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PARTNERSHIPS OR JOINT VENTURES AS VEHICLES TO ACHIEVE CHARITABLE OBJECTIVES

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The way I would like to approach this subject is to go back and look at some very basic principles. A principle in the law for a long time is that a non-profit organization, tax-exempt organization, can invest.

There is nothing in the law that prohibits a charitable, religious, educational or like organization from investing. The law speaks of an entity being organized and operated exclusively for exempt purposes. In real life, as we know, in addition to program outlays, a non-profit organization can spend money for administrative purposes and can invest.

The law is very clear on that because exempted from unrelated income is an entire raft of so-called "passive income"—rents, interest, royalties, dividends, and capital gains that tax-exempt organizations can receive and receive really without limit.

The receipt of those moneys will not adversely impact upon an organization's tax-exempt status. So, suppose a non-profit organization, be it a church, a college, or any type of charitable, educational, or religious organization, decides that it wants to invest in some property. Maybe it wants to invest in real estate. Maybe it wants to purchase some form of capital asset like a large computer system.

What can it do under existing law? Well, it has a variety of options. It can take money out of its existing resources and go buy the property. It can go out into the commercial marketplace and borrow the money. It can launch a capital campaign and raise the money through contributions. In some cases, it can go out and raise the money through tax-exempt financing.

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In all of those situations, and I have seen situations where frankly all four techniques were used simultaneously, the non-profit organization is not going to lose its tax-exempt status because it borrows money or raises money and invests it.

Recently, more sophisticated management has come up with another way, a fifth way, if you will, for non-profit organizations to raise money, and that is to involve itself in a partnership. My question to you is should it make any difference whether, in deciding to invest in property, a non-profit organization spends its own money, borrows it, raises it through contributions or involves itself in a partnership?

My answer is that, no, it ought not to make any difference, that the act, per se, of investing is not going to harm an organization's tax-exempt status. The law ought not to turn on the mechanics of it. It ought to turn on the substance of it.

Before I get into my differences with the government on this particular issue, I think we ought to stop for a second and just make sure we all understand what we are talking about.

When I think of a joint venture in this context, I think of a tax-exempt organization and a for-profit entity marrying up in some way and going forward in tandem to further some project. A partnership, on the other hand, particularly a conventional limited partnership, has the tax-exempt organization as the general partner and investors as limited partners. This is, in a sense, like the Georgetown University case that Jim was talking about, where persons come in as limited partners, they have limited liability and they invest. The general partner runs the partnership and the limited partners take out some economic return from the partnership.

I want to just review one other basic point. When you are talking about a charitable organization or a religious organization, a section 501(c)(3) entity, it has to be organized for an exempt purpose, has to be operated for an exempt purpose, has to be done so exclusively, and cannot be operated for private benefit, and its net earnings cannot inure to individuals in their private capacity.

We all know those rules and I submit to you that those rules are adequate to cover what we are facing in the partnership area. With those basic principles in mind, let's take a look at the current position of the IRS on exempt organizations in partnership—which was not the original IRS position. You can read Jim's article about the original IRS position.

This is a position that has been gently imposed upon the IRS by sundry judges. The original IRS position was a very simple one. It was that tax-exempt organizations, speaking now of section 501(c)(3)s, that became general partners in limited partnerships lost their tax exemption, period. Very simple rule. It is what has come to be known over the years as the "per se rule." The rationale underlying the per se rule was a private benefit, private inurement rationale. The thought was that if a charitable organization is in a partnership, it is operating the partnership for the economic benefit of the limited partners and, since the limited partners take out an economic return, it follows that the general partner/charitable organization is providing a private benefit to the limited partners.

After *Plumstead,*[1] *Strawbridge,* and a few other cases, the Service was persuaded to moderate its position, and it came out with, and now follows, the so-called "two-part test." Aside from the fact that the two-part test is really a three-part test, that is today the current position of the IRS. Let's take a look briefly at what the two-part test says.

The first part of the two-part test looks at the partnership and says that if the partnership, itself, is in furtherance of charitable purposes, then the charitable organization will not lose its tax-exempt status if it participates in the partnership as a general partner. So, the threshold test looks at the nature of the partnership itself.

If the partnership is in furtherance of charitable purposes, then the organization has passed the first part of the test. If it is not in furtherance of charitable purposes, then the Service will take the position that the organization will lose its tax-exempt status.

The first part of the two-part test, mind you, is not the IRS' view; the Service's position for years, and it is still the case, is that there is no such thing as a tax-exempt partnership.

Let's assume now that the organization can satisfy the first part of the two-part test, in that the partnership is in furtherance of charitable purposes. By that, I am talking about partnerships that Jim has alluded to, partnerships for low-income housing, medical office building partnerships involving hospitals, university partnerships for student housing, and hospital partnerships to purchase CAT scanners. Those are the types of partnerships that we have seen so far in the private letter rulings where the partnerships have been deemed to be in furtherance of charitable purposes.

The next test of the two-part test looks to see whether the general partner/charitable organization is adequately insulated from the day-to-day responsibilities of managing a partnership. Here we are seeing an attempt to make certain that the exempt organization does not deviate from its charitable purposes, and spend too much time running the partnership.

