Partnering With Nonprofits: Navigating a Tax Law Minefield

by Mark Hoenig

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In this report, Hoenig describes the current landscape in which parties combine socially conscious and profit-making goals, and he untangles the development of tax rules governing ventures between exempt organizations and nonexempt parties. Hoenig examines the areas of confusion and uncertainty and makes recommendations.

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I. Introduction

“When Worlds Collide.” That was the working title of this report. It captures the feeling I have each time I am involved with a collaboration between a for-profit investor and a nonprofit corporation in a venture driven by both charitable and profit-making goals. The process seems invariably to start with a sense of excitement at the prospect of solving or addressing acute societal needs while making lots of money, and it proceeds quickly toward frustration: Most people in the business community simply haven’t grappled with the rules and constraints governing the nonprofit community, and they struggle to find within their normal bag of tricks — the traditional, tried-and-true solutions to the issues and challenges that emerge in any normal commercial venture — the pathways to achieve their profit-driven yet noble goals, while avoiding the traps that lay uniquely within the labyrinth of rules governing the nonprofit community.

Alas, as a saying might go, you need to be able to judge a report by its cover page. While my working title captures a feeling, it fails to convey what the report is about. Thus, the title was changed so that anyone considering
collaborations or joint ventures between for-profit and nonprofit organizations (and struggling with the intersection between a familiar world and an unfamiliar one) will know where to look.

For varying reasons, nonprofit corporations have been partnering with those outside the nonprofit community with what appears to be increasing frequency, and in ventures with both charitable and money-making aspirations that are simply bigger and more complex than was the case only a few years ago. At the same time, however, there has been no discernable increase in the business community’s understanding of the fundamental rules that govern nonprofits. The tax law itself as it relates to nonprofits remains complex, nuanced, unclear, in some respects illogical, and riddled with subjective tests that dare risk-takers and stymie progress toward solving some of our world’s greatest problems.

When exploring collaboration with a for-profit partner, aside from focusing on compliance with state and other nontax laws, a nonprofit corporation will also examine the effect the collaboration could have on its status for tax purposes and on the taxability of revenue generated (whether as part of or outside the venture). Specifically, the tax-exempt organization’s primary focus will be retaining its status as such, as well as its subcategorization within the tax law as either a public charity or private foundation, and on the possibility — even assuming retention of tax-exempt status — that the collaboration may result in taxable income. While each situation may raise additional unique or less significant issues or consequences under the tax law, those remain outside the scope of this report.

A few other preliminary notes: The federal tax law provides tax-exempt status to a wide array of organizations; most exempt organizations receive their status under and are governed by section 501(c)(3). This report focuses on collaborations and ventures involving only those EOs. Also, while EOs explore and implement collaborations and other forms of co-venturing for purposes of profit-making (not necessarily prohibited under state or tax law), this report is focused on collaborations through which the EO intends — principally if not entirely — to advance its exempt mission.

This report covers a lot of ground and necessarily will not try to drill too deeply into the minutiae of every tax law concept introduced. After listing the more common reasons that drive tax-exempt and for-profit parties toward collaboration, this report details the building blocks within the tax law that set the guidelines for the EO in the context of these collaborations, and it explores the spectrum of structuring alternatives that may be used to achieve the goals of a collaboration while minimizing risks. But first, it is useful to discuss a few relatively recent developments that fall under the heading “We want to make money, but we also want to save the planet” — inventions that seem well-intentioned but have sown much confusion.

II. Recent Trends in Charitable Entity Law

Socially conscious investing is a relatively new concept; it was not so long ago that a business’s obligation to pursue maximum profitability was incontrovertibly understood to be the one and only polestar guiding corporate and other business decision-making. The rise of socially conscious investing and the growing influence of corporate accountability has attracted for-profit investors to fund more charitable projects with the hope of achieving charitable goals while making money. New forms of business entities and vehicles — such as entities set up to pursue both profit and charitable goals at the same time, low-profit limited liability companies (L3Cs), benefit corporations, and social purpose corporations — have been imagined and codified under state law to facilitate these socially responsible investments. Investors are trying out these recent innovations, often with

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1 As we pivot to the focus on tax law, it makes sense here to observe that the term “nonprofit” (or “not-for-profit”) is not the same as “tax-exempt.” Nonprofit is a state corporation law concept; it generally refers to an organization formed under a state’s corporate law that governs a corporation formed not for profit. The term “tax-exempt” generally refers to an organization that has been recognized under federal (or state) tax law as exempt from income or other taxes. To qualify for tax-exempt status under federal income tax law, an organization must be a nonprofit organization. Thus, although it is safe to say that the tax-exempt organizations on which this report focuses are nonprofits, it is not safe to say that all nonprofits are tax-exempt. This report refers to both nonprofits and tax-exempt organizations, but “tax-exempt” (or exempt organization or E0) is used when it is the more appropriate term. The terms “for-profit” and “nonexempt” are likewise quite similar but not exactly the same. This report refers to for-profit parties or nonexempt parties as makes most sense within a given context.
the mistaken assumption that these new entity forms will yield the same tax benefits provided by traditional forms of charitable giving. These new forms of entities may provide incremental convenience in some respects, but the IRS has not afforded them any special tax treatment, at least not yet. The following is a brief introduction to some of these recent trends.

A. Venture Philanthropy

The concept of venture philanthropy (the meaning of which is further explored later) may have been first introduced in a 1997 article titled “Virtuous Capital: What Foundations Can Learn From Venture Capitalists.” Why, many have asked, have trillions of dollars been invested in philanthropy without having had a great enough impact on addressing societal problems? These voices have wondered whether philanthropists, to better achieve their noble objectives, should borrow from the playbook of venture capitalists.3

Over only the last few decades, at an initially slow but increasing pace, grant makers started to consider scalability and financial accountability of their grant-making, and the notion of philanthropy shifted from a charitable donation to a form of investment.4 The idea of venture philanthropy has been, over many years, continually discussed and promoted by business scholars and popular media.5 Proponents have called it the “greatest revolution in the nonprofit sector.”6 Even detractors have admitted that venture philanthropy “has drawn the most significant attention among ideas for advancing the field of philanthropy in recent decades.”

In actuality, venture philanthropy, as understood and discussed since coming into vogue, has been taken to mean many things not all consistent with one another. In its earliest incarnation, the concept was understood to mean charitable work done well, more efficiently. Over the years, however, the concept has morphed, and “venture” has often been used more as a noun than as an adjective; today, venture philanthropy can even be used to refer to an activity undertaken with the dual purpose of making money while saving the world.7

At least as initially conceived, venture philanthropy has been described as “the process of adapting strategic investment management practices to the nonprofit sector to build organizations able to generate high social rates of return on their investments.” This rudimentary form of the concept typically includes some combination of the following four core elements:

1. In contrast to traditional philanthropists who use grant-making as the pathway to achieving charitable goals, venture philanthropists use various philanthropic and market-based funding instruments, such as loans and equity.8
2. Venture philanthropy investors typically provide strategic assistance to the organization, which includes long-term planning, board and executive recruitment, coaching, and management training programs.9
3. Venture philanthropists often take seats on the boards of funded organizations.
4. Probably its hallmark characteristic, venture philanthropy emphasizes measurable results.10 The success of a venture might be measured either by the magnitude of an organization’s actual impact, such as the number of lives that

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7 Id.
8 Id.
11 See, e.g., Onishi, supra note 5, at 70.
13 Miller, supra note 4.
have been affected by the organization, or the size and scope of the societal problems that have been addressed.\(^\text{13}\)

Although exit strategies for venture philanthropists are variable and still evolving, the exit goal of a funder or investor is generally to leave the philanthropic project able to continue its charitable mission on solid financial footing and with stable management.\(^\text{14}\) More recently, with some venture philanthropy focused as much on the venture as on the philanthropy, investors also are designing exit strategies intended to yield an acceptable — even if relatively modest — return.\(^\text{15}\)

Venture philanthropy, while an innovative concept, does not afford the investors any special benefits under tax law. As a general proposition, describing the investment as venture philanthropy simply has no effect under the tax law.\(^\text{16}\)

B. Low-Profit Limited Liability Companies

An L3C, a legal entity under the law of a few states, is a variation of the traditional state law LLC. An L3C typically is required by statute to "have a primary purpose of furthering a charitable or educational mission and not maximizing profits."\(^\text{17}\) Although state statutes vary, the essence of the L3C is that (1) it must be formed and operated to significantly further the accomplishment of one or more charitable or educational purposes; (2) it must demonstrate that it would not have been formed but for the accomplishment of the charitable or educational purposes; (3) it may not have as a significant purpose the production of income or the appreciation of property; and (4) it may not have been formed for political or legislative purposes.\(^\text{18}\)

The L3C provides significant flexibility in governance and economic allocations, giving legal protections to owners and managers. It thus appeals to private capital investment that is not principally motivated by profit-making, in the same manner a typical LLC appeals to investment driven entirely by profit motive.\(^\text{19}\)

The idea of an L3C was introduced in Vermont in 2008, largely as a statutorily created entity form that would attract investments by private foundations. As detailed later in this report, tax-exempt organizations subclassified as private foundations are subject to program-related investment rules.\(^\text{20}\) Because the state law requirements for an L3C closely mimic the federal tax regulations that define program-related investments by private foundations, the L3C seems well designed to attract investments from private foundations that will qualify as program-related and thereby avoid imposition of certain federal penalty taxes.\(^\text{21}\) Many had high expectations that L3Cs would become the entity of choice for this substantial investment community.

Despite these early expectations, the tax law has not quite cooperated, and consequently, the idea of the L3C has (at least for now) lost much of

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\(^{14}\) Id.

\(^{15}\) Perhaps there is an irony, or even a message, in the evolution of venture philanthropy. The concept originally focused on philanthropy done well, but it has come to include the idea of "doing good while doing well." Maybe the original premise — that noble goals are achievable with just the infusion of proper management — has given way to a realization that proper management is insufficient to achieve some goals, that there are some objectives that can be achieved only with enhanced financial incentives.

\(^{16}\) The IRS has not specifically addressed the tax treatment of venture philanthropy. Note, however, that venture philanthropy investments may be designed in such a way that is similar (or perhaps even identical) to investments that qualify as program-related investments under rules applicable to private foundations (discussed later). Consequently, private foundation investments described as and designed under the rubric of venture philanthropy may, in assessing compliance with the program-related requirements, provide the foundation a level of additional comfort.

\(^{17}\) Cassady V. Brewer, Elizabeth C. Minnigh, and Robert A. Wexler, "Social Enterprise by Non-Profits and Hybrid Organizations," 489 Tax Mgmt. Port. at IV.B.

\(^{18}\) See, e.g., La. Rev. Stat. Ann. Section 12:1302; MCL section 450.4102(m); 805 ILCS 180/1-26. Note the prohibition on having a "significant purpose the production of income or the appreciation of property" permits some degree of profit motive by the L3C, as long as it is not significant and that profit-making is a secondary or ancillary objective of the entity.


\(^{20}\) Id. An investment is program-related under these rules if (1) its primary purpose is to accomplish one or more charitable purposes; (2) no significant purpose of the investment is the production of income or the appreciation of property; and (3) no purpose of the investment is the carrying on of propaganda or otherwise attempting to influence legislation or intervening in any political campaign on behalf of any candidate for public office. Section 4944(c).

its early luster. To date, federal tax law has not expressly recognized L3Cs as satisfying the program-related investment rules. The IRS has signaled that it has not made a final determination on whether an investment made through an L3C automatically qualifies as program-related, and that private foundations should exercise caution when investing with or through L3Cs. Indeed, inasmuch as the program-related requirements can also be satisfied through a regular LLC, practitioners have questioned the necessity of using this new form of legal entity — which is not approved for this purpose by the IRS.

C. Benefit Corporations

The term “benefit corporation” refers to a type of state law corporation that has both socially responsible and business purposes. At this point, well over half the states have enabled the creation of benefit corporations.

Typically, a corporation can either elect to become a benefit corporation at the time of incorporation or convert later. Generally speaking, benefit corporations retain the traditional corporate form and are governed by the state corporate law, but state benefit corporation law relaxes the fiduciary duty requirement on the directors concerning the obligation to maximize profits. Thus, the directors are given greater latitude — protected from shareholder lawsuits — to achieve positive social purposes at the expense of maximizing profits.

The positive social purposes that generally define a benefit corporation include environmental preservation, promotion of health, and promotion of the arts and sciences. When making decisions, directors may consider not only the effect on economic performance and profits for shareholders, but also the effect on stakeholders such as employees, suppliers, customers, the community at large, and the environment.

Forming (or choosing to become) a benefit corporation may bring some advantages to a corporation. These include gaining a reputation as a business that respects its multiple stakeholders, protecting directors from liability for considering the interests of all the stakeholders, and attracting socially conscious investors. However, a benefit corporation is not afforded any special tax treatment. It is taxed as a corporation in the same manner as traditional state law corporations and generally cannot claim tax-exempt status.

D. Flexible and Social Purpose Corporations

Effective in 2012, California legislation adopted the flexible purpose corporation. An existing corporation can elect to become a flexible purpose corporation by amending its articles of incorporation with the approval of at least two-thirds of the shareholders. An existing corporation can also become a flexible purpose corporation through a transaction such as a merger, reorganization, asset sale, or conversion.

There is no requirement for the flexible purpose corporation to achieve “general public benefit.” Rather, a flexible purpose corporation needs to achieve only the specific purposes that

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22 Congress has been reluctant to enact substantive amendments to the program-related investment provisions to facilitate increased private foundation investments in L3Cs.
24 See id.
28 Id.
29 Hopkins, supra note 25, at 131.
30 Model Benefit Corporation Legislation, section 301(a)(3).
31 See O’Reilly and Aquino-Hagedorn, supra note 26.
32 See CT Corp. staff, “Benefit Corporations FAQs” (Jan. 7, 2016).
33 Michael I. Sanders, Joint Ventures Involving Tax-Exempt Organizations 550 (4th ed. 2013). Note that (effective January 1, 2015) California amended its corporate laws to rename flexible purpose corporations, which are now referred to as special purpose corporations, but the amendment did not change the substantive corporate form.
34 Brewer, Minnigh, and Wedler, supra note 17, at IV.C.
35 Id.
36 Sanders, supra note 33, at 550.
are articulated in its articles of incorporation, which could be “charitable or public purpose activities that could be carried out by a nonprofit corporation providing public benefits,” or the promotion of positive effects on its employees, suppliers, customers, creditors, the community and society, and the environment.\(^{37}\)

Additionally, Florida, Texas, and Washington state have adopted an entity form called the social purpose corporation, which is very similar to California’s flexible purpose corporation.\(^{38}\) Neither the social purpose nor the flexible purpose corporation enjoys any special tax treatment. They are taxed as any other traditional state law corporation.

