRS has focused its attention on discrete industries, such as credit counseling and down payment assistance, which have little or no donative support and do not serve any charitable purpose.

<sup>43</sup>For a persuasive historically-based argument for this theory, see Kenneth C. Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?* 21 TAX L. REV. 53 (1963). Eliasberg, however, may have been a special pleader. While employed as an IRS attorney, he appears to have been a chief architect of the commensurate-in-scope doctrine. See also Spitzer, *supra* note 32; Thomas C. Troyer, *Quantity of Unrelated Business Consistent with Charitable Exemption—Some Clarification*, 56 TAX NOTES 1075 (1992); John D. Colombo, *Regulating Commercial Activity by Exempt Charities: Resurrecting the Commensurate-in-Scope Doctrine*, 39 EXEMPT ORG. TAX REV. 341 (2003).

<sup>44</sup>Rev. Rul. 64-182, 1964-1 C.B. 186.

<sup>45</sup>On occasion, the IRS has invoked the commensurate-in-scope doctrine to support revocation of exemption. See, e.g., Evelyn Brody, *A Taxing Time for the Bishop Estate*, 21 U. HAWAII L.REV. 537, 573-578 (1999) (discussing the IRS's use of the doctrine against Hawaii's Bishop Estate for its failure to conduct a charitable program commensurate with its enormous financial resources).

<sup>46</sup>See Gen. Couns. Mem. 32869 (Oct. 9, 1963). Under this analysis, "in furtherance of" does not mean "related," and an organization's "primary purpose" is to be determined based on whether it has a "real, bona fide, or genuine charitable purpose, as manifested by the charitable accomplishments of the organization, and not a mathematical measuring of business purpose as opposed to charitable purpose." *Id.* See also Gen.

So there is much confusion – especially by those who need academically tidy answers about the impact of commercial activity on qualification for exemption. What is the right answer? Although the IRS has never revoked Revenue Ruling 64-182 or formally stated that its pro-taxpayer application of the commensurate-in-scope doctrine is wrong, the ruling has become marginalized and should be put to sleep rather than resurrected. To begin the memorial service with a few technical hymns, the activity in the 1964 ruling was rental of commercial real estate. Absent debt-financing, most real estate rents are not subject to the UBIT. This means that the only published ruling endorsing no per se limit on unrelated business activity did not itself involve an unrelated business. A later G.C.M. did involve an unrelated business – a department store that paid all its net profits to charitable organizations. If that store were a § 502 feeder, it would not be exempt. The IRS's distinction—that the department store was not a feeder because distributions of its income to other charities was discretionary with the board (rather than legally obligatory) – is hypertechnical and unsatisfying. Moreover, the 1964 ruling predated the private foundation excess business holdings rules. Under the law since 1969, a grantmaking charity with no public support that owns a significant stake in an operating business is required to divest or face severe life-threatening excise tax penalties.<sup>47</sup> Although these rules are avoidable if the grantmaker qualifies as a certain type of

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Couns. Mem. 34682 (Nov. 17, 1971). For other authorities applying the commensurate-in-scope doctrine, see *Help the Children, Inc. v. Commissioner*, 28 T.C. 1128 (1957)(organization contributing less than one percent of bingo revenues to charity did not qualify for exemption because its principal activity was the profitable operation of a commercial bingo business); Tech. Adv. Mem. 2000-21-056 (Feb. 8, 2000) (organization formed to give financial assistance to needy women qualifies for § 501(c)(3) exemption even though 66 percent of its revenue was from operation of an unrelated business (a gift shop and tea room); IRS reasons that an unrelated business that raised funds for a charitable purpose is "in furtherance of" a charitable purpose and does not constitute a substantial non-exempt purpose); Tech. Adv. Memo 96-36-001 (Jan. 4, 1995) (organization with substantial unrelated religious publishing activity was still exempt because no evidence that publishing profits were not used to further its educational purposes). For a contrary view, see *Orange County Agricultural Society v. Commissioner*, 893 F.2d 647 (2d Cir. 1990)(organization that received one-third of its income from an automobile racetrack was operated for a substantial non-exempt purpose, but revocation of exemption also was based on inurement of private gain).

<sup>47</sup>I.R.C. § 4943, providing generally that private foundations, along with their disqualified persons (e.g., substantial contributors and other insiders) may not own more than 20 percent of any incorporated or unincorporated business enterprise. The rationale of the excess business holdings rule has been questioned. See FLEMING-SMITH, *supra* note 10, at 277-278; Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX L. REV. 59 (2004).

§ 509(a)(3) supporting organization, the requisite relationship with the supported public charities might be (or at least should be) enough to classify the supporting organization as a feeder if, as in the 1971 G.C.M., its only activities were operating a department store and distributing the profits to specified charities named in its charter.<sup>48</sup>

Quite apart from tax technicalities, the notion that an organization deriving most or all of its revenue from unrelated business income can qualify as a tax-exempt charity, even if the revenue is used to cross-subsidize charitable activities, creates serious problems of perception even in the absence of inurement of private gain, unfair competition, economic inefficiency, or other bad things. If one were to poll all current members of the Congressional taxwriting committees and ask: "True or False: under current law, there is no per se limit on the amount of unrelated business activity that may be conducted by a qualified § 501(c)(3) charity," it is highly unlikely in this author's opinion that a single member would answer "true." And if the same poll were taken of all the current members of the American Bar Association Tax Section's Committee on Tax-Exempt Organizations, only a small minority of those high priests would answer "false."<sup>49</sup> Similarly, it is unlikely that the IRS would issue a published ruling today expanding the commensurate-in-scope doctrine to give carte blanche for unlimited unrelated business activity. Over the past year or so, pressured by Senator Charles Grassley and his staff pit bulls, it has been doing just the opposite by more frequently invoking the doctrine to revoke exemptions of "charities" that do very little that is charitable.<sup>50</sup>

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<sup>48</sup>Those "in the know" will respond that there are easy ways to avoid the problem—and there are. The point is that the fact patterns where the IRS has permitted a charity to remain exempt despite substantial unrelated business income are very limited under current law.

<sup>49</sup>The minority would include several respected elders and thinkers, but query whether those in private practice would ever write a covered opinion stating that there is no per se limit on unrelated business activities.

<sup>50</sup>*See, e.g.,* Priv. Ltr. Rul. 2008-18-023 (May 2, 2008) (Christian missionary with principal activity of sponsoring "asset exchange programs" through sale of annuities devoted less than .5 percent of funds received to charitable activities; IRS ruled that the organization was not "charitable" because it did "not carry on a charitable program commensurate in scope with [its] financial resources.") *See* Grant Williams, *IRS Denies Tax-Exempt Status to Group That Spends Too Little Money on Charitable Programs*, CHRON. PHILANTHROPY, May 15, 2008, at 29.

With this catharsis behind us, we can turn to a survey of the basic structures, the motivations for using them, and their implications, keeping in mind that choice of form is heavily influenced by the doctrinal disarray and the opportunities and pitfalls that it presents.

### III. A SURVEY OF BASIC STRUCTURES

#### A. Directly Conducted Activities

The most basic structure is to conduct an income-producing activity directly, especially when it is the charity's reason for existing (e.g., health care, education, low-income housing), or "substantially related," in UBIT parlance, to the organization's exempt purposes (e.g., museum restaurants, college bookstores, and the NCAA men's basketball tournament program). In either case, there is no threat to tax exemption, no UBIT exposure, less complexity, and thus no compelling reason for utilizing a more complex structure, although non-tax factors (e.g., insulation from liabilities, separation of staff for compensation purposes, accounting or regulatory issues) may dictate use of corporate subsidiary, affiliated entity, or single-member LLC.

The challenge for theorists and tax regulators with directly conducted commercial activities is in determining whether they are "charitable" or "substantially related." This inquiry is complicated (or eased, depending on one's perspective) by what Professor Burton Weisbrod has called "mission vagueness" (a better term might be "mission sprawl"), which has contributed to a widening away of revenue-enhancing activities that are said to be linked to a charity's mission but often appear to be indistinguishable from the for-profit businesses with which they compete.

Despite mission sprawl and the expansive modern notion of charity, some activities clearly are not mission-related, and they do raise UBIT issues. But with planning (e.g., taking advantage of the permissive allocation of expense rules), even an unrelated business activity such as advertising (one of the most lucrative) often will not generate much if any tax liability. If a directly conducted unrelated business is profitable and substantial relative to the totality of a charity's activities, however, it may jeopardize exemption and perhaps

even raise fiduciary duty issues under state law. In those situations, a different structure, such as a corporate subsidiary, is usually recommended. Alliances with outsiders, such as licensing and sponsorship deals and more formal ancillary joint ventures, also may be conducted directly, usually without any federal tax concerns, but in some cases the better strategy is to employ a separate entity for reasons to be developed later in the paper.

An illuminating case study of the benefits and dangers of directly conducted business ventures has nothing to do with tax concerns. It is provided by Smithsonian Business Ventures (“SBV”), a division of the Smithsonian Institution. SBV was the subject of an extensive task force report as part of the Smithsonian’s efforts at damage control following a Congressional investigation triggered by news articles on various excesses and abuses at the venerable federal museum complex.<sup>51</sup> From its earliest days, the Smithsonian had a museum shop, restaurants and cafes, and a magazine, and in the 1980s it added IMAX theaters and licensing agreements. In 1998, when the Smithsonian Board of Regents determined that the revenues from these various activities were not living up to their potential, the board exercised its best business judgment (so no duty of care violation) and engaged a consultant who recommended the creation of “an operationally and culturally distinct entity” with a separate governing board, an incentive-based compensation structure, and “strong business leaders” to manage the activities going forward.<sup>52</sup> The Smithsonian board endorsed this approach, emphasizing that the new organization should be “profit-driven” with a compensation system designed to attract employees “from the business world” and provide them with financial incentives to succeed. A separate division – Smithsonian Business Ventures – was formed, with its own CEO and “board of directors” (since SBV was not a separate entity, this advisory board was not subject to the same fiduciary duties as the legally constituted Board of Regents),

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<sup>51</sup>See Task Force on Smithsonian Business Ventures, *Increasing the Contribution of Revenue-Generating Activities to the Smithsonian Institution Mission* [hereinafter “Task Force Report”] (Jan. 28, 2008), available at <http://newsdesk.si.edu/releases/SBV-task-force-report.pdf>. For press coverage, see Robin Pogrebin, *Report Details Smithsonian Business Unit’s Problems*, N.Y. TIMES, Jan. 29, 2008, at A17; Jacqueline Trescott & James V. Grimaldi, *Smithsonian Termed “Endangered”; Board Structure Questioned*, WASH. POST, April 12, 2007, at C1.

<sup>52</sup>Task Force Report, at 56-57.

and a mandate to “maximize the financial value of the assets under its stewardship to support the overall mission of the Institution” and to evaluate the CEO’s performance.<sup>53</sup> The salaries of SBV employees, unlike those of museum staff, were performance driven, with a complex web of targeted benchmarks common to the for-profit sector. SBV’s CEO oversaw multiple departments, including human resources, member services, licensing, retail operations, publishing, and media services<sup>54</sup> and reported to Smithsonian’s then Secretary (its term for CEO), Lawrence Small.

The Task Force concluded that generation of unrestricted revenue through commercial activities was a desirable and important source of funding at the Smithsonian but only when conducted in consonance with the Smithsonian’s mission and values – i.e., the activities should support the Institution’s scholarship and programs by offering “authentic and high-quality products, media content, and visitor services” that complement the mission of increasing and diffusing knowledge.<sup>55</sup> It recommended that the Smithsonian continue to manage its business ventures as a distinct “but not separate” operational unit, albeit with a different name – “Smithsonian Enterprises or something similar” was suggested – and found that the greatest revenue potential was in web-based communication for catalog sales and publications.<sup>56</sup>

SBV’s most serious flaw was its physical and cultural separation from the mission of the Institution and its professional staff. Collaboration was weak or non-existent; SBV executives and museum curators did not communicate with one another; SBV’s activities were not transparent; SBV lacked a coherent system for sharing its revenue with constituent units of the Institution; museum staff were alienated by the generous incentive compensation structure for SBV employees; and the governance structure was disjointed, with inadequate oversight. Notably, all these deficiencies existed even though SBV was not a separate legal entity, as the outside consultant had recommended.

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<sup>53</sup>*Id.* at 57-59.

<sup>54</sup>*Id.* at 59-60.

<sup>55</sup>*Id.* at 4-7.

SBV may be an isolated case, unique to the Smithsonian with its odd and dysfunctional board structure that is currently under repair. But the SBV debacle (among others) serves as a reminder that making money is a risky business, more likely to fail than succeed. More importantly, commercial ventures can interfere with a charity's ability to fulfill its core mission and infect its culture. The Smithsonian Task Force report should be required reading for any nonprofit board that is considering a major business expansion. Also instructive is a recent study by the Seedco Policy Center. While acknowledging the value of creative financing and outside-the-box thinking, Seedco's researchers found that most nonprofit business ventures fail to make money and rarely, if ever, generate enough revenue to sustain the organization by cross-subsidizing charitable activities.<sup>57</sup>

## B. Corporate Subsidiaries

### 1. Motivations for Use

Some charities conduct commercial activities through wholly owned corporate subsidiaries formed as taxable C corporations. Although affiliated nonprofit entities also may be used to further charitable purposes,<sup>58</sup> our focus here is on for-profit subsidiaries. Why use them? This structure is not motivated solely by tax considerations. The tax-exempt parent may wish to insulate itself from the liabilities of the business activity; adopt compensation arrangements, fringe benefit plans or accounting methods that are more suitable for a for-profit entity; employ different management structures; expand access to investment capital; avoid public disclosure of certain sensitive financial information; protect some members of the tax-exempt parent's governing board from liability; and

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<sup>56</sup>*Id.* at 8-10, 34-35.

