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**joint ventures
involving
tax-exempt
organizations**

Fourth Edition

Michael I. Sanders

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Joint Ventures Involving Tax-Exempt Organizations

Fourth Edition

Michael I. Sanders

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V V A L L A

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

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Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Sanders, Michael I.

Joint ventures involving tax-exempt organizations / Michael I. Sanders. – Fourth Edition.

pages cm. – (Wiley nonprofit authority series)

Includes index.

ISBN 978-1-118-31711-2 (cloth); ISBN 978-1-118-41998-4 (ebk); ISBN 978-1-118-42168-0 (ebk) 1. Nonprofit organizations–Law and legislation–United States. 2. Joint ventures–Law and legislation–United States. 3. Partnership–United States. 4. Nonprofit organizations–Taxation–Law and legislation–United States. I. Title.

KF1388.S257 2013

343.7306'6–dc23

2013008462

*To my wife, Judy,
whose love, devotion and patience
has made this book possible;
and to David, Patty, Hayley, and Jacob;
Noah, Brooke, and Emme;
Adam, Randi, Gabby, and Eva;
and Dr. Sammy.*

Preface

There are approximately 1.6 million nonprofit organizations in the United States, with 960,000 of those being Internal Revenue Code §501(c)(3) charities. According to an August 2012 study by the Chronicle of Philanthropy, total contributions to those charities was \$135.8 billion in 2008, the most recent year for which data were available. These organizations had \$1.51 trillion in total revenues, \$1.45 trillion in expenses, and more than \$2.7 trillion in total assets, based on 2010 statistics.

While one would assume that these figures are indicative of a strong sector, it is actually quite vulnerable. In December 2012, the United States faced going over the so-called fiscal cliff, followed by the impact of sequestration and Federal budgetary concerns. As an aside, there have been numerous proposals to limit the charitable deduction. Newspapers across the country are featuring news articles and editorials debating the pros and cons of maintaining the status quo versus curtailing or even eliminating the deduction on grounds that true charitable spirit does not necessitate a financial reward.

Even if the charitable deduction is not modified in connection with the 2013 tax reform, it will remain a target, in the words of the *Wall Street Journal*, in future revisions of the Internal Revenue Code. At a time when the services of nonprofits are in greater demand, they are receiving less support from budget-constrained governmental agencies and contributions from the private sector. These stresses could worsen if future tax reform incorporates provisions that reduce incentives for charitable giving and participation in credit transactions by wealthy individuals.

Beyond this potential legislative change, nonprofit organizations face other challenges. Many charities “compete” for the same charitable dollars. For example, after Hurricane Sandy struck New York and New Jersey in October 2012, taxpayers were urged to make donations to numerous local and national organizations that were publicizing their ability to provide a variety of necessary services, although it actually took time for some organizations to provide emergency aid. In fact, Doctors Without Borders, a charity that usually operates internationally, provided medical services to hurricane victims in certain areas before other charities, such as the Red Cross, a high-profile disaster relief provider, began to do so.

Although the Internet has facilitated fund-raising in certain respects, such as allowing taxpayers to make donations by sending a cell-phone text message in connection with international natural disasters such as the 2004 tsunami in Asia, Hurricane Katrina, and the 2010 earthquake in Haiti, charities need to develop new avenues and partners to conduct their programs. In some cases, charities have joined forces to accomplish fund-raising or program-related goals. Increasingly, charities are forging partnerships with for-profit entities to access otherwise unavailable capabilities, e.g., low-income organizations using the low-income housing and New Markets Tax Credits programs with for-profit investors to subsidize development (Chapter 13), and universities partnering with for-profits to offer distance-learning programs.

Over the years, the IRS's position has evolved from opposition to joint ventures between non- and for-profit entities to acknowledging their various bona fide purposes and establishing guidelines for nonprofits to protect their exempt status while engaged in such partnerships. Pursuant to these guidelines, charities will not

jeopardize their exemption by participating in a joint venture so long as the charities have sufficient control to ensure that the venture will further the charity's exempt purposes and there will be no impermissible private benefit or inurement. There is no bright line test, although having at least 50 percent voting control of a venture in regard to matters that relate to its charitable goals is a positive factor. The IRS considers this to be a facts and circumstances determination and will not issue rulings except in connection with an application for exemption. It is therefore important to have a joint venture policy in place and to carefully structure ventures pursuant to these guidelines.

There is an impetus to establish new avenues to achieve fund-raising and charitable objectives, many of which involve some form of joint venture, with an ever-evolving combination of tax-exempts, governmental agencies, for-profit entities, and individual philanthropists seeking novel solutions to current crises. One example is (Red)©, an innovative worldwide fund-raising effort to eradicate the AIDS virus that was started by a celebrity from the world of rock music, Bono. Presidents Obama, Bush, and Clinton have demonstrated a continuing tradition of support for this project. An early example of a for-profit corporation seeking a “halo effect” was Ben and Jerry's, which widely advertised its “doing good” philosophy and approach to business. This has been labeled the double- or triple-bottom-line for-profit organization—one that directs a portion of its profits to achieve social goals while earning profits.