E. Any Good Options?

The socially conscious investor, hoping to make profit and at the same time wishing to help the world, may find a workable solution in one of these recently developed organizational forms. By and large, however, these forms and concepts remain too new, too undeveloped, too limited, too uncertain, and even too misunderstood to serve as useful solutions in many of the more common situations. Consequently, investors today — whether because they are socially conscious or for other reasons — who want to team up with or integrate elements of charities turn to nonprofit corporations as potential partners when seeking to “do good while doing well.” And the nonprofit corporation often has its own motivations driving it toward these partnerships.

III. Why Do Opposites Attract?

What drives the two parties — one a profit-seeking but socially conscious investor, the other a nonprofit with charitable objectives — to explore collaboration? There is no single answer. The circumstances that give rise to these collaborations are so variable that it is challenging to articulate the applicable tax rules, the way they apply, and the solutions that they dictate in a manner that will make sense in every case.\(^{39}\) Not surprisingly, different parties will have varying objectives, and perhaps more often than not, a single party will have multiple goals, sometimes even a combination of motivations that are somewhat in conflict. Understanding what typically or often motivates the parties in these deliberations helps to anticipate the issues that will arise, to understand the tax rules that apply, and to fashion the solutions that might work.

A. For-Profit Motivations

What does the for-profit investor or partner seek? Often, a nonprofit organization owns specialized assets or products, has an unusual network of relationships, or commands a unique market position, and any or all of these attributes are otherwise not accessible to the typical for-profit party. The nonprofit organization may even have a proven track record of success in its field that would enhance the profile of the planned joint venture. The for-profit investor may have an idea about refining and improving the nonprofit organization’s business model, its approach, or its management in a way that will leverage the organization’s assets or market position toward making or increasing profit.

Perhaps the for-profit investor hopes to leverage the goodwill and the aura of trustworthiness and integrity associated with the nonprofit. The collaboration might permit the investor to enter a business, or expand an existing business, armed with the cloak of respectability derived from a co-venture relationship with the nonprofit. Along similar lines, it may be that the for-profit investor simply feels that association with the nonprofit organization will signal to the public at large a social consciousness and virtue that can serve to enhance the investor’s profile —


\(^{39}\) This statement should not be read as reflecting excuse-making by an author anticipating a failure to lay out the tax concepts in a way that will make sense to every reader. My hope is that after reading this report, the reader will understand and agree the existing tax rules and standards don’t make sense in all the factual circumstances that arise in collaborations between for-profit and tax-exempt parties.
and therefore profitability — within its community of customers.

The investor may also have more noble motivations. The for-profit partner may have no or little interest in creating a thriving profitable activity, but rather is more interested in helping the nonprofit organization achieve its charitable mission. So why structure the collaboration as a joint venture? Because the investor, who is willing to devote time and energy to achieve the nonprofit organization’s noble goals, also wants to make money. In this circumstance, the parties might discuss a salary or other form of compensation payable by the nonprofit, but given the nonprofit’s circumstances — financial, regulatory, and otherwise — the level of compensation that could be safely promised by the charity simply is insufficient. Instead, the investor pursues a profit-making aspect to the otherwise charitable activity with a hope to participate in profits as a way to be satisfactorily compensated. An example of this, discussed more later, is the partnership between hospitals and their doctors, a co-venture relationship designed to create sufficient profit to encourage quality doctors to remain associated with the hospital while also (it is argued) still advancing and achieving the charitable goal of providing healthcare.

Another possible reason a for-profit investor might pursue a collaboration with an EO is access to tax-deductible capital. In this scenario, the planned activity combines charitable goals with profit-making goals, and the thought is that proper structuring can permit the charity, through current assets and future revenue derived from charitable donations and grants, to invest in and to finance at least the charitable element of the joint activity. In this way, a single activity with dual purposes can be financed in part through tax-deductible donations.

Sometimes for-profit entities find that collaboration with tax-exempt entities is necessary to receive attractive government contracts or benefits. An example of this is the federal low-income housing tax credit, a nonrefundable tax credit under section 42 that can be awarded to developers of qualified low-income rental projects through a state-level application administered by state housing authorities. Under these rules, for-profit investors often end up forming joint ventures with EOs.

B. Nonprofit Organization Motivations

How about the charity? Why does it engage in these joint ventures? By and large, the nonprofit organization is focused on achieving its charitable mission. Perhaps the charitable goal simply cannot be achieved with charitable donations, grants, and government funding alone. The limits and constraints imposed under the system in which nonprofits operate may simply render the largest goals unattainable. For example, the charity may hope to cure cancer but confronts a reality in which that goal is unachievable within a system that is limited to funding through charitable dollars. The nonprofit organization may want to partner with for-profit entities as a means to raise capital and gain access to new sources of cash and property, all to further the organization’s exempt purposes.

The nonprofit organization may believe that the nonexempt party owns or has access to assets or networks that, when combined with the nonprofit’s assets, would materially enhance the ability to achieve its charitable goals. Along similar lines, the for-profit party may be viewed as having a management and business-oriented approach expected to meaningfully enhance the effectiveness of the activity, significantly moving the needle toward achieving the nonprofit organization’s charitable goals. Or perhaps a collaboration would enable the nonprofit organization to access industry professionals who

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40 See generally section 42(m) (administration by state housing authorities as defined under section 42(h)(8)).
41 These credits are often sold to outside investors in exchange for equity in a particular housing project, thereby establishing a joint venture. Section 42(h)(5)(A) requires that a substantial portion of each state’s annual tax credits be allocated to projects involving a qualified nonprofit organization (which includes tax-exempt entities qualifying under section 501(c)(3)), and the nonprofit organization must materially participate in the development and operation of the project throughout the compliance period set forth in section 42(j)(1). Under the statute, it is implied (and commonly done in practice) that for-profit entities can enter into a joint venture to take advantage of this tax credit.
have business experience that is uniquely suited for the organization’s activity or charitable goals but not easily found within the nonprofit sector.

Often the discussion of a joint profit-making venture with a nonexempt party leads the charity toward another goal, even if secondary: finding a reliable source of funds with which to pursue its charitable goals. In other words, the nonprofit organization might view the joint venture not exclusively as a means to achieve its goals, but also as a revenue-generator to finance its other charitable activities.

For these and other reasons, the business community has explored a variety of arrangements with tax-exempt organizations, the heart of which involves some form of co-venturing. This may mean a for-profit corporation hoping that a collaboration with a nonprofit organization will allow for enhanced profits; a private equity fund intrigued with the potential to partner with a nonprofit in a way that will facilitate realization of the charitable goal while also generating attractive financial yields; an individual who wishes to help a nonprofit achieve its noble goal but wants to make money while doing so; or any one of a number of other parties. In any of these discussions, aside from the issues and considerations typical in any co-venture, a second layer of considerations, hurdles, and constraints emerges: The EO will want to preserve its tax-exempt status, remain compliant with the rules to which it is uniquely subject, and focus on the taxability or nontaxability of profits generated by the proposed co-venture.

IV. Tax Law Principles Impeding Collaborations

To qualify for and maintain tax-exempt status, a nonprofit organization must meet several requirements and avoid proscribed activity. For an existing EO, failure to conform to these requirements and constraints can lead to loss of exemption, incurrence of tax, and even some forms of penalty tax imposed not only on the organization but also on those who manage it. Like anything the EO does, collaboration with a nonexempt party must be analyzed through the lens of these requirements and constraints imposed by the tax law. In addition to the questions about exempt status and potential incurrence of tax, an EO also may be focused on the manner in which a collaboration might affect its status as a public charity (as opposed to being classified as a private foundation).

Before describing different forms of collaboration and the tax considerations typically encountered with each, the following sets out the more significant governing principles unique to tax-exempt organizations exploring these collaborations. This discussion is intended only as a general summary of principles important to understand the impediments to and contours of collaboration with nonprofits discussed later in the report, and it is not fashioned as a detailed exposition of each rule.

A. Exclusively for Charitable Purposes

To qualify as a tax-exempt organization under section 501(c)(3), the entity must be organized and operated exclusively for exempt purposes. Oddly, one of the settled questions in this area of the tax law is that “exclusively” does not mean exclusively. Rather, the rule is generally interpreted to mean that an organization can conduct activities outside the scope of its tax-exempt objectives, even activity that is intended entirely to generate profit and with no noble goal in mind, as long as the nonexempt activity is not so substantial as to call into question whether the essence of the organization is truly charitable. If an organization does noble work but also expends its assets, energy, and other resources in noncharitable activity, at what point, the tax law wonders, is the organization no longer a charity qualifying for tax-exempt status? At what point has the organization crossed the line?

42 When describing a corporation, the term “nonprofit” generally means that the corporation’s assets, profits, and performance cannot be for the benefit of private parties or shareholders. This state corporate law concept is an analog of the tax law requirement that to qualify for and maintain tax-exempt status, an organization’s assets may not inure to the benefit of shareholders and other insiders, as discussed in Section IV.B. One result of this confluence of principles is that to qualify for tax-exempt status under section 501(c)(3), an organization must be formed as a nonprofit under the law of its jurisdiction of formation. Thus, a tax-exempt organization cannot have shareholders who would share in any profits of the corporate activity, and in this way alone an EO does not have the ability to raise capital through the issuance of stock or equity.

43 Again, there are numerous provisions within the tax law affording tax-exempt status. This report focuses on organizations exempt from federal income tax under section 501(c)(3).
When considering an organization’s qualification for tax-exempt status under this requirement, the IRS often relies on Better Business Bureau, a 1945 case in which the Supreme Court barred an organization from maintaining a specific tax exemption on the basis that it failed to organize and operate exclusively for exempt purposes. In Better Business Bureau, the Court stated that “the presence of a single nonexempt purpose, if substantial in nature, will destroy the [organization’s tax] exemption.” The meaning of “substantial,” however, was not defined in the Court’s opinion.

The regulations under section 501(c)(3) shed light on the interpretation of “exclusively,” providing that an organization is operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more exempt purposes. On their face, these words indicate that exclusively means primarily, which (at least in theory) can be taken to suggest that only 50.1 percent of the activities must accomplish exempt purposes.

The regulation further provides that an organization does not satisfy the operational test if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. The definition of “insubstantial,” however, is not provided in the regulations and has not been elucidated by case law. To make things even fuzzier, the regulations also provide that an organization may meet the requirements for exempt status even though it operates a trade or business as a substantial part of its activities if the operation is in furtherance of its exempt purposes and if the primary purpose of the organization is not to operate an unrelated trade or business. Thus, we are left with a regulation that gives a standard of “insubstantial” and another standard of “primarily,” that fails to provide guidance on what those words mean or how they are to be applied, and thereby leaves us a wide swath of uncharted territory when trying to determine how much nonexempt activity is too much.

Where does all that leave us? What we know is that some amount of nonexempt activity will not disqualify the organization from receiving and maintaining tax-exempt status, but that the size, scope, and presumably importance of the activity cannot be large enough to cast doubt on the organization’s primary — really, defining — focus on its charitable mission. However, we do not know where precisely to draw the line.

### B. Private Inurement

The underlying legislative purpose of tax exemption is to facilitate, encourage, and support the formation and operation of organizations that pursue and advance charitable goals. One requirement for tax-exempt status is that “no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual.” This principle — the doctrine of private inurement — essentially demands that none of the income or assets of a tax-exempt entity be permitted to directly or indirectly provide undue benefit to an individual or entity who has a close relationship with the organization and some aspect of control over that organization and its assets.

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44 This requirement that an organization be (organized and) operated exclusively for exempt purposes to qualify for tax-exempt status under section 501(c)(3) is known as the operational test.
46 Id. at 283.
47 Better Business Bureau involved exemption from specific Social Security taxes under a section of the Social Security Act. That provision included language based on an income tax exemption provision in the then-applicable IRC, which was the precursor to current section 501(c)(3) and was intended to apply to the same organizations. Because of this, Better Business Bureau is regularly cited by courts and the IRS as authority for interpreting and applying the section 501(c)(3) operational test.
48 Reg. section 1.501(c)(3)-1(c)(1).
49 Id.
The prohibition against private inurement prevents people or entities that are in a position of control or influence to improperly take advantage of a tax-exempt entity’s assets or income for noncharitable uses.\(^54\) While the tax law provides no granular articulation of exactly which people or entities are covered, they are colloquially referred to as “insiders.” In some respects, in determining the reach of the private inurement doctrine, the tax law has adopted the definition of insiders from federal securities laws: One who has a unique relationship with an EO such that the person can influence or control the activities of the organization, in contrast with the lack of any such influence in the hands of members of the general public or the organization’s intended beneficiaries.\(^55\) Insiders typically include a tax-exempt entity’s founders, directors, trustees, officers, and key executives, plus family members of these persons and entities controlled by these persons.\(^56\) In appropriate circumstances, insiders may also include service providers and even grant recipients.\(^57\)

The prohibition applies to every asset and every benefit that an EO owns or is able to confer. Although the statute refers to net earnings, the rule applies to an organization’s tangible and intangible assets however derived or attained.\(^58\) It is long established that the private inurement rule is not limited to net earnings, or even earnings of any kind, but rather applies to any asset owned (or controlled or directed) by the organization. Thus, for example, donated assets (in whatever form) as well as intangible property — such as intellectual property, brand, or generic goodwill — are included within this prohibition.\(^59\) Actually, any asset you can think of, as well as any asset or benefit you cannot think of, could be swept up in the private inurement rule.\(^60\)

Ultimately, any unjust enrichment provided to an insider, whether or not from identifiable assets of the organization and regardless of the manner by which the enrichment is delivered, is subject to the private inurement rule. Prohibited inurement might arise from a direct payment; through a contractual relationship; through a complex, multipartied arrangement; or through any other situation in which the EO is taking some act (or failing to take some act) that confers any benefit on an insider. The organization need not intend for inurement to occur; if it does, even by inadvertence, the private inurement rule may apply.\(^61\)

Not all transactions resulting in benefit for an insider are prohibited. Under the private inurement doctrine, the tax law focuses on undue benefit to insiders. Thus, in a transaction in which the EO receives at least full fair value (taking into account all the assets and benefits that it provides), there typically would not be private inurement.\(^62\) Simple examples include reasonable compensation for services rendered, or a fair price for property sold. The question in any transaction

\(^{55}\) See American Campaign Academy v. Commissioner, 92 T.C. 1053, 1067 (1989).
\(^{56}\) GCM 39670 (1987) also includes within the private inurement rule all key employees of a tax-exempt entity, which seems to be overly expansive. Although the IRS could again try to assert this view in the private inurement context, the inclusion seems to be overly broad and inappropriate for general application.
\(^{57}\) See, e.g., GCM 39862 (expanding the term “private shareholder or individual” to include any persons having a “personal and private interest in the activities of the organization”).
\(^{58}\) As noted, the tax law prohibition against private inurement is an analog to the constraint imposed under state law encompassed by the term “nonprofit.” For the linguist, it may be interesting to observe that the state law term “nonprofit” does not mean the organization may not earn a profit, and the tax law reference to “net earnings” in setting the boundaries of the private inurement rule is hardly limited to net earnings.
or other interaction is whether the EO is providing for any insider value that exceeds what the organization is receiving from the insider in return. If it is, there is private inurement potentially subject to this prohibition.

