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joint ventures involving tax-exempt organizations

2018 Cumulative Supplement

Fourth Edition

Michael I. Sanders

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

Contents

Preface

In almost 25 years since publication of the first edition of *Joint Ventures*, I've often expressed concern about the challenges confronting tax-exempt organizations in generating funds to conduct programs and activities that further their exempt purposes. Exploring the potential of increased revenue by participating in joint ventures was the genesis of this book. Unfortunately, after passage of The Tax Act of 2017 (Pub. L. No. 115-97) (the "Tax Act"), my concern, along with others in the nonprofit world, is heightened. As readers know by now, the 2017 tax bill made numerous changes to the Internal Revenue Code (the "Code") that affect the sector in a negative way, and in a manner that suggests that tax cuts elsewhere in the Code are, in part, economically supported by new burdens on the nonprofit sector. The changes and their potential impact are described in this Supplement. There is a reduction in the corporate and individual tax rates, which will be beneficial to many, including nonprofits, which will benefit from a lower tax rate on UBIT, notwithstanding its expanded scope, discussed later. And the deduction for cash contributed to public charities is increased from 50% to 60%; the provision sunsets in 2025, and, as a result of some complex rules, cash contributions have the effect of reducing other contributions (new § 170(b)(1)(G)). On the other hand, it is anticipated that the increase in the estate tax exemption and the doubling of the standard deduction, in effect eliminating the deductibility of charitable contributions for many, may result in fewer charitable contributions. There are also budgetary restraints that will affect government agencies that often support charitable projects.

Moreover, the aforesaid expected revenue decrease will be compounded by the anticipated increases in taxes to be paid by exempt organizations stemming from several new Code provisions, including the new "siloing" UBIT rules disallowing the bundling of gains and losses from all UBIT activities but requiring instead the separate computation of gains and losses from each unrelated activity (new § 512(a)(6), a practice not required of for-profit entities); the new excise tax based on investment income of private colleges and universities (new § 4968); the excise tax on excess executive compensation (new IRC § 4960); and a UBIT tax on expenses associated with the provision of certain employee fringe benefits (§ 512(a)(7)). The latter tax is particularly unusual in that it imposes a tax not on revenue but on *expenses* incurred by applicable institutions.

On the other hand, the new opportunity zone legislation in the 2017 tax bill will incentivize individuals and corporate investors to invest in qualified census tracts that have been designated by state governors, thereby attracting companies to locate in such zones; and perhaps fund new technology and healthcare businesses as well.

There remain myriad questions among nonprofits and their representatives regarding interpretation of these rules; for instance, What constitutes separate businesses? How will expenses among them be allocated? Although the IRS added these two issues to its 2018 Priority Guidance Plan, there have been calls for a delay in implementation of the rules, which are effective for years after December 31, 2017, with debate as to IRS's authority to institute a delay. Alternatively, exempt organizations are requesting that no penalties be imposed until guidance is issued. There is a great deal of uncertainty, with some practitioners, including your author, recommending that a reasonable approach should be defensible in this interim period. In any event, we await IRS guidance and a revised Form 990, without certainty at this time as to when either will be forthcoming and what they will provide.

Some provisions, such as repeal of the so-called Johnson Amendment prohibiting § 501(c)(3)'s from participating in political activities and expansion of the intermediate sanctions under § 4958, were not included in the Tax Act but continue to be introduced in other legislation. Whether lawmakers are using this as a vehicle to garner votes from their constituencies or there is a sincere effort to overturn this decades old rules remain to be seen. Other modifications are being sought through new federal level legislation as well, including a repeal of the college and university investment income excise tax and a proposal to move charitable deductions to "above the line" as an incentive to taxpayers taking the new higher, standard deduction to continue making charitable contributions. In addition, high-tax states, such as New Jersey, Connecticut, and New York, have passed laws facilitating deductibility of charitable contributions, with California poised to do the same, despite IRS Notice 2018-54 stating that federal law governs characterization and deductibility questions.

Although the ultimate impact is not yet foreseeable, the Tax Act will lead to increased joint venture activity and structuring, including other related party structures. For example, if a nonprofit has several unrelated businesses that are deemed separate and therefore "siloed," should those be "dropped" into one or more C corporations so that revenue from all can be offset by losses, thereby reducing the tax paid at the 21 percent rate? Or would a joint venture be suitable for certain activities in order to attract funds to support charitable projects? To fully take advantage of the new opportunity zone incentives, the IRS needs to issue additional guidance in view of the technical complexity that exists. And, in light of the reduced corporate tax rate, would a C corporation be an appropriate joint venture vehicle, as opposed to the traditional LLC? How do the changes to IRC

§ 163(j), limiting deductibility of net operating losses (NOLs) to 80 percent but with perpetual carryforwards, affect planning? Analysis of these issues will depend in great deal on future IRS guidelines and could be affected, and potentially upended, by future Code changes, such as tax rate increases if Congressional party leadership changes with subsequent elections.

