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JOINT VENTURE ARRANGEMENTS BETWEEN IRC SECTION 501(C)(3) ENTITIES AND FOR-PROFIT ENTITIES

A recurring question that arises among IRC Section 501(c)(3) organizations, especially tax-exempt hospitals, is whether they would jeopardize their IRC Section 501(c)(3) status if they hold a general partnership interest in either a general or limited partnership in which one or more of the other partners, whether general or limited, are for-profit entities. At one time, the IRS would automatically revoke the tax-exempt status of the tax-exempt general partner if it even entered into such an arrangement. Lately, the IRS has, however, abandoned its automatic revocation policy as long as some fairly strict guidelines are followed. These guidelines are discussed below.

Q: As of today, can an IRC Section 501(c)(3) organization lose its IRC Section 501(c)(3) status if it becomes a general partner in either a general partnership or limited partnership in which one or more of the other partners are for-profit entities?

A: Yes, but only if it fails to abide by some fairly strict guidelines first articulated by the IRS in Rev. Rul. 98-15, and subsequently modified in Rev. Rul. 2004-51. Historically, at least prior to 1979, the IRS regularly revoked the IRC Section 501(c)(3) status of tax-exempt organizations that became a general partner in either a general or limited partnership in which one or more for-profit entities or individuals were the other partners. The IRS followed this policy in the belief that the tax-exempt general partner would operate the partnership, at least to some extent, for the benefit of the for-profit partners, i.e., for private rather than for public interests.

This attitude started to change with the U.S. Tax Court's decision in *Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980), *aff'd per curiam* 675 F2d 244 (9th Cir. 1982).

Q: What were the facts and the holding in the *Plumstead Theatre Society, Inc.* case?

A: Plumstead Theatre Society, Inc. ("Plumstead") was an IRC Section 501(c)(3) organization organized to promote the arts through its promotion of dramatic theater productions. In an effort to raise

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funds for the production of a new play entitled "First Monday in October", it formed a limited partnership, in which it was the sole general partner and two individuals and a for-profit business corporation were the limited partners. Plumstead contributed to the partnership a portion of its intellectual rights in the play for its 36.5% general partnership interest and the limited partners all contributed cash for their 63.5% limited partnership interests. Each of the partners' equity interests in the partnership was commensurate with the value of their respective capital contributions to the partnership. The IRS had initially sought to deny Plumstead's application for IRC Section 501(c)(3) status on the grounds that Plumstead's participation in the partnership caused it to be operated for private rather than public interests (a key prerequisite for IRC Section 501(c)(3) status). The Tax Court disagreed with the position of the IRS for the following reasons:

- Plumstead's syndication of an equity interest in one of its assets was not the same as an assignment of an equity interest in Plumstead itself;
- The partnership was created solely as a means of raising capital to further the exempt purpose of Plumstead;
- Plumstead's transactions with the partnership and the other partners were at "arm's length" and commercially reasonable; and
- The limited partners had no control over the way Plumstead operated or managed the partnership (and, as demonstrated below, this last factor has been emphasized by the IRS in approving subsequent joint venture arrangements).

Q: Did the IRS offer any formal guidance on how it would analyze joint ventures with for-profit entitles after the Plumstead decision?

A: Yes. Between 1982 and 1998, the IRS issued a stream of General Counsel Memoranda (GCM) that reflected the response of the IRS to the holding in Plumstead. In those GCMs, the IRS basically took the position that an IRC Section 501(c)(3) organization's participation in a partnership with for-profit entities would be permissible under IRC Section 501(c)(3) if the organization could demonstrate that (1) the business of the partnership furthers a charitable or other exempt purpose of the organization, and (2) under the partnership agreement, the organization is being operated exclusively for its exempt purpose and not for the private benefit of the other partners.

Then, in 1998, the IRS published Rev. Rul. 98-15 in which it formalized its position on this issue. In that Ruling, the IRS stated that, with respect to a tax-exempt organization serving as a general partner in a partnership, the organization's IRC Section 501(c)(3) status was at risk unless the organization could demonstrate that the following requirements were met:

- Participation in the partnership furthers a charitable purpose of the exempt organization; and
- while it is not necessary for the exempt organization to actively manage and control the assets and activities of the partnership, the partnership agreement must nevertheless permit the exempt organization the exclusive right to exercise ultimate control over the assets and activities of the partnership; and
- if a private party is allowed to control or use the exempt organization's assets or activities for the benefit of the private party, such benefit must only be incidental to the accomplishment of the organization's exempt purposes.