Is any amount — even a single dollar of excess value — sufficient to trigger the private inurement rule and jeopardize the organization’s tax-exempt status? Yes . . . and no. The IRS and courts have repeatedly found that there is no incidental private inurement, meaning that any violation may lead to revocation of tax exemption under section 501(c)(3). The IRS has often revoked an entity’s tax exemption based on a violation of the private inurement doctrine. With that said, there are cases in which inurement to specific insiders is allowed if the inurement is found to be unintentional or secondary to the charitable purpose of the tax-exempt entity.

Thus, the private inurement doctrine can apply even to a small unreimbursed benefit provided to a class of people not clearly defined. In this way, the doctrine serves as a robust disincentive for organizations to transact with insiders without properly analyzing whether there is too much value headed in the wrong direction, which would jeopardize the continued maintenance of tax-exempt status.

C. Private Benefit

EOs also are restricted from conferring private benefit, a concept similar to but with important differences from private inurement. In its simplest, even if a bit imprecise, formulation, the private benefit rule extends the private inurement rule beyond insiders, and it can apply if the activity of an EO confers more than an incidental benefit upon an unrelated individual, entity, or group. Examples of private benefit situations might include the public relations boost provided by publicizing the identity of a big donor, or the economic benefit enjoyed by a real estate developer when a community development organization improves a neighborhood. As is the case with private inurement, violation of the private benefit rule can jeopardize an organization’s tax-exempt status. Thus, even in situations in which there is no undue benefit to an insider and therefore no private inurement, if benefit is improperly provided by an EO to unrelated parties, there may be a violation of the

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63 See Better Business Bureau, 326 U.S. at 7 (finding that a nonprofit’s efforts to support honest business practices may have served incidentally to educate specific persons, but that the efforts were “directed fundamentally to ends other than that of education” and thus impermissible). Also, some federal courts have found private inurement of any kind to be impermissible for tax-exempt entities. See, e.g., Geokin v. United States, 707 F. Supp. 1156 (N.D. Cal. 1988).

64 See, e.g., LTR 201306028 and LTR 201203022 (both revoking section 501(c)(3) tax-exempt status because of violation of private inurement doctrine).

65 For example, the Eighth Circuit has held that inurement that is only incidental and that is comparatively unimportant to the tax-exempt entity’s ultimate mission is generally not alone sufficient to warrant revocation of tax-exempt status. St. Louis Union Trust Co. v. United States, 374 F.2d 427 (8th Cir. 1967). Similarly, benefit that is “incidental to the purpose of” the organization has been found by the IRS not to represent private inurement. Rev. Rul. 74-146, 1974-1 C.B. 129 (“any private benefit that may accrue to the few proprietary members . . . is incidental to the purpose of” the organization). See also LTR 201306028 and LTR 201203022. Perhaps the IRS is often reluctant to revoke exempt status for organizations that are good citizens and that contribute real value to society, even if they cross this line of private inurement. In fact, this IRS reluctance to “go nuclear” resulted in the 1996 enactment of section 4958, which imposes “intermediate sanctions” (a term used to denote the imposition of significant penalty taxes in lieu of revocation of tax-exemption) on organizations, their managers, and insiders found guilty of violating these principles. Under section 4958, if an EO is found to overpay any of a defined group of people for goods or services, aside from jeopardizing exempt status under the private inurement doctrine, the transaction — an excess benefit transaction — can result in penalty taxes imposed on the recipient, the organization, and those within the organization involved in the decision-making that led to the transaction.

66 See American Campaign Academy, 92 T.C. at 1078; and GCM 39862 (“Any private benefit arising from a particular activity must be ‘incidental’ in both a qualitative and quantitative sense to the overall public benefit achieved by the activity if the organization is to remain exempt.”).
private benefit rule, jeopardizing the organization’s tax-exempt status.\textsuperscript{67}

The private benefit doctrine is derived from the regulations under section 501(c)(3), which provide that an organization will satisfy the statutory “organized and operated exclusively for [charitable] purposes” requirement only if it serves a public rather than a private interest.\textsuperscript{68} The rationale underlying the private benefit doctrine is that if an organization provides undue benefit to a private person or persons,\textsuperscript{69} the proposition that the organization is operating exclusively for exempt purposes is called into question.\textsuperscript{70} The presence of a substantial amount of private benefit (even when an organization has other charitable activities) can be taken to indicate that the organization is not organized and operated exclusively (or even primarily) to achieve its exempt objectives, and, as a consequence, does not or no longer qualifies for tax-exempt status.\textsuperscript{71}

For the private benefit doctrine to apply, the benefit must be “greater than incidental” both quantitatively and qualitatively.\textsuperscript{72} Although the IRS and courts have articulated the meaning of quantitative and qualitative, it remains true that these standards provide no hard and fast rules that can be followed. As a result, EOs (without large risk appetites) tend to steer clear of the line.

To be quantitatively incidental, the benefit to the private person must be insubstantial in amount.\textsuperscript{73} The IRS examines this by comparing the amount of private benefit bestowed on a private person with the amount of public benefit generated by the specific activity under scrutiny.\textsuperscript{74} In making a determination about a given benefit, the IRS does not look to the public-versus-private benefit provided by all of a tax-exempt entity’s activities, just the activity or activities at issue.\textsuperscript{75} In other words, when an activity confers a private benefit, the underlying question is whether that activity itself is appropriate for the organization; if that activity does not alone advance the charitable goals sufficiently when compared with the benefit conferred on the private party, the activity should not be undertaken or continued by a tax-exempt organization. The IRS also has stated that if a small number of entities benefit from the activity, such as a single entity, group, or individual like a promoter or developer, there is more likely to be impermissible private benefit present.\textsuperscript{76}

To be qualitatively incidental, the benefit must be indirect or unintentional.\textsuperscript{77} This is understood to mean that incidental private benefit must be a “necessary concomitant” of the activity that confers a public benefit. A private benefit is qualitatively incidental if “the benefit to the public cannot be achieved without necessarily

\textsuperscript{67} Id. at 10681069 (“The absence of private inurement of earnings to the benefit of a private shareholder or individual does not, however, establish that the organization is operated exclusively for exempt purposes. Therefore, while the private inurement prohibition may arguably be subsumed within the private benefit analysis of the operational test, the reverse is not true. Accordingly, when the Court concludes that no prohibited inurement of earnings exists, it cannot stop there but must inquire further and determine whether a prohibited private benefit is conferred.”).

\textsuperscript{68} Reg. section 1.501(c)(3)-1(d)(1)(ii). Section 501(c)(3) requires, as a precondition to exempt status, that the organization be “organized and operated exclusively for [charitable] purposes.” As noted earlier, the statute’s “organized exclusively” element has come to be referred to as the operational test. Thus, the private benefit doctrine ultimately is a derivative of the operational test.

\textsuperscript{69} Again, these persons are not insiders, for whom the provision of benefit would be tested under the private inurement doctrine.

\textsuperscript{70} Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999) (finding that the tax-exempt organization had ceded effective control over the operations of a subsidiary entity to private parties, conferring impermissible private benefit, and consequently did not qualify as having operated exclusively for exempt purposes).

\textsuperscript{71} Better Business Bureau, 326 U.S. at 7.

\textsuperscript{72} GCM 39862.

\textsuperscript{73} See GCM 35701 (1974) (finding that an art gallery that paid 90 percent of the profits from each sale back to the artist provided the artist with a “direct monetary benefit and serves to enhance his artistic career,” which was “substantial by any measure”); and GCM 37789 (1978) (finding that a tax-exempt hospital’s lease of land to its doctors at $1 per year for 99 years was “essentially free land” and “more than incidental quantitatively”).

\textsuperscript{74} See GCM 35701 (analysis by the IRS included “balancing the public and private interests served by the organization’s activities”); and GCM 39862 (“To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity.”).

\textsuperscript{75} TAM 9451001 (“The private benefit conferred by an activity or arrangement is balanced only against the public benefit conferred by that activity or arrangement, not the overall good accomplished by the organization.”).

\textsuperscript{76} Andrew Megosh et al., “Private Benefit Under IRC 501(c)(3),” IRS EO CPE (2001). See also LTR 201702039 (revoking exempt status of a section 501(c)(3) organization that dedicated its funds to the care of the founder’s disabled grandson).

\textsuperscript{77} GCM 37789. As we explore the meaning of “qualitatively,” keep in mind that an organization must pass both the quantitative and qualitative tests; passing only one but failing the other does not establish the “incidental” standard necessary to avoid private benefit treatment.
benefiting certain private individuals.”  A classic case of a necessary concomitant is described in Rev. Rul. 70-186, 1970-1 C.B. 128, involving a tax-exempt entity formed to conserve a lake for public recreational use and improve the condition of water in the lake to enhance the recreational features and enjoyment of the lake. The organization not only benefited the public at large, but also necessarily provided a private benefit to the individuals who owned property abutting the lake. The IRS found that this benefit to the property owners was not fatal to the organization’s tax-exempt status, stating that it would be “impossible for the organization to accomplish its exempt purposes without providing benefits to the lakefront property owners.”

D. Lobbying and Political Activity

In most collaborations between a tax-exempt organization and a nonexempt party, the issues regarding restricted or prohibited lobbying by EOs have no application. However, in a proposed collaboration that may include advocacy around legislation or candidates for public office, these issues can arise.

1. Participation in political campaigns.

A section 501(c)(3) organization may not participate or intervene, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. A candidate for public office is any individual who has offered himself, or has been proposed by others, as a contestant for a federal, state, or local elective public office. Prohibited political activities include (but are not limited to) the publication or distribution of written statements or the making of oral statements on behalf of or in opposition to a candidate. Whether the activities of an organization or its members or officers amount to prohibited political activities is tested with reference to all the facts and circumstances, meaning that the totality of the situation is assessed to determine the intent and impact of the activity. This prohibition is absolute and can result in the revocation of tax-exempt status by the IRS if the organization engages in any prohibited political activity.

2. Lobbying regarding legislation.

Unlike participating in political campaigns, a tax-exempt entity may participate in limited lobbying activity. Section 501(c)(3) states that “no substantial part of the activities” of a section 501(c)(3) organization may be “carrying on propaganda, or otherwise attempting, to influence legislation.” Application of these restrictions does not depend on whether the legislation at issue would benefit the community

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82 Section 501(c)(3).
83 See reg. section 1.501(c)(3)-1(c)(3)(iii).
84 See, e.g., Rev. Rul. 2007-41, 2007-1 C.B. 1421 (listing examples of activities that do or do not constitute participation or intervention in a political campaign).
85 Id.
86 See, e.g., TAM 9812001 (the IRS revoked the tax-exempt status of an organization that had made a loan to a related but nonexempt organization empowered to make contributions to candidates and parties in state and local political campaigns).
87 This applies to an EO subclassified as a public charity. As briefly discussed later, a section 501(c)(3) organization that is subclassified as a private foundation is generally constrained from conducting lobbying activity through the imposition of excise taxes on enumerated taxable expenditures, which (subject to limited exceptions) generally include lobbying.
and promote the exempt purpose for which the organization was formed. As noted, the tax law allows some amount of lobbying before an organization risks losing its tax-exempt status. Unless the charity is eligible for and makes an election under section 501(h), the amount of lobbying permitted is unclear; it cannot be substantial, which is a subjective test that provides sufficient comfort for an EO only if its lobbying activity — measured by its allocation of assets, time, and money — is very modest. If the charity is eligible and makes an election under section 501(h), an objective test applies to define acceptable levels of lobbying, a test that measures dollars expended for specific types of activity.

E. Classification as Private Foundation

Every organization that is tax-exempt under section 501(c)(3) is further subclassified as either a private foundation or a public charity. Private foundation status is the default subclassification, unless the organization falls into one of the excluded categories in section 509(a)(1) through (4). Generally, a section 501(c)(3) organization will escape subclassification as a private foundation if its sources of funding and revenue are broad. If classified as a private foundation, an EO is subject to additional restrictions, requirements, and tax.

The theory underlying such a subclassification is that an organization controlled by one person or a small group will more likely take inappropriate liberties with its activities and assets than is the case with an organization that answers to many. Thus, the tests to determine whether a section 501(c)(3) organization is subclassified as a private foundation generally are arithmetic determinations about the breadth of the organization’s financial support. The tests are designed to reveal whether the organization relies principally or meaningfully on a single person, one family, or a small group for its financial support, in which case the organization is classified as a private foundation and subject to an additional set of rules.

The additional rules do the following:

- result in additional administrative and operating costs;
- impose a tax on net investment income;
- require minimum levels of distributions or spending on specified charitable activity;
- restrict ownership of equity in corporations, partnerships, and other entities;
- enhance focus on (and second-guessing of) prudent investment of assets;
- prohibit some forms of spending otherwise permitted to charities; and
- prohibit an expanded grouping of transactions with related parties.

