JOINT VENTURES INVOLVING TAX EXEMPT ORGANIZATIONS

(***For complete and up-to-date information regarding tax liability, please consult with your CPA or financial advisor***)

Due to the economic downturn a number of tax exempt organizations have turned to alternative sources of revenue in order to finance their charitable purposes.

A strategy that is often suggested is the formation of a joint venture with a for-profit consortium. For example, a non-profit entity organized for the purpose of promoting a greater understanding of local art intends to set up a bistro on its premises; a portion of the bistro-profits would be utilized for supporting the non-profit's charitable endeavors, while the remaining profits would remitted to outside parties (joint venturers in the proposed bistro endeavor) as a return on their investment. In order to understand the consequences of such a proposed course of action an understanding of the applicable rules is in order.

A "tax-exempt organization" is any organization exempt from federal income taxes under Section 501 of the Internal Revenue Code. In order to obtain tax-exempt status, an entity must be **organized and operated exclusively for tax exempt purposes**. In the event a tax-exempt organization fails to be operated exclusively for tax exempt purposes, two consequences may follow: (1) the organization may lose its tax-exempt status, or (2) the organization will be taxed on income derived from activities unrelated to its exempt purposes (i.e., just because the tax-exempt organization is not subject to tax on ***some*** income doesn't necessarily mean that it is exempt from tax on ***all*** income). Luckily, a number of authorities (along with federal regulations) have interpreted that the "exclusivity" requirement is satisfied if the entity is engaged only "primarily" in tax-exempt activities.

The question whether an organization is operated *primarily* for charitable purposes will arise in the situation where the entity is also engaged in a commercial activity (generally defined as any trade or business which is not substantially related – aside from the need of such organization for income derived from such activities – to the purposes of the organization). In this scenario, it is important to determine whether the commercial activity is related to the charitable purpose or whether the sole purpose of the activity is to earn profits (which will be used to finance the organizations' charitable purposes). Generally, an organization that engages in commercial activity that is directly related to its charitable purpose will not be denied an exemption, and will not be taxed on the income earned from such activities. Conversely, as stated above, an organization that engages in substantial commercial activities which are unrelated to the exempt purposes risks losing its tax-exempt status. In the alternative, such organization will be taxed in such unrelated income.

Based on these rules, great care must be taken when structuring a joint venture between a tax-exempt organization and a for-profit entity. Accordingly, when structuring such an entity the following should be kept in mind:

- In California, partnerships are defined as association of two or more persons to carry on as co-owners a ***business for profit***. Therefore, when forming a partnership with a for-profit entity, non-profit organizations will have a difficult time arguing that they are not engaged in commercial activities since, by definition, partnerships ***are*** formed for the purpose of operating a business for profit. As a result, historically, the use of partnerships has not been a favored form of business structure for such endeavors (see Plumstead Theater Society v. Commissioner). Nevertheless, even if the tax-exempt status of the non-profit entity is maintained, the tax-exempt organization may be taxed on the partnership's share of income in the same manner as if it had conducted the activity in its own capacity (i.e. unrelated business income tax). Furthermore, if the income derived from the commercial activity is substantial (when compared to income derived from tax-exempt purposes), the status of the tax-exempt partner may be jeopardized.

- In the event the activity is in furtherance of the non-profit entity's tax exempt purposes (and tax on unrelated business income is not desired), the non-profit entity should seek to establish and maintain operational control (e.g. majority of the members of the board of directors, non-profit has the power to veto actions which do not further its principal purposes, terms do not unreasonably favor the for-profit venturer, etc.)

- Consider utilizing a taxable subsidiary. The subsidiary may engage in commercial activity without fear of loss of tax-exemption to the non-profit shareholder. In addition, although the subsidiary will be taxed on its net profit, the dividends passed through to the non-profit shareholder are not generally regarded as unrelated business income. Therefore, the unrelated business income tax rules should not apply.

- For the time being, although the utilization of limited liability companies is not specifically prohibited for conducting business activities with for-profit entities, it is important to note that LLCs are taxed as partnerships for federal tax purposes. Accordingly, the LLC's activities are generally attributed to its partners (i.e. subjecting the non-profit LLC member to tax on unrelated business income or jeopardizing the tax-exempt status of such member).