<sup>57</sup>Seedco Policy Center, *The Limits of Social Enterprise: A Field Study & Case Analysis* (June 2007), available at [http://www.seedco.org/publications/publications/social\\_enterprise.pdf](http://www.seedco.org/publications/publications/social_enterprise.pdf). See also William Foster & Jeffrey Bradach, *Should Nonprofits Seek Profits?*, HARV. BUS. REV. (Feb. 2005), which includes a study finding that "there is every reason to believe that the lion's share of earned-income ventures do not succeed at generating revenue beyond their costs."

<sup>58</sup>Tax-exempt subsidiaries are used for some of the same non-tax reasons as taxable subsidiaries – e.g., creditor protection for the parent, facilitating separate management and compensation structures, and sometimes attracting government or private funding that is not available to the parent. Tax-exempt subsidiaries usually achieve public charity status as § 509(a)(3) supporting organizations.

circumvent regulatory obstacles.<sup>59</sup> All of this can be accomplished if the subsidiary is properly structured and corporate formalities are observed. Some overlap in board membership and management is permitted, but good practice dictates the presence of independent outside directors for the subsidiary, and the parent's proper role is as a shareholder, with the power to elect and replace directors, rather than a day-to-day manager.

Tax considerations also play a role. Under current exemption qualification standards, the activities and income of separate controlled entities generally are not taken into account in determining whether an organization's "primary purpose" is a tax-exempt purpose—at least if the parent does not exercise day-to-day operational control over the subsidiary's activities. Exempt organizations thus may conduct substantial unrelated business activities through subsidiaries without risking their exemption even though, under the "conventional wisdom" discussed earlier, their favored tax status might be threatened if they conducted the same activities directly.<sup>60</sup> Taxable subsidiaries also can serve as the general partner when an exempt organization engages in a joint business venture with for-profit entrepreneurs and investors. The parent's exemption might be jeopardized if it served directly as a general partner in ventures where the partnership activity does not otherwise further the organization's exempt purposes.

Under current law, the separate identity of a controlled subsidiary is almost always respected by the Service. In this area, the tax doctrine of substance over form gives way to an equally hoary line of cases that respect a corporation's separate existence.<sup>61</sup> The business activities of the subsidiary are not attributed to the parent if the purposes for which the subsidiary is formed are the equivalent of business activities, or the subsidiary subsequently carries on business activities. But if the parent so controls the affairs of the

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<sup>59</sup>For the historical development of the use of taxable subsidiaries, see James J. McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities – A Tax Policy Issue for 1988*, 38 TAX NOTES 1125 (Mar. 7, 1988).

<sup>60</sup>This structure is only useful to public charities. Private foundations and now some § 509(a)(3) supporting organizations are impeded by the excess business holdings rules in § 4943.

<sup>61</sup>*See, e.g., Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S.Ct. 1132, 87 L.Ed. 1499 (1943);

subsidiary that it is merely an instrumentality of the parent, the separate corporate status of the subsidiary can be disregarded. Against this permissive background, the use of complex structures began to proliferate in the 1980s, particularly in the health care sector.<sup>62</sup>

Use of a controlled subsidiary also may reduce the overall tax burden from one or more business activities even if tax exemption would not be threatened if the businesses were conducted directly by the charity. For example, a for-profit subsidiary could be employed to conduct two separate activities, one unprofitable and related and the other profitable and unrelated, enabling the losses to offset the gains. This strategic allocation of expenses could not be accomplished if the activities were conducted directly, although it will backfire if the related activity turns around and begins to generate a profit. Taxable subsidiaries also make it easier to match revenue and expenses and avoid squabbles with the IRS over allocation issues.

In deciding whether to form a for-profit subsidiary, a charity's board must be mindful of its fiduciary duties of loyalty and care, including prudent investment standards and avoidance of conflicts of interest. Exit strategies must be anticipated, and the complexity and extra expense of a subsidiary evaluated. In most cases, the business judgment rule, including reliance on experts, adherence to a conflict of interest policy, and thoroughly documenting the decision making process, will protect directors from liability. A broader question is whether formation of a for-profit subsidiary implicates the duty of obedience, if there is one. If, as most believe, there no such separate legal duty, query whether fidelity to the organization's mission should be imported more robustly into the duties of loyalty and care.<sup>63</sup> And with more information about charities easily accessible

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National Carbide Corp. v. Commissioner, 336 U.S. 422, 69 S.Ct. 726, 93 L.Ed. 779 (1949).

<sup>62</sup>In the interest of time and compassion, corporate tax mavens will be disappointed as we dispense with any discussion of other tax consequences on formation – e.g., § 351 and related Code sections. Suffice it to note that issues exist and most are surmountable with planning.

<sup>63</sup>For a persuasive argument in favor of a state law duty of fidelity to mission, see Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience Into Fidelity*, 76 FORD. L. REV. 893 (2007).

to investigative journalists and nonprofit beat reporters, public perceptions and their effect on an organization's reputation also should be considered.

## 2. Payments from Controlled Subsidiaries

If a controlled subsidiary makes any money, tax planning can ease the pain as cash flows back to the tax-exempt parent. The proper tax treatment of payments such as dividends, interest, rents and royalties is a much-debated subject. The agenda is tax arbitrage: reducing the subsidiary's taxable bottom line by making payments that are deductible by the for-profit but not taxable as UBTI to the parent. For readers still in flight, seat belts should be tightened, as this is technical material without a crystal clear solution.

Payments from subsidiaries to tax-exempt parents historically were viewed as opportunities for tax avoidance. To reduce the subsidiary's tax bill and provide the parent with a nontaxable investment return, dividends should be avoided or minimized. Instead, the parent can loan money, rent real property, or license intellectual property to the subsidiary in exchange for regular payments. This widely recommended technique works unless the subsidiary is too thinly capitalized (converting debt to equity) or the payments exceed an arm's length benchmark. Is this a problem requiring correction, or is it only abusive if and to the extent that the payments exceed the value of the property or services for which the payments are being made? Is it relevant that the exempt organization controls the subsidiary and, if so, how should control be measured?

Beginning in 1969, Congress enacted legislation to police payments from controlled subsidiaries. Section 512(b)(13), as it was then, treated what otherwise was excludable passive investment income as taxable by tracing the payment back to the subsidiary's business operations and treating it as UBTI to the parent to the extent it was sheltered (through deductions) by the subsidiary. Inflated payments were a major concern but a broader theory, it seems, was that payments labeled as interest, royalties or rent were really attributable to the profits of an unrelated business when made by a taxable subsidiary to its tax-exempt parent. The cure was accomplished by including in UBTI all or part of interest, annuities, royalties and rent (but not dividends) received by a

"controlling organization" from a "controlled entity".<sup>64</sup> Under the current version of § 512(b)(13), "control" is defined as ownership (by vote or value) of more than 50 percent of the stock of a corporation,<sup>65</sup> and constructive ownership rules apply in measuring control.<sup>66</sup> Prior to 1997, "control" was determined by an 80 percent test without attribution rules.<sup>67</sup>

When Congress acted in 1997 to strengthen the definition of control in § 512(b)(13), tax advisors to adversely affected organizations emerged from their previously secure bunkers to question the fundamental premise of the longstanding anti-abuse rule, arguing that it tries "to kill an ant with a sledgehammer" and violates rather than enforces basic tax principles.<sup>68</sup> They argued that the only problem is when the subsidiary pays an inflated price to the parent for property or services. So viewed, the cure goes well beyond the abuse, and the proper remedy was to replace § 512(b)(13) with an arm's length standard along the lines of § 482, which regulates abusive transactions between commonly controlled taxpayers in the for-profit sector.<sup>69</sup> To illustrate, assume an exempt organization ("P") has a wholly owned subsidiary ("S") that engages in an unrelated business. P owns a building that is available for rental as office space. If P leases the space to S at market rates, S can deduct the rent which is then taxable to P under § 512(b)(13). If P leases the space to an unrelated third party ("U"), U can deduct the rent, and it will not be taxable to P. The after-tax return from the building is lower, so the argument goes, when P leases space to S than when it leases to U, causing exempt

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<sup>64</sup>I.R.C. § 512(b)(13)(C).

<sup>65</sup>I.R.C. § 512(b)(13)(D)(i)(I). For the definition of "control" in other settings, *see* I.R.C. § 512(b)(13)(D)(i)(II), (III).

<sup>66</sup>I.R.C. § 512(b)(13)(D)(ii).

<sup>67</sup>*See, e.g.* Priv. Ltr. Rul. 93-38-003 (June 18, 1993). This loose definition enabled just about any well-advised charity to avoid the impact of § 512(b)(13) by breaking control (easily accomplished) or through crafty devices such as the "double drop down," under which a holding company was placed between the exempt parent and the second-tier taxable subsidiary.

<sup>68</sup>*See, e.g.,* Fred Stokeld, *EO Specialists Have Doubts About Section 512(b)(13) Modification*, 17 EXEMPT ORG. TAX REV. 246, 247 (Aug. 1997).

<sup>69</sup>For the most comprehensive critique, complete with algebraic equations, *see* Harry L. Gutman, *Taxing*

organizations to be driven away from contractual relationships with subsidiaries and toward relationships with third parties. In addition, the rental income has nothing to do with capital P invests in S. If P used its control to cause S to pay above-market rent, *that* would shift UBTI from S to P, but only to the extent of the excess. Taxing P on the fair market rent received from S is overkill and represents an inefficient and arbitrary tax penalty, given the overall policy to exclude rent from UBTI.<sup>70</sup>

Advocates of a “fair market value” exception in § 512(b)(13) prevailed when Congress temporarily amended § 512(b)(13) in the Pension Protection Act of 2006. The amendment was effective for payments received or accrued after December 31, 2005 and before January 1, 2008.<sup>71</sup> New § 512(b)(13)(E) provided that the recharacterization rule shall apply only to the portion of interest, rent, annuity, or royalty payments received or accrued in a taxable year that exceeds the amount of the specified payment that would have been paid or accrued if the payment had been determined under the arm's length standard principles used to patrol transactions between commonly controlled taxpayers under § 482. As a result, if a payment by a controlled subsidiary to a tax-exempt parent exceeds fair market value, this excess amount is generally included in the parent's UBTI. In addition, a 20 percent valuation misstatement penalty is imposed on excess payments received by a controlling parent.<sup>72</sup> Congress directed the Treasury to study this issue and submit a report to the tax-writing committees by January 1, 2009 (don't hold your breath) on the effectiveness of the IRS's administration of amended § 512(b)(13), the results of any audits, and recommendations relating to the tax treatment of payments from controlled to controlling organizations.

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*Transactions Between Exempt Parents and their Affiliates*, 84 TAX NOTES 1081 (Aug. 16, 1999).

<sup>70</sup>One point the opponents fail to address is why P chose to hold back the building (or cash, or patent, and so on) and lease it to S rather than contribute it along with the other capital needed to launch and operate the business.

<sup>71</sup>There is bipartisan support to extend the amendment for another two years but, as this footnote is being written in September 2008, Congressional gridlock has impeded extender legislation. A bold prediction – it will be extended by the time of the conference. Breaking news – it was extended, for two years, by § 306 of the economic “rescue” legislation enacted in early October.

<sup>72</sup>I.R.C. §§ 512(b)(13)(E)(ii).

So the debate continues. Defenders of the historical approach to § 512(b)(13) argue that an arm's length standard is inadequate because even in the absence of abusive pricing, P is not making a passive investment when it leases the building to S (as it would be if it rented the building to an outsider).<sup>73</sup> They contend that excluding arm's length payments from a controlled subsidiary would permit the exempt parent to get a tax-free return on capital used in an active business that it controls. Consider this comparison. Assume P owns a building and uses it in an unrelated trade or business conducted directly by P rather than through a subsidiary. P is taxed on the net profits from this business, including its "implicit return" on all its capital, including the building. If P opts to operate the business through S, and S could deduct the rent payable to P, less tax would be payable than if P ran the business directly or contributed the building to S. Allowing an "internal deduction" in these circumstances results in less overall tax liability to the P/S group than if P operated the business directly or S owned and used the building -- the very result § 512(b)(13) is supposed to prevent.

Section 512(b)(13) raises a tricky policy question. It seems appropriate to prevent a conversion of taxable trade or business income to excludable investment income in situations where the income-producing property is owned by the exempt organization and used in an unrelated trade or business. Moreover, importing § 482 transfer pricing principles, with all their attendant valuation disputes and opportunities for manipulation, would be difficult to administer. In this area, if in doubt, going with the bright line rule is a safer solution.<sup>74</sup>

Another lingering question is -- how should control be defined? Even under current law, the look-through rule of § 512(b)(13) is avoidable if a group of exempt organizations form a subsidiary to operate a taxable business. Assume, for example, that four prestigious universities each own 25 percent of the stock of a C corporation that

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<sup>73</sup>See, e.g., Michael Schler, *Letter to the Editor: The Implicit Rationale for Section 512(b)(13)*, 84 TAX NOTES 1329 (Aug. 30, 1999).

<sup>74</sup>For a thoughtful and deeper argument to this effect, see Daniel Halperin, *The Unrelated Business Income Tax and Payments from Controlled Entities*, 109 TAX NOTES 1443 (Dec. 12, 2005).

operates an online "e-learning" university, each licensing technology, alumni lists, and other tangible property as agreed.<sup>75</sup> Since none of the universities are related to each other and none have 50% control, royalty payments should retain their exclusion from UBTI. If this is an abuse, § 512(b)(13) will not correct it.