Private foundation grants to and investments in nonexempt parties are subject to restrictions and potential penalties not applicable to grants and investments made by public charities. Consequently, a private foundation exploring collaboration with a nonexempt party confronts additional hurdles. Among these are the rules regarding program-related investments.

Like other charities, a private foundation might consider, in addition to (and often just another form of) making grants, investing in nonexempt entities in furtherance of the foundation’s mission and tax-exempt purpose. These investments, whether in the nature of equity investments, loans, or some other form, if directed toward and intended to achieve the foundation’s goals, are referred to as program-related investments. Commonly, a program-related investment made in support of a private foundation’s charitable purposes might be intended and expected to earn below-market returns.

The qualification of an investment (which can include grants) as program-related affects the private foundation in many ways. Among them

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88 Rev. Rul. 67-293, 1967-2 C.B. 185 (the IRS concluded that an organization engaged in substantial lobbying activities did not qualify for exemption under section 501(c)(3), even though all of the organization’s lobbying activities were beneficial to the community). Importantly, in connection with some of the tax law tests for permissible levels or types of legislation lobbying, lobbying that advances the tax-exempt objectives may be permitted. A discussion of those rules is beyond the scope of this report.

89 This last rule — the self-dealing rules applicable to private foundations — can be an eye-opener for the uninitiated. Unlike self-dealing rules in other areas of the tax law and nontax law, this self-dealing rule even prohibits and penalizes some transactions and interactions that ordinarily would be considered arm’s-length and unrestricted.

90 Section 4944(c).
are whether the private foundation satisfies its annual distribution requirement; whether the investment earnings will be taxable; whether making the investment itself will subject the foundation to an excise tax; and whether the income, earnings, or other proceeds derived from the investment will affect the private foundation’s tax-exempt status under the law.

Section 4944 and the underlying regulations provide that an investment is program-related if (1) the primary purpose of the investment is to accomplish one or more charitable purposes; (2) the production of income or the appreciation of property is not a significant purpose or goal of the investment; and (3) the foundation has no purpose to carry on propaganda or otherwise try to influence legislation or intervene in any political campaign on behalf of any candidate for public office through the investment.

The regulations under section 4944 provide some additional gloss and guidance regarding the program-related investment rules. An investment will be considered to have been made primarily to accomplish the requisite exempt objectives if the investment would not have been made “but for [its causal] relationship” to the accomplishment of the private foundation’s tax-exempt objectives. Also, in determining whether the production of income or appreciation of property was a significant purpose of the investment, an important factor is whether a profit-motivated investor would make the same investment on the same terms; however, the fact that an investment incidentally produces for the foundation significant income or capital appreciation is not, in the absence of other factors, conclusive evidence that a significant purpose is the production of income or the appreciation of property. Example 1 of reg. section 53.4944-3(b) provides the prototype for an investment that qualifies as program-related: a below-market interest loan to a small business located in a deteriorated area and owned by members of a minority group, made by the private foundation primarily to encourage economic development of the minority group.

F. Unrelated Business Tax

An EO is generally required to pay taxes on business income that is unrelated to the organization’s exempt purposes. This type of income, known as unrelated business taxable income, is taxed at regular corporate rates; however, if the UBTI comprises a substantial portion of an EO’s income, loss of tax-exempt status may result. UBTI is income derived from a “trade or business” that is “regularly carried on” and that is not “substantially related” to the organization’s exempt purpose. To be UBTI, the income must be derived from an activity or investment that meets all three of those prongs.

1. Trade or business.

A trade or business is “any activity which is carried on for the production of income from the sale of goods or the performance of services.” Specifically, any activity that qualifies as a trade or business under section 162 will also qualify as trade or business for section 501(c)(3) UBTI purposes. Generally, the focus is on the extent and the breadth of the elements that make up the income-producing activity. For example, is the

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91 Reg. section 53.4944-3(a).
92 Private foundations can only make an investment with the primary purpose to achieve one or more of the charitable objectives described in section 170(c)(2)(B). This is taken to mean that a private foundation may not make a grant to a non-section 501(c)(3) organization unless (1) the grant itself is a direct charitable act or a program-related investment or (2) the grantor is reasonably assured that the grant will be used exclusively for the purposes of a tax-exempt entity. See IRS, “Grants to Noncharitable Organizations,” Life Cycle of a Private Foundation. In many (if not all) respects, this rule for private foundations does not differ from the rules applicable to public charities.
93 This rule regarding lobbying and other political activity is a relatively simple requirement, but importantly, the rule applicable to investments by private foundations differs from the rule applicable to grants made by private foundations; in limited circumstances, a private foundation is permitted to make grants in support of lobbying.
94 Reg. section 53.4944-3(a).
95 Reg. section 53.4944-3(a)(2)(i).
96 Reg. section 53.4944-3(a)(2)(ii).
97 See sections 511 through 515.
98 See Indiana Retail Hardware Association v. United States, 366 F.2d 998 (Ct. Cl. 1966) (court denied the association’s business league exemption status under section 501(c)(6) because it engaged in income-producing activities that served particular members according to particular needs, which produced 50 percent of association’s income and consumed 50 percent of the association’s time).
99 Reg. section 1.513-1(a).
100 Section 513(c).
101 Section 162 allows a deduction for the ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business.
sale of product a trade or business in the absence of any marketing or other typical elements of commercial activity? An activity will not lose its identity as a trade or business merely because it is carried on within a larger complex of other activities that may be related to the exempt purpose of the organization.

2. Regularly carried on.

A trade or business is regularly carried on if it “manifests a frequency and continuity, and is pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.” The IRS has indicated that a trade or business is not regularly carried on when an EO engages in a one-time only operation. Organizations often struggle with this prong when an activity is not regularly carried on in any conventional sense, but the activity is repeated with some regularity — for example, a merchandise sales event twice a year (or maybe even an annual auction).


A trade or business is substantially related to the organization’s exempt purpose only when the conduct of the business activities has a substantial causal relationship to the achievement of the organization’s charitable goal. To be substantially related, the regularly carried on trade or business must contribute importantly to the accomplishment of the exempt purpose. If income is realized by an EO from an activity that is generally related to the performance of its exempt functions, but the activity is conducted on a larger scale than necessary, the gross income attributable to the portion of the activity that is in excess of the needs of the exempt functions constitutes UBTI because it does not itself contribute importantly to achievement of the organization’s exempt purpose.

UBTI is generally thought by the nonprofit community to have (at least) two adverse tax consequences. The first and most obvious is that UBTI is subject to tax at regular corporate income tax rates. As a general proposition, charities are not used to paying any tax, and the idea that a given activity will yield a tax liability elicits something of an allergic reaction. The second concern, perhaps only theoretical, is that realization of UBTI and the consequent reporting of the UBTI on the annual tax return will invite greater scrutiny of the organization’s tax return by the IRS.

G. Activity Attribution

The discussion to this point regarding fundamental tax rules that govern, constrain, and in some cases prohibit the actions and activity of an EO raises a question: Under the tax law, what activity is the EO treated as doing? To determine whether an EO complies with these rules that focus on its activity, one needs to first determine what the organization’s activity actually is. For the most part, this is not a difficult question; the activity of the organization is everything it is doing. Thus, if the organization makes a grant, enters a different kind of relationship, transacts in any way, or otherwise invests its assets, these actions are the actions of the organization and must be analyzed through the prism of these rules. But what about activity and conduct undertaken not by the EO itself but rather by a subsidiary, an affiliate, or some other party? In

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107 Reg. section 1.513-1(b). When a potentially unrelated trade or business activity is carried on within a larger set of activities related to the charity’s tax-exempt mission, the determination of whether the activity will be UBTI would focus on the two other prongs of the test.
108 Reg. section 1.513-1(c)(1).
109 LTR 201015037 (the receipt of leasing commission income by a tax-exempt organization did not result in the imposition of UBTI tax because the leasing activity was not regularly carried on by the organization).
110 Reg. section 1.513-1(d)(2). This does not include an income-producing activity that has no relationship to the organization’s exempt mission even though the income realized from the activity is used in furtherance of the organization’s exempt objectives; the fact that earnings or profit from an activity will be used by the organization to advance its exempt purpose does not make the activity “related.”
111 Id.

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107 Id. It is useful to consider the apparent similarities between “substantially related” for purposes of UBTI and “program-related” as applied to investment returns realized by private foundations. At some level, program-related is a concept designed for analyzing passive or one-off investments, while the issue of UBTI is by its nature relevant when the EO engages in a commercial activity that is more active and regular. Nonetheless, particularly in joint ventures and other collaborations involving EOs, these two concepts can intersect and overlap.
108 Section 511(a).
109 Because of the concern about enhanced audit risk exposure, many charities choose to conduct their commercial activity, even if not certainly UBTI, inside a taxable corporate subsidiary. In those cases, although the activity will generate tax for the taxable subsidiary, the charity would not be required to report UBTI on its own tax return.
what circumstances might the activity of others be treated as though it is the activity of the EO itself?

Generally, the conduct and activity of a corporation owned by an EO will not be treated as conducted by the organization itself. Stated using the tax nomenclature, a corporate subsidiary’s activities will not ordinarily be attributed to the EO. As a general proposition, this principle — that a subsidiary corporation’s activity is not attributed to its shareholders — is applicable across the wide range of tax law. The principle, however, has exceptions — for example, when the corporation fails to adhere to corporate formalities, and that consequently, activity conducted inside the corporate subsidiary will not be attributed to its tax-exempt parent.

What about activity conducted in a different form of business entity, such as an LLC or a partnership? If the activity is housed within an LLC whose sole member is the EO, then in the absence of an election otherwise, the very existence of the LLC as a separate legal entity will be (under principles of tax law applicable generally) disregarded, and the LLC’s activity will be treated as being conducted directly by the LLC’s sole member — the EO. Similarly (although not exactly the same), if the activity is housed within a partnership (or an LLC with two or more members, or any other form of entity treated for tax purposes as a partnership), the activity inside the partnership will be attributed to the EO, meaning that, in applying these tax rules to the tax-exempt partner, it will be treated as directly conducting the activities being conducted within the partnership.

V. Forms of Collaboration

What does collaboration look like? A drug company wants to work with a cancer research foundation to develop a cure. A book publisher wants to work with a church to publish and market religious-themed books. A real estate developer wants to work with a community development corporation to gentrify a run-down neighborhood. An investor wants to work with a nonprofit that establishes industry safety standards to expand (and monetize) the effectiveness of the standards. A group of doctors wants to work with a hospital to assure the successful implementation of cutting-edge medical technology.

These few examples of collaboration help to introduce the different ways that these parties consider partnering with each other, which should make more meaningful the following discussion regarding the forms of collaboration and the attendant tax law considerations and constraints. As should be obvious even from just the examples, the motivations of the parties will vary from situation to situation; identifying, developing, and negotiating the contours of the relationship will lead the tax analysis in very different directions.

There is no single correct way to structure a successful collaboration between a for-profit party and a tax-exempt organization. Naturally, any form or structure used will take into account the goals of the parties and their underlying needs and demands. For the EO, these needs and demands will be driven by considerations not present in typical commercial collaborations. As depicted in the graphic below, these relationships can range from simple contracts between the

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110 See, e.g., LTR 9519057 and LTR 9635037 (both determining that the activities of a taxable subsidiary will not be attributed to a tax-exempt parent or affiliated organizations if (among other factors) the taxable subsidiary is separately incorporated, engages in distinct activities, and observes separate corporate formalities, and if the tax-exempt parent (including through affiliated organizations) is not involved in the day-to-day activities of the taxable subsidiary).

111 See reg. section 301.7701-3(a). See also (and compare fully) section 512(c) (activity attribution for UBTI purposes).

112 For example, the IRS has attributed the activities of pass-through subsidiaries (such as partnerships and LLCs) to their tax-exempt parents in a line of cases on joint ventures between tax-exempt hospitals and for-profit entities. See, e.g., Rev. Rul. 98-15, 1998-1 C.B. 718, and Rev. Rul. 2004-51, 2004-1 C.B. 974. Perhaps it is noteworthy to observe that this principle of activity attribution from a partnership (or other pass-through entity) to its partners is typically if not always applied regardless of whether the partner controls the partnership, and with no established limit that makes application of the rule dependent on any minimum level of ownership in the partnership.
parties, to partnerships formed to carry out a project, to the acquisition of all the tax-exempt entity’s assets.

As will be explored later, at least in some important respects, the risks and stakes for the EO increase as the form of collaboration progresses from a simple grant to a more complicated contract, to a co-venture, and ultimately to a more complete business combination.

**A. Grants Made by an Exempt Organization**

Many EOs are in the business of making grants, so the notion that grant-making by an EO may involve some tax risk may come as a surprise to the uninitiated. Consider, for example, a nonprofit organization dedicated to finding a cure for cancer (the Cancer Be Gone Foundation) that raises funds and makes grants for cancer research projects. The grants may be made to other nonprofits — such as a hospital or research institute — or to individuals and even to for-profit organizations, like drug companies. Often the drug company has the resources and the motivation without which the effort to find a cure would be fruitless and, frankly, a waste of charitable resources. The idea that this kind of grant may be materially constrained by tax considerations, or that it may come with tax risks, therefore seems odd.

Grants made by an EO organization to a for-profit individual or entity will by their very nature almost invariably result in some benefit to the grantee. Of course, the EO hopes to advance its charitable mission — in the case of the Cancer Be Gone Foundation, to find a cure — but at the same time, these collaborations typically are not undertaken by the for-profit grantee for charitable reasons. Consequently, the EO must test the grant relationship for compliance under the private inurement and private benefit doctrines.

1. **Activity attribution.**

The first step in any analysis of these issues is to assess what it is that the EO is actually doing, and what activity must be subjected to scrutiny through the lens of these tax law principles. There are arrangements and transactional structures that can result in the EO being treated, at least for purposes of these tax law principles, as though it is engaging in activity that otherwise appears to be activity of another party. So a first step always is to determine the extent to which the activity attribution principles might result in treatment of the organization as conducting activity not obvious to the non-discerning observer.