In the 2018 additions to the Supplement in Chapter 2, there is an expanded discussion of the new 2017 tax legislation with an examination of the technical details, which are also discussed in other chapters, including the Taxation of Partnerships and Joint Ventures, Unrelated Business Income Tax, Healthcare Entities in Joint Ventures, Opportunity Zone Fund, and Joint Ventures with Universities. There is also a brief discussion of a number of provisions that were considered by the House and Senate but did not survive the conference committee in the Tax Act; however, there is potential that some of these will be "in play" in the near future. Chapter 2 also includes a brief discussion of new version of Form 1023-EZ.

In Chapter 3 there is discussion of treatment of business income to noncorporate taxpayers, which was one of the highlights in the Tax Act; it allows a for-profit taxpayer who participates in a joint venture with a nonprofit a deduction of 20 percent of the individual's qualified business income in a partnership S corporation or sole proprietorship. There is also included in Chapter 3 a brief discussion of new provisions contained in the Tax Act that affect partnership interest in exchange for services, termination of the partnership interest, and the passive activity loss rules.

In Chapter 6, which involves the choices of structure when engaging in a joint venture, there is a discussion of the impact of the Tax Act and implications on the choice of entity business as well as compensation policy.

In Chapter 8 there is an analysis of the new UBIT rules, including the introduction of the separate business or "silo" legislation. This is an important subject especially because a for-profit corporation is now subject to 21 percent tax on taxable income each year, which reduces the tax on unrelated business taxable income.

In Chapter 10 there is discussion and analysis of the Enterprise Act of 2017, which added a provision allowing private foundations to retain 100 percent of the business under certain conditions. In effect, it benefits Newman's Own Foundation, who owns 100 percent of No Limits LLC, a for-profit company.

In Chapters 12 and 14, the Tax Act is analyzed relative to hospitals and university joint ventures, examining the new 1.4 percent excise tax on the net investment income on endowments for private colleges and universities and the opportunities available to potentially minimize the taxation of unrelated business income. In a joint venture context there is discussion of PLR 201744019, which reexamines the control rules of Rev. Rul. 98-15.

In Chapter 13 there is a brief discussion of the 2018 Omnibus Spending Bill, which provided increases for affordable housing both on the tax and appropriation front, as well as a detailed examination of the new opportunity zone funds, §§ 1400Z-1 and 1400Z-2, with further discussion of the pairing of the opportunity zone incentives with new market tax credits.

In Chapter 16, conservation organizations involved in joint ventures are studied, including an examination of additional rulings and cases that affect the rules. In Chapter 19 the debt restructuring asset protection issues are updated as well.

The bottom line once again: There is no longer one paradigm for joint ventures in face of the Tax Act. Tax-exempt organizations and their for-profit counterparts need to be creative—that is, flexible in forging new paths to create and solve any issues affecting charitable organizations. It is especially important for nonprofits to be able to expand their activities and income stream to support their exempt activities through the use of properly structure joint ventures with other nonprofits or otherwise for-profit investors. The opportunity zone fund may create an extremely attractive alternative; in fact, many socially minded organizations may attempt to be reclassified under § 501(c)(4) (Chapter 2 contains a brief overview of the 501(c)(4) structure compared with 501(c)(3)). It is important to note that prominent philanthropists may attempt to forgo tax exemption, similar to the Chan Zuckerberg Initiative, to accomplish their "charitable" goals. (See § 6.8.)

Acknowledgments

I gratefully acknowledge the assistance of my colleagues at Blank Rome, LLP, who have given freely of their time in the research and review of the manuscript of the Supplement. I appreciate the work of three graduate students in the Georgetown Law Center, Master of Tax Program: Caroline Koo (exempt organizations as accommodating parties in tax shelter transactions, debt financed income, limitation on excess business holdings, private benefit, private inurement, excess benefit transactions; the unrelated business income tax and § 501(c)(4) discussion); Nina Roca (analysis of the impact on UBIT, separate trade or business legislation in the 2017 Tax Act); and Kevin Winters (analysis of the impact of the new opportunity zone fund). In addition, I thank Marcia Seiler Landsburg (debt restructuring). I also thank Ronald Schultz at Alliant Group (current developments regarding conservation organizations).

I am especially indebted to Gayle Forst for her contributions to the healthcare and university joint venture chapters; her analysis of the application of the process for exemption of (c)(4) organizations; and the conversion of status of § 501(c)(3) status to another exempt status, such as (c)(4). And I especially acknowledge Linda Schrader, whose extraordinary kindness and sensitivity have been invaluable in the preparation of the manuscript as has her coordination with the staff of John Wiley and Sons; Linda has been critical to the entire process.