### 3. Other Tax Policy Issues Involving Subsidiaries

During its scrutiny of the UBIT in the late 1980s, the Oversight Subcommittee of the House Ways and Means Committee made several specific proposals to limit the use of controlled subsidiary tax avoidance strategies. One controversial recommendation would have required the activities of an exempt parent and its controlled subsidiaries to be aggregated in testing whether the organization's primary purpose was tax exempt.<sup>76</sup> The proposal never gained traction. Under current law, however, unrelated business activities conducted through a partnership or LLC are attributed to the tax-exempt partner or member and may threaten tax exemption even though conducting the same business in a C corporation subsidiary removes the threat. Form often prevails over substance in transactional tax planning, but it seems more sensible, at least for determining the impact of business activities on exempt status, not to make distinctions based on the legal form (corporation vs. pass-through entity) in which the activity is conducted.<sup>77</sup>

A bolder proposal would be to extend the §4943 excess business holdings rules to public charities.<sup>78</sup> If those rules were imported in their present form, controlled taxable subsidiaries would cease to be viable structures. A third option – a punt so that we can analyze more data – would be to make the activities and finances of controlled subsidiaries

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<sup>75</sup>See, e.g., Bill Workman, *Top Universities Join E-Learning Experiment*, S.F. CHRONICLE, Oct. 2, 2000, at B2, which describes such an alliance between Stanford, Oxford, Yale and Princeton.

<sup>76</sup>Subcomm. on Oversight, House Comm. on Ways and Means, 100<sup>th</sup> Cong., 2d Sess., Draft Report Describing Recommendations in the Unrelated Business Tax (Comm. Print 1988) (hereinafter "1988 Draft UBIT Report").

<sup>77</sup>See Colombo, *supra* note 36, at 689, who objects to this formalistic distinction and also proposes that the UBIT should extend to "all commercial activities by charities, whether related or not," while adding that they should not adversely affect tax exemption if the revenues are used to cross-subsidize charitable outputs.

<sup>78</sup>See McGovern, *supra* note 59, who argued that "an intensive look at the imposition of the section 4943 excess business holdings rules on public charities is appropriate."

more transparent by requiring public disclosure of their tax returns, with the ability to redact trade secrets and other proprietary information. Now that Form 990-T's are available to the public and the questions asked on the new Form 990 are more comprehensive, this is a likely next step but one that will face heated opposition by charities who believe such public disclosure is an invasion of privacy and a threat to their taxable businesses in a competitive environment.

### C. Partnerships, LLCs and S Corporations

#### 1. In General

Partnerships, LLCs and S corporations are treated as pass-through entities for income tax purposes. These forms are frequently employed as structures in which charities participate as passive investors (e.g., limited partners or non-managing LLC members), such as in real estate, hedge funds, private equity, oil and gas, and other hard assets – all beyond the scope of this paper. If a partnership (including LLCs, which are treated as partnerships for tax purposes) regularly carries on an unrelated trade or business, any net unrelated business taxable income passes through and is treated as UBTI to its tax-exempt partners even if they hold their interests as limited partners and play no role in management of the business.<sup>79</sup> Interest, dividends, rents, and other passive investment income items of the partnership, however, are generally excluded from the partner's UBTI absent debt-financing. These rules are faithful the principles of pass-through taxation and preclude an easy end run around the policy of the UBIT.

Like partnerships and LLCs, S corporations are generally not subject to entity-level taxation and pass through their tax items to their shareholders. Since 1998, tax-exempt organizations have been permissible shareholders of S corporations but with a trade-off. As a result, an exempt organization's entire interest in an S corporation, even if held as an investment, is "treated as an interest in an unrelated trade or business,"<sup>80</sup> and its share of S corporation tax items, including passive investment income such as dividends and interest that would not be subject to the UBIT if realized directly or through a partnership or LLC,

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<sup>79</sup>I.R.C. § 512(c). See *Service Bolt & Nut Co. v. Commissioner*, 78 T.C. 812 (1982).

<sup>80</sup>I.R.C. § 512(e)(1).

are taken into account in determining UBTI. For this and other reasons (e.g., lack of flexibility in crafting ownership interests), S corporations are rarely chosen by charities for commercial or investment activities. When a charity receives a donation of S corporation stock and is unable to liquidate the holding promptly, it must make a cost/benefit analysis in deciding whether to accept the gift. There usually is a benefit, but some charities view exposure to the UBIT as a communicable disease or are uncomfortable with the complexity that an S corporation holding may bring.

## 2. Limited Liability Companies

In the 1980s, limited liability companies (LLCs) arrived on the scene and in 20 years they have become the best of all worlds structure for conducting a privately held for-profit business. The major advantage of LLCs are well known: limited liability for all owners, even those that participate in management; pass-through income taxation; and flexibility in governance and ownership structure. Thanks to the liberal check-the-box treasury regulations, multiple-member LLCs enjoy default classification as partnerships for federal tax purposes.<sup>81</sup> Single-member LLCs, now permitted in every state, are treated as disregarded entities unless they elect to be taxed as a corporation.<sup>82</sup> As such, their income, deductions and other tax items are treated as realized by their single member and they do not have to file separate tax returns. In the for-profit world, the number of LLCs increased 1,136 percent between 1995 and 2005 (from 115,559 to 1,465,223), and LLCs now outnumber limited partnerships by more than 2 to 1.<sup>83</sup> The IRS has recognized that an LLC wholly owned by a single § 501 exempt organization may be a disregarded entity unless it elects to be taxed as a corporation, and the exempt owner must treat the operations and finances of the LLC as its own for tax and information reporting purposes.<sup>84</sup>

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<sup>81</sup>Treas. Reg. § 301.7701-2(c)(1).

<sup>82</sup>Treas. Reg. § 301.7701-2(c)(2).

<sup>83</sup>Tim Wheeler & Nina Shumofsky, *Partnership Returns 2005*, 27 SOI BULLETIN 69 (2007).

<sup>84</sup>Ann. 99-102, 1999-43 I.R.B. 545.

LLCs have limited utility for tax-exempt organizations conducting a substantial unrelated business. Like partnerships but unlike C corporations, the business activities of an LLC will be attributed to its tax-exempt owner. As a result, unless it elects to be taxed as a corporation, an LLC that conducts a substantial unrelated trade or business, violates the inurement or private benefit limitation, or engages in more lobbying or political campaign activity than permitted by § 501(c)(3), will jeopardize its parent's tax exemption. In some cases, this attribution of activities is a good thing – e.g., it may permit a nonprofit hospital that contributes its operating assets to a joint venture with a for-profit partner to retain its public charity status, assuming the co-owned facility conforms to the community benefit standard and the nonprofit partner does not cede control.<sup>85</sup> It follows that LLCs are not effective vehicles to avoid the UBIT or protect against loss of tax exemption. The major uses of single-member LLCs by charities are to insulate their exempt parent from liability by holding real property (an alternative to using a § 501(c)(2) title holding company) or to conduct high-risk “related” activities (e.g., clinical trials of pharmaceuticals). Multiple member LLCs are most commonly used in ancillary joint ventures with private individuals and for-profit partners. These structures are discussed in Parts IV and V, below.

A less settled question is whether an LLC can itself be a tax-exempt organization. Initially, this is a question of state law. Some states require an LLC to be formed for a “business purpose.” Others, such as California, allow LLCs to engage in any lawful business activity, “whether or not for profit.”<sup>86</sup> Assuming the LLC form is available to a nonprofit organization under state law, the IRS will recognize it as exempt under § 501(c)(3) if elects to be treated as a separate legal entity for tax purposes and its operating agreement includes the obligatory magic language (purposes, distribution of assets on dissolution, etc.) mandated by the organizational test and it meets 12 additional

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<sup>85</sup>See *infra* note 108 and accompanying text.

<sup>86</sup>Cal. Corp. Code § 17002.

requirements largely designed to patrol against inurement and private benefit.<sup>87</sup> A key requirement is that the LLC's members must be § 501(c)(3) organizations or government units or instrumentalities. For that reason, among others, the IRS recently denied exemption to an LLC organized exclusively for charitable purposes because its sole member was a pastor who used the LLC to provide chaplaincy and other counseling services to the elderly for a fee.<sup>88</sup>

#### IV. JOINT VENTURES WITH FOR-PROFITS

##### A. What is a Joint Venture?

Joint ventures come in many shapes and sizes, and their legal structures vary, as do the roles played by the nonprofit partner. Michael Sanders, who has written a 907-page treatise on the topic, defines a joint venture as "an association of persons or entities jointly undertaking a particular transaction for mutual profit."<sup>89</sup> He divides nonprofit joint ventures into four categories: (1) alliances involving only tax-exempt organizations,<sup>90</sup> (2) passive investment joint ventures,<sup>91</sup> (3) joint ventures in which the nonprofit partner contributes all or substantially all its assets (what we will call "whole-activity" joint ventures), and (4) those that represent only a portion of the assets or activities of the nonprofit partner ("ancillary" joint ventures). Some joint ventures are conducted through an entity—most typically, a partnership or limited liability company. Other economic

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<sup>87</sup>See Richard A. McCray & Ward L. Thomas, Limited Liability Companies as Exempt Organizations—Update, EO Technical Instruction Program for FY 2001, *available at* <http://www.irs.gov/pub/irs-tege/eotopicb01.pdf> (hereinafter "McCray & Thomas").

<sup>88</sup>Priv. Ltr. Rul. 2008-027-041 (July 4, 2008).

<sup>89</sup>MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS (3d ed. 2007).

<sup>90</sup>An example would be two § 501(c)(3) health care providers that wish to operate their facilities as a combined entity without a merger. Assuming the joint venture does not stray from its charitable mission or engage in unrelated business activities, the Service has ruled that such an arrangement would neither jeopardize the exemption of the venturers or result in UBTI. *See, e.g.*, Priv. Ltr. Rul. 97-220-42 (June 4, 1997).

<sup>91</sup>Although Sanders and others properly have used the term "joint venture" to encompass participation by exempt organizations in investment pools or direct but passive minority investments in start-up companies, those situations do not really fit the more active mold we are considering in this paper and will be mentioned

alliances use a wide variety of contractual arrangements, such as technology licensing agreements, exclusive provider deals, and corporate sponsorships. These collaborations often leverage a charity's intangible assets, such as intellectual property or a valuable brand name or expertise that is ripe for exploitation.

Formal structures attracting the most attention from the IRS have been whole activity joint ventures (almost always involving hospitals) and the more prevalent ancillary joint ventures. In a whole activity joint venture, all of a charity's assets are transferred in exchange for an interest in a limited partnership or LLC which usually is managed by an affiliate of the for-profit partner. The nonprofit typically continues as a grantmaking entity, but for tax purposes it is deemed under an aggregate theory to be principally engaged in the LLC's activities. The joint venture is said to be "whole" because it is the substantial or sole activity of the exempt organization, apart from grantmaking. In an ancillary joint venture, the charity does not contribute all of its operating assets and its participation in the venture is not the organization's sole activity.<sup>92</sup> In a hospital ancillary joint venture, for example, the activity could be a core function (e.g., the anesthesiology department), or a relatively insubstantial pursuit (e.g., a dialysis unit), or a support function (e.g., a laundry). In a university setting, an ancillary joint venture might be a technology alliance, an on-campus hotel, distance learning programs, or links between a law or business school and a for-profit publisher or continuing education provider.

Joint ventures can be an effective means for a nonprofit organization to raise private capital and earn valuable unrestricted revenue. Many joint ventures are justified as directly advancing the nonprofit partner's core mission, or at least "contributing importantly" to exempt purposes. It is reasonable to assume that the motives of the for-profit partners are market-oriented, not altruistic, although a new breed of philanthropic for-profits is emerging to challenge that assumption.<sup>93</sup> Most for-profit joint venturers in

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only in passing.

<sup>92</sup>See generally Mary Jo Salins, Judy Kindell & Marvin Friedlander, *Whole Hospital Joint Ventures*, FY 1999 IRS EXEMPT ORGANIZATIONS PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM 1 (1998).

<sup>93</sup>See *infra* notes 164-165 and accompanying text for a discussion of L3Cs.

health care, education and housing seek to profit from the nonprofit partner's reputation, name recognition, intellectual capital, and "fuzzy good" image, or to take advantage of targeted tax benefits such as credits for low-income housing.

The precise number and economic significance of joint ventures is difficult to quantify. Public information is scarce because nonprofit participants in joint ventures historically have not been required to disclose many details on their annual Form 990 information returns.<sup>94</sup> Nonprofits entering into alliances with for-profit firms are sensitive about divulging any specifics, viewing the information as proprietary—or perhaps they fear a backlash from legislators, regulators, donors and the general public. As a result of this information deficiency, much of what is known about the structures used for joint ventures is based on a handful of reported cases and private rulings, news reports, anecdotes, trade gossip (for those with access to it), and speculation. In this area, details matter, and informal efforts to convince nonprofit joint venture participants and their counsel to discuss their deals on (or even off) the record with any specificity were met with muted resistance or apologetic blank stares—an understandable response, perhaps, in view of the ethical constraints on revealing confidential client information. The current (2007) version of Form 990 asks (Part VI, Question 88) if at any time during the year the organization owned a 50 percent or greater interest in a taxable corporation, partnership or disregarded entity (e.g., single-member LLC). If the answer is yes, the name, percentage ownership interest, nature of activities, total income, and end-of-year assets must be provided in Part IX. Exempt organizations must disclose if they had unrelated business gross income of more than \$1,000 and, if so, whether they filed a Form 990-T UBIT return, but Form 990-T is not subject to public disclosure. Part VII of Form 990 includes a very general "analysis" of income-producing activities, and organizations are

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<sup>94</sup>The Joint Committee on Taxation and others have proposed requiring exempt organizations to disclose their Form 990s except for trade secrets or other highly confidential proprietary information. Staff of Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, 109th Cong., 1st Sess. 310-311 (JCS-02-05, Jan. 27, 2005) (hereinafter "Joint Committee 2005 Tax Reform Options"), available at <http://www.house.gov/jct/s-2-05/pdf>. The Panel on the Nonprofit Sector opposed disclosure of 990-Ts, recommending instead expanded reporting of unrelated business activities. Panel on the Nonprofit Sector, STRENGTHENING TRANSPARENCY, GOVERNANCE, ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS, A SUPPLEMENT TO THE FINAL REPORT (hereinafter "Supplemental Report") 26-27 (April 2006).

required to include gross amounts of unrelated business income in broad categories, but this information is cryptic and often incomplete. Data about the most influential institutions also is scarce because government instrumentalities, including most public colleges and universities, are not required to file Form 990. The revised Form 990, which makes its debut for 2008 tax years, will probe further in its new Schedule R (Related Organizations and Unrelated Partnerships) by requiring more detailed information on disregarded entities and related organizations (with separate schedules for exempt affiliates, partnerships, and corporations and trusts). For related organizations taxable as partnerships through which the 990 filer conducted more than five percent of its activities (measured by total assets or gross revenue), additional information is required. It will take a while, but once they become widely available, the new Form 990s will yield a treasure chest of new data about nonprofit business and investment structures.

