

JOINT VENTURES AND OTHER HOT TOPICS IN SENIOR HOUSING

Joint Ventures under Rev. Rul. 2004-51 and *St. David's*

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- I. Starting Point – Qualification for Tax Exempt Status
 - A. Under the statutory definition, the organization must be “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual.” I.R.C. § 501(c)(3).
 - B. Thus, are two requirements under the statutory language that the organization be “organized and operated exclusively for” an exempt purpose:
 1. Organizational Test: The articles of organization must contain certain limiting language prescribing the authorized exempt activities of the entity. Treas. Reg. § 1.501(c)(3)-1(b).
 2. Operational Test: The entity must be operated exclusively for an exempt purpose and no more than “an insubstantial part of its activities” may be in furtherance of a non-exempt purpose. Treas. Reg. § 1.501(c)(3)-1(c).
 - C. Two key restrictions under the operational test: private inurement and private benefit
 1. Private Inurement: Under § 501(c)(3), no part of an exempt organization’s net earnings may inure, in whole or in part, to the benefit of any private shareholder or individual.
 2. Private Benefit: An exempt organization must be organized and operated exclusively for a public purpose—it may not operate for the benefit of private interests such as designated individuals, the creator or his family,

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shareholders of the organization or persons controlled directly or indirectly by such interests. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

- a) The private benefit requirement does not derive its authority from the portion of the statute proscribing private inurement.
- b) Rather, it is based upon the operational test in the statute that requires an organization to operate “exclusively” for a charitable purpose. *See, e.g.*, I.R.M. 4.76.3.11.3 (Apr. 1, 2003); *Redlands Surgical Services*, 113 T.C. 47, 74 (1999), *aff’d* 242 F.3d 904 (9th Cir. 2001).

D. Private inurement and private benefit requirements are two distinct concepts that should be independently analyzed. Treas. Reg. § 1.501(c)(3)-1(a); *Redlands*, 113 T.C. at 74 (citing *American Campaign Academy v. Comm’r*, 92 T.C. 1053 (1989)).

E. Intermediate Sanctions

1. An incidental amount of private benefit may be acceptable but no private inurement is permitted. *See, e.g.*, *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945); *Ginsberg v. Comm’r*, 46 T.C. 47 (1966); GCM 39862 (Nov. 21, 1991).
2. Any amount of private inurement can result in loss of the organization’s tax exempt status. Because of the severity of this result, Congress enacted certain “intermediate sanctions” in 1996 under which an excise tax is imposed on excess benefits received by certain insiders. *See* I.R.C. § 4958; H.R. Rep. No. 506, 104th Cong. 2d Sess. 55 (1996).
3. Under § 4958, any “disqualified person” who benefits from an “excess benefit transaction” with an “applicable tax-exempt organization” is liable for excise tax equal to 25% of the excess benefit. I.R.C. § 4958(a)(1). Also, managers of the organization are also liable for a tax equal to 10% of the excess benefit if they knowingly, willfully and without reasonable cause participated in the excess benefit transaction. I.R.C. § 4958(a)(2).
4. An additional tax of 200% may be imposed if an excise tax of 25% has already been imposed and the excess benefit is not corrected within the taxable period. I.R.C. § 4958(b). *See also, e.g.*, P.L.R. 2004-35-018 (Aug. 27, 2004) (ruling that an excise tax of 200% should be included within the statutory notice of deficiency for a church founder as the result of his excess benefits from his personal use of a truck).
5. Definitions:
 - a) Disqualified person: any person “in a position to exercise substantial influence over the affairs of the organization” plus their

family members (spouses, ancestors, most descendants and their spouses, siblings and their spouses) and 35% controlled entities. I.R.C. § 4958(f).

