TO: HEALTH CARE CLIENTS

DATE: June 2, 2004

RE: IRS Publishes Ancillary Joint Venture Revenue Ruling

I. INTRODUCTION

Tax-exempt entities frequently enter into joint ventures ("JVs") with for-profit entities to further their exempt purposes or enhance their economic performance. Such ventures involve important issues regarding the entity’s ability to retain its tax-exempt status and to avoid being taxed on the income derived from the venture.

The Internal Revenue Service ("IRS") recently issued Revenue Ruling 2004-51, its first published guidance on “ancillary” JVs. The ruling indicates that, under certain circumstances, an exempt organization that contributes a portion of its assets to, and conducts a portion of its activities through, a JV formed with a for-profit company can both (1) retain its tax-exempt status and (2) avoid being subject to unrelated business income tax ("UBIT") on its share of the income derived from the venture. While the ruling did not involve a health care JV, IRS personnel have indicated that its principles apply to such arrangements.

In Revenue Ruling 98-15, the IRS previously addressed the “whole hospital” JV arrangement (i.e., JVs where an exempt hospital contributed all of its assets and operations to the JV). The “good facts” example in that ruling required the tax-exempt participant to retain effective control over the use of its assets through contractual arrangements with its for-profit partner. Subsequently, while the IRS was litigating the Redlands Surgical Services and St. David’s Healthcare System cases, it was unwilling to publish guidance in this area. Accordingly, even exempt organizations that chose to proceed with an “ancillary” JV (i.e., JVs between an exempt organization and a for-profit company in which the JV’s activities represent only a portion the total activities of the exempt participant) felt constrained to organize the JV within the constraints of Revenue Ruling 98-15. Revenue Ruling 2004-51 should permit ancillary JVs to be formed on terms that are considerably less restrictive to the for-profit participant, without jeopardizing tax-exempt status or subjecting the tax-exempt participant to UBIT.
II. FACTS

A 501(c)(3) tax-exempt university teamed to form a limited liability company (“LLC”) with a for-profit company that specialized in interactive video training programs. The entity was owned equally by the exempt organization and the for-profit entity. Each owner made identical capital contributions and shared equally in the allocations, distributions, and other economic rights associated with the LLC. Unlike in the whole hospital JV cases, the tax-exempt organization contributed only a portion of its assets to, and conducted only an insubstantial part of its activities through, the LLC.

The sole purpose of the LLC was to offer interactive video training seminars at off-campus locations to enhance the skills of elementary and secondary school teachers. The seminars covered the same content as those offered on the university’s campus. The activity contributed to the accomplishment of the university’s educational purposes, allowing it to reach individuals who could not attend the seminars on its campus.

The university had the exclusive right to approve the curricula, seminar content, training materials, and instructors and to determine the criteria for successful completion of the seminars. The for-profit company had the exclusive right to approve the camera operators and other personnel required to conduct the video training seminar and to select the locations for the video links to the seminars. All other aspects of the seminars, including advertising, enrolling participants, arranging for facilities, distributing course material, and broadcasting the seminars to the various locations were conducted by the LLC.

The LLC was managed by a governing board consisting of three directors chosen by the university and three directors chosen by the for-profit entity. Except for those issues noted above, actions required the mutual consent of the members. However, the LLC’s operating agreement prohibited activities contrary to the university’s tax-exempt status. The governing documents also required the terms of the LLC’s contracts and transactions to be arm’s length and at fair market value.

III. IRS RATIONALE AND HOLDINGS

The IRS noted that because the LLC was to be treated as a partnership for federal income tax purposes, its activities were to be attributed to its members. Accordingly, it determined that:

(1) The university’s participation in the venture did not jeopardize its tax-exempt status because the LLC activities were not a substantial part of the university’s activities and there was no improper private benefit; and
The income the university derived from the venture was not subject to UBIT because the LLC’s seminar activity was determined to be substantially “related” to the university's exempt educational purposes. This was based on a determination that the university selected the instructors and controlled the content of the program, which was the same as those conducted on its campus, and the arrangement extended the university’s reach to additional teachers.

IV. SIGNIFICANCE OF THE RULING

? If an ancillary JV represents only an insubstantial part of the exempt organization’s activities, exempt status should not be jeopardized. (The strict exempt status requirements set forth in Revenue Ruling 98-15 should not apply to such arrangements.)

? Numerical voting control of an ancillary JV is not required for an exempt organization to retain its tax-exempt status. Although the ruling involved voting control that was shared equally by the exempt owner and the for-profit owner, it is possible the control issue may no longer be relevant where a JV’s activities are insubstantial to the exempt organization’s overall activities.

? Provided that an ancillary JV furthers a tax-exempt purpose of the exempt organization participant and does not involve private inurement or more than incidental private benefit, exempt status should not be jeopardized.

? Numerical voting control of an ancillary JV should have no effect on whether the exempt organization’s share of the income from the venture will be subject to UBIT. Instead, the key factor is whether the JV’s activities are substantially related to the charitable or exempt purposes of the exempt participant.

? In testing “relatedness,” an exempt organization does not need to control all aspects of the JV’s activities. Instead, if the exempt organization has exclusive control over the aspects of the JV that further its exempt purposes income derived from the JV should not be subject to UBIT. (In the ruling, the tax-exempt university had control over program content and determining the criteria for successful completion of the program.)

? The “charity care” and “community benefit” issues that had been the focus of prior cases were not even addressed in the ruling. Presumably, these factors should only apply to a sole activity “whole hospital” type venture and should not be relevant when analyzing an ancillary JV.

V. UNRESOLVED ISSUES

The ruling does not provide guidance on:

? How to determine whether activities will be an “insubstantial” part of an exempt organization’s activities. This remains a key factual determination in ancillary JVs. (Many advisors believe that any amount up to 5% of gross revenues fits within a safe harbor and should not be treated as being substantial, and that anything between 5% and 15% is subject to a facts and circumstances test. Presumably, if an exempt organization
engages in multiple ancillary activities, each of which taken alone would insubstantial, such activities must be aggregated to determine whether the activities comprise more than an insubstantial part of an organization’s activities.)

? Private inurement and private benefit issues. (The ruling instead relied on carefully drafted facts and assumptions that circumvented these exemption-related issues.)

? The extent to which day-to-day operations matters can be handled by the for-profit entity under professional services, management services, billing services or similar agreements. (Presumably, such arrangements should not be troublesome in the context of an ancillary JV if they are at arm’s-length and for fair market value.)

? The extent to which the legal principles set forth in Revenue Ruling 98-15, Redlands Surgical Services and St. David's Health Care System apply in the ancillary joint venture context. (Even though these authorities were cited in Ruling 2004-51, they were not specifically applied in its brief analysis. Thus, the IRS did not demonstrate how it would analyze the control issue, for example, in an ancillary joint venture where the activities conducted through the joint venture constituted unrelated, although insubstantial, activities of the exempt organization, or where the activities arguably constituted more than an insubstantial amount of the activities of the exempt organization.)

VI. CONCLUSION

Revenue Ruling 2004-51 should permit ancillary JVs to be formed under terms that are more favorable to for-profit participants than under prior IRS guidance, without jeopardizing tax-exempt status or triggering UBIT to tax-exempt participants. As a published revenue ruling, it has precedential value and may be relied on by parties desiring to form such ventures. The ruling is particularly important because the IRS continues to have a “no ruling” policy on ancillary JVs and has informally indicated that it has no current plans to issue further guidance in this area. It should be noted, however, that antitrust, self-referral, anti-kickback and other regulatory issues must be considered in addition to tax exemption and UBIT when planning such ventures.

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