#### B. Some Examples

Some examples, gathered from press releases, news reports, private rulings, and shop talk, offer a glimpse at the variety of contemporary joint ventures. In the interest of brevity, some important details and nuances have been omitted.

In June 2006, Baptist Health System of East Tennessee announced that it had signed a letter of intent to form a joint venture with for-profit Triad Hospitals to operate Baptist's four hospitals. Triad will have 80 percent ownership and Baptist will retain 20 percent; governance will be shared 50:50; physicians will have at least 50 percent board representation and "be given the immediate opportunity to invest in the new joint venture." The infusion of capital will permit Baptist to immediately pay off \$210 million in debt. According to the chair of Baptist's board, the hospitals will "maintain the Baptist faith-based mission and commitment to charity care at the current level."<sup>95</sup> This is what we will come to know as a whole hospital joint venture.

Community Neighborhood Housing, Inc. ("CNH") is a § 501(c)(3) charity dedicated to providing low-income housing in compliance with IRS safe harbor guidelines. To obtain the necessary capital and efficiently utilize federal low-income

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<sup>95</sup>Press Release, June 14, 2006, *available at* <http://www.baptistoneword.org/whatsnew/newsreleases/newsDetail.asp?id=284>.

housing tax credits allocated to it by its home state, CNH enters into a limited partnership with For-Profit Syndicators ("FPS"), a pool of for-profit investors, to own and operate a low-income housing complex.<sup>96</sup> CNH will serve as the sole general partner, and FPS will be a limited partner, providing 99 percent of the equity capital for the project. LP's participation is motivated by the ability to obtain low-income housing tax credits. The partnership agreement provides that CNH will have operational control of the project, which must be operated in a manner that is consistent with CNH's charitable purposes. In keeping with standard industry practice, the agreement obligates CNH to provide various indemnifications and guarantees to FPS, such as an indemnification for any loss or damage attributable to environmental hazards and guarantees to advance funds if necessary for completion of construction or to cover operating deficits.

In 2004, the University of Delaware and for-profit Shaner Hotel Group formed Blue Hen Hotel, LLC, to develop and operate a 126-room hotel on university land near the central campus. The university owns a 75 percent interest and Shaner, which will manage the hotel as a Courtyard by Marriott, owns 25 percent. Students in the university's hotel, restaurant and institutional management school work at the hotel, which is adjacent to the university's 40,000 square foot and highly profitable conference center.<sup>97</sup> This is an ancillary joint venture.

In 2006, Showtime Networks and the Smithsonian Institution announced an agreement to develop Smithsonian Networks, a cable television channel to produce and broadcast a cable television channel, Smithsonian on Demand, with programming to be drawn from the Smithsonian's collections and curators. Under the agreement, commercial filmmakers who wish to make "more than incidental" use of Smithsonian archives or curators must receive approval from this venture. According to news reports, Showtime will pay the Smithsonian a flat fee for the rights plus additional fees based on the number of subscribers to the service and will pay the cost of producing roughly 100 hours of programming a year.<sup>98</sup> In response to queries from

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<sup>96</sup>This is a generic example of a typical low-income housing joint venture, adapted from a letter to the IRS from two leading practitioners. *See* Letter from Michael A. Sanders & Celia A. Roady to Steven T. Miller, Director, IRS Exempt Organizations, TE/GE Division (hereinafter "Sanders/Roady Letter"), May 3, 2002, *available at* 2001 Tax Notes Today 106-67.

<sup>97</sup>Milford, *supra* note 15. The university's web site reports that students are involved in all aspects of the hotel, from the front office to accounts and engineering, sales and marketing—"students will have total immersion in the hotel industry" in "a working laboratory." *See* [www.udel.edu/hotel](http://www.udel.edu/hotel). Since the University of Delaware, as a public university, is not obligated to file a Form 990 information return, it is impossible to determine if the hotel partnership gives rise to any unrelated business income. It is fair to assume, however, that the business is treated as a "related" activity because of the student involvement.

<sup>98</sup>Wyatt, *supra* note 20.

Congress and others, the Smithsonian has stated that the agreement will not restrict public access to Smithsonian resources, only commercial *use* of those resources.<sup>99</sup> The Smithsonian also entered to an agreement with HarperCollins to publish "Smithsonian Books" in areas such as science, American history, and design.<sup>100</sup>

In 1998, the University of California at Berkeley and Novartis, a multinational pharmaceutical company, entered into a five-year agreement under which Novartis gave UC Berkeley \$25 million to fund basic research at a department in the College of Natural Resources. Berkeley granted Novartis first refusal rights on approximately one-third of the department's discoveries and two of five seats on the departmental research committee, which determines how the money will be spent. The agreement gave the faculty access to Novartis's proprietary genomic data base if they agreed to sign a confidentiality provision requiring them to keep the information secret.<sup>101</sup> The UC-Novartis joint venture was contractual and did not involve the creation of a separate entity. This is a unique example of a technology sharing alliance between a research university and a for-profit company.

In 2003, the National Wildlife Federation and Home Depot entered into a multifaceted agreement under which Home Depot stores will offer selected products (e.g., jugs of Pro's Choice Wild Bird Mix and bird feeders designed to keep out bird-eating snakes) bearing the Federation's logo. The Federation reportedly earns a portion of the proceeds from the sale of products and an annual fee for its part in other joint promotions that Home Depot uses to persuade customers of its commitment to the environment. The Federation also received a grant from Home Depot's corporate

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<sup>99</sup>Oversight Hearing on the Smithsonian Business Ventures: Hearing Before House Comm. on House Administration, 109th Cong. (2006)(testimony of Lawrence M. Small), *available at* <http://cha.house.gov/hearings/Testimony.aspx?TID=765>.

<sup>100</sup>See Harper Collins press release, Feb. 10, 2005, *available at* <http://www.harpercollins.com/press/display.asp?ACT=showid&ID=321>.

<sup>101</sup>The Berkeley-Novartis deal has been widely reported. *See, e.g.*, Press & Washburn, *supra* note 12. For the contract and an external review by Michigan State University, *see* [http://www.berkeley.edu/news/media/releases/2004/07/NovartisAgreement\\_public.pdf](http://www.berkeley.edu/news/media/releases/2004/07/NovartisAgreement_public.pdf) (the agreement), and [http://www.berkeley.edu/news/media/releases/2004/07/external\\_novartis\\_review.pdf](http://www.berkeley.edu/news/media/releases/2004/07/external_novartis_review.pdf) (the external review). In July 2005, UC Berkeley entered into an alliance with Yahoo to operate a research lab near the Berkeley campus. Verne Kopytoff, Yahoo Cements UC Partnership, S.F. Chronicle, July 15, 2005, at C1. For other commercial collaborations in the UC system, *see* WASHBURN, *supra* note 12, at 17-23; BOK, *supra* note 12, at 151-152. For partnerships at MIT, *see id.* at 35-37. *See also* KIRP, *supra* note 12, at 207-220.

foundation.<sup>102</sup> Home Depot has entered into a similar marketing alliance with the American Association of Retired Persons, a § 501(c)(4) organization, to sell products specifically aimed at older adults.<sup>103</sup> These are examples of licensing, marketing, and corporate sponsorship agreements.

### C. The IRS's View of Joint Ventures

The IRS's initial position was that a charity could not qualify for § 501(c)(3) exemption if it served as a general partner in a joint venture with for-profit limited partners because of the conflict between its fiduciary duty to maximize profit for the for-profit partners and adherence to its tax-exempt mission and the possibility that the unlimited liability of the nonprofit general partner exposed its charitable assets while protecting the private investors.<sup>104</sup> In *Plumstead Theatre Society, Inc. v. Commissioner*,<sup>105</sup> the Tax Court rejected the Service's noncharitable per se rule. After *Plumstead*, the IRS reconsidered, announcing that joint ventures would be evaluated by asking two questions: (1) does the charity's participation in the joint venture further its exempt purposes (the "charitable purpose" test), and (2) does the legal structure of the joint venture permit the charity to operate exclusively for exempt purposes and not for an impermissible private benefit (the "private benefit" test).<sup>106</sup> If the answer to either question was "no," exemption was denied. In most cases, the charitable purpose test was met without great difficulty. The greater hurdle was the private benefit limitation, which was grounded in the IRS's concern that joint ventures created a potential conflict of interest between maximizing

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<sup>102</sup>See Schwinn, *supra* note 21.

<sup>103</sup>See, e.g., *Eric Dash, AARP Agrees to Endorse Home Depot Products*, N.Y. TIMES, Dec. 2, 2004, at C10. AARP, a § 501(c)(4) organization, has numerous other marketing deals for products ranging from elder-friendly cell phones and luggage to health insurance and even motorcycle insurance. See Claudia H. Deutsch, *AARP Wants You (to Buy Its Line of Products)*, N.Y. Times, Oct. 28, 2005, at C1. The Nature Conservancy has allowed S.C. Johnson & Sons to use the Conservancy logo in ads for toilet cleaner and other products in exchange for a royalty. Ottaway & Stephens, *supra* note 19.

<sup>104</sup>See, e.g., Gen. Couns. Mem. 36,293 (May 30, 1975).

<sup>105</sup>74 T.C. 1324 (1980), *aff'd per curiam*, 675 F.2d 244 (9th Cir. 1982).

<sup>106</sup>See, e.g., Gen. Couns. Mem. 39,005 (June 28, 1983).

investment return for the private investors and the organization's exempt mission. For this purpose, the structural details often were determinative. Many private rulings required partnership agreements to include sufficient protections to ensure the charitable character of the activity. Later rulings were more permissive, looking not so much to structural safeguards as to the presence or absence of direct or indirect economic benefits to the limited partners, as evidenced by disproportionate allocations of profits and losses, nominal capital contributions by the limited partners, and the charity's assumption of all the risk or liability for partnership losses.<sup>107</sup>

The Service's two-part test was criticized as unduly rigid. One complaint was that partnerships and LLCs are separate legal entities and, like corporate subsidiaries, they should not in themselves jeopardize an organization's exemption absent other negative factors, such as inurement of private gain. A second was that the "commercial" nature of a partnership should not adversely affect qualification for exemption when that same activity, if conducted directly by the organization without taxable partners, would not have been a problem because, for example, it was consistent with or substantially related to the organization's exempt purposes. And even if the joint venture activity was an unrelated business, so the argument went, that only should expose the nonprofit partner to the UBIT, not loss of exemption, if the organization's primary purpose remained charitable—e.g., if it had a significant grantmaking program or other charitable activities that were commensurate in scope with its financial resources.

#### D. Whole Activity Joint Ventures

Beginning in the late 1990s, the IRS's approach to joint venture structures was shaped by a handful of whole hospital joint venture transactions that are not particularly representative of the larger phenomenon. Whole hospital joint ventures were pioneered by Columbia/HCA, a for-profit health care giant, aided by its financial engineers at boutique investment banks. In the prototype transaction, a nonprofit hospital joined forces with a for-profit firm (often an affiliate of HCA/Columbia) to form a limited partnership or LLC. The hospital contributed all of its assets (e.g., an acute care hospital)

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<sup>107</sup>See, e.g., Gen. Couns. Mem. 39,732 (May 19, 1988).

and the for-profit would contribute capital, primarily cash and possibly some operating assets, and when the smoke cleared the parties emerged with interests in the new entity that were proportionate to the negotiated values of the assets contributed by each.

Regardless of the economic interests, each party usually had equal representation on the governing board and the for-profit firm had day-to-day management authority over the hospital. The § 501(c)(3) organization remained alive, owning its interest in the joint venture entity and using any cash distributions for grantmaking or, in rarer cases, other charitable activities such as research.

In structuring a typical whole hospital joint venture, use of a partnership or LLC was critical for the tax-exempt partner to retain its public charity status. If the venture were incorporated and the nonprofit partner held its interest as corporate stock, it likely would be reclassified as a private foundation and, worse still, private foundation status would force it to divest its stake in the hospital under the § 4943 excess business holdings rules. By structuring the joint venture as a pass-through entity, the activities of the hospital were attributed to the nonprofit partner under an aggregate theory, and the nonprofit partner continued to enjoy "hospital" status, enabling it to remain a public charity without having to demonstrate any broad public support<sup>108</sup> if the hospital continued to satisfy the exceedingly loose community benefit standard for health care providers.

Whole hospital joint ventures were a response to rapid market forces in the health care sector, the decline of the traditional community hospital, and a shift from "fee-for-service" to "managed care" financing mechanisms. These pressures forced many nonprofit hospitals to form alliances, first with private physicians and clinics and later with larger for-profit hospital systems. The most extreme step was the conversion transaction, in which a nonprofit hospital was acquired by a for-profit firm. Whole hospital joint ventures were viewed as a more palatable alternative for nonprofit hospitals who needed

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<sup>108</sup>I.R.C. §§ 509(a)(1); 170(b)(1)(A)(iii). The IRS's position is that under an aggregate theory (which treats a partnership as an aggregate of its partners rather than an entity), the activities of a partnership are attributed to a nonprofit partner for purposes of determining qualification for tax exemption and liability for the unrelated business income tax.

to affiliate with a larger system in order to survive but balked at an outright sale or conversion. A stated goal was preservation, albeit in altered form, of the cherished community benefit and the accompanying tax exemption under § 501(c)(3). Proponents argued that the economies of scale and greater access to more cost-efficient managed care contracts was critical to survival of the nonprofit hospital and its charitable mission. Charitability would be protected by a shared governance structure and provisions in the joint venture agreement requiring adherence to the § 501(c)(3) community benefit standard through such factors as an open emergency room, open medical staff, community board, nondiscriminatory treatment of Medicare and Medicaid patients, and (possibly) some charity care, research and teaching activities.<sup>109</sup> The for-profit firm also expected to come out a winner – why else would it enter into such a transaction if it did not expect to make a profit? The prototype transaction enabled the for-profit partner to obtain day-to-day control over an entire hospital for a capital contribution equal to not more than half (and usually less) than its true fair market value. The desired result was increased market share and all the accompanying economic advantages and growth opportunities, as well as leveraging the halo of a nonprofit hospital with a familiar name and a longstanding reputation in the community.

