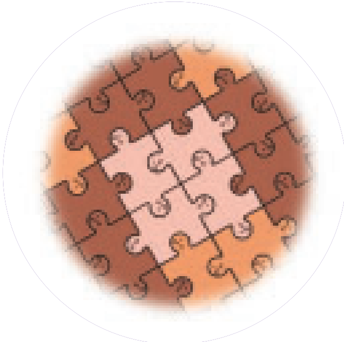

Many Ways to Achieve Joint Ventures

But Be Aware of Tax and Exemption Issues

by Kathryn M. Vanden Berk

Back in the early 1990s, we all heard how funders were trying to force nonprofit providers to work together to avoid duplication in the marketplace. The United Way led this change by insisting that some of its grants would not be approved unless more than one service provider was part of the application. These forced alliances were not always successful. The better ones either figured out how to successfully blend resources or hired consultants to help them do so.

These early joint enterprises were the beginning of a movement that has been building momentum: strategically joining forces to provide a wide range of services while remaining a "lean and mean" organization. Our practice has been involved in the front-end activities related to a number of joint ventures, and I want to share some of my observations with you.

There are many ways of joint venturing. Much of our work involves two major areas of legal advice: (1) exploring the tax ramifications of the proposed venture, and (2) drafting contracts that confirm the parties' agreement and establish their future relationship.

Joint Venture Combinations

Perhaps it's best to start by describing what a joint venture is not. Outsourcing a task by bringing in an outside vendor is not a joint venture. When a residential treatment center contracts out its food preparation to a catering entity, or a small agency contracts for claims processing or payroll functions with a service vendor, this is a simple business deal because there is no shared enterprise.

For a joint venture to exist, there must be a community of interest in the performance of a common purpose; an ownership interest in the subject matter; a right to direct and govern; a duty, which may be altered by agreement, to share both in profit and losses; and one member of the joint enterprise is liable to third parties for acts of the other venturer, especially payment of debts.[1]

Most often, nonprofits will partner with other nonprofits to accomplish something that neither could do on its own. One common strategy we often see brings together two agencies to jointly construct an office building to house their operations. Or they might form a joint enterprise to engage in a business opportunity such as workforce training for jointly needed staff. These joint ventures typically are exempt from taxation because their parent organizations are exempt. However, the joint venturers may or may not be required to pay unrelated business income tax on the profits generated, depending upon whether the business activities are within or outside of their recognized exempt purposes.[2]

The type of joint venture I discuss in the remainder of this article is tax-exempt nonprofits joint venturing with for-profit business partners. I am going to refer to the nonprofit as an exempt organization, or EO, since my discussion will revolve around the tax ramifications under cases and rulings of the Internal Revenue Service.

The Plumstead Principle of Control

The way was paved for partnering arrangements between EOs and for-profit entities in 1980, when the U.S. Tax Court ruled that a tax-exempt theater group could partner with private investors without losing its tax exemption. In Plumstead, the EO's exemption[3] was allowed to stand because the court found that (1) the nonprofit had no obligation to return equity contributions to its investors if the play failed to break even, and (2) none of the investors had control over, or were involved in, the theater company's day to day activities.

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TAX CONSIDERATIONS ARE NOT THE ONLY ELEMENTS TO TAKE INTO ACCOUNT WHEN PREPARING A JOINT VENTURE. GOOD BUSINESS SENSE SHOULD ALWAYS BE APPLIED TO ANYTHING YOU DO, WHETHER ALONE OR WITH ANOTHER ORGANIZATION. BE SURE TO KEEP THESE THINGS IN MIND.

KEY ELEMENTS

MAINTAIN CONTRACTUAL INTEGRITY

Contracts are valid only so long as they respect the relative bargaining positions of the parties. They should be drafted in such a way that it is clear that they were between willing parties who bargained in good faith and at arm's length. If there was a preliminary proposal that was approved before the governing documents were drafted, be sure that the provisions of the proposal are reflected in the final documents. Contracts that deviate substantially from the agreed-upon deal, or are unduly burdensome to one party while unduly benefiting another, are likely to cause trouble in the long run. Be sure that any joint venture agreement is reasonable and fair.