Q: Did Rev. Rul. 98-15 provide examples of how these guidelines were to be applied?

A: Yes. Rev. Rul. 98-15 applied these guidelines to two fact patterns, both of which involved acute care hospitals that were each IRC Section 501(c)(3) organizations.

Q: What lessons can we learn from the IRS analysis of these two fact patterns?

A: ***The first fact pattern*** in Rev. Rul. 98-15 was determined not to adversely affect the IRC Section 501(c)(3) status of the acute care hospital since the partnership's operations were found to be furthering the hospital's charitable purpose. Indeed, such charitable purpose was expressly stated in the partnership's partnership agreement. Furthermore, although the day-to-day management of the partnership was contracted out to a private third party, the IRS determined that the hospital retained the exclusive rights to ultimately control the management and operation of the newly formed partnership.

The ***second fact pattern*** is similar in most respects to the first fact pattern except as to (1) the stated purpose of the partnership as recited in the partnership agreement, and (2) the control issue. With regard to the stated purpose of the partnership, the IRS was troubled that it did not expressly recite the charitable nature of the partnership's operations. With regard to the control issue, the IRS was also troubled by the fact that the hospital shared control of the partnership's operations on an equal basis with the for-profit entity. As a result of these two differences in the structure and intended operation of the partnership, the IRS ruled that the hospital would be unable to "establish that it is neither organized nor operated for the benefit of private interests". Accordingly, under the second fact pattern, the IRS would revoke the IRC Section 501(c)(3) status of the hospital when if forms the partnership, contributes assets to the partnership, and then serves as the general partner of the partnership.

Q: What is the most recent IRS guidance on the ability of an IRC Section 501(c)(3) organization to serve as a general partner in a partnership that has one or more for-profit partners?

A: Rev. Rul. 2004-51 appears to be the most recent formal IRS guidance on this issue.

In that Ruling, a tax-exempt university formed an LLC (treated as a partnership for federal income tax purposes) with a for-profit corporation for the purpose of expanding the reach of the university's teacher training seminars. Each partner held a 50% ownership interest in the LLC.

The LLC's Operating Agreement provided that the LLC would be managed by a 6-member Board of Directors, with each partner permitted to choose 3 of the 6 members. The LLC's teacher training seminars are run the same as the seminars hosted by the university on its campus with the seminar teachers being teachers already employed by the university. The university is granted the exclusive right to set the curriculum, training materials, and instructors for the seminars and the for-profit entity is granted the exclusive right to select the locations for the seminars and the hiring of the non-teacher personnel needed to hold the seminars. The IRS assumed that the university's participation in the LLC would be considered to be an insubstantial part of its overall exempt activities.

Based on these set of facts, the IRS had little difficulty in finding that the activities of the LLC contributed importantly to the accomplishment of the university's exempt purpose and that the activities were substantially related to such purposes. Accordingly, the IRS held that the university's status as an IRC Section 501(c)(3) organization would not be adversely affected by its participation in the LLC. The fact that the university did not retain exclusive control over the operations of the LLC, by virtue of only having an equal representation in the LLC's Board of Directors, was not even mentioned by the IRS.

It seems therefore, that the IRS is becoming more flexible in scrutinizing joint ventures between tax-exempts and for-profit entities. ***But the consequences of being on the wrong side of the argument, namely loss of an organization's IRC Section 501(c)(3) status, should probably cause any tax-exempt organization entering into a joint venture with a for-profit entity to carefully ensure that the joint venture arrangement with the for-profit entity easily meets the more stringent requirements of Rev. Rul. 98-15.***

THE GREAT REVENUE CONVERGENCE: HOW TO RECOGNIZE REVENUE

In May 2014, the FASB (Financial Accounting Standards Board) and the IASB (International Accounting Standards Board) issued Revenue *From Contracts With Customers*, ASC 606 and IFRS 15, the converged standard for revenue recognition. This news will affect most entities: public, private and nonprofit.

The standard is effective for reporting periods beginning after December 15, 2017, for US GAAP nonpublic entities. Early adoption is permitted but not earlier than periods beginning after December 15, 2016. The standard is effective for public and IFRS entities with reporting periods beginning after December 31, 2016.

Adoption of the new standard may be a challenge. There are two adoption methods available:

Full retrospective approach (excludes practical expedience) — which applies to all periods presented. This would require all contracts that existed during the periods being presented to be in compliance with the new standard. There would also be a cumulative effect on the beginning retained earnings (net assets) and disclosure of the reason for the change.