The case for favorable tax treatment for whole hospital joint ventures was effectively deconstructed by VHA, a large and diverse nationwide health care provider alliance in a 1996 letter to the Treasury and IRS. VHA asserted that whole hospital joint ventures failed to advance a charitable purpose and should result in revocation of the nonprofit partner's exemption for three reasons: (1) the nonprofit partner's influence over future hospital operations would be too attenuated to guarantee that the venture would advance charitable purposes (i.e., despite 50:50 board representation, the nonprofit's power would be weak in practical terms; the for-profit partner would manage the hospital and its staff gradually would shift loyalty to profit margins rather than community concerns); (2) the community benefit test, when transported to a situation where the for-

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<sup>109</sup>See, e.g., Cain Brothers, *Focus on Joint Ventures Agreements*, 12 STRATEGIES IN CAPITAL FINANCE 2 (Spring 1995).

profit partner had effective control of the hospital, was inadequate to ensure "maintenance of a charitable focus;" and (3) the private benefits derived by the for-profit partner would be more than incidental compared with the community benefits.<sup>110</sup> The VHA submission emphasized that an IRS endorsement of whole hospital joint ventures where the nonprofit partner lacked both legal and practical control would lead to a further erosion of the community benefit standard and cause a major diversion of charitable assets to private parties whose natural instincts and fiduciary duty to their shareholders would cause them to exploit these assets for private ends.<sup>111</sup>

Revenue Ruling 98-15<sup>112</sup>, the IRS's first published ruling on joint ventures, was responsive to these concerns. A typical model of IRS caution, the ruling employed "good" and "bad" examples of whole hospital joint ventures and avoided any analysis of ancillary joint ventures. In each "situation," a nonprofit corporation owned and operated an acute care hospital that had been recognized as a tax-exempt public charity under § 501(c)(3). The for-profit partner was a corporation that owned and operated a number of hospitals and, in Situation 2, it provided management services to hospitals that it did not own. The nonprofit, concluding that it could "better serve its community" by obtaining additional funding, formed a limited liability company with the for-profit corporation, contributing all of its operating assets (including a hospital) The for-profit firm contributed "assets" (presumably, cash, although the ruling is not explicit on this point). Each partner received ownership interests in the LLC proportional and equal in value to its respective contributions. The nonprofit partner intended to use any distributions from the LLC to fund grants to support activities that promote community health and to help the indigent obtain health care. This grantmaking program and its participation as an owner of the LLC were the nonprofit's only activities.

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<sup>110</sup>Robert A. Boisture & Albert G. Lauber, Jr., *Letter to Donald C. Lubick, Asst. Treas. Sect'y for Tax Policy and Marcus Owens, Director, IRS Exempt Organizations Division*, Dec. 12, 1996, reprinted in 16 EXEMPT ORG. TAX REV. 650 (1997).

<sup>111</sup>*Id.*

<sup>112</sup>1998-1 C.B. 718.

A useful way to compare the differences between the two situations in Revenue Ruling 98-15 is to identify the "good facts" in Situation 1 and the "bad facts" in Situation 2. Good facts were: (1) the LLC's governing documents committed the venture to provide health care services for the benefit of the community as a whole and to give charitable purpose priority over maximizing profits; (2) the LLC had a five-person governing board, a majority of whom were members of the community selected by the nonprofit partner and who were not on the hospital staff and had no business dealings with the hospital; (3) the board had authority over changes in activities, disposition of assets, and renewal of the management agreement, enabling the nonprofit partner to ensure that the LLC's activities would primarily further exempt purposes and any benefits to the for-profit partner would be incidental to the accomplishment of charitable purposes; and (4) the LLC entered into a management agreement with a company unrelated to the for-profit partner for an initial five-year period and was renewable for five more years by mutual consent and terminable for cause. What the ruling did not say was that this good example likely does not exist in the real world.

Bad facts in Situation 2 were: (1) each partner had the power to appoint three members of the governing board and thus the nonprofit partner did not have control, only veto power; (2) the LLC entered into a management agreement with a wholly-owned subsidiary of the for-profit partner for an initial five-year term and terminable for cause; (3) the management agreement was renewable for additional five-year periods at the discretion of the manager; and (4) as part of the joint venture agreement, the nonprofit partner agreed to approve the selection of two individuals who previously worked for the for-profit partner as the LLC's CEO and CFO. In holding that the organization in Situation 1 qualified for exemption and the organization in Situation 2 did not, the IRS applied most of the doctrinal principles surveyed earlier in this paper. The overriding principle was that if a private party is allowed to control or use the nonprofit organization's activities or assets for its own benefit and that benefit is not incidental to the accomplishment of exempt purposes, the nonprofit partner is not organized and operated exclusively for exempt purposes.

The message of Revenue Ruling 98-15 was that the legal structure of a joint venture is highly influential if not determinative. Actual operations were far less relevant. Control was the super-factor. The ruling left many important questions unanswered. For example, was the control requirement limited to "whole activity" joint ventures or did it also extend to ancillary joint ventures? Does "control" mean legal control of the governing board, or would effective control over the venture's charitable activities be sufficient? Is a 50:50 shared governance structure acceptable if the joint venture agreement legally obligates the parties to operate in a manner that is consistent with the requirements of § 501(c)(3) and the nonprofit partner has meaningful rights to enforce that mandate?<sup>113</sup>

The IRS's control test for whole activity joint ventures has been endorsed by the few courts to consider it. The major precedent<sup>114</sup> involved St. David's Health Care System, which since 1938 owned and operated a tax-exempt hospital and related health care facilities in Austin, Texas.<sup>115</sup> In the mid-1990s, St. David's was encountering financial difficulties and concluded that it should consolidate with another health care organization. After failed attempts to join forces with a city hospital and another tax-exempt health care system, it entered into a limited partnership with an affiliate of Columbia/HCA Healthcare ("HCA"), a nationwide for-profit corporation. HCA already had a presence in the Austin suburbs and was interested in expanding into the urban market. St. David's contributed all of its assets to the newly formed partnership in exchange for a 45.9 percent interest, and HCA contributed its Austin-area facilities in exchange for 54.1 percent. The

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<sup>113</sup>See *infra* notes 128-129 and accompanying text for some suggested answers.

<sup>114</sup>See also *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9<sup>th</sup> Cir. 2001). In *Redlands*, the Tax Court held that the Service properly denied exemption to a § 501(c)(3) hospital's nonprofit subsidiary whose sole activity was participating in a joint venture with a for-profit corporation to operate an ambulatory surgery center. Significantly, the partnership agreement failed to establish any obligation of the partnership to put charitable purposes ahead of economic objectives (a "must" for a whole activity joint venture); the nonprofit partner lacked voting control and was unable unilaterally to cause the surgery center to respond to community needs (its power to veto expansion was an insufficient mitigating factor, as was an arbitration process to break deadlocks); and a revenue-based management contract with an affiliate of the for-profit partner provided an incentive to maximize profits.

<sup>115</sup>*St. David's Health Care System, Inc. v. United States*, 349 F.3d 232 (5<sup>th</sup> Cir. 2003).

partnership hired an HCA subsidiary to provide day-to-day management,<sup>116</sup> and an HCA affiliate served as the managing general partner. Each partner had the power to appoint six members of the partnership's 12-person governing board.<sup>117</sup> The partnership agreement contained certain safeguards to preserve the charitable nature of the facility (e.g., the manager was required to abide by the community benefit standard), and St. David's had the unilateral legal right to dissolve the venture if the partnership did not act in accordance with the recognized community benefit standard for tax exemption. When its exemption was revoked, St. David's paid the disputed tax and sued for a refund in federal district court – a wise choice of forum. After pausing to characterize the operational test as "a horrible amalgamation of negatives arranged like an inside joke prompting laughter only from seasoned and sadistic bureaucrats,"<sup>118</sup> the district judge granted St. David's motion for summary judgment, finding that the hospital had "substantially more control than the for-profit partner" despite its lack of formal voting control. In response to the Service's argument that St. David's failed to provide sufficient charity care, the court found that the hospital met the community benefit standard by providing *emergency* care regardless of ability to pay.<sup>119</sup>

On appeal, the IRS emphasized that St. David's had ceded control over the partnership and failed to meet the community benefit standard by lacking the requisite "community board." St. David's viewed the critical question as one of function, not control, and emphasized that its partnership provided free emergency room care and was open to all persons, regardless of ability to pay (the IRS disputed this contention), and

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<sup>116</sup>The management agreement was 55 years and terminable only by default. The manager was compensated based on a percentage of the venture's net revenue. The IRS argued that this type of compensation formula gave the manager an incentive to reduce charity care and service to Medicaid patients.

<sup>117</sup>St. David's thus had veto power, not control, but it lost its veto if its equity interest fell below 20 percent. This was unlikely to happen but could, for example, if HCA exercised its right to unilaterally request a capital call if partnership debt reached a certain level. This would cause a capital shift if St. David's was unable to meet the commitment.

<sup>118</sup>St. David's Health Care System, Inc. v. United States, 2002-1 USTC ¶ 50,452 (W.D.Tex., June 7, 2002).

<sup>119</sup>*Id.*

used its share of profits to fund research grants and other health-related initiatives.<sup>120</sup> The Fifth Circuit, purporting to apply the IRS's control test, scrutinized the partnership documents to determine if St. David's had ceded control. Because it was "uncertain," it held that genuine issues of material fact required it to vacate the summary judgment in favor of St. David's and remand the case to the district court for further proceedings.

The Fifth Circuit's opinion included a long list of observations and conclusions, which offer some guidance in structuring a successful whole activity joint venture. Favorable factors included: (1) the for-profit manager was required to operate the facilities in compliance with the community benefit standard;<sup>121</sup> (2) the parties had equal representation on the governing board, giving St. David's veto power; (3) St. David's had the power to appoint the initial CEO, subject to approval of HCA's board members, and either party unilaterally could remove the CEO; and (4) St. David's had the power to dissolve the partnership if it received legal advice from a mutually acceptable attorney that its participation in the partnership would hinder its tax-exempt status.

Unfavorable factors were: (1) because St. David's did not control a majority of the governing board, it had veto power but no power to initiate action without HCA's consent; and its authority to appoint the board chair was insufficient because the chair was unable to initiate actions without a majority of the full board; (2) because the hospital manager was a for-profit subsidiary of HCA, it was "not apparent" that the manager would be inclined to serve charitable interests and more likely that it would prioritize the noncharitable interests of its for-profit parent; (3) St. David's primary means to enforce

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<sup>120</sup>The City of Austin, Texas, filed an amicus brief in support of St. David's, arguing that the region relied on the hospital as a safety net to provide a large share of its health care for the indigent and disadvantaged. Amicus Curiae Brief of the City of Austin, Texas in Support of St. David's Health Care System, Inc., available at 2003 Tax Notes Today 56-58 (Mar. 12, 2003).

<sup>121</sup>The court found that this provision secured "some protections" for St. David's charitable mission. The IRS disagreed, arguing that a partnership agreement must go further and expressly require the manager to place charitable concerns above other goals. Although the court found the IRS's interpretation too narrow, it agreed that the provision in the St. David's agreement, standing alone, was insufficient to ensure adequate control -- other provisions must provide the nonprofit partner with an effective means of *enforcing* the manager's obligation to be "charitable" (which, in this case, required adherence to the community benefit standard). Query, what would be required for a church or school or other § 501(c)(3) organization, where there is no explicit community benefit standard?

adherence to the community benefit standard was to take legal action, which would be time-consuming and expensive; it was unrealistic to expect St. David's to resort to litigation every time a decision was made that conflicted with that standard; and (4) although St. David's had 50 percent board representation, the board's power was limited in scope and did not extend to day-to-day operational decisions; as a practical matter, St. David's could not overrule a management decision that fell outside the range of the Board's authority.

And then there were the "uncertainties" that dictated the Fifth Circuit's decision to send the case back to the trial court. The court was unsure whether St. David's ever would be willing to exercise its option to cancel the for-profit manager's contract without HCA's consent or, if it did terminate the current manager, whether a new manager would prioritize charitable purposes. Moreover, although St. David's had the power to appoint and terminate the CEO, there were instances cited by the IRS where the CEO failed to comply with the partnership agreement (e.g., no reports of charity care were furnished until IRS audit commenced), suggesting that St. David's was unable to enforce a provision of the partnership agreement specifically dealing with charity care. Finally, the court surmised that it was unlikely St. David's would exercise its dissolution power even if the partnership strayed from its charitable mission because the partnership agreement included a non-compete clause providing that, in the event of dissolution, neither partner can "compete" in the Austin area for two years. Since St. David's only served Austin, its facilities would in effect cease to exist if the partnership were dissolved.