INSURE AGAINST RISK

Indemnify the parties within the governing documents and obtain insurance to protect against risk.

ALLOCATE RESPONSIBILITY AND ESTABLISH STANDARDS

Make sure the party that accepts ultimate responsibility for outcomes is clearly identified and that standards against which that entity will be held accountable are set forth. Evaluate the performance of each party against these agreed-upon standards and take action if the performance is not up to par.

AVOID OVERBLOWN PROMISES

Don't promise more than you can deliver. Don't guarantee results that cannot be guaranteed. Spend sufficient time in setting things up and getting the paperwork done. This will bear fruit after operations begin and issues arise that can only be ironed out by reference to your governing documents.

BE CAREFUL WITH INSIDERS

Your officers, directors, and key employees are especially vulnerable when you work with private for-profit corporations. They have a tendency to offer sweetheart deals that could be detrimental to the exempt organization and raise the specter of excess benefit transactions.[1] If you suspect that there is even a possibility of a conflict of interest, be sure to have the transaction thoroughly examined by experienced legal counsel. When your joint venture is up and going, be sure to insist upon adherence to conflict of interest policies if a situation arises that must be dealt with under them.

MAINTAIN CONTROL OF THE JOINT ACTIVITIES

Although it has been addressed in the article, never forget that the exempt organization must remain in control of a joint venture with a for-profit entity in order to maintain its tax exemption and the exempt status of the enterprise. Draft governing documents (partnership agreement, bylaws, or operating agreement) so that the exempt organization always has the ability to block any action that would frustrate the charitable mission, improperly use charitable assets for private benefit, or allocate profits against the stated intent of the joint venture. Operate the joint venture in a way that carries this out.

[1] Excess benefit transactions are described in Section 4958 of the Internal Revenue Code (26 U.S.C. §4958 et seq.). Any "disqualified person" under that section can be required to pay back the entire amount of the benefit to the organization and, in addition, pay an excise tax to the IRS of up to 25% of the amount.

venturing. The most notorious area of aggressive joint ventures involved health care organizations. In these, tax-exempt hospitals either sold all their assets to a for-profit hospital corporation and placed the sale proceeds in a grant-making foundation, or entered into "whole hospital" or "partial hospital" joint ventures in which the hospital (or a portion of it) was contributed to the joint venture and thereafter managed by a for-profit management corporation.

After the IRS successfully challenged a California whole-hospital joint venture in the mid-1990s,[4] it issued Revenue Ruling 98-15 that established the rules we abide by today.[5] While there are a number of factors that differentiate a "good" situation from a "bad" situation, basically, the exempt entity must maintain sufficient formal or informal control to ensure furtherance of its charitable purpose, and the joint venture must actually carry out the EO's exempt purpose. Failure to do either may result in loss of exemption.

Types of Joint Venture Vehicles

If you intend to undertake a joint venture, be sure to structure it properly.

Partnership. If you establish a general partnership between your organization and another, you and your partner agency will typically share management responsibilities and be jointly and severally liable for the debts of the partnership. Under a limited partnership, one of the entities will be a general, or managing, partner and the rest are passive. The general partner remains liable for the debts of the partnership and the others are liable only to the extent of their actual investment.[6] Partnerships are formed by a written partnership agreement.

Business Corporation. A business corporation is a separate entity that will provide complete protection from liability for all investor agencies. While most corporations formed by tax exempt organizations will be relatively easy to obtain an exemption for, they are not automatically exempt just because their shareholders are exempt—unless they elect under Subchapter S of the IRS Code. If they do, then the S corporation adopts the same taxpayer status as its investing organizations. Business corporations are formed by the filing of articles of incorporation, usually with your secretary of state.

