

Client Alert

A report
for clients
and friends
of the firm June 2004

Revenue Ruling Provides Favorable Treatment For Ancillary Joint Venture Between Exempt Organization and For-Profit Entity

On May 6, the Internal Revenue Service (the "IRS") issued an advance copy of Revenue Ruling 2004-51¹ providing that a tax-exempt organization may share 50/50 ownership and governance of an ancillary joint venture with a for-profit entity without jeopardizing its exempt status and without incurring any unrelated business income tax ("UBIT") on its share of income from the joint venture, so long as the activity conducted by the venture is conducted in a manner that contributes importantly to the exempt organization's exempt purpose. An ancillary joint venture is a joint venture between an exempt organization and a for-profit entity, where the activity conducted through the partnership is not a substantial part of the exempt organization's overall activities.

An exempt organization must be operated exclusively for charitable, scientific, or educational purposes. If an exempt organization owns an interest in a pass-through entity, *i.e.*, a partnership or a limited liability company ("LLC"), activities conducted by the pass-through entity are imputed to the exempt organization for purposes of determining whether the exempt organization is operated exclusively for charitable, scientific, or educational purposes. Accordingly, if the pass-through entity is conducting activities that are not in furtherance of exempt purposes, the exempt organization may jeopardize its

exempt status and its income generated by the pass-through entity's activities may be subject to UBIT, as income generated from a trade or business that is unrelated to the exempt purposes of the organization.

The Revenue Ruling was issued approximately six months after the Fifth Circuit backed the IRS's position in a whole-hospital joint venture case, *St. David's Health Care System v. United States*.² In *St. David's*, the appellate court reversed and remanded the case to the lower court to determine whether a hospital that contributed all of its assets to, and conducted all of its activities through, a partnership jointly owned with a for-profit entity maintained sufficient control over the partnership.³ It was not clear from *St. David's*, however, whether the same control over the partnership was required in an ancillary joint venture. Further, the consequences to an exempt organization that participated in an impermissible ancillary joint venture were unknown. Would participation in an ancillary joint venture cause the exempt organization to jeopardize its exempt status and incur UBIT on income generated from the ancillary joint venture?

These questions have been addressed in Revenue Ruling 2004-51. In the ruling, the IRS held that a Section 501(c)(3) tax-exempt university did not jeopardize its exempt status when it formed an LLC with a for-profit entity to create an interactive video training program to be used off-campus by elementary and secondary school teachers because the LLC was not a substantial part of the university's overall activities. Further, the IRS found that the university's distributive share of income from the joint venture was not unrelated taxable income subject to UBIT, even though the LLC's ownership and governance were split 50/50 between the university and the for-profit entity, because the university maintained exclusive control over the training program's curriculum, materials, instructors, and

¹ Rev. Rul. 2004-51, 2004-22 I.R.B. 1.

² 349 F.3d 232 (5th Cir. 2003).

³ On remand from the Fifth Circuit, a jury determined that the hospital did not jeopardize its exempt status. On May 13, 2004, the IRS filed documents with the court to preserve its right to appeal the jury verdict to the Fifth Circuit.

criteria for completion of the program and thus the training program “contribute[d] importantly to the accomplishment of [the university’s] educational purposes.” The IRS found that the operational aspects of the LLC over which the for-profit member had control, such as the location of training programs and hiring of support personnel, did not adversely affect whether the program was substantially related to the university’s educational purposes. Interestingly, the IRS noted in the ruling that the video training program enabled the university to expand its educational reach to individuals who could not otherwise travel to campus.

Analysis

Revenue Ruling 2004-51 presents a long awaited example of a permissible ancillary joint venture in which the exempt organization preserves its exempt status and avoids UBIT. In addition, the ruling provides comfort that an exempt organization may enter into a 50-50 jointly owned, jointly governed venture with a for-profit-entity, provided that the exempt organization can demonstrate that the activities of the venture are in furtherance of its exempt purposes. Based on the ruling, however, it seems that the IRS will continue to require that the exempt organization maintain significant control over the substantive aspects of the venture’s activities, in this case, the curriculum, teachers, and learning materials, while permitting the for-profit entity to control the logistical aspects of the activity, *e.g.*, the location of training programs and support personnel.

Practitioners have noted that this ruling complements previous IRS guidance on participation in joint ventures such as Revenue Ruling 98-15.⁴ The ruling, however, does not address any health care-related issues and according to the IRS, it is unlikely that further joint venture guidance specific to health care organizations will be issued any time in the near future.

**Joint 50/50 ownership
of an LLC permissible –
Substantive control
should remain with
exempt organization**

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⁴ Rev. Rul. 1998-15, 1998-1 C.B. 718.