This trend is not limited to private-sector activity. In addition to the adoption of L3C statutes (a for-profit limited liability entity formed to engage in socially beneficial activity) in nine jurisdictions, several states have adopted legislation authorizing the creation of “social benefit corporations”—for-profit corporations that permit directors to consider socially responsible goals along with the

obligation to generate profits when engaged in the corporate decision-making process. In effect, this legislation represents the legalization of the triple-bottom-line trend discussed above.

Another important area blending social need and tax-based incentives is the growth of the New Markets Tax Credits program by joint ventures consisting of community-based and for-profit organizations that establish charter schools and commercial development in low-income census tracts. Creating the vehicle for this to occur in today's environment is the challenge. One example of a successful venture in 2011 is the development by Robin Hood Foundation of a charter high school in the Bronx that leverages a grant from the Department of Education in New York City. Robin Hood is a nonprofit created to support schools in New York's poorest neighborhoods. In 2009 the charity formed a joint venture LLC to develop a charter school in the Crown Heights section of Brooklyn; a New Market Tax Credit transaction also provided a significant part of the funding for the project. In addition, the low-income housing tax credit not only should be retained, it should be expanded in light of the need to rebuild so many U.S. communities in the aftermath of recent hurricanes.

Because charities receive federal income tax exemption as well as state and local income and property tax exemptions, their activities come under scrutiny. Scandals involving excessive compensation paid to executives of nonprofits have made headlines, including The United Way, American University, and The Smithsonian Institution. To curb this type of excess, Congress enacted stricter rules regarding how public charities, which are charitable organizations with a public base of support, compensate their executives. Under the intermediate sanctions rules, organizations and their managers who approve compensation arrangements that do not comply with its guidelines are subject to

penalties. The extent of their effectiveness remains to be seen. In an effort to obtain more information about the activities and income of nonprofits, and increase “transparency,” the IRS released a revised Form 990 in 2008, a form that requires a great deal more information, including details about partnerships and joint ventures that nonprofits engage in, as well as their governance practices, another focus of the IRS, which believes that “good governance” leads to compliance with the provisions of the Internal Revenue Code.

The two largest sectors in the nonprofit world, hospitals and universities, have been the subject of particular scrutiny. The IRS conducted a study of universities, issued an Interim Report, and subsequently initiated a university audit program, which is currently underway. Section 501(c)(3) hospitals have been a magnet of Congressional attention for many years, with the charitable care and community benefits offered by tax-exempt hospitals, as well as their compensation practices, a particular focus. As part of the Patient Protection and Affordable Care Act of 2008 (PPACA), Congress adopted a new regime of rules to be met by charitable hospitals, with the potential loss of exemption and/or imposition of stiff penalties for failure to comply. Hospitals must satisfy these new provisions in addition to the requirements of §501(c)(3), and, as discussed in Chapter 12, there are many outstanding questions in regard to the applicability of these rules to hospitals operated by joint ventures.

Chapter 12 also describes other changes in the health arena, including the IRS's issuance of exemption rulings to regional health information organizations (RHIOs) and health information exchanges (HIEs) requesting recognition of tax-exempt status under §501(c)(3). RHIOs and HIEs are the organizations and networks, respectively, through which doctors, pharmacies, and hospitals share electronic medical

records. Some of these entities are structured as joint ventures. In addition, the PPACA also authorized the formation of new tax-exempt organizations. The first category is accountable care organizations (ACOs), wherein groups of service providers coordinate the care of Medicare beneficiaries with the goal of rendering more efficient services. Tax-exempt organizations such as hospitals and nursing homes will partner with other medical service providers to form ACOs, which in effect are joint venture entities, and share in the savings gained from coordinated efficiencies. The second category is health insurance exchanges or CO-OPs. Under new §501(c)(29), tax-exempt status will be available to a new type of health insurance issuers that offer affordable healthcare plans to small employers and individuals.

The bottom line: There is no longer one paradigm for joint ventures. Creativity, flexibility, and unique approaches are flourishing as individuals and businesses forge new paths in an effort to address world problems through outside-the-box solutions. For the nonprofit seeking to expand its activities and income stream to support those activities, properly structured joint ventures provide unlimited potential.

Acknowledgments

It seems like yesterday when I was first invited by John Wiley & Sons to prepare an outline for a new book on partnerships and joint ventures involving nonprofit entities, yet almost 20 years have passed and I have now completed the Fourth Edition of *Joint Ventures Involving Tax-Exempt Organizations*, a treatise that provides guidance and structure to an ever-growing, complex area, in order to enable tax-exempt organizations to meet critical economic, political, and social challenges. Since the first edition, charitable organizations have been using the joint venture structure to respond to international natural disasters such as the 2004 tsunami in Asia, the 2010 earthquake in Haiti, and national disasters such as Hurricane Katrina in Louisiana and the Gulf Coast and Hurricane Sandy in New Jersey and New York. In the Third Edition I acknowledged the many colleagues who have provided valuable, technical assistance over the years, having given freely of their time in the research and development of an emerging and dynamic subject matter. I incorporate the acknowledgment section in the prior edition by reference in this edition since their contribution has been so critical to the success of this book.