Is the grant being made to an independent party? What, if any, levers of control does the charity retain over the use of granted funds? In grant arrangements in which the funds are and private benefit will not materially interfere. Similarly, for grants received by an EO, although there will be some implications to consider, concern regarding the benefit provided to a class outside the charitable group or mission ordinarily will not be an impediment. The discussion that follows focuses on grant arrangements that can or do provide benefit or value to nonexempt individuals or entities — benefits or value that may trip the private inurement or private benefit rules.

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113. Indeed, one may observe that the for-profit grantee, if it is a corporation or other form of entity that has statutory or contractual obligations to its investors, is actually obligated to focus on making profit and not permitted to waste assets on pursuing unprofitable goals.

114. Consideration of the activity attribution is a first step in any analysis of these issues, whether the collaboration is carried out through a grant, a more elaborate contract, or through an arrangement that amounts to a joint venture. The idea is explored here in connection with grants, but it is not again repeated when exploring the other forms of collaboration. This is not to suggest inapplicability but rather to avoid repetition.
handed over to an independent party for a clearly defined use or project, typically the grantee is required to report to the grantor organization periodically (to enable appropriate oversight and ensure that the funds are being used as initially contemplated and agreed), but the grantor organization otherwise has no control over or involvement in the conduct of the funded activity. In this fairly common scenario, the activity conducted by the grantee should not be attributed to the grantor organization. Rather, the activity of the EO should be limited to the act of grant-making and analyzed under the private inurement and private benefit principles as such. In this grant scenario, fairly common if not most typical, the activity attribution concepts play little or no role.

The analysis might shift, however, if the grant is made to a party controlled by the charity (for example, an employee or wholly owned subsidiary) or to an LLC or partnership in which the organization has a meaningful stake. In those situations, the charity might be treated as doing more than simply grant-making and instead be treated as conducting the underlying project or activity being funded by the grant. For our purposes, we will assume the grant is made to a party — for example, an unrelated corporation or an affiliated corporation with which corporate formalities are properly maintained — in circumstances that do not lead to activity attribution, and we will analyze the private inurement and private benefit rules as applicable to the act of grant-making alone.

2. Private inurement.

If a grant is made to a party that would be considered an insider under the private inurement rules, the EO will want to be sure that the grantee receives no value exceeding what the grantee is “giving.” In the context of a simple grant, under which the grantee may produce nothing of value — at least not value that emerges from the funded activity in a way that can be measured — this principle may seem difficult to apply or even understand. For example, if the EO funds the operation of a soup kitchen by a related party, although the activity is noble and charitable, it nonetheless produces nothing of enduring value. So how do we measure whether the organization is receiving full value in return for its grant? How do we get comfortable that the granted funds are truly at arm’s length?

In the case of the soup kitchen, and the many comparable situations in which grants are made to address important immediate charitable needs/objectives but nothing of value — not counting the lives of human beings that have been improved or even saved — emerges for the charity to “receive,” the answer to the private inurement and self-dealing issues probably is not terribly difficult and is best analyzed by focusing on what, if anything, the insider or related party is taking away from the activity. This follows from the probably obvious observation that the value received by the granting organization is the advancement or achievement of its exempt mission, so the only meaningful way to test for private inurement is to focus on what the grantee gets and gives.

As noted, the population of people and entities swept up as insiders subject to the inurement rules is not clearly defined. It is probably fair to observe that EOs generally err on the side of caution regarding whether the tax-law inurement rules apply, but that caution — at least in theory — gives up no real ground in view of the reality that nonprofits are generally constrained from engaging in any kind of self-dealing transactions under state law alone, and also are typically quite cautious when it comes to attracting litigation or even negative press that might result from or be associated with non-arm’s-length transactions with related parties or insiders. Looking strictly through the lens of the tax law, however, EOs subclassified as public charities confront not only the private inurement rule when considering the question of who is an insider, but also potential exposure to intermediate sanctions imposed under section 4958 on excess benefit transactions. Along different but similar lines, EOs subclassified as private foundations confront not only the private inurement rule but also restrictions, penalty taxes, and loss of exempt status if they engage in transactions subject to the section 4941 self-dealing rules, which have far greater sweep and application than typical related-party and self-dealing rules found in other areas of tax law and nontax law.
In the simple case, assuming the insider takes at most a reasonable salary for services rendered, or a reasonable price for goods provided, the EO should confidently conclude that the grant money was given entirely to pay a fair price for goods and services and otherwise 100 percent to invest in and achieve the organization’s exempt mission. That conclusion fits comfortably within the private inurement rules.

But what if there is more? What if the funded project produces something of value that is retained by the grantee, the related party? For example, suppose (in our soup kitchen example) that involvement in the activity is serving the purpose of enhancing (or rehabilitating) the related party’s standing within the community, perhaps even the business community in which he or she works. In that situation, the EO will want to assess whether the additional benefit enjoyed by the related party might trigger the private inurement rule. Can the organization confidently draw the conclusion that the additional benefit can be assigned a value and that, when aggregated with any other payments or benefits to the related grantee, the total amount “paid” to the grantee does not exceed the value of goods and services provided in return? And if there is or might be any excess value, will it be treated as private inurement? As noted earlier, although sometimes the IRS insists that no extra benefit whatsoever is permitted under the private inurement rule, at other times the agency signals that some level of incidental benefit might be permitted. But this premise is fraught with lack of clarity and the line quite difficult to find.

The situations become considerably more challenging if the additional benefit goes beyond amorphous concepts like rehabilitated reputation and even public relations. Consider, for example, the case of the for-profit publisher, who is involved with and holds a position of authority within his local church and receives a grant from the church to publish and circulate theological books. What if, under the grant agreement, aside from the publisher’s obligation to use the grant to publish and circulate the books, the ownership of the books remains lodged with the publisher, and the publisher is left free to sell the books without limitation? The publisher in that scenario, whom we can assume to be an insider in relation to the grantor church, is walking away with valuable IP. Is that OK?

EOs — in a variety of situations like these, in which valuable intellectual or other intangible assets are created and retained by the grantee — struggle with the issue of private inurement (and private benefit). Often the organization will seek to impose restrictions on the use of the intangible property, designed both to reduce or eliminate the potential value that can be derived by the related party and to limit use of the property in a manner designed to achieve or advance the organization’s exempt objectives. Those two steps serve to mitigate or eliminate this aspect of the private inurement issue.

The truth, however, is that allowing the related grantee to retain ownership of property created by the grant arrangement creates thorny issues, which charities often ultimately choose to avoid. If a grant arrangement is one in which an insider may walk away with any meaningful level of benefit over and above receipt of fair payment for goods provided or services rendered, EOs are and should be quite reluctant to rely on the often-impossible analysis of what the related party is giving and what he or she is getting, and on the undefined concept of acceptable incidental benefit for private inurement purposes. Instead, in any situation in which a grant will generate valuable property, the EO either should seek to retain all rights to that property or switch gears and find a grantee who is not an insider.

3. Private benefit.

Which leads us to the private benefit rule. Although technically an outgrowth of the statutory operational test (and not a derivative of the statutory prohibition against private inurement), it is something of an analog to the private inurement rule but applicable when the benefit is not to an insider or related party. Thus, let us assume in our scenario a grant by an EO made to an unrelated nonexempt party. Let’s focus, if only to ground the discussion, on the Cancer Be Gone Foundation exploring a grant...
arrangement with a wholly unrelated for-profit drug company.

Of course, the first hurdle is for the organization to conclude that the grant under consideration is necessary and important to advance or achieve the organization’s tax-exempt objectives. In our scenario, particularly given that the for-profit drug company is unrelated, this is likely a simple hurdle; after all, why else would the foundation consider the grant? Passing this hurdle is a first step, not the last.

Just as was true in connection with a grant to an insider and the potential application of the private inurement rule, when the grant is to an unrelated nonexempt party, the organization must examine the value and benefits accruing to the grantee and test for compliance under the private benefit rule. In our scenario, the foundation will consider what value is received by the drug company. That value may be limited to easily identifiable and quantifiable compensation for goods and services, or it may include less easily quantifiable enhancement of reputation or public profile, use (even if only through association) of the foundation’s intellectual or other intangible property at no or low cost, or ownership of any valuable asset produced as a result of the funded project.

In many cases, it is easy to identify the items and elements of value received or enjoyed by the grantee. Even in these situations, it often remains difficult to ascribe an actual dollar value. For example, we might all agree that the rehabilitation or enhancement of the grantee’s reputation or public profile has undeniable value, but what is the dollar amount of that value? In most situations, there is no rule or even safe harbor prescribing a valuation method, and the EO is left with the challenge of determining a value that it can comfortably assume to proceed with its assessment of compliance under the private benefit rule. In other cases it is difficult to even identify the items or elements of value, so the challenges of quantifying the value and testing for compliance under the private benefit rule may go unnoticed or rendered impossible.

Despite these challenges, the EO must identify and quantify any benefits accruing to the grantee (or any other unrelated nonexempt party) and consider whether the value being enjoyed by such parties (outside the class of people being served by the EO) is incidental within the meaning of the private benefit rule. This entails application of the quantitative and qualitative analysis, often a difficult one.

To illustrate, consider the challenge confronting the Cancer Be Gone Foundation if, under the grant agreement, the for-profit drug company retains ownership and free use of any actual cancer treatment or cure that may be developed using the foundation’s grant. Whatever the arrangement, the foundation must conclude (to paraphrase the quantitative and qualitative tests) that the collaboration is essential to pursue the mission of finding a cure, and that the benefit that the drug company does or may receive is not greater than the benefit of achieving the charitable mission (in this case, curing cancer).

In practice, these kinds of research grant arrangements are quite common, and they do not and should not raise meaningful concern under the private benefit rule. After all, in most cases, the collaboration underlying the research grant is critical to advance the EO’s charitable mission; the grant agreement typically requires that any asset or product developed as a result of the research project be used, at least to some extent, for charitable ends; and the potential value (measured at the outset of the grant arrangement) of retained residual rights is speculative at best. Thus, the EO typically gets comfortable that the two prongs of the incidental test — quantitative and qualitative — are met and that private benefit

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117 There are, unfortunately, answers to this “why else” question, all of which must be addressed by the organization. For example, consider the case in which a foundation board member drives the organization toward making a grant because he wants to curry favor for some reason with the drug company. These types of breaches of fiduciary duty are commonly addressed by conflict-of-interest policies and similar policies designed to steer a corporation away from any such self-dealing and conflicted conduct. The point, however, is that the breakdown of basic traffic rules of corporate governance can have many negative consequences, including acting in ways that jeopardize tax-exempt status and invite penalties under the tax law.

118 Although in most situations a formal appraisal from a third party is not required, it can be an important tool to provide comfort, as is true in many areas of tax law. Other valuation methods also may be considered, such as the transfer pricing methods used to satisfy compliance under section 482.

119 For example, the low-income people who eat soup at a soup kitchen are nonexempt parties and unrelated to the EO that sponsors or operates the soup kitchen, but the provision of value/benefit to them is (of course) not constrained by the private benefit rule.
does not exist. But what if the cure is discovered? What if the collaboration produces a product with immense value and the for-profit collaborator, having marketable rights to the IP, “laughs all the way to the bank”? Will that change the tax answer? Is the fact that such a possibility exists at the onset something that should chill these kinds of collaborations?

4. Additional restrictions on private foundations.

Before shifting our focus to complex contractual collaborations, I should add a word or two about some additional constraints confronted by private foundations. The prior discussion regarding private inurement and private benefit, for the most part, had as its focus public charities. These rules — or at least the underlying principles — apply as well to private foundations. Private foundations, however, face some additional hurdles and potential exposure to incremental costs.

In connection with a grant to a nonexempt party, a private foundation can incur significant penalties unless it exercises appropriate oversight or the grant itself furthers the foundation’s exempt mission. These principles are quite similar to (perhaps even the same as) those applicable to public charities, but the potential for excise tax imposed on the foundation and its managers invariably grabs just a little extra attention.

Also, private foundations are subject to a self-dealing prohibition — with associated penalty taxes — that restrains transactions with related parties beyond the boundaries ordinarily imposed under nontax law and other areas of tax law. The definition of disqualified persons (related parties) covered by the self-dealing prohibition is very broad, and the breadth of transactions potentially covered is sweeping and not intuitive. Consequently, private foundations considering a grant even to an unrelated party must analyze the grant through the prism of these sweeping self-dealing rules.

B. Contractual Relationships

Grant arrangements are, whether formal or informal, written or not, contractual relationships. Indeed, the immediately preceding discussion focusing on grant arrangements generally applies to any contractual collaboration between an EO and a nonexempt party. Here, however, we want to explore a relationship between an EO and a for-profit individual or entity that is more complex than a simple grant arrangement, a relationship that involves more than, “Here is a wad of cash, and this is what you must do with it.”

A contract is a fairly simple and effective way for a tax-exempt entity and for-profit entity to engage in a collaboration. If properly crafted, the contract spells out the entire relationship, including what each party is expected to do and not do, what each party’s rights and obligations are, who gets to make which decisions, what is done with the product of the collaboration, what happens if things go other than as planned, and what happens when the collaboration is over. Depending on the scope of the planned collaboration, the contract can provide for resource sharing, lease agreements, royalty arrangements, and more. As compared with the establishment of a new legal entity to house the planned collaboration, contracts can be more flexible and easier to terminate. Indeed, when exploring methods of collaboration, contractual relationships are often seen as a safe and simple way to proceed. When one of the parties is an EO, however, the added lens of exempt status maintenance and the potential incurrence of tax by an otherwise tax-exempt organization presents for the parties a few dimensions not otherwise present.

Let’s continue to consider the tax law principles through the eyes of the Cancer Be Gone Foundation, but let us now assume that the relationship between the foundation and the for-profit drug company involves more than a dollar amount to be granted accompanied by a precise and detailed articulation of steps to be taken by the grantee and a product or goal that is to be achieved. Assume instead that the Cancer Be Gone Foundation wants to take a greater role, perhaps providing expertise or maybe just personnel. Or perhaps the foundation plans to provide accumulated information, or trademark, or other branding assistance. In other words, the relationship will be more of a collaborative effort than is involved when simply transferring funds and monitoring the use of the funds according to a prearranged understanding. Also, for now we
will assume that the collaboration is intended to produce a medical or scientific advance that itself has no commercial application, and that the product of the collaboration will be made available to the entire research community at no charge and with no impediment.  