- b) Excess benefit transaction: any transaction in which an economic benefit is provided by an applicable tax-exempt organization and the benefit exceeds the value of the consideration received by the organization. I.R.C. § 4958(c)(1)(A).
- c) Applicable tax-exempt organization:
 - (i) Any organization that would be described in § 501(c)(3) or (4) currently *or in the 5-year period ending on the date of the transaction*. I.R.C. § 4958(e).
 - (ii) Does not include private foundations. *Ibid.*

6. The Service is stepping up enforcement of the private benefit and private inurement requirements. For example, the Service recently issued five related private letter rulings involving the same church and the church founder's family and ruled that the 25% and 200% excise taxes should be imposed for proscribed private benefits from the use of church owned real estate, a vehicle, credit cards and cellular phones. See P.L.R. 2004-35-018 (Aug. 27, 2004); P.L.R. 2004-35-019 (Aug. 27, 2004); P.L.R. 2004-35-020 (Aug. 27, 2004); P.L.R. 2004-35-021 (Aug. 27, 2004); P.L.R. 2004-35-022 (Aug. 27, 2004).

II. Background – Tax Exempt Joint Ventures

A. A partner in a partnership carrying on a trade or business will be deemed to be carrying on that business. *Butler v. Comm'r*, 36 T.C. 1097 (1961); Rev. Rul. 98-15. Therefore, a tax exempt organization that partners with a for profit enterprise will be deemed to be carrying on the trade or business of the partnership.

B. Rev. Rul. 98-15 and *Redland's*

1. Rev. Rul. 98-15, 1998-1 C.B. 718

- a) Ruling addressed two situations involving joint ventures between a tax-exempt hospital and a for-profit hospital in which the tax-exempt hospital transferred its sole activity to the venture.
 - (i) In the first situation, the tax-exempt hospital had numerical control of the joint venture's governing board (by appointing 3 of its 5 board members). Additional facts:
 - (1) The joint venture's governing documents required it to operate in a manner that furthered charitable

purposes by promoting health for a broad cross section of its community.

- (2) The governing documents stated that the joint venture's charitable purpose took precedence over any duty to operate for the financial benefit of its owners.
 - (3) The joint venture was managed by an unrelated management company.
 - (4) The tax-exempt partner intended to use its distributions from the joint venture to fund grants to promote the health of the community and to help the indigent obtain health care.
- (ii) In the second situation, the tax-exempt hospital shared control of the joint venture's governing board (by appointing 3 of its 6 board members). Additional facts:
- (1) The joint venture's governing documents did not state a charitable purpose but rather stated that the joint venture's purpose was to, in general, engage in health care related activities.
 - (2) The joint venture was to be managed by a subsidiary of the for-profit hospital.
 - (3) Like in the first situation, the tax-exempt partner intended to use its distributions from the joint venture to fund grants to promote the health of the community and to help the indigent obtain health care.
- (iii) The Service ruled that the joint venture in the first situation would be in furtherance of the tax-exempt hospital's charitable purposes and the tax-exempt hospital would, as a result, continue to be operated exclusively for a charitable purpose. The benefits from the joint venture to the for-profit hospital were only incidental. Therefore, the joint venture would not affect the tax-exempt hospital's tax exempt status.
- (iv) In contrast, the Service ruled that the joint venture in the second situation would terminate the tax-exempt hospital's exemption because the joint venture would cause the tax-exempt hospital to no longer be operated exclusively for a charitable purpose.

2. *Redland's*

- a) In *Redlands Surgical Services*, 113 T.C. 47, 74 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001), a nonprofit subsidiary ("RSS") of a nonprofit corporation ("RHS") along with a for-profit corporation ("SCA") formed a general partnership which served as the general partner with a 61% interest in a limited partnership that owned and operated an ambulatory surgery center. Additional facts:
- (i) The day to day operations of the limited partnership / ambulatory surgery center were managed by a wholly owned subsidiary of SCA. *Id.* at 51.
 - (ii) Four managing directors – two of which were appointed by RSS – decided all questions regarding the affairs and policies of the limited partnership / ambulatory surgery center. *Ibid.*
 - (iii) All but one of the 32 limited partners were physicians at a hospital owned and operated by another nonprofit subsidiary of RHS. *Id.* at 54.
 - (iv) In exchange for its 37% contribution to capital, RSS received a 46% interest in profits, losses and distributions of the general partnership. *Id.* at 50.
 - (v) The partnership agreement contained no statement of charitable purpose. *Id.* at 54-55.
 - (vi) The ambulatory surgery center offered no free care to indigent persons and had no emergency room or certification to treat emergency patients. *Id.* at 67.
 - (vii) The sole activity of RSS was its investment in the limited partnership / ambulatory surgery center. *Id.* at 97.
- b) The court ruled that RSS had ceded effective control of the limited partnership / ambulatory surgery center's activities to for-profit parties conferring on them significant private benefits and, therefore, the venture was not operated exclusively for a charitable purpose. *Id.* at 78.
- c) Even had effective control not been ceded to for-profit parties, the court likely would have reached the same result that RSS was not entitled to exemption from tax. *See id.* at 92-93 (noting the lack of any express or implied obligations to put charitable objectives ahead of noncharitable ones).