On remand, the case was tried by a jury, and St. David's emerged victorious. The judge's instructions were based on the IRS's control test and requested the jury to find whether or not St. David's retained sufficient control over the operations of the partnership to ensure they were conducted primarily for charitable purposes and only incidentally for the private benefit of HCA/Columbia. St. David's introduced evidence on the control issue that reportedly was not effectively challenged by the government, and it also is said to have presented undisputed testimony that the partnership's hospitals provided significant charity care in their emergency rooms. The jury rendered a verdict in

favor of St. David's. Shortly thereafter, the government and St. David's reached an out-of-court settlement under which St. David's retained its tax exemption.<sup>122</sup>

Before summarizing the implications of the *St. David's* saga, it is instructive to pause for a snapshot of this still-charitable organization's current financial profile, based on a review of its most recently available Form 990s. For 2006, St. David's reported total assets of \$283 million, most of which was its stake in the hospital partnership, and \$29.8 million in net program service revenue—virtually all from the partnership. Total grants in 2004 were \$1.7 million; net program service revenue for 2004 was \$38.9 million.<sup>123</sup> In 2006, with \$31.3 million in program service revenue, it made \$4.5 in grants. The narrative report of activities describes St. David's as a partner in the St. David's Healthcare Partnership, L.P., and states that all income reported as program service revenue "was derived from health care services rendered to the central Texas community in accordance with the community benefit standard of IRS Rev. Rul. 69-45." Additional information is provided about the four acute care hospitals (e.g., according to the Form 990, in 2004 they handled 48 percent of the total emergency room visits in the Austin area and provided \$127 million of uncompensated care). The not subtle message is that the St. David's hospitals continue to comply with the community benefit standard and, given the looseness of that standard, they probably do.

The whole hospital joint venture skirmish currently appears to be in a hiatus, perhaps because the courts' acceptance of the IRS control test and the other regulatory strictures or other market forces have dissuaded for-profit partners from pursuing this kind of transaction. The decision to deny exemption to nonprofit partners who cede control in whole activity joint ventures is sound tax policy. In theory, control is a reasonable bright line benchmark—a reality check on whether the activity going forward will remain faithful to its charitable roots and ensure that charitable assets are not diverted

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<sup>122</sup>For a news report, see Fred Stokeld, *St. David's Settles With IRS, Retains Tax Exempt Status*, 45 EXEMPT ORG. TAX REV. 13 (July 2004).

<sup>123</sup>The next largest outlay was \$786,000 in legal fees, some of which presumably were incurred for the tax litigation.

to private ends. A lingering concern, however, is that the taxpayer victory in *St. David's* makes it possible to structure a whole hospital joint venture that appears to satisfy the IRS's test in situations where control is illusory and community benefit minimal. It is unfortunate that this "wiggle room" provided by a central Texas jury is now viewed as an endorsement of strategically designed whole hospital joint ventures where it is likely that, over time, the nonprofit's control will be diluted or ineffective.

When we have a sufficient history and reliable data about whole hospital joint ventures, research may reveal more about their behavior and whether it comports with appropriate standards for charitable tax exemption, whatever they may be for hospitals. Until then, the IRS is justified in applying strict and skeptical scrutiny. Then again, perhaps further research is unnecessary. In the first chapter of his best selling book, *Blink*, Malcolm Gladwell describes how the Getty Museum devoted over a year to investigating whether a sixth century marble statue—a kouros—was legitimate and worth its \$10 million asking price. The Getty finally agreed to buy the piece and displayed it with great fanfare. But several experts who saw the kouros after it was acquired knew instantly that it was a fake. One explained that he felt a wave of "intuitive repulsion" when he first laid eyes on it. It was a fake.<sup>124</sup>

Let the empirical research proceed, if it must, but at the end of the day whole hospital joint ventures don't pass the blink test. Whole school joint ventures, if they should emerge, similarly should be met with a wave of intuitive repulsion. But that does not end the inquiry. Whole activity joint ventures, despite all the attention they have received, are the outlier transaction, not the norm, and rules designed to prevent hijacking an entire charity are not necessarily appropriate for other types of alliances, whether or not they are substantially related to a charity's exempt mission. It has taken almost 25 years, but the IRS now appears to understand that a "one size fits all" doctrinal approach to joint ventures is overly simplistic and unfair. The punishment should fit the crime.

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<sup>124</sup>MALCOLM GLADWELL, *BLINK* (2005).

## E. Ancillary Joint Ventures

A typical ancillary joint venture was described by the IRS in its 1998 training manual for exempt organization specialists:<sup>125</sup>

A hospital ancillary joint venture refers to those joint venture arrangements where an exempt organization that operates a hospital or other health care facility owns an interest in a joint venture with a for-profit entity to operate a particular service. The exempt organization, usually part of a health care system, owns and operates a hospital as well as other health care facilities or services, such as ambulatory surgery center, MRI, or home health care services. It transfers the assets of the health care facility or service to the joint venture; or contributes funds to establish the ancillary service. The for-profit partner contributes cash equal to the fair market value of the exempt organization facility transferred to the joint venture. The joint venture owns and operates the health care facility or service. The exempt organization still owns and operates the hospital facility.

In the 1987 House UBIT hearings, a Treasury Department official noted that joint ventures were generating considerable controversy and raised significant tax policy issues. He said the Treasury's principal concern was to prevent shifting of deductions from exempt to taxable partners and to uncover violations of the inurement limitation. Another stated concern, however, was that (at the time) the IRS's only response to joint ventures was revocation of the nonprofit partner's exempt status. The official concluded:<sup>126</sup>

This sanction is unduly severe, at least where the partnership activity relates to a limited and discrete aspect of the exempt organization's overall activities. A more appropriate result may be to make an exempt organization's income from a partnership with a taxable partner subject to the UBIT.

This proportionate approach to ancillary joint ventures makes good sense, but the IRS was slow to embrace it until issuing Revenue Ruling 2004-51, the long-awaited first

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<sup>125</sup>Mary Jo Salins, Judy Kindell & Marvin Friedlander, *Whole Hospital Joint Ventures*, FY 1999 IRS EXEMPT ORGANIZATIONS PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM 1 (1998).

<sup>126</sup>Unrelated Business Tax: Hearings Before the Subcomm. on Oversight, House Comm. on Ways and Means, 100<sup>th</sup> Cong., 1<sup>st</sup> Sess. (hereinafter "1987 UBIT Hearings"), Statement of O. Donaldson Chapoton, at 51-54 (1987).

published ruling on the subject. Unfortunately, the ruling deals with such a simple situation that it does little more than confirm the obvious. In the fact pattern, a university joined forces with a for-profit corporation to form a limited liability company to conduct off campus teacher training classes with the same substantive content as the university's on-campus seminars. The for-profit partner's role was to provide its interactive video technology and handle marketing and administration, including selecting the camera operators and locations where the programs would be held. Economic ownership and governance rights were shared equally, and there was no evidence of non-arm's length transactions or improper allocations of income or distributions. The university controlled the curriculum, teaching materials, instructors, and educational standards. The LLC's operating agreement provided that the venture could not engage in any activity that jeopardized the university's exempt status. Significantly, the ruling stipulated that the university's participation in the joint venture was an "insubstantial" part of its activities but in so doing it provided no illumination on how to measure substantiality for this purpose.

After reciting all the controlling legal principles,<sup>127</sup> the ruling states that the university's participation in the joint venture did not jeopardize its exempt status and it would not be subject to the unrelated business income tax on its distributive share of the LLC's income. The IRS apparently was only comfortable ruling on a tightly controlled fact pattern where: (1) there was no inurement and no improper income-shifting (that's reasonable); (2) the joint venture activity was "insubstantial" and "related" to the university's exempt purposes; and (3) the university controlled the substantive program. The only concession was that a 50:50 governance structure was permissible if it was coupled with all the other favorable factors.

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<sup>127</sup>The principles, all discussed earlier in this paper, were: (1) any activities that did not further an organization's purposes had to be "insubstantial"; (2) the organization could not be organized or operated for the benefit of "private interests" (the private benefit limitation); (3) in evaluating the presence or absence of the requisite exempt purpose, "charitable" includes the advancement of education; (4) "educational" relates to instruction or training of individuals; (5) the activities of a partnership or LLC is attributed to the nonprofit partner in evaluating its qualification for exemption; (6) a § 501(c)(3) organization may participate in a joint venture and not violate the operational test if its participation furthers a charitable purpose and permits the organization to act exclusively in furtherance of its exempt purpose (the two-part test); and (7) if the nonprofit partner cedes effective control, it impermissibly serves private interests.

Revenue Ruling 2004-51 is better than nothing, but it leaves many questions unanswered. It does not consider the possibility of impermissible private benefit on these facts. And yet private benefit (among other things) was a critical negative factor in the whole hospital joint venture cases. What does it take to cause a private benefit problem in an ancillary joint venture where dealings between the parties are assumed to be at arm's length (if they are not, obviously there is a problem)? And what if the activity were "insubstantial" and not an unrelated business but the nonprofit partner ceded substantive control? Would it matter if the activity were an unrelated trade or business? If an activity were unrelated and insubstantial -- or, for that matter, if it were unrelated and substantial but "in furtherance of" the organization's exempt purposes, would it adversely affect exempt status, assuming no private benefit problem, or does that very situation raise the specter of private benefit? The ruling leaves these questions to conjecture.

To explore some alternatives, consider the following law school hypotheticals, with the usual vexing variables and, atypically, some suggested answers.<sup>128</sup>

*Basic Fact Pattern:* Sturdley University is a private nonprofit university with an undergraduate college, numerous graduate programs, and professional schools in law, business and medicine. To further its educational mission and raise revenue, Sturdley's business school is exploring whether to enter into a joint venture with ExecutiveEd.com ("Dot Com"), a for-profit provider of on line executive education. Under the proposal, Sturdley's School of Business will develop the courses and contribute its name, logo and the services of selected faculty. Dot Com will contribute cash, and a Dot Com subsidiary will manage the venture for a fee under a renewable five-year contract. All operational decisions, including marketing and fee structure, will be made by Dot Com. The venture will be structured as a

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<sup>128</sup>For some similar illustrations and consistent analysis, see Michael I. Sanders, *Health Care Joint Ventures Between Tax-Exempt Organizations and For-Profit Entities*, 15 HEALTH MATRIX: J.L.-MED. 83, 115-121 (2005); American Bar Association Tax Section, Committee on Exempt Organizations, *Proposed Joint Venture Examples for Inclusion in a Revenue Ruling* (May 15, 2002), 36 EXEMPT ORG. TAX REV. 508 (2002); American Bar Association Health Law Section, *Tax and Accounting Interest Group, Proposed Revenue Ruling on Ancillary Health Care Joint Ventures* (Aug. 1, 2002), 2002 TNT 190-14.

limited liability company under state law. In exchange for their respective contributions, Sturdley and Dot Com each will take back a 50 percent LLC interest and have equal board representation. Income, expenses and distributions will be proportionate to the member's capital accounts, and any disputes will be resolved through binding arbitration. The LLC operating agreement states that the joint venture must be operated to further the "educational purposes" of Sturdley University.

*Analysis:* Under a strict reading of Revenue Ruling 98-15, there is cause for concern here because Sturdley does not have legal or effective voting control. In addition, although Sturdley will develop the curriculum, all day-to-day management decisions will be made by the for-profit partner's wholly owned subsidiary. But if carefully structured, it should neither jeopardize Sturdley's exempt status nor give rise to any unrelated business income. Like the joint venture in Revenue Ruling 2004-51, this alliance is an insubstantial activity and, under the loose UBIT standard for relatedness, it will not be difficult to demonstrate that the program contributes importantly to Sturdley's educational mission—even if it makes lots of money.<sup>129</sup> Dot Com seems to have somewhat more control over operational decisions than the for-profit partner in the ruling, and its subsidiary manages the LLC, but otherwise the fact patterns are quite similar.

*Variation 1.* Same as the basic fact pattern, except Dot Com has a 60 percent economic interest but the governance structure remains 50:50. The result should

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<sup>129</sup>For example, Harvard Business School's "interactive" executive education and research program, operated through a separately incorporated § 501(c)(3) supporting organization, is described on its Form 990 as contributing importantly to the instructional program in all sorts of ways (the generic language on the tax return used seems to have been pulled out of a form book). For its 2006 fiscal year, Harvard Business School Interactive, Inc. earned \$22.3 million of program service revenue, none of which was treated as unrelated business income. Harvard Business School Publishing, Inc., another successful enterprise, also is structured as a separate § 501(c)(3) subsidiary.

be the same. The economic stakes of the parties in the venture are less important than the factors of substantive control, insubstantiality, and relatedness.

*Variation 2.* Same basic facts, except Dot Com has a 60 percent economic interest and can appoint three out of the five members of the governing board of the LLC, and there is nothing in the agreement giving Sturdley control over the content of the courses. Sturdley's role is to provide its reputational and intellectual capital and provide faculty to teach the courses. The IRS has not tipped its hand on the result here, but revocation of Sturdley's tax exemption would be a bizarre and untenable result. A sensible approach, at least where the joint venture activity is "insubstantial," is to make lack of control a factor on the issue of relatedness for UBIT purposes. It would not be unreasonable for the IRS to issue a ruling that if a nonprofit partner lacks control (based on board composition and other relevant facts and circumstances), that leads to a rebuttable presumption that the activity is unrelated to Sturdley's exempt purposes but does not jeopardize exemption.

*Variation 3.* Assume the joint venture had the same 50:50 division of control as in the basic fact pattern and the activity, though "insubstantial," was clearly unrelated to Sturdley's exempt purposes—e.g., a purely profit-driven surgery center that failed to meet the community benefit standard or an off-campus hotel operated by the for-profit's management company. This seems to be another easy case—no revocation of exemption but the income from the activity is subject to the UBIT.

*Variation 4.* Same as Variation 3, except Dot Com has a 60 percent economic stake and control of the board as well as the management company that operates the activity, and Sturdley lacks even veto power. At first glance, this also seems too easy and no different than an unrelated business that Sturdley could operate directly without jeopardizing its tax exemption. But does the university's lack of control over this insubstantial ancillary joint venture result in more than incidental

private benefit and thus loss of exemption? The IRS's private benefit argument breaks down in this fact pattern, and loss of exemption on private benefit or even inurement grounds (absent egregious violations) would be an inappropriate sanction. As Congress recognized when it enacted the § 4958 intermediate sanctions rules, a fairer approach would be to consider Dot Com as a "disqualified person" because of its substantial influence over an important (albeit not dominant) segment of the university and impose § 4958 penalties for any excess benefits and "sanction" Sturdley through the unrelated business tax.