1. Private inurement and private benefit.

The fundamental requirements for maintenance of tax-exempt status and avoidance of penalties — restrictions on private inurement and private benefit and additional constraints on private foundations — remain the focus, but the greater complexity of the relationship can make navigating these rules more difficult and possibly more uncertain. The introduction of more interrelatedness, sharing, and collaboration between the two parties alters the equation of how much exactly the charity is giving and how much the for-profit partner is getting. In our simple grant arrangement, we were better able to assess the dollar value of the EO’s contribution to the collaboration, and that alone makes an analysis of the applicable tax rules easier. With the more intertwined relationship between the foundation and the for-profit drug company it gets considerably more difficult to apply the quantitative and qualitative tests for assessing compliance with the private benefit rule.  

It probably also is fair to observe that the complexion of the tax law analysis is altered merely by the appearance, if not reality, of a far more significant cooperative effort; the elevated level of interrelatedness and cooperative co-venturing likely shines a brighter spotlight on the question of private benefit. 

2. Impact on classification as public charity.

As was true for our simple grant arrangement, if valuable property gets created as a result of the contract-based collaboration, the issues around private inurement and private benefit become more acute. It may be useful here to add, however, that if the EO takes or keeps ownership of any valuable property developed as a result of the collaboration, the organization will want to anticipate the potential impact on its subclassification as either a public charity or a private foundation. If the valuable property may generate income in the future, the organization will need to analyze whether the character, amount, and timing of that income could result in a shift from public charity to private foundation status, and plan either to avoid that result or to avoid any adverse consequences or costs resulting from that change in status.

3. Recharacterization of contract as a joint venture.

The tax law introduces an entirely new set of rules and considerations for an EO involved in a joint venture. Some contractual relationships between a tax-exempt party and a nonexempt party clearly establish a joint venture, and the EO party appreciates the need to consider these collaborations through the prism of the joint venture rules. For other contractual collaborations, however, treatment of the relationship under consideration as a joint venture is less obvious.

When a contract provides for sharing of profits or income, it may be treated as a joint venture for these tax purposes even if there are no formal trappings of a partnership or other legal entity under state law. Generally, a joint venture entity will be deemed to be formed for tax purposes if there is co-ownership of property and business activity, plus a division of profits between the co-owners. Stated bluntly, any arrangement between an EO and another party, 

120 As will be important in discussing the possible application of the private benefit doctrine, however, we will also assume that even though the product of the collaboration will be freely available to the entire research community, the for-profit drug company will benefit from its ground-floor involvement. Perhaps that is because the drug company has an inside track and knows in advance where the collaboration is heading, or because the product developed, even though not itself commercially marketable, fits nicely within the drug company’s existing infrastructure of scientific and product development. Indeed, these benefits of ground-floor involvement may well be an important reason the for-profit drug company engages in this collaboration.

121 To illustrate, in our collaboration between the Cancer Be Gone Foundation and the for-profit drug company, we have assumed that even though the product of the collaboration will be freely available to the entire research community, the drug company will benefit from its ground-floor involvement. How does one evaluate that benefit for the drug company and assess the effect under the private benefit rule?

122 As a general observation, unlike a corporation or a partnership, a joint venture is not a legally recognized entity under federal or state law. Yet the term is used by the tax and business communities to refer to a broad range of commercial relationships without conveying the legal structure used in housing the relationship.

123 See William McKee et al., Federal Taxation of Partnerships and Partners, para. 3.01 (1977).
regardless of whether the relationship is housed within a formal state law entity, is susceptible to classification as a joint venture if there is a sharing of success or failure.\textsuperscript{124}

Consequently, any collaboration between an EO and a nonexempt party must be examined to determine the likelihood that it could be treated as a joint venture. If so, the collaboration would become subject to the following additional layer of rules and considerations.

C. Joint Ventures

For reasons that we will explore (but that do not necessarily make sense), the tax law — at least currently — looks at joint ventures between exempt and nonexempt parties through a special lens. With such a joint venture, the EO must consider a set of additional rules and constraints, an extra layer of risk and requirements piled on top of those confronted in connection with “lesser” forms of collaboration.

Joint ventures between exempt and nonexempt organizations have become quite common. Two (or more) parties, at least one an EO and the other(s) not, want to join forces to achieve objectives that they think would be out of reach in the absence of a collaboration. A combination of their resources and their efforts, the parties believe, would make a huge difference. Perhaps ironically, although the parties work in environments at different ends of the spectrum — one focused on saving humanity and the other focused on maximizing returns for investors — as they plot out their collaboration they appear to be closely aligned. The venture would, they hope, significantly move the needle addressing the EO’s charitable objective while also generating attractive levels of profit and the collaboration under consideration is one in which there will be some element of sharing of profits. We have entered the world of joint ventures.

The discussion — as relates only to the tax rules and their effect on structuring — in connection with a possible joint venture between an EO and a nonexempt party is wide-ranging and dynamic. Perhaps like any or at least many areas of tax practice, the process involves understanding and steering the parties regarding the objectives, economics, governance, and other elements of the proposed collaboration; navigating the relevant tax (and other) considerations that will inform, constrain, or even dictate these elements; forging a nonlinear path toward a solution or set of solutions that achieves the often competing aspirations; and drawing a conclusion about whether the collaboration is possible, and, if so, how it would be implemented. The discussion would typically include the following questions:

- What does the EO hope to achieve?
- What does the nonexempt organization hope to achieve?
- What will each party contribute to the venture?
- How will profits be shared? And losses?
- How will the venture be governed?
- On what basis will decisions be made? Which objectives will be decisive?
- What value do the parties expect will be generated by the venture, and how and when will that value be realized and monetized by each party?
- Will there be IP created? How will it be used, marketed, or shared, and who will own it if/when the venture terminates?
- What is the time horizon for the venture, and are there exit pathways anticipated?

These and other questions will inform the tax analysis and the potential structure for a collaboration. The EO, principally hoping to advance its charitable mission and perhaps also hoping to make money from its involvement in the venture, generally will focus on its tax-exempt status and whether income it realizes from the venture will be taxable. Constrained by these overarching considerations, the venture may take the form of a corporation or a partnership. If the venture is fashioned as a partnership (or other passthrough entity for tax purposes), the EO may

\textsuperscript{124}It is often difficult, however, to determine the level of interrelatedness and sharing of responsibilities upside and downside that will trigger treatment as a joint venture. EOs often explore entering into relationships that may be joint ventures without even realizing it. For example, an arrangement with a fundraiser in which the fundraiser is compensated with a percentage of the funds raised is presumably safe from characterization as a joint venture in most situations. Even so, viewing this common situation within the context of the joint venture rules can be troubling; at a minimum it refines one’s appreciation and respect for the underlying lack of clarity regarding the meaning of joint venture for these purposes.
decide to invest through a corporate blocker. Or the idea may simply be abandoned as too risky.


When an EO enters a joint venture with one or more nonexempt parties, the organization’s tax-exempt status may be at risk. Typically, joint ventures are conducted through a partnership or an LLC (which might be referred to as a partnership-style joint venture), or through a contractual arrangement that provides for the sharing of gain and loss from an activity (which might be referred to as a contract-style joint venture).

This area of law as relates to EOs and their continued status as such when involved in collaborations with nonexempt parties is of relatively recent vintage, has been evolving over time, and probably is not yet fully settled. Authoritative guidance on this topic is embodied principally (if not entirely) within two revenue rulings, as informed by the handful of cases on which those rulings are based, and two more recent cases. The first ruling, Rev. Rul. 98-15, is based on case law from 1945 to 1995. The ruling considers a joint venture between an EO and a for-profit entity and establishes principles governing whether the collaboration will disqualify the organization for exempt status under section 501(c)(3). Generally stated, the ruling focuses on the impact that the organization’s involvement in the joint venture has on its satisfaction of the operational test (the statutory requirement that it be operated exclusively for exempt purposes).

The second ruling, Rev. Rul. 2004-51, essentially establishes that if the joint venture is an insubstantial part of the organization’s activities, participation in that venture, taken alone, will not trigger the rule of Rev. Rul. 98-15 and, at least in that regard, will not expose the organization to loss of its exempt status. More on that later.

There are several issues with this current framework that in many circumstances make it difficult to assess whether a given collaboration will jeopardize an organization’s tax-exempt status. In many ways the rules are ambiguous (even perhaps inherently inconsistent); there is little guidance on when a venture is insubstantial within the meaning of Rev. Rul. 2004-51; and the scope of permissible activity in an insubstantial venture is unclear. Let’s drill down into the existing authority and its evolution to better understand what the law is today and in what ways it is unclear.


The 1998 ruling addresses a venture in which a section 501(c)(3) organization operating an acute-care hospital contributes all its assets to a venture with a for-profit party. The venture was operated through an LLC, treated for tax purposes as a partnership. The ruling focused on how a co-venture arrangement with a nonexempt party, in which profits would be generated and through which the nonexempt party (not to mention the exempt hospital) hoped to make money, might affect the hospital’s tax-exempt status, particularly under the operational test.

In the context of testing whether a joint venture would disqualify an EO from attaining or retaining its tax-exempt status, the IRS said the following:

- For purposes of the operational test, the activities of a tax-exempt/for-profit partnership are considered to be the activities of the section 501(c)(3) organization.
- A section 501(c)(3) organization may form and participate in a partnership with a for-profit entity and meet the operational test if participation in the partnership furthers a charitable purpose and the partnership arrangement permits the EO to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.
- Along these lines, a section 501(c)(3) organization may enter into a management contract with a private nonexempt party

125 The meaning of joint venture in this context (as in many others) is unclear. Although many situations are easy to assess, and a determination of joint venture status can be made confidently, in other situations the determination is difficult or even impossible.


128 This reflects a recognition and application of the activity attribution principle.

129 A reader unfamiliar with this area of law may wish to read this sentence again; the principle enunciated has, for now, become the heart of the rules applied to some joint ventures.
The collaboration described in Rev. Rul. 98-15 and for which the ruling established its governing principles is referred to as a “whole hospital joint venture.” The ruling addresses and provides important guidance regarding situations in which an EO transfers all or substantially all its assets to a partnership with a nonexempt party and shares in the profits, losses, and management of the venture. The ruling is understood to require, in connection with any such whole hospital joint venture, that an organization’s tax-exempt status will be preserved only if (generally stated) the document or documents that govern the venture provide that (1) the organization’s charitable objectives take priority over any other factor (meaning profit motive or any other objective) when it comes to any decision made or action taken in carrying out the venture, and (2) the EO retains ultimate control over the conduct of the venture.\footnote{The ruling is understood to also require that all contractual relationships be at arm’s length (or more favorable to the EO). Because that requirement is generally present in any transaction or activity that an EO conducts, it is not truly an extra rule layered on top of otherwise applicable rules in conjunction with a joint venture. For a better understanding of what the ruling is saying and why, it may be useful to read the following cases, cited in the ruling and establishing its foundation: Better Business Bureau, 326 U.S. 279 (operational test under a different statutory provision was not met by an organization established to promote honest and fair business practices and to foster a business climate of increased consumer confidence, when the organization’s founders, who were members of the business community, had an important if not primary goal of enhancing their own business interests); Broadway Theatre League Inc. v. United States, 293 F. Supp. 346 (W.D. Va. 1968) (operational test met when a tax-exempt theater shared 15 percent of ticket proceeds with exclusive booking agent, a percentage-based fee that the court held to be reasonable and necessary and that did not otherwise taint the activities or purpose of the theater); Harding Hospital Inc. v. United States, 505 F.2d 1068 (S.D. Ohio 1973) (both the operational test and the private inurement rule not met when the hospital’s relationship with its group of doctors was overly commercial and did not support the proposition that the hospital was principally focused on a charitable mission); Estate of Hawaii v. Commissioner, 71 T.C. 1067 (1979) (operational test was not met by an organization purportedly dedicated to helping people with self-help lectures and courses, when the organization paid 50 percent of course fees as compensation to nonexempt third parties that exerted considerable control over the conduct of the educational content and programming and were found to have enjoyed too much benefit from the entirety of the activity — even if the total benefit was reasonable for the services rendered); Plumstead Theatre Society v. Commissioner, 74 T.C. 1324 (1980) (organizational test was met when a theater company entered into profit-sharing arrangement with third-party nonexempt investors as a means to shore up financial difficulty; the theater company was found to limit the duration and scope of the partnership in a manner that supported the conclusion that the theater was and remained principally focused on providing high-quality/noncommercial theater, as opposed to commercial success); and Housing Pioneers Inc. v. Commissioner, 58 F.3d 401 (9th Cir. 1995) (organizational test not met for an organization that was formed to provide housing to handicapped and low-income individuals and hold a small interest in a partnership with the organizer and his family, largely if not entirely to secure property tax exemption).}

After the 1998 ruling (but before the 2004 ruling was published), two important cases emerged that essentially confirmed and even clarified these rules as applied to whole hospital joint ventures. When it comes to any decision made or action...
joint ventures. In *Redlands*, the court denied tax-exempt status to a nonprofit corporation. In drawing its conclusion, the court focused on the totality of all relevant factors, placing weight on its factual determination that the venture did not have as its governing principle the pursuit of charitable ends and that the nonprofit corporation had, in effect, ceded control over the enterprise to its nonexempt partners. In *St. David’s*, also involving a whole hospital-type joint venture (this one involving an actual hospital), the court applied the Rev. Rul. 98-15 principles and, because it was unconvinced that the hospital retained control over the venture, the court concluded that the hospital failed the operational test and consequently no longer qualified for tax-exempt status.


With the guidance of *Redlands* and *St. David’s*, the nonprofit community was on red alert regarding the standards that would need to be met in any joint venture with a nonexempt party that involved all or substantially all of the EO’s assets. Less clear, however, was how to figure out when those rules kicked in. How much of an organization’s assets would need to be committed or invested in a venture to be considered a whole hospital joint venture? What rules were to be applied if less than substantially all the organization’s assets were caught up in the venture?