Modified retrospective approach — where only the most current period is presented. This would require any contracts in existence as of the effective date to be in compliance with the standard, as well as any new contracts. The cumulative effects of the changes would be reflected in the beginning retained earnings (net assets). The disclosure would require presentation of the current period as if prepared with the current standard, effectively requiring two sets of accounting records for the year of adoption.

The new standard will significantly increase required disclosures and change how revenue from contracts with customers is recognized. Entities will have to consider changes that might be necessary to information technology systems, processes and internal controls to capture new data and address changes in financial reporting requirements. In the past there was industry-specific guidance. The new standard provides a single, comprehensive revenue recognition model.

The underlying principle is that an entity will recognize revenue to show the transfer of goods or services to customers at an amount that the entity expects to be entitled in exchange for those goods and services.

The revenue standard applies to all contracts with customers, **except for the following:**

- Lease contracts;
- Insurance contracts;
- Financial instruments and certain contractual rights or obligations within the scope of other standards;
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers; and
- Certain guarantees within the scope of other standards.

Please note that although contributions are not included in the exceptions listed above, contributions are considered support and not revenue. Contributions may contain restrictions on use but there is no specific customer receiving a good or service for their financial exchange.

Entities will need to follow a five-step approach to apply the standard to contracts with customers:

Step 1: Identify the contract with a customer
Step 2: Identify the separate performance obligations in the contract
Step 3: Determine the transaction price
Step 4: Allocate the transaction price to separate performance obligations
Step 5: Recognize revenue when or as each performance obligation is satisfied
The standard prescribes accounting for an individual contract with a customer, but allows for application of the guidance to a group of contracts with similar characteristics, if the entity is consistent with its application.

It is anticipated that entities may struggle with how to apply the new standard to their particular situation. The FASB and IASB have formed the Joint Transition Resource Group for Revenue Recognition (TRG) to address these issues. Some of the issues include gross versus net revenue, sales-based and usage-based royalties in contracts with licenses and goods or services other than licenses and impairment testing of capitalized contract costs. The FASB is looking at deferring the implementation date but organizations need to continue implementation work.

> "Adoption of the new standard may be a challenge. There are two adoptions methods available."

By Deborah Crown, Senior Manager (Columbia, MD)

DID YOU KNOW?

I touch a lot of IRS Form 990s in a year. I confess. I enjoy reading 990s and I think I know more about the form, its history and the reasons for the questions than most individuals. But, as with all topics, I do not know everything.

Recently a colleague asked if I knew why there is a question on the 990 asking "Did the organization receive any payments for indoor tanning services during the tax year?" I said that I did not know the reason but guessed that it could be the IRS's method to find tanning salons that had inappropriately gotten exempt status as health orgs. Wrong guess! I had never focused on that question as it did not apply to any of my clients. In fact I saw it as one box that did not require thought. But now I was curious...

What I discovered is that the question is fairly new on the 990 and it is there in response to provisions of the Patient Protection and Affordable Care Act (ACA). The ACA imposed an excise tax on indoor tanning services as a method of raising revenue. At one point a similar tax was proposed on cosmetic surgery but that was dropped. The tax on indoor tanning services is 10 percent of the amount paid for that service, and it is paid by the consumer, to the provider, which then remits the tax to the federal government. The service provider also must file quarterly the Form 720, which is how one reports all kinds of excise taxes. The tax for indoor tanning services is reported just below the reporting on arrow shafts ($.48 per shaft).

So why is this on the 990? Well, Part V of the 990 is where the IRS questions you about your other tax filings such as payroll tax filings and the 990-T. It is possible that 990-filing organizations may provide tanning services and the IRS wants to know if you are paying the tax. There are provisions in the law about allocating bundled payments to the tanning services. For example, a college may have a student activity fee covering many services including tanning booths. The instructions explain how much of that fee is taxable.

So if your organization is providing tanning services (or arrow shafts), check out the instructions to Form 720. They may apply to you.

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NOT-FOR-PROFIT INDUSTRY INSIGHT

With the increasing complexity of laws and regulations, it's important for associations, foundations, charities, hospitals, schools and other tax-exempt entities to seek out professionals with extensive experience in nonprofit compliance issues. We understand there are many challenges affecting the industry and provide the attention needed to help clients stay focused on their job at hand.

UHY LLP's National Not-For-Profit Practice offers comprehensive audit and assurance, tax planning and compliance and business advisory services to meet the unique, complex needs of nonprofit organizations.

These types of specialized services, which cut across the traditional service lines, demonstrate our philosophy of skilled professionals integrating industry expertise with technical services.

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