CHAPTER 1

Introduction: Joint Ventures Involving Exempt Organizations

§ 1.4 UNIVERSITY JOINT VENTURES

p. 11. ***Add the following new paragraph at the end of this section:***

There is continued congressional focus on university endowments in light of the soaring cost of tuition and the perceived relatively low rate of financial assistance provided by colleges and universities with substantial endowments. See Chapter 14 for a discussion on policy changes that are being proposed, including imposing an annual payout requirement on endowment funds, among others.

§ 1.5 LOW-INCOME HOUSING AND NEW MARKETS TAX CREDIT JOINT VENTURES

pp. 13–14. ***Delete the last paragraph on p. 13 and replace with the following:***

The CDFI Fund has made 1,032 awards totaling $50.5 billion in allocation authority since the NMTC Program's inception. Through January 2017, CDEs disbursed a total of $42.8 billion in QEI proceeds to more than 4,224 qualified active low-income community businesses (QALICBs).

§ 1.6 CONSERVATION JOINT VENTURES

p. 15. ***Add the following to the last paragraph of this section:***

In January 2014, Treasury and the IRS issued Revenue Procedure 2014-12, 2014-3 I.R.B. 414, which established a safe harbor for federal historic tax credit investments made within a single tier through a master lease pass-through structure. The guidance was issued in response to the *Historic Boardwalk* decision referenced earlier.

§ 1.8 REV. RUL. 98-15 AND JOINT VENTURE STRUCTURE (NEW)

p. 18. ***Add the following to the end of footnote 65:***

PLR 201744019 (revocation of exemption of a § 501(c)(3) exempt hospital that was not operated exclusively for § 501(c)(3) purposes because it lacked ability to require for-profit manager to operate for charitable purposes.)

§ 1.10 ANCILLARY JOINT VENTURES: REV. RUL. 2004-51

p. 21. ***Add the following new paragraph to the end of this section:***

In section 4.10, there is an analysis of a virtual joint venture hypothetical, as to which a similar rationale should apply in a case in which the IRS proposes the revocation of an existing 501(c)(3) organization, alleging impermissible private benefit following an examination of its relationship with a for-profit entity. This commentator believes that the rationale should apply, notwithstanding the fact that no formal joint venture arrangement exists between the parties.

§ 1.14 THE EXEMPT ORGANIZATION AS A LENDER OR GROUND LESSOR

p. 28. ***Insert the following new paragraph at the end of this section:***

The Internal Revenue Service recently issued final guidance for private foundations that updates examples that relate to program-related investments that pass muster under § 4944(c). The rules (T.D. 9762) provide changes and examples that were first provided in the 2012 Proposed Regulations. See § 6.5(b) for a detailed discussion of the new examples.

In April 2016 the IRS issued final guidance for private foundations that updates a number of examples of program-related investments that won't trigger excise taxes. Final Rules (T.D. 9762) illustrate changes to the examples provided in the 2012 Proposed Rules. In one change involving Example 11, a private foundation that invested in a drug company subsidiary developing a vaccine for disease predominantly affecting poor people in developing countries recognizes that, in addition to distributing the vaccine at affordable prices, the subsidiary is allowed to sell the vaccine to those who can afford it at fair market value prices. In Chapter 6, each of the examples and its revised Treasury guidelines are set forth.

§ 1.15 PARTNERSHIP TAXATION

(a) Overview

p. 30. ***Add the following new paragraph to the end of this subsection:***

In the Bipartisan Budget Act of 2015, the partnership audit rules have been revised, the effect of which is that adjustments of income, gain, loss, deduction, or credit are to be determined at the partnership level and the taxes attributable thereto will be assessed and collected at the partnership level. The new rules are effective beginning taxable years after December 31, 2018, although small partnerships may opt out before then. See Chapter 3 for a discussion of the application of the new rules.

(b) Bargain Sale Including "Like Kind" Exchange

p. 30. ***Add the following to the end of footnote 101:***

See discussions regarding contribution of LLC/partnership interests to charity in § 2.11(f) (new), *infra*, and § 3.11, Sale or Other Disposition of Assets or Interests.

§ 1.17 USE OF A SUBSIDIARY AS A PARTICIPANT IN A JOINT VENTURE

p. 34. ***Add the following paragraph after the first full paragraph on this page:***

In September 2015, National Geographic Society formed a joint venture with 21st Century Fox, called the National Geographic Partners, a for-profit media joint venture. In this new venture, Fox contributed a substantial amount of cash to National Geographic, which increased its endowment to nearly $1 billion, in exchange for the contribution of significant assets, including its television channels and related digital and social media platforms. See § 6.3(b)(iv) for an analysis of the structure.