Along came Rev. Rul. 2004-51 to help with, but not solve, this question. The ruling addresses a venture in which an exempt university partnered with a for-profit video company to offer training sessions for teachers by video seminar under an agreement giving control over the content to the university and control over administration to the video company. The ruling stated as a fact that the university’s participation in the venture would be an insubstantial part of its activities. Under these circumstances, the IRS ruled that the university did not fail the operational test because participation in the venture (taken alone) — an insubstantial part of the university’s activities — would not cause disqualification of its tax-exempt status under the standard of reg. section 1.501(c)(3)-1(c)(1). The ruling, however, did not explain or define what it meant by “insubstantial.”

Thus, the ruling establishes that an EO’s investment in a joint venture that represents an insubstantial part of its activities is not subject to the extra layer of rules established under Rev. Rul. 98-15. What constitutes insubstantial, however, is ambiguous and remains an area of difficulty in applying the 2004 ruling. At what point does the ruling apply to shut off the whole hospital rules of Rev. Rul. 98-15? Is insubstantiality tested entirely with reference to whether the absolute dollar amount or value of the EO’s investment is large or small, or is the test of an investment’s insubstantiality made with reference to the totality of the organization’s activities and assets?

As noted, the ruling’s focus on “insubstantial” is tied to the regulatory language that sets boundaries around the operational test. An organization fails the test if “more than an insubstantial part of its activities” is not in furtherance of an exempt purpose. A plain reading of this regulation suggests that by insubstantial, it is referring to the size of the activity relative to all activities of the organization. Moreover, in other contexts (meaning, in cases and rulings not concerning joint ventures) the meaning of insubstantial as used in this regulation is tested with reference to

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131 *Redlands Surgical Service*, 113 T.C. 47, aff’d, 242 F.3d 904 (9th Cir. 2001).
132 *St. David’s Health Care System v. United States*, 349 F.3d 232 (5th Cir. 2003).
133 That regulation provides that an organization will fail the operational test “if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.” Joint ventures that fit within the ruling’s classification of “insubstantial” are commonly referred to as “ancillary” or “partial hospital” joint ventures. Escaping disqualification from exempt status under this classification doesn’t mean the organization is home free; for example, the activity inside the venture may generate income subject to the UBTI tax.
the size of the activity relative to the totality of the EO’s activities.\footnote{For example, in Senior Citizens of Missouri Inc. v. Commissioner, T.C. Memo. 1988-493, the Tax Court considered an organization’s payments for services. The court, after concluding that the payments were not incidental to the organization’s exempt purposes (which, the court said, would render them permissible), proceeded to assess whether the payments were substantial within the meaning of reg. section 1.501(c)(3)-1(c)(1). It determined that they were. In support, the court noted that the payments represented 33.2 percent of the organization’s gross revenue on activities furthering its exempt purposes. In another case, Spanish American Cultural Association of Bergenfield v. Commissioner, T.C. Memo. 1994-510, the court explicitly declined to establish thresholds for the question of what the organization truly focuses on. Nonetheless, there is no authoritative connecting of dots establishing that the ruling can be interpreted that way.}

Consequently, one can fairly conclude that insubstantial as used in the 2004 ruling is a relative concept, intended to be determined with reference to the totality of the organization’s activities and assets. Understanding insubstantial in this way makes sense, in that the magnitude of the venture within the larger scheme of things that attract the organization’s attention bears on the question of what the organization truly focuses on. Nonetheless, there is no definitive guidance that insubstantial as used in Rev. Rul. 2004-51 focuses only on the relative size of the activity; there simply has been no authoritative connecting of dots establishing that the ruling can be interpreted that way.

The questions, therefore, remain. Can an organization with, say, $500 million in assets comfortably ignore Rev. Rul. 98-15 in connection with an investment of 10 percent of its assets in a joint venture with a nonexempt party? And what portion of an organization’s assets or activities can be invested in a venture without tripping into application of the 1998 ruling?

A clearer statement — whether judicial or administrative — that the focus is on relative values would be very welcome. Also welcome would be a clearer articulation of what percentage of assets is small enough to be treated as insubstantial for these purposes. In theory, particularly given that the 1998 ruling and the follow-on cases of Redlands and St. David’s were about all or substantially all of the organization’s assets, one could argue that less than 50 percent ought to be small enough to escape the extra focus and burden imposed under Rev. Rul. 98-15. Bear in mind that when considering a less-than-50-percent threshold, the organization presumably would remain subject to the panoply of requirements, restraints, and tests (discussed earlier) generally applicable to EOs. If not less than 50 percent, what percentage would be insubstantial? Perhaps 20 percent? Clearer guidance would help.

Before we turn away from Rev. Rul. 2004-51, a final oddity deserves mention. If an EO enters into a joint venture that can be treated as insubstantial within the meaning of the 2004 ruling, what then? Some have suggested, based on the way the ruling is written, that if only an insubstantial portion of the organization’s assets and activities are tied up in the venture, the venture itself can pose no risk to exempt status and the only issue that needs addressing is whether income from the activity is subject to the UBTI tax. This would mean that a so-called ancillary joint venture need not be examined under the private inurement and private benefit tests generally applicable to any activity conducted by an EO. According to this interpretation of the 2004 ruling, there would be no need to focus on undue benefit to an insider, or to apply the quantitative and qualitative tests to benefits enjoyed by unrelated nonexempt parties as a result of the venture. Frankly, given the consequences that would flow from such an interpretation and extension of the ruling, that conclusion seems impossible.

4. What is a joint venture?

At this point, then, we have rules that deal with whole hospital joint ventures and ancillary joint ventures. We remain unsure about where the dividing line is, and we even remain a bit uncertain about the rules that apply (or get shut off) if we comfortably conclude that a given collaboration between an EO and a nonexempt party can be treated as an ancillary joint venture. But these rules (and the associated uncertainty) have no application unless we first determine that our collaboration amounts to a joint venture.

When does this extra layer of tax law applicable to a joint venture kick in? In view of the ubiquitous nature of our business community’s use of this term, it is almost funny to observe that there is no single or authoritative definition of joint venture (at least not for these purposes, and probably not for any). Black’s Law Dictionary
defines a joint venture as “an association of persons jointly undertaking some commercial enterprise,” or “a one-time grouping of two or more persons in a business undertaking.” That is not law, but it does serve as a good starting point.

To be clear, even though there is no bright-line definition, there are many articulations of the meaning of joint venture, and these certainly inform our understanding and ability to assess a given set of circumstances. Consequently, many situations are obviously joint ventures, and many obviously are not. For example, a partnership with a nonexempt party in which an EO has significant equity and voting power clearly is a joint venture subject to the extra layer of tax law focus and constraints discussed earlier. On the other hand, an EO’s prudent investment of assets in a private equity fund in exchange for a miniscule percentage interest — and zero say — in the fund would not be treated as a joint venture. Application of these rules and principles to situations somewhere in the middle, however, is not as easy.

The Tax Court has defined joint venture as “a special combination of two or more persons where in some specific venture a profit is jointly sought without any actual partnership or corporate designation,” and also as “an association of persons to carry out a single business enterprise for profit.” Other definitions capture a collaboration in which the parties jointly undertake an enterprise, share the distribution of profits and losses from the operation of the enterprise, and share the right to govern and direct the policy in connection therewith. It is probably fair to say that a joint venture (1) is created by a contract or is conducted through a separate entity, such as a partnership, corporation, or LLC; (2) involves investment of some sort by at least two co-venturers; (3) involves some degree of sharing of the success or failure of the joint activity; and (4) involves some form of sharing or delegation of control of its activities and operations between or among the co-venturers.

With that said, there really is no single definition of joint venture that can be universally applied to determine in every situation whether a joint venture exists. In the final analysis, we look at several factors, including the sharing of profits and losses, the EO’s percentage interest in the activity (whether housed within a formal legal entity or not), the allocation of control and the process for decision-making, the nature (including the stated and apparent objectives) of the activity itself, and the portion of the EO’s total assets (and attention) allocated to the activity.

The absence of any authoritative articulation of clear standards defining joint venture for these purposes is frustrating, although admittedly the frustration is mitigated by the introduction in 2004 of the ancillary joint venture. Because Rev. Rul. 2004-51 makes inapplicable the extra layer of rules under Rev. Rul. 98-15 (and Redlands and St. David’s), the real focus in any collaboration shifts from “Is there a joint venture?” to “Even assuming there is a joint venture, is it ancillary?” If one can comfortably conclude that a collaboration, even if it may be characterized as a

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140 It may be intriguing and a bit perplexing to keep this mutual fund example in mind as we try to refine the boundaries of what constitutes a joint venture for these purposes.
137 See Sierra Club Inc. v. Commissioner, 103 T.C. 307, 322 (1994), aff’d in part and rev’d in part, 86 F.3d 1526 (9th Cir. 1996).
138 See John R. Washlick, Joint Ventures Involving Tax-Exempt Organizations, 478 Tax Mngt. Port.
135 See 141 To illustrate, consider the following fairly typical judicial articulation of the meaning of joint venture: “A joint venture contemplates an enterprise jointly undertaken; it is an association of such joint undertakers to carry out a single project for profit; there must be a community of interest in the performance of a common purpose, a proprietary interest in the subject matter, a right to direct and govern the policy in connection therewith, a duty, which may be altered by agreement, to share both in profit and losses. One member of the joint venture is liable to third parties for acts of the other venturer, especially payment of debts.” Moore Charitable Trust, 812 F. Supp. at 132. Consider this definition of a joint venture when analyzing a commercial activity carried on through a two-member LLC. Is the activity conducted through the LLC a joint venture even though neither member is liable to third parties? Alternatively, consider whether a 50 percent nonvoting interest in a commercial venture held by an EO would be treated as a joint venture despite the EO’s lack of any control or say in the venture. Both of those examples certainly are covered under the joint venture rules, yet neither would necessarily be treated as a joint venture under the judicial articulation.
joint venture, is no more than ancillary, the applicable standards and rules remain the same as though there were no joint venture at all. The organization would test for compliance under the private inurement and private benefit test. This is a long way to say that if any authoritative guidance is coming, it probably would be most useful if it first provided a bright line between whole hospital and ancillary joint ventures.


Given these rules applicable to grants, contractual relationships, and joint ventures, in any arrangement with a nonexempt party an EO must go through a checklist of questions:

• Can this relationship possibly be characterized as a joint venture? Is there any sharing of profit or loss generated by an activity jointly conducted or otherwise jointly sponsored or owned? Do both the EO and the nonexempt partner care about the financial success of the arrangement?

• If the arrangement may be characterized as a joint venture, where does it fall within the spectrum between whole hospital and ancillary?

• If the arrangement may be treated as whole hospital, which requires an assessment of whether the underlying activity is insubstantial, will the contract/document governing the arrangement clearly establish that (1) achieving the charitable goals will be the primary driver, trumping profit motive and any other noncharitable motive, in connection with any decision made or act taken in planning and operating the activity, and (2) the EO will have ultimate control over the conduct of the activity?

• If certainly ancillary (or if not even a joint venture), will the collaboration result in any benefit to the other party that would violate either the private inurement or private benefit doctrine?

If, after analyzing these questions, the EO remains unsure of the answers or otherwise uncomfortable that it can proceed with the arrangement unconcerned about retaining its tax-exempt status (or incurring UBTI tax), the organization could explore use of a corporation. The corporate solution might be used in one of two ways: Either the EO can hold its interest in the venture through a wholly owned subsidiary formed as a taxable corporation (a subchapter C corporation), or the entire venture can be housed within a C corporation.

If the activity or venture is housed within a partnership, an LLC, or any other vehicle treated as a pass-through entity for tax purposes, the EO may choose to hold its interest in the venture through a C corporation, a so-called corporate blocker. Under the governing tax law principles, the activity conducted within the pass-through venture vehicle might be attributed to its members — in this case the C corporation and the nonexempt partner — but would not be attributed through the C corporation to its shareholder (the EO). In other words, there generally is no activity attribution from a C corporation, and, as a result, the ownership of stock in the C corporation would be analyzed entirely as such: Would the EO trip over any rules through the mere act of holding 100 percent of the stock of the C corporation?

Assuming the ownership of the stock does not represent a substantial portion of the EO’s assets or activities, ownership of the C corporation stock ought not serve to dwarf the organization’s other (exempt) activities, and should not therefore call into question whether the organization is operated exclusively for exempt purposes. In that situation, use of the corporate blocker might be a good solution to avoid application of the joint venture rules. The cost, however, is that the C

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142Subject to the presumably incorrect view noted earlier that Rev. Rul. 2004-15 may have shut off all or some of those rules.

143Consider the implications of this introductory question. Assume an activity is profit-making and also advances the charity’s exempt mission. Further assume that under the contractual arrangement, the nonexempt party is entitled to 100 percent of the profit. We considered this scenario in connection with grants and contractual arrangements — the Cancer Be Gone Foundation making a grant to a for-profit drug company and permitting the drug company to retain 100 percent ownership of all valuable property created by the collaboration. In that scenario, we observed, the private inurement and private benefit rules would need to be satisfied. But why isn’t this scenario a joint venture potentially subject to Rev. Rul. 98-157? Is there a rationale underlying Rev. Rul. 98-15 and Rev. Rul. 2004-51 that would be inapplicable in this scenario?

144Even so, care would be taken that — through its investment in the venture — the EO is not providing or facilitating any undue benefit to a third party, including the nonexempt partner in the venture. This is equally true if, in the alternative, the entire venture is housed within a corporation (as described below).
corporation would be fully taxable. As such, any profits that the EO hoped to realize through its participation in the venture would be subject to tax at the subsidiary corporate level.

An alternative, as suggested, might be to house the entire venture within a C corporation. In that case, both the EO and the nonexempt co-venturer would be shareholders in the corporate vehicle through which the venture is operated. As was true when the organization held its interest in a passthrough entity through a C corporation, so long as the EO’s interest in the corporation does not represent a substantial portion of its assets or activities, use of a corporate vehicle to house the entire venture would serve the same blocking function and would protect the EO from activity attribution that might otherwise trigger the joint venture rules. Here again, however, the parties would consider the tax inefficiency of adding a taxable subsidiary corporation to the mix, creating a second layer of tax to the venture that otherwise would not be incurred.