3. In the wake of Rev. Rul. 98-15 and *Redland's*, an ABA subcommittee proposed a revenue ruling on ancillary hospital joint ventures to clarify when a tax-exempt hospital's exemption would be terminated by a proscribed joint venture and to facilitate venture between nonprofit health care providers and for-profit companies.
 - a) On October 4, 2002, the ABA's Tax and Accounting Interest Group of the Health Law Section proposed a revenue ruling that expanded upon the fact patterns in Rev. Rul. 98-15. *See* 2002 Tax Notes Today 196-10 (Oct. 9, 2002).
 - b) The only difference in the proposed ruling from the two situations in Rev. Rul. 98-15 was that in both situations the joint venture represented an insubstantial portion of the tax-exempt hospital's activities.
 - c) The proposed revenue ruling hoped to clarify that in both situations, the tax-exempt hospital's exemption would be unaffected and that the only tax risk posed by the joint venture is that the distributive share of joint venture income would be subject to unrelated business income tax. *See* discussion of UBTI, *infra*.

C. Requirements of tax exempt joint ventures ante Rev. Rul. 2004-51 and *St. David's*.

1. A tax exempt organization will not fail the operational test "if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners." Rev. Rul. 98-15.
2. The operation of the partnership's trade or business must be in furtherance of the tax exempt organization's exempt purpose(s). *Ibid.* Treas. Reg. § 1.501(c)(3)-1(e)(1); *Plumstead Theatre Society, Inc. v. Comm'r*, 74 T.C. 1324 (1980), *aff'd* 675 F.2d 244 (9th Cir. 1982).
 - a) Promotion of health is an exempt purpose. Rev. Rul. 98-15.
 - b) Senior housing can be an exempt purpose. *Infra.* at III.A.
3. If the joint venture is not in furtherance of the organization's exempt purpose, the joint venture's activities may not comprise more than an insubstantial part of the organization's activities as a whole. Rev. Rul. 98-15; *Better Business Bureau of Washington, D.C.*, 326 U.S. at 283.
4. Partnership may not cause tax exempt organization to impermissibly serve private interests. *Redlands*, 113 T.C. at 92-93. Ceding effective control impermissibly serves private interests. *Redlands*, 242 F.3d at 904.

5. Tax exempt partner must control the partnership. Rev. Rul. 98-15. Equal control arguably not enough. *See id.* (ruling that joint venture controlled equally by tax exempt and for profit entities would terminate tax exemption when there was joint control but also noting lack of charitable purpose and management by for profit entity's subsidiary).
6. Contract terms must be reasonable. *Ibid.*

D. Unrelated Business Income Tax (UBTI)

1. Under § 511(a), tax is imposed upon certain tax exempt organization's UBTI.
2. UBTI means the gross income derived from any "unrelated trade or business." I.R.C. § 512(a)(1).
3. Income from a trade or business that is "substantially related" exempt purpose is not UBTI. I.R.C. § 513(a); Treas. Reg. § 1.513-1(d)(2).
4. In order to escape UBTI treatment, the conduct of a business activity must contribute importantly to the accomplishment of the organization's exempt purposes. Treas. Reg. § 1.513-1(d)(2).

III. Non-Profit Senior Housing

- A. Senior assisted living facilities are tax exempt if they provide for the special needs of the elderly, in particular, their housing, health care and financial security needs. Rev. Rul. 72-124, 1972-1 C.B. 145.
1. In Rev. Rul. 72-124, the Service ruled that an organization was tax exempt that operated a housing facility that limited admission to residents over 65 and charged admission fee and monthly fee for the life of the resident because: i) the board of trustees consisted of leaders in the community and ii) residents would never be evicted, if possible, even if subsequent to their admission they became unable to pay.
 2. Analyzed requirements of addressing elderly persons' needs of housing, health care and financial security.
 - a) Housing – generally met if the residential facility has facilities designed to meet some combination of "physical, emotional, recreational, social, religious, and similar needs of aged persons." *Id.* at 146-47.
 - b) Health care – met if facility provides direct or in-direct form of health care including through a "continuing arrangement with other organizations, facilities, or health personnel, designed to maintain

the physical, and if necessary, mental well-being of its residents.”
Id. at 147.