*Variation 5.* Same facts as in Variation 4 except that, in a bold move to improve its U.S. News and World Report rankings, Sturdley also decides that its law and medical schools each should enter into separate "whole school" joint ventures with for-profit firms. Each school will be operated through a separate LLC; Sturdley and the for-profit partner will share economic and governance rights 50:50; and the governing documents will be silent about furthering educational purposes of the university or the community benefit standard for health care. Total net program service revenue from the law and medical schools represents about 40 percent of Sturdley's total net program service revenue. This is a much harder (but also unrealistic?) case, but remember—we are simulating law school, so the real world is irrelevant. Sturdley has three separate joint ventures which, in the aggregate, appear to be "substantial," although we really have no idea what it takes to cross the substantiality threshold or even what to measure for this purpose. It seems reasonable that, in evaluating "substantiality," all the ancillary joint ventures should be aggregated. Under what we have referred to as "the conventional wisdom" on the permissible level of unrelated business activity, Sturdley has placed its entire exemption at risk if all three activities are unrelated. The law is unsettled here, and there is no way it can be refined until the underlying doctrinal principles are clarified. Until then, the IRS is unlikely to rule, and any sensible tax planner would

protect its exemption by using taxable subsidiaries for any substantial unrelated business.

Until Revenue Ruling 2004-51, formal guidance was sparse on ancillary joint ventures conducted with a pass-through entity structure. Many would say it still is. A few concluding points are made here to sort out the possibilities. First, if an ancillary activity is insubstantial but the venture regularly engages in a trade or business, the inquiry should be limited to the UBIT rather than loss of exemption, and control over the substantive program should be an important but not necessarily conclusive factor in evaluating relatedness. If the venture is a substantial but related activity, qualification should not be jeopardized unless the arrangement results in inurement or private benefit but, once again, ceding control should have a bearing on the question of relatedness. If an activity conducted by an ancillary joint venture is both substantial<sup>130</sup> and unrelated to the organization's exempt purposes, the organization's exemption may be at risk unless it insulates itself by using a taxable subsidiary even if the organization does not cede control but query again why the legal form in which the activity is conducted should play such a protective role.

#### F. Low-Income Housing Joint Ventures

After health care, the most common type of nonprofit joint ventures are formed to develop and operate low income housing projects.<sup>131</sup> The partnering of nonprofit organizations with private investors to develop low income housing would not occur without the tax credits offered by § 42 of the Internal Revenue Code.<sup>132</sup> In a typical

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<sup>130</sup>An unresolved question is when holding an interest in a joint venture is substantial.

<sup>131</sup>See generally Sanders, *supra* note 88, at 9-11; Bennet L. Hecht, DEVELOPING AFFORDABLE HOUSING: A PRACTICAL GUIDE TO NONPROFIT ORGANIZATIONS (2006); Marni Hussong, *Notes & Comments: Protecting the Tax-Exempt Status of Housing Developers Participating in Low-Income Housing Tax Credit Partnerships*, 76 WASH.L.REV. 243 (2001).

<sup>132</sup>The low-income housing tax credit is an intricately designed incentive, and we have opted to exercise restraint in describing its numerous requirements. The federal government allocates the credits to state agencies who then award them to projects that comply with various requirements relating to the income level of residents and rent restrictions. The statute requires state agencies to award at least 10 percent of total credits to projects where qualified § 501(c)(3) or § 501(c)(4) organizations own an interest and materially

partnership, private investors provide virtually all the capital while the nonprofit developer, usually through a tax-exempt corporate subsidiary that acts as general partner, manages the property and has an option to acquire it when the tax credits expire.<sup>133</sup> Many nonprofit developers are large and sophisticated enterprises, with numerous partnerships and multiple subsidiaries to carry out various functions. A good example is Bridge Housing, based in San Francisco, which has developed over 11,000 homes and has a typically complex structure.<sup>134</sup>

Low income housing joint ventures were impeded by the IRS's myopic pre-1980 position. As surveyed earlier, the IRS gradually retreated from this early rigidity and now looks to whether the nonprofit's participation in the joint venture serves its exempt purposes and permits the nonprofit to act exclusively in furtherance of exempt purposes rather than for the private benefit of for-profit partners. The first prong of this two-part test is easily met by any nonprofit developer that follows IRS low income housing guidelines.<sup>135</sup> The second prong, private benefit, can be a problem. The IRS does not take the position that acquisition of tax credits by for-profit partners is impermissible. Its concern is that the limited partners, who have greater bargaining power, can dictate the terms of the agreement. For that reason, the IRS scrutinizes low-income housing agreements carefully, seeking to uncover provisions that confer more than an incidental private benefit on the limited partners.<sup>136</sup> This tension between charitability and investor

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participate in the development and operation of the project through the 15-year compliance period. *See generally* Mary Jo Salins & Robert Fontenrose, *Housing Partnership Agreements*, EXEMPT ORGANIZATIONS TECHNICAL INSTRUCTION PROGRAM FOR FY 2003 (2002), at G7-G8.

<sup>133</sup>*See, e.g.*, Rev. Rul. 70-585, 1970-2 Cum.Bull. 115.

<sup>134</sup>*See* <http://www.bridgehousing.com>. Its latest available Form 990 reveals that Bridge Housing had 50 tax-exempt corporate subsidiaries, many formed presumably to serve as general partner in separate housing developments, and two taxable subsidiaries, one for "affordable housing development" and the other to provide "management services for affordable housing development."

<sup>135</sup>*See* Rev. Proc. 96-32, 1996-1 C.B. 717, in which the IRS established a safe harbor to determine whether low-income housing organizations are "charitable." The safe harbor provides quantitative tests for occupancy by low and very low-income residents, using HUD guidelines on family income. If the safe harbor is not met, an organization may still rely on a list of facts and circumstances to demonstrate its charitable character.

<sup>136</sup>To avoid private benefit, the IRS requires housing partnership agreements to avoid disproportionate profit

protection is at the heart of a handful of highly specialized technical issues that have been a source of frustration for § 501(c)(3) housing groups. The major points of contention involve industry standard requests by limited partners for various guarantees and indemnification to protect them from risk of loss.<sup>137</sup>

A letter submitted to the IRS in 2002 on behalf of a consortium of national nonprofit housing organizations set the stage for a more targeted and taxpayer-friendly approach to housing partnerships.<sup>138</sup> The consortium proposed a safe harbor guideline, first articulating the relevant policies (e.g., the national policy for the § 42 tax credit and its encouragement of nonprofit-sponsored projects) and then providing a long and rather technical list of requirements which, if satisfied, will assure § 501(c)(3) status for any nonprofit organization serving as a general partner for a project that complies with the safe harbor. Control over the charitable character of the project and legal protection limiting the nonprofit partner's liability are the key components of the safe harbor. Among its essentials are: (1) only § 501(c)(3) organizations may act as a general partner; (2) the nonprofit partner may not be founded by or have any other affiliation with the for-profit investors apart from the partnership; (3) the charity must have a conflict-of-interest policy governing all transactions with interested parties; (4) the initial nonprofit partner or another § 501(c)(3) organization must have an option to acquire the property at the end of the 15-year tax credit period; and (5) the governing documents must recite that the purposes of the venture include providing decent, safe and affordable housing to low-income persons and families.<sup>139</sup>

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or loss allocations, unreasonable loans by the nonprofit partner, special distributions to the limited partners, and abnormally low capital contributions by the limiteds. The agreement also must avoid provisions diluting the nonprofit partner's effective control. It would be fatal, for example, to give the limited partners authority to dissolve the partnership without the concurrence of the general partner, to remove the general partner, or unilateral authority to hire architects, contractors, and management agents. Salins & Fontenrose, *supra* note 132, at G16.

<sup>137</sup>For the IRS's latest primer on housing partnership agreements, see Salins & Fontenrose, *supra* note 132.

<sup>138</sup>*Sanders/Roady Letter*, *supra* note 97.

<sup>139</sup>*Id.*

A centerpiece of the proposed safe harbor was a list of "do's" and "don'ts" relating to the obligations of the general partner to provide various industry-standard guarantees and indemnification to the investors. For example, it would not be fatal for the nonprofit partner to advance necessary funds to complete construction if there was a fixed price contract with a bonded contractor or advance funds to cover operating deficits for a limited period, subject to a cap, and so on. For our purposes, all these details are not as important as the overall approach, which is to permit real world joint ventures to proceed on commercially reasonable terms without threat to the nonprofit partner's tax exemption; to ensure that the charitable character of the project is protected and enforceable; and to prevent diversion of charitable assets by requiring dollar caps and other mechanisms to limit the nonprofit partner's liability.

It took a while, but in April 2006 the IRS mercifully embraced the spirit of the consortium's proposal in a directive to guide agents who process exempt applications for low-income housing organizations.<sup>140</sup> To recite all the technical details here would require far more ink, caffeine and time than necessary for purposes of our broader inquiry.<sup>141</sup> Suffice it to report the following good news: (1) the IRS at last has issued customized guidance for low-income housing partnerships rather than importing standards from whole hospital joint ventures; (2) low-income housing organizations now have a basic blueprint on which they can rely in negotiating agreements with for-profit investors; and (3) national housing policy is furthered rather than impeded by tax policy.

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<sup>140</sup>*IRS Memorandum on Low-Income Housing Partnerships* (April 25, 2006), reprinted in 52 EXEMPT ORG. TAX REV. 305 (2006). One aspect of the directive addressed longstanding logistical problems by allowing applicants to submit representations on critical matters in the governing documents rather than the final documents, which typically are not complete until days or minutes before a real estate closing. Historically, deals were delayed and sometimes abandoned while awaiting IRS review. Under the new procedure, applicants must eventually submit all the final documents and the IRS may revoke any previous favorable determination if they are inconsistent with the previous representations.

<sup>141</sup>For a crisp and informative overview, see Michael I. Sanders & Jerome A. Breed, *IRS Issues Guidance for Nonprofit Organizations Involved in Low-Income Housing*, 52 EXEMPT ORG. TAX REV. 263 (2006).

## V. CONTRACTUAL ALLIANCES

### A. Licensing

Charities with valuable intellectual property frequently enter into contractual arrangements to license a wide range of intangible assets, such as a charity's name, reputation, logo, mailing lists, and technology. These arrangements rarely create tax problems under current law. First, they usually are insubstantial relative to the totality of the nonprofit's activities. Second, § 512 excludes from UBTI "all royalties . . . whether measured by production or by gross or taxable income from the property," less directly connected deductions.<sup>142</sup> The Code does not define "royalty" for UBIT purposes, and the legislative history is silent as to why royalties were included in what otherwise is a list of traditional passive investment income items. Presumably, Congress concluded that mineral royalties and revenue from licensing various forms of intellectual property were among the proper passive sources of support. As it has been interpreted, the royalty exclusion extends to virtually all payments for the right to use intangible property, including income received for the use of valuable intellectual property rights, such as patents, trademarks, and copyrights,<sup>143</sup> but not to compensation for services rendered by the owner of the licensed property.<sup>144</sup> Even when a charity performs significant services in connection with a licensing arrangement, its UBIT exposure can be minimized by using a taxable subsidiary or unrelated third party to perform the services. This bifurcation strategy separates the royalty and services income and preserves the § 512(b) exclusion for the bulk of the revenue generated from the arrangement.<sup>145</sup>

There are valid business reasons for a charity to license intellectual property. Licensing permits the organization to obtain outside marketing expertise and relieves it of

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<sup>142</sup>I.R.C. § 512(b)(2).

<sup>143</sup>Treas. Reg. § 1.512(b)-1(b).

<sup>144</sup>See, e.g., *Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996). See Priv. Ltr. Rul. 1999-38-041 (June 28, 1999).

<sup>145</sup>See Priv. Ltr. Rul. 1999-38-041 (June 28, 1999), modified by Priv. L. Rul. 2001-49-053 (Aug. 1, 2001). It is understood that this ruling involved the AARP. Another approach is to have separate agreements for royalty and services income.

the risks and burdens of manufacturing and distributing the licensed product. Similar factors influence the decision to license valuable patents. Although the upside is more limited, so is the downside risk. The vast majority of licensing arrangements do not require a charity to devote much of its time to the enterprise. Manufacturing, marketing, distribution, and all the "active" elements of a trade or business are handled by the for-profit licensee. A major concern is to prevent the licensee from misusing the nonprofit's reputation, The IRS permits tax-exempt licensors to retain quality control, and royalty payments may be based on a percentage of gross sales, but the line is crossed if a charity becomes actively involved in the development and marketing of the product.<sup>146</sup>

During the 1987 UBIT hearings, the Treasury characterized many licensing deals as akin to joint ventures in an active business, permitting the exempt licensor to share revenue from an unrelated business while escaping the UBIT with the aid of the royalty exclusion. Even purely passive arrangements were seen as tantamount to endorsements of commercial products. The House Oversight Subcommittee concurred with the Treasury's recommendation to tax amounts measured by net profits and arrangements where exempt organizations were exploiting goodwill and other intangibles generated by their exempt mission except in cases where the arrangement furthered the organization's exempt purposes. The report specifically stated that licensing a trademark or logo in an attempt to foster name recognition would not, without more, be treated as furthering an exempt function.<sup>147</sup>

Charitable sector advocates defended the royalty exclusion as a sound way to encourage exempt organizations to leave active management of income-producing businesses to for-profit taxpayers.<sup>148</sup> Where the exempt organization actively participated in production, distribution, marketing or sale, however, a clearer standard for

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<sup>146</sup>See, e.g., Rev. Rul. 81-178, 1981-2 C.B. 135.

<sup>147</sup>1988 *Draft UBIT Report*, *supra* note 76, at 52.