The Fourth Edition reflects a comprehensive set of revisions to the earlier three editions. Over the years the IRS position has evolved from initially opposing joint ventures between non- and for-profit organizations to acknowledging their various bona fide purposes and establishing guidelines for nonprofits in order to protect their exempt status while engaging in these ventures. Unfortunately the IRS is not willing to rule on the more complex structures. As a result, the chapters have been edited to discuss joint venture

policy and enable the reader to structure ventures pursuant to these guidelines.

I'm especially grateful to Ronald Schultz, PricewaterhouseCooper, formerly Senior Technical Advisor to the Tax Exempt/Government Entities, Commissioner of the Internal Revenue Service, for his critical role in discussing the revised Form 990 and new IRC §501(r), as well as his insights on the developments regarding conservation organizations. His analysis continues to raise important questions regarding the structure and operation of joint ventures in regards to these topics. A special thanks to Ed Creskoff for his comprehensive review and update of the low-income housing and historic tax credit sections. I appreciate the dedication of Susan Leahy (unrelated business income tax, debt financing, excess business holdings, and business leagues); and Megan Christensen (taxation of partnerships and LLCs). I thank Marcie Seiler Landsburg and Michael Schaedle for their work on the debt restructuring discussion in Chapter 20. Thanks are of course due to our research assistants, Jorge Lopez and Micah Miller, for their contributions.

Most important, I am truly indebted to Gayle Forst, who has played an indispensable role in the research and drafting of a significant number of chapters; Gayle was the editor of the Second Edition and has played a more critical role in the drafting of the manuscript of the Fourth Edition. I also acknowledge Linda Schrader's unique and invaluable assistance in the preparation of the manuscript, as well as her coordination with the staff of John Wiley & Sons, which is critical to the entire process.

Finally, I would like to add a special note of appreciation to my colleague of more than 30 years, Susan Cobb, who passed away during 2012. Susan was intelligent, creative, and reserved, yet brilliant. She made innumerable contributions to this book and to my practice over the years.

Thank you to my colleagues at Blank Rome, LLP, who have given freely of their time in the research and review of this manuscript.

About the Author

Michael I. Sanders is the lead partner of the Washington office's tax group at Blank Rome LLP. He served with the U.S. Department of Justice (Attorney General's Honors Program 1967-1968; and attorney advisor to the Assistant Secretary for Tax Policy, Office of Tax Legislative Counsel, 1968-1970), and was formerly Chairman of the Exempt Organizations Committee, Tax Section of the American Bar Association, member of the Internal Revenue Service Commissioner's Exempt Organizations Advisory Group. He is a member of the American Institute of Certified Public Accountants.

Mr. Sanders is an adjunct professor of taxation at Georgetown University Law School, teaching tax treatment of charities and other nonprofit organizations and joint ventures between non-profits and for-profits and at George Washington University Law School, teaching income taxation of partnerships and subchapter S corporations. Mr. Sanders was honored in 2010 by The George Washington University School of Law for his 35 years of teaching at the law school.

Mr. Sanders has co-authored *Private Foundations—Taxable Expenditures, Tax Management Portfolio, 293-3rd*, and authored “Exploring the Role of the Tax Attorney,” *Tax Settlements and Negotiations: Leading Lawyers on Issuing Tax Opinions, Managing Audit Situations, and Representing Clients before the IRS, 2006*. Mr. Sanders was named by the *Washington Business Journal* as one of the City's Top Ten Lawyers and the City's Top Tax Lawyer in 2004. Mr. Sanders was selected for the 2010, 2009, 2007 and 2006 editions of *Best Lawyers in America* and has also been honored as one of “Washington D.C.'s Legal Elite” by *Smart CEO Magazine*

for 2006 and 2007. In 2007 and 2010, Mr. Sanders was selected from a field of the nation's leading lawyers and judges as a finalist for the Lawdragon 500 based upon his current impact on the biggest issues and deals in the law. He was also recognized by *Washingtonian* magazine as "One of Washington's Top Lawyers" for 2007, 2008 and 2010. The American Registry has recognized Mr. Sanders as a Top Attorney in the DC Metro Area for years 2009 and 2010. Mr. Sanders has also been selected as a "Super Lawyer" in Tax for 2008, 2009 and 2010. And the *Washington Post*, in association with the *LegalTimes*, selected Mr. Sanders as one of Washington DC's Best Lawyers in Tax Law for 2009, 2011 and 2012. Mr. Sanders speaks at numerous conferences and forums around the country and regularly serves as an expert witness in complex cases involving federal income tax.

Mr. Sanders earned his LLB at New York University, and his LLM at Georgetown University.