c) Financial security – two requirements, the organization must:

- (i) “be committed to an established policy, whether written or in actual practice, of maintaining in residence any persons who become unable to pay their regular charges.” *Ibid.*
- (ii) “operate so as to provide its services to the aged at the lowest feasible cost.” *Ibid.*

B. Likewise, senior apartment housing also tax exempt if requirements of Rev. Rul. 72-124 met. Rev. Rul. 79-18, 1979-1 C.B. 194. Specifically, the Service ruled that the organization operating the apartment facility was tax exempt because it:

1. Charged rents at a level “within the financial reach of a significant segment of the community’s elderly persons.” *Id.* at 195.
2. Committed to operating at the “lowest feasible cost.” *Ibid.*
3. Maintained in residence, to the extent possible, those who become unable to pay. *Ibid.*
4. Operated to “to relieve the major forms of distress to which the elderly are susceptible.” *Ibid.*

IV. *St. David’s Health Care System v. U.S.*

A. Numerical control of board by tax exempt organization not necessary if contractual and other indicia of control are present. *St. David’s Health Care System v. U.S.*, 349 F.3d 232 (2003).

B. Although tax exempt hospital and for profit hospital system each appointed half of the joint venture’s trustees in *St. David’s*, a genuine issue of material fact existed as to whether the tax exempt entity nevertheless had effective control of the joint venture. *Id.* at 244.

C. Shared 50/50 control does not *per se* terminate an entity’s tax exempt status.

D. Other factors of control asserted by the tax exempt hospital included, *inter alia*,:

1. Partnership agreement required the manager to operate facilities in a manner that complied with the community benefit standard. *Id.* at 240.
2. Manager could not take any action with a “material probability of adversely affecting” the hospital’s tax exempt status. *Id.* at 241.
3. Tax exempt hospital appointed the CEO. *Ibid.*

- E. The Service has indicated that despite its loss in *St. David's*, it believes the framework from Rev. Rul. 98-15 provides the proper guidance for structuring ventures between tax exempt organizations and for-profits entities. See *Stokeld and Gary, Officials at EO Conference Discuss Nonprofit Abuses, Other Issues*, Tax Notes 1469-70 (March 22, 2004) (reporting comments of Stephanie Caden, senior legal counsel, IRS Office of Chief Counsel (TE / GE), made at a panel on joint ventures between tax exempt organizations and for-profits entities at the Washington Non-Profit Legal & Tax Conference in March, 2004 that the *St. David's* decision had nothing to do with the correct interpretation of the law).

V. Rev. Rul. 2004-51

A. Facts

1. Joint venture between tax exempt university that offered summer programs in teacher training and a for profit entity that specialized in conducting interactive video training programs.
2. Joint venture provided teacher training via interactive video technology.
3. Each party owned one-half the ownership interests and appointed one-half of the governing board.
4. The university had the sole right to approve the curriculum, training materials, instructors and to determine the standards for completion of the seminars.
5. Governing documents also provided that all contracts and transactions had to be at arm's length at reasonable, fair market prices and that the joint venture could not engage in any activity that would jeopardize the university's tax exempt status.

B. Rulings

1. Joint venture did not terminate the university's tax exempt status because the activities of the joint venture were not a substantial part of the organization's activities.
2. Because the joint venture's operations constituted a trade or business that was "substantially related" to the university's exempt purpose, the university was not subject to unrelated business income tax on its share of the joint venture's income. The joint venture was substantially related to the university's exempt purpose and did not result in UBTI because:
 - a) The teacher training conducted via interactive video technology covered the same content as the seminars that the university conducted on its campus and

- b) The joint venture's activities expanded the reach of the university's teacher training seminars.
- C. Participation in a joint venture, even one that does not advance the exempt organization's charitable purpose, should not result in a loss of exemption if the venture represents an insubstantial portion of the exempt organization's activities.