<sup>148</sup>1987 *UBIT Hearings*, *supra* note 126, at 210 (statement of Independent Sector).

differentiating active from passive businesses was the suggested solution.<sup>149</sup> Practitioners with adversely affected clients argued that "passive" licensing arrangements presented no threat of unfair competition and warned that taxing royalties would be a radical departure from the longstanding policy of exempting revenue from passive sources. They noted, with some persuasive force, that the effort to tax royalties was motivated more by a subjective sense that some arrangements were inappropriate or "unseemly" and defended royalty arrangements as a means to foster greater name recognition for the charity.<sup>150</sup>

If Congress intended the § 512(b) "modifications" to exempt passive *investment* income, the expansive definition of "royalty" under current law seems incompatible with that policy. The House Oversight Committee recognized as much in 1987, but proposals to tighten the royalty exclusion remain on the far back burner, and the IRS's track record in litigation does not hold out much hope that the courts will come to the rescue. There is no indication that the current state of affairs is creating any competitive imbalance or mission drift problems. But like some corporate sponsorships and exclusive provider arrangements, royalty and endorsement deals are viewed by purists as unseemly and inconsistent with proper charitable behavior. The challenge for those who seek to tax royalties is to articulate a coherent rationale that goes beyond indignation. That sort of uprising is unlikely, especially since most charities can demonstrate that their licensing revenue is used to cross-subsidize legitimate charitable activities.

#### B. Research and Technology Alliances

Income from technology transfer and sponsored research is another rich source of nondonative revenue for universities and other leading nonprofit research centers. Stanford University's Office of Technology Licensing ("OTL") provides an impressive snapshot of the importance of technology transfers in modern higher education.<sup>151</sup> Through 2005, OTL's cumulative revenue from technology transfers over its 35-year

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<sup>149</sup>*Id.*

<sup>150</sup>For one of the more thoughtful arguments, see Thomas A. Troyer, *Changing UBIT: Congress in the Workshop*, 41 TAX NOTES 1221, 1225-1226 (Dec. 12, 1988).

<sup>151</sup>Stanford University, Office of Technology Licensing, Annual Report 2005, available at <http://otl.stanford.edu/about/resources/otlar05.pdf>.

history exceeded \$1 billion and spanned 1,500 U.S. patents and 2,500 license and option agreements. In its 2005 fiscal year alone, Stanford received \$384 million in gross royalties.<sup>152</sup> Its most lucrative invention launched a start-up company known as Google; Stanford's equity interest mushroomed in value to \$336 million by the time Google went public. OTL's annual reports describe its other accomplishments, including its pioneering collaboration with the University of California that led to the 1973 discovery of gene splicing and cloning techniques known as recombinant DNA.

The dramatic surge of technology transfer opportunities for research institutions was spurred by the enactment in 1980 of the Bayh-Dole Act, which permits universities to patent and license for profit technologies developed by its research team. Prior to Bayh-Dole, title to inventions developed wholly or partially with federal funding reverted to the government. The technology transfer boom also was driven by factors such as the privatization trend, which reduced government support and forced research institutions to seek other funding sources; the technology explosion and the opportunities for universities to profit from its growth; and the desire of faculty to share the profits from their discoveries, as Bayh-Dole permits.

Under current law, typical technology transfer alliances can be structured so that the tax-exempt licensors are not subject to the UBIT. Patent royalties qualify for the § 512(b) exclusion, even when a university accepts equity in partial consideration for a license to develop the intellectual property.<sup>153</sup> Even without the royalty exclusion, educational and scientific organizations have a good case that their patent licensing and corporate supported research income is not taxable because these activities are substantially related to their exempt purposes. To remove most lingering doubt, Congress also has provided three statutory exclusions from UBTI for research income if it is: (1) performed for the United States, any agency or instrumentality of the federal government,

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<sup>152</sup>*Id.* For the 2006-2007 fiscal year, gross royalties dropped to \$50.4 million. Stanford University, Office of Technology Licensing, Annual Report 2006-2007, *available at* <http://otl.stanford.edu/about/resources/otlar07.pdf>.

<sup>153</sup>*See, e.g.*, Priv. Ltr. Rul. 95-30-009 (April 25, 1998).

or a state or local government,<sup>154</sup> (2) performed by a college, university or hospital "for any person"<sup>155</sup>, or (3) "fundamental" (as distinguished from "applied") and the results are freely made available to the general public.<sup>156</sup>

The regulations limit the reach of these exclusions by distinguishing "research" activities from other activities "of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc."<sup>157</sup> The term "fundamental research" does not include research carried on for the primary purpose of commercial or industrial applications.<sup>158</sup> In a 1976 ruling, the Service set forth factors to be considered in determining whether income from commercially sponsored research conducted by a scientific organization would be subject to the UBIT.<sup>159</sup> If the results of those research projects are published in a form available to the public within a reasonably short time after completion, the organization is treated as engaging in scientific research in the public interest even if the sponsor retains ownership rights in the research results. But if the scientific organization agrees to withhold publication beyond the time reasonably necessary to obtain patents or agrees to forego publication entirely, its income from conducting the commercially sponsored research is subject to the UBIT.

The public policy arguments in favor of encouraging research collaborations between universities and private industry are well known: they contribute to the advancement of knowledge. But concerns are mounting about the abandonment of academic values in this new academic/industrial complex.<sup>160</sup> No serious observer would

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<sup>154</sup>I.R.C. § 512(b)(7).

<sup>155</sup>I.R.C. § 512(b)(8).

<sup>156</sup>I.R.C. § 512(b)(9).

<sup>157</sup>Treas. Reg. § 1.512(b)-1(f).

<sup>158</sup>Id.

<sup>159</sup>Rev. Rul. 76-296, 1976-2 C.B. 141.

<sup>160</sup>See BOK, *supra* note 12, at 139-156.

propose that a research university that cross-subsidizes its educational program with technology licensing revenue should lose its tax exemption. The largely unexplored question<sup>161</sup> is when "purely commercial" research revenue should be taxable. Any such effort to expand the UBIT would require a delicate and highly controversial line drawing exercise that would be difficult to implement. Factors to be considered could be conflicts of interest, confidentiality agreements with private industry, and corporate-imposed limits on dissemination of research results to the public. Additional tensions are raised by contracts between entire university departments and a single company, such as the UC Berkeley/Novartis alliance summarized earlier in this paper.<sup>162</sup> An epidemic of Novartis-like contracts, where one company has first refusal rights to departmental research and to license patents, distorts the academic mission of a university and might cause Congress, in one of its moments of hyperactivity, to respond with punitive legislation.

A broader dialogue on these issues is underway, and it should continue for a while without intervention of the tax system. As Derek Bok has observed, academic leaders need to draw adequate lines that will accommodate a vigorous technology transfer program while preserving the openness, independence, and objectivity that good science requires," and "the time is ripe . . . to set appropriate limits and see to it that they are vigorously enforced."<sup>163</sup>

## VI. LOW-PROFIT LIMITED LIABILITY COMPANIES

A new structure is emerging to accommodate the desire to promote social entrepreneurship but avoid the regulatory strictures of tax-exempt status. The low-profit limited liability company, or "L3C," has been touted as a vehicle to pool private capital and traditional philanthropy to address unmet societal needs. An L3C is a for-profit entity

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<sup>161</sup>For one of the few comprehensive discussions, see Peter D. Blumberg, Comment: *From "Publish or Perish" to "Profit or Perish": Revenues from University Technology Transfer and the 501(c)(3) Tax Exemption*, 145 U.P.A.L. REV. 89 (1996).

<sup>162</sup>See *infra* note 100 and accompanying text.

<sup>163</sup>BOK, *supra* note 12, at 156.

organized for business purposes which: (1) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of § 170(c)(2)(B) of the Internal Revenue Code, (2) might not have been formed but for its relationship to the accomplishment of charitable or educational purposes, and (3) no significant purpose of which is the production of income or the appreciation of property. L3Cs leverage the attractive features of LLCs by offering limited liability to all participants, pass-through tax treatment, and flexibility in creating multiple classes of investments with different risks and rewards. If after formation, an organization formed as an L3C fails to meet these tests, its status converts to a regular LLC. Vermont is the first state to enact legislation recognizing the L3C.<sup>164</sup> Similar legislation has been proposed in North Carolina and several other states.

The L3C movement is laudable but narrow. L3Cs are intended to facilitate program-related investments (PRIs) by private foundations in collaboration with private investors, including institutional investors such as pension funds. For purposes of the five percent payout private foundation payout requirement in § 4942, PRIs count as qualified distributions and, even if imprudent under normal fiduciary standards (and they usually are), PRIs are insulated from jeopardy investment penalties under § 4944. Foundations are said to avoid PRIs either because of lack of understanding, fear of complexity, and aversion to the expense of tax compliance. The L3C model would establish state law requirements that mirror the IRS rules for PRIs and obviate the need for an expensive private ruling. Foundations would be expected to provide the seed capital and bear the greatest risk (e.g., by subordinating their interests and agreeing to a lower rate of return). Private investors would be enticed into the pool with the promise of a risk/reward profile that offers a comfortable market rate of return albeit with limited upside. Use of the L3C structure permits layering of different types of ownership interests and, its proponents predict, will create a desirable climate for the investment of private capital (assuming any

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<sup>164</sup>11 Vt. Stat. Ann. § 3001(23) (2008).

is left by the time of this conference) and “open the door to millions of dollars not currently available.”<sup>165</sup>

To illustrate a typical L3C scenario, consider this example borrowed from materials distributed by Robert Lang, the CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation which, in collaboration with Americans for Community Development, are founding visionaries of the L3C concept:<sup>166</sup>

A for-profit business decides to close a furniture factory in a small town where it is the major employer, causing 200 employees to lose their jobs. Keeping the factory open would only produce a 3 percent annual return as compared to alternatives with similar risks that would yield 6 percent, but this analysis fails to consider the costs to the community from loss of the factory. An L3C could be organized by a private foundation to buy the factory and keep the jobs. It would be structured so that the foundation's ownership stake is subordinate to other investors and earn a “very low” rate of return. The remaining ownership shares could then be marketed at rates of return and risk levels necessary to attract market-driven investors. To ensure that the L3C fulfills its social mission, the foundation would insist on having 60 percent of the voting power and control of the governing board.

A reasonable question is whether preserving jobs for workers in an industry or geographical location whose time has passed is a prudent social investment notwithstanding the negative impact that the plant closing would have on the community.

One assumes that more compelling examples of program-related investments through L3Cs will emerge.<sup>167</sup>

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<sup>165</sup>Robert M. Lang, Jr., LC3 Overview (Americans for Community Development), *available at* <http://www.americansforcommunitydevelopment.org/13c.asp>.

<sup>166</sup>*Id.*

<sup>167</sup>A few have been suggested by Americans for Community Development: operation of a hotel in a deteriorating business district with ability to generate revenue but not enough to attract sufficient capital to begin operations or financing the conversion of historic buildings into office or retail property. *See* Frequently Asked Questions About L3Cs, *available at*

The L3C is an intriguing new “fourth sector” niche structure that would appear to have a limited impact. LC3s are not seeking tax-exempt status. They are designed to operate as self-regulating private businesses, governed by a board, officers, members, and structural mandates that ensure the furtherance of social goals. L3Cs will succeed, however, only if a sufficient pool of private investors can be enticed to participate by receiving a bond-like investment return, with perhaps more risk (who is to say the furniture business will survive, even with the L3C’s help?), along with the psychic income of doing good. It seems unlikely that pension funds and other noncharitable institutional investors would find LC3s attractive unless they have a uniquely broad fixed income mandate.

## VII. CONCLUDING OBSERVATIONS

Our selective survey of basic structures suggests that it is an exciting time to be an architect for entrepreneurial nonprofits. It may be time for NYU’s celebrated graduate tax program to add a seminar on Business Planning for Nonprofits to complement its rich and textured curriculum. Legal and tax advisors are essential players as nonprofits evaluate their options and opportunities for revenue-generating activities.

From a public policy standpoint, the critical questions are not about architecture or business planning but immigration law (and maybe economics). Should the legal system, and by default it would be federal tax law, continue to play its traditional role of patrolling the borders between the for-profit and nonprofit sectors. Or, as it seems to be doing, should the law take a more relaxed approach in recognition of the value of more varied, efficient and innovative approaches to funding socially desirable activity?

As warned, this paper has no grant thesis to propose – only a cautionary note. An unregulated and permissive approach to commerciality, coupled with mission sprawl, doctrinal disarray, the resourcefulness of tax planners, and the base instinct of greed, all could conspire to dilute the unique societal role played by nonprofits and ultimately lead to an overbroad regulatory reaction. In the face of pressure by business-oriented funders

and stakeholders, nonprofit board members and managers need to stay focused on their organization's *charitable* mission and avoid engaging in revenue-generating activities that compromise it. Every board should have a new officer – the “mission steward” – to ensure fidelity and provide leadership by critically evaluating any fundamental strategic changes that may be proposed.

But self regulation is not enough to secure the border. In a tax professor's dream world, the Internal Revenue Code would clarify the impact of commercial activities on tax-exempt status and strengthen the unrelated business income tax. But be careful what you ask for. This dream could degenerate into a nightmare unless these efforts are undertaken with respect for the diversity and independence of the nonprofit sector. The best approach would be to design measured and workable intermediate sanctions, such as those proposed in the discussion of ancillary joint ventures, rather than the overbroad threats to revoke tax exemption that the IRS used in its early approach to joint ventures. The 1987 UBIT Hearings were a constructive step toward reform of the UBIT, but momentum was lost in the face of a lobbying effort by special pleaders.

The more likely scenario, however, is that the law will meander along, with occasional venting from Congress and the IRS, resulting in targeted legislation and regulations aimed at the more potentially abusive structures and situations, such as whole hospital joint ventures, credit counseling organizations, and use of charities as tax shelter facilitators. Or, considering the stock market declines during the too short time that this paper was being written,<sup>168</sup> perhaps the topics of commerciality and social enterprise will wither and become dormant while the for-profit sector enters rehab, with the timing of its recovery uncertain.

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<sup>168</sup>As someone once said, if I had more time, I would have written a shorter paper.