In any situation in which the EO chooses to acquire stock in a C corporation — whether the corporation is merely the vehicle to hold an interest in a passthrough entity or serves as the vehicle to house the entire venture — the organization should anticipate the type of income and revenue that may be generated (whether during the course of the venture or upon exit) to assess any effect that participation in the venture may have on the organization’s subclassification as a public charity. If the subsidiary corporation may generate dividends, for example, the arithmetic determination of the organization’s status as either a public charity or private foundation may be altered, and the organization may find itself reclassified as a private foundation. Given the additional restrictions imposed on private foundations, this might be an unwelcome development.\footnote{145}

D. Business Combinations

Based on the complexity and uncertainty of the tax law on joint ventures that pair an EO with a nonexempt party, and in the face of the various hurdles presented by those rules, an EO may simply throw up its hands and choose a different path to accomplish its mission. The EO may be convinced that the only way to achieve its charitable mission is through a collaboration with a nonexempt partner. It may find that the tax law as it is now applied and understood simply doesn’t permit the kind of collaboration that is necessary. And it may decide that the only pathway to achieve the charitable goal is to hand over all or substantially all its assets to the nonexempt partner and craft a profit-driven business that will be best suited to achieve the charitable mission.

That is one reason an EO may explore disposing of substantially all its assets or otherwise being acquired by (or merging with) a nonexempt partner. There surely are other reasons. For example, an organization may wish to divest or wind down a charitable project by selling those assets and reinvesting the cash in a new charitable project. Or the EO may simply have completed what it set out to do, run out of steam, or for any other reason resolved to close up shop.\footnote{147}

Even as it considers and prepares to go out of business, the EO must continue to consider the variety of tax law requirements associated with its exempt status (as well as nontax law, contractual, and other constraints). Failure to comply with the tax law constraints can result in liability attaching to the transferred assets and even penalties imposed on those who manage the EO.

\footnote{145}{That is not to say that potential reclassification as a private foundation can be ignored when considering a collaboration using a passthrough entity. In those circumstances, though, the decision to proceed with the venture using no C corporation blocker vehicle more likely reflects a determination that the activity is in furtherance of the organization’s exempt objectives and therefore less likely to result in reclassification as a private foundation.}

\footnote{146}{By way of illustration, the organization may have business holdings that it would need to divest, lobbying activity that it would need to abandon, or relationships with related parties that it would need to terminate.}

\footnote{147}{Of course, in any of these situations, the EO could sell its assets to another charity. Often, however, the assets will fetch a higher price if sold to a for-profit buyer, typically because such a buyer, unlike the tax-exempt buyer, will be using the assets in a profitable activity.}
A sale or merger must be structured so that there is no private inurement or private benefit in the transaction. Whether the EO is transferring assets or acquiring assets, the organization needs to comfortably conclude that it is receiving at least as much value as it is transferring to nonexempt parties. A transaction between entirely unrelated parties—leaving little reason to suspect anything other than at arm’s length—affords some level of confidence that the values and pricing have been fairly set. In many situations, however, there is a question of whether the parties truly are at arm’s length, or some other detail or factor impairs the ability to draw sufficient comfort from this principle. Generally, formal valuations are not a requirement, but often they are prudent. In some cases other methods of valuation may also be confidently used.

Often, particularly when a sale of assets or merger is undertaken to combine the charitable mission with a profit incentive, the people previously involved with and integral to the EO join the new organization. In those cases, of course, the private inurement issue (along with its tax-law cousins, the intermediate sanctions under section 4958 or the self-dealing restrictions under section 4941) must be addressed.

In connection with a dissolution (or deemed dissolution), the EO also must ensure that the transfer and other application of its assets—including the proceeds of a sale—are consistent with its charitable mission. So for example, the Cancer Be Gone Foundation would need to ensure that the proceeds of a sale of its assets are applied in a manner consistent with its charitable mission. In many situations, the initial application to the IRS for tax-exempt status, along with the organization’s incorporating charter, allow for a broader use of such liquidating transfers, although always in some fashion consistent with tax exemption (and nonprofit status). EOs subclassified as private foundations must, of course, adhere to the section 4944 restrictions on permitted distributions and expenditures, but in a dissolution they also confront an additional burden: Failure to properly choreograph and direct the foundation’s liquidating distributions can lead to liability for a termination tax under section 507.

VI. Final Thoughts: Overcoming Challenges

Collaborations between nonprofit and for-profit parties face a host of challenges under the tax law. Merely identifying, understanding, and applying the rules in a given set of circumstances can be difficult or even impossible. Solving for the issues that are identified in a manner that satisfies all parties, even if possible, often alters the dynamics of the endeavor in a way that actually impairs the likelihood of achieving the underlying charitable goals.

The simplest and most run-of-the-mill grant arrangements can raise issues under the private benefit rule. Although these issues are often addressed, at other times they are ignored as presenting immaterial risk or they are not even noticed. Applying the private benefit rule—with its incidental rule and its quantitative and qualitative tests that do not easily fit many relationships—can be treacherous. And these issues only become more challenging as a grant or contractual arrangement becomes more complex, as the interrelationship between the parties gets more involved and nuanced.

148 In the context of a merger, in which the EO seems to transfer nothing and simply is gobbled up whole (or does the gobbling), one may wonder how to think about assets being transferred or acquired by the EO. A discussion of how the tax law treats merger transactions is well beyond the scope of this report. Generally, if an EO merges into another entity, the tax law will reconstruct the merger and treat it as though the organization transferred all its assets (and liabilities) to the entity that survives in the merger, and then dissolved. It is within that hypothetical construct that the organization must determine whether sufficient value was received by the EO in exchange for the assets deemed transferred, (which might include any assumption of the EO’s liabilities by the entity that survives in the merger), and whether any amount deemed received by the EO was properly disposed of in connection with the organization’s hypothetical dissolution.


150 Thus, the Cancer Be Gone Foundation may be permitted to transfer assets or grant funds, in connection with a dissolution, to charities unrelated to cancer research. As noted earlier, nontax constituents will also have a say, such as the attorney general of the organization’s state of incorporation, as well, perhaps, as those who have donated to the organization, whether expressly restricted or implicitly so.

151 Section 507, generally dealing with termination of private foundation status, can result in a termination tax when a private foundation dissolves. Proper planning, however, can minimize or even eliminate the tax.
The potential overlay of the joint venture rules adds yet another set of hurdles. We don’t always know whether a given collaboration would be treated as a joint venture, and even if we do, we have no bright line to distinguish between ancillary and whole hospital joint ventures. Even if we confidently solve for these uncertainties, we are left with persistent questions surrounding whether a given venture may run afoul of the private benefit rule. These issues seem particularly difficult in connection with a venture intended to produce a commercially valuable product that would address a significant societal need (think: cure for cancer). Consequently, it can be argued, the tax rules that govern joint ventures involving EOs may serve to preclude or render less effective the type of collaboration most likely to address the biggest problems that confront our world.

The result of these rules as currently understood and applied is that hugely worthwhile collaborations between EOs and nonexempt parties may be abandoned. Parties exploring the possibility of combining assets, energies, and passions to solve a problem and at the same time make money are often discouraged. Important, even critical, collaborations do not happen. Some might say this is the right answer, that it is never acceptable for a charitable organization (supported by public funds as a result of its tax-exempt status) to be involved with a nonexempt party in profit-making. Those people would argue that profit motive is corrosive and distortive and that the venal objective tends to subvert the focus of any activity, perhaps even morph noble into non-noble.

Others would disagree. These voices would argue that government cannot solve our biggest problems, that we have witnessed time and again government’s inability to do so. These dissenters would remind us of the successes achieved by public-private partnerships, evidence of the greater effectiveness realized when combining the passions and resources of different constituents. The idea that collaboration between nonprofit and for-profit parties may be a good thing may draw support from our now decades-long experience with venture philanthropy, evidence that charitable goals alone, even if managed like a business, do not result in solutions to many of our most difficult and serious problems. Indeed, the evolution of venture philanthropy to the current-day blend of charitable and profit motives may even suggest that the only way these problems will be solved is through a merging of the passions and strengths of both the nonprofit and for-profit communities.

The argument of the dissenters seems quite compelling. In a nutshell, we may have finally arrived at the realization that at least for our most intractable problems, solutions will take more than a passion to do and achieve good; we need to combine that passion with another powerful one, the so-called animal spirits of our less-noble natures. The following story may illustrate this point.

Over two decades ago, I was privileged to discuss with one of America’s most renowned medical researchers the possibility of curing AIDS. This doctor, a genuine icon credited with eradicating one of the world’s most frightening and devastating health problems of the 20th century, now planned to eradicate another. He planned to set up a charitable foundation to fund his research. But, I asked, who will own the results of the funded research? Who would own the rights to the cure? Without a pause, he answered that he personally would retain all rights to the IP. After walking him through (a very abridged version of) the relevant tax rules, he was (I say this with utmost respect) dismissive, incredulous at the notion that these trivial tax concepts would stand in the way of his addressing a global health crisis. Right then I understood:

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152 When you step back, it is difficult to understand why the overlay of the joint venture rules is necessary. Why do we need this extra layer of rules, the standards set under Rev. Rul. 98-15, Redlands, and St. David’s, which are a derivative of the operational test? In what way is the quantitative-qualitative benefit rule, also a derivative of the operational test, insufficient to determine whether a given joint venture has crossed a line? The common answer is that if an activity is a large enough component of an organization’s overall activity, it serves to define what the organization truly is about. A possible additional argument is that a collaborative effort between an EO and a nonexempt partner introduces greater potential for abuse and for the diversion of tax-exempt dollars. Thus, according to this point of view, we can’t merely apply the quantitative-qualitative tests — testing relative amounts of noble and non-noble elements and consequences of an activity — if we cannot first comfortably establish both that (1) the organization’s defining activity is designed and conducted to advance the organization’s exempt objective and (2) the organization’s assets will not be diverted for inappropriate use. One might counterargue, however, that if the quantitative-qualitative test properly establishes the boundaries for meeting the operational test, it should be sufficient to test for compliance even in a joint venture. Perhaps the real answer is that the quantitative-qualitative test is simply an imperfect tool.
This one person, driven by two passions, could solve a problem. He had dual motivations, both of which served as critical drivers; one or the other would not be sufficient to get the job done. But our tax law permitted only one of those passions to be in play. He would have to choose. Whether he chose one, the other, or neither, however, the power of those two drivers converging would be lost. Our tax system rendered less likely that a cure for AIDS would be developed.

Today we continue to face huge problems, even after years and years of efforts to overcome them: illness and diseases that have no cure; hunger; drought; risks to our environment; crime and public safety; and education. Huge problems unsolved. Problems unsolved by government and unsolved by the nonprofit community. In every case, not for lack of trying. Perhaps we should consider a new approach, a break with unsuccessful approaches, a new paradigm. Maybe we should encourage, rather than discourage or cripple, partnerships between our nonprofit community and others who are motivated by the possibility of big paydays.

What would that look like? Perhaps we could facilitate these kinds of joint ventures simply by applying a different set of rules in testing for compliance with the statutory operational requirements. Instead of the quantitative and qualitative tests, and instead of the Rev. Rul. 98-15 standards, we could satisfy ourselves that the organization involved in a joint venture with a nonexempt partner is “organized and operated exclusively for” exempt purposes so long as its governing documents establish a charitable mission and its nonexempt co-venturer is demonstrably unrelated. This latter requirement — that an EO cannot co-venture with a related party — would be the linchpin providing comfort that the organization is not being used as a subterfuge to squeeze profit out of the system in an inappropriate manner. The idea here is to use the dynamics between truly unrelated parties, each with its own objectives, limitations, and constraints, negotiating with one another as the tool to ensure that the EO is entering into and participating in the venture exclusively for its charitable purpose.

An organization wholly unrelated to a potential co-venturer, properly governed and managed, will not intentionally allow its charitable goals to be subverted or give away too much to the unrelated party. Permitting joint ventures between an EO and a wholly unrelated nonexempt partner, therefore, would not lead to the type of money grab that concerns many who object to joint ventures between exempt and nonexempt organizations. Indeed, potential application of the section 4958 intermediate sanctions on excess benefit transactions would serve as yet a second safeguard against this potentiality.

One might remain concerned, however, that the prospect of making money would distract or distort the organization’s focus on its exempt objective. Involvement in a money-making venture, one that promises to throw off profits (maybe significant profits) to the charity, could result in the charity turning its focus away from its tax-exempt mission and toward the profit maximization of the venture. This argument fails or at least falters once we recognize that any such profits enjoyed by the charity remain trapped for use toward the organization’s charitable mission, both under state law applicable to nonprofits and tax law applicable to EOs. Might the lure of huge profits create a distraction for the organization’s managers or lay leadership? Sure. Ultimately, however, the organization and its leadership must remain grounded within the framework of the organization’s mission and tax-exempt objectives. Given the penalties imposed on doing otherwise, including penalties on the individuals who veer away from these governing principles, there really is little escape from that reality.

To make this type of system work, we would need to craft clear rules about what “unrelated” means. As noted earlier, clear and incontrovertible independence is the linchpin to this proposal, so it will be important to get this element right. One would think that given the maturity and sophistication of our corporate, securities, and tax laws in the development of this concept, there are many good templates to use for these standards. We should not need to reinvent any wheels to establish a set of rules for independence that is clear and effective.

That is the proposal. Encourage these partnerships between the nonprofit and for-profit worlds. Facilitate the important combination of
assets and the merger of two distinct passions in a way that may actually yield solutions to our greatest challenges. Safeguard against abuse — make sure charitable assets are deployed for charitable means — by setting up a system in which the watchdog will be the organization itself, working from a mindset of independence and otherwise with an incentive to protect the organization’s assets and the integrity of its transactions by the threat of section 4958 sanctions.

Yes, there will be mistakes, even with the best intentions. Even an independent decision-maker operating under a threat of sanctions can inadvertently allow too much value into the hands of nonexempt parties. Under our new paradigm, we need to adopt a mindset that, so long as there is no malfeasance, this is OK. We need to stop trying to thread the needle; it hasn’t worked. We need to allow for the possibility that a few dollars may slip through the cracks.

Think about it: if Cancer Be Gone Foundation enters into a joint venture with a for-profit drug company partner, and the venture results in the cure for cancer — a pill that generates for the drug company, say, many billions of dollars — is that really a terrible outcome?