Limited Liability Company. An LLC is a new entity that is very useful as a joint venture organization. It can take on the characteristics of either a business corporation or a partnership, since it is a statutory blend of both. A multiple-member LLC whose members are all exempt may elect to be treated as an exempt entity. We like to work with LLCs because they are easy to establish and flexible. Thus, we have great leeway within the operating agreement to describe responsibilities and structure relationships. LLCs are formed by the filing of articles of organization, again usually with your secretary of state.

A recent revenue ruling provides us a good example of a joint venture between an exempt organization and a for-profit business. A university that provided teacher training seminars set up a joint venture with a for-profit enterprise that specializes in conducting interactive video training programs. The university maintained total control of the curriculum, materials, and instructors while the video company maintained control over locations where participants were to receive a video link and technicians needed to produce and transmit the programs. All other decisions were to be arrived at jointly. The IRS held that this was not a substantial part of the university's activities, and therefore would not jeopardize its exemption. Further, it ruled that the training programs furthered the university's mission and that the profits would therefore not be taxed as unrelated business income.

I encourage you to think creatively about how you might join forces with other organizations and businesses to carry out your mission to children and families. If you do decide to create a joint venture, be sure you structure it properly so that it will not jeopardize your tax exemption and/or generate unnecessary taxes. ▲

Alliance Member Summit

Learn more about social enterprise on November 3–4, 2004 at an Alliance "Hot Topic" Member Summit in Los Angeles. Seedco, an Alliance member, will share its social enterprise efforts in support of its social mission, and provide best practice tools for developing a successful business plan. For current information on the summit, the participants, and the agenda, visit www.alliance1.org/summits. You can also contact Maggie Skarich at mskarich@alliance1.org or at 800-221-3726, ext. 3664. For more information on Seedco, visit www.seedco.org.

Disclaimer

This article has been prepared to convey general information on topics of interest to child care agency boards and executive staff. Although prepared by an attorney, it should not be used as a substitute for legal counseling in specific situations. Readers should not act upon the information contained in this article without professional guidance.

Endnotes

1 Harlan E. Moore Charitable Trust v. United States, 9 F.3d 623, 624-25 (7th Cir. 1993).
2 Unrelated business income (UBI) is subject to tax (UBIT) under the provisions of section 513 of the Internal Revenue Code (26 U.S.C. §513).
3 Plumstead Theatre Society v. Commissioner, 74 Tax Court 1324 (1980), aff'd 675 F. 2d 244 (9th Cir. 1982).
4 Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999) aff'd 242 F. 3d 904 (9th Cir. 2001).
5 The Redlands case has recently been upheld in a Texas case St. David's Health Care System v. U.S., 349 F. 3d 232, (5th Cir. 2003). The IRS' decision to revoke St. David's exemption was overturned by a jury in March of this year when the jury determined that the joint venture, which to many observers looked like a virtual takeover of the nonprofit hospital by the for-profit Columbia/HCA hospital corporation, still remained subject to the public interest. The IRS will probably not appeal this jury verdict, since the federal appeals court decision that preceded it contains a strong statement of the service's position and is the decision that will make law for the rest of us.
6 A limited liability partnership is a new form of partnership that affords protection from tort liability, but not from commercial debts and other business contracts. It is not relevant to my article.

Kathryn Vanden Berk practiced law for 9 years before serving as the president of two residential treatment centers for children. Now with Chicago-based Mosher & Associates, her law practice focuses on nonprofit start-ups, corporate and tax law, and employment issues. She serves as adjunct faculty at the University of Chicago School of Social Service Administration and is a trainer in financial and risk management for the Council on Accreditation for Children and Family Services, 1st and 2nd Annual Best Practices Conference. She also is the author of "Chapter 5—Employment Issues," in the Illinois attorney's handbook entitled Not-for-Profit Corporations, 2001 Ed., published by the Illinois Institute of Continuing Legal Education. She can be reached at info@beavandenberk.com.