My problem with that test is very simple. You are either a general partner or you are not a general partner, and under the partnership law you cannot escape the responsibilities of a general partner if that is what

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[1] Plumstead Theatre Soc'y, Inc. v. Commissioner, 74 T.C. 1324 (1980), *aff'd,* 675 F.2d 244 (9th Cir. 1982).

you are. While responsibilities could be delegated and assigned, and you could move them around on paper all you want to, the fact of the matter is that if a charitable organization is a general partner, it is a general partner. To try to hide the charity from those responsibilities or to claim that those responsibilities taint its status automatically as a charitable organization to me simply does not make any sense.

The second part of the two-part test is that the Service will look at the economic return that the limited partners are receiving and if it is an undue return then the organization will lose its tax-exempt status. If it is a fair return and the other tests have been met, then the organization will not lose its tax-exempt status.

As I have noted, to date there are no rulings that have been released by the Service adversely impacting the tax-exempt status of a section 501(c)(3) organization because of involvement in a partnership. I have a lot of trouble with these rules and I will try to outline my reasons.

First of all, there is this test about whether a partnership, itself, is in furtherance of charitable purposes. My position on that is that it does not make any difference.

Today a section 501(c)(3) organization can go out and buy land, not use it, and hold it strictly as an investment, or it can lease it to the general public, can do anything it wants and, it will not lose its tax status.

It can buy its own building. It can use part of it and lease the other part to the general public, and it will not lose its tax-exempt status. In fact, if it structures it right, the rental income will not be taxable. It will not even be treated as unrelated income. So if a tax-exempt organization can do these things directly, then why can it not do them indirectly?

The tax law has always been that, if you cannot do it indirectly, you cannot do it directly, and vice versa; so why should it not apply here? The purpose of the partnership simply, in my judgment, ought not to be the test.

As to this business about insulation of the general partner from the management responsibilities of the partnership, I do not see how that can possibly be a test because the law does not permit it.

As I said, you are either a general partner or not a general partner. Jim has already given away my punch line on this because I agree completely that the government has to monitor this matter of non-profit organizations and partnerships. There have to be some boundaries. But the boundaries can be achieved under existing law.

It is a private inurement, private benefit standard. If the general partner is using a partnership in a reasonable way, if the limited partners are getting only a reasonable return, whatever they may mean in the particular facts of the case, that ought to be the end of it. The Service ought not to be concerned about anything else because in any other situation individuals are not being privately benefited.

If the exempt organization borrows money, it presumably is paying interest, which is profit to some financial institution or some other lender. If it is raising money, the donors are getting their tax deduction so, there is always going to be somebody making a "profit" whenever a tax-exempt organization is involved in a property transaction.

Generally, as long as it is reasonable, the law tolerates it. In my judgment, that ought to be the case in this situation.

But it is even a little bit different than that. This is not an area where Congress has not spoken. The Service has written the per se test and now the two-part test as if there was no statutory law on the point at all.

The facts are quite the contrary. I would like to just mention to you three provisions of the Internal Revenue Code. One is the statute mentioned earlier. There is a specific provision in the Code—it is section 512(b)(3). It specifically tells us that tax-exempt organizations, including section 501(c)(3)s, can get rental income and not be taxed on that income as unrelated income. So we know already that an exempt organization can go out and directly own property and lease it to the general public and if structured properly, not pay tax on the rental income.

There is another rule, section 512(c), which is in the unrelated income area as well. That rule looks to see what happens when a tax-exempt organization is a partner in a partnership and receives income from the partnership. The purpose of the rule is to determine whether that income is unrelated income or not. The rule basically is a "look-through" rule. The rule says that if it would be income that the organization received directly, then you look to see if it is related or unrelated, and if it comes through a partnership, you simply look through the partnership and you make a judgment as to whether the income is related or unrelated.

Now, if the law was intended to mean that by being in the partnership to begin with, the organization would lose its tax-exempt status, then what in the world would the Congress be thinking about in writing a rule as to whether it is unrelated income or not? It makes no sense. The statute already assumes that the exempt organization can be a partner and then it goes on from there in an unrelated/related income context, not in an exemption/non-exemption context.

Then, as recently as 1984 after being well aware of *Strawbridge Square* and *Plumstead* and the Service's position, Congress wrote the exempt entity leasing rules that Jim discussed. One of the interesting provisions of the exempt entity leasing rules, section 168(j)(9)(a) to be precise, specifically talks about a tax-exempt organization and a non-tax-exempt entity being a partner in a partnership.

It then goes on to discuss what happens to the depreciation deduction when that situation occurs. Again, I ask you: How could Congress write such a rule if it was correct that by participating in the partnership to begin with, the organization would lose its tax exemption status? If this was the case, there would be no point in having the rule.

So Congress has spoken at least twice expressly, in my judgment, authorizing exempt organizations to participate in partnerships and then has gone on to legislate about what happens to either the investors or to the organizations from a related/unrelated income standpoint after that.

To conclude this point, I take the position that only the second half of the second part of the Service's two-part test is the part that ought to apply. That is, you look to see whether or not the investors are receiving a reasonable return.

Let me point out to you three other aspects of this. Some organizations have tried to side-step these troubles by creating a for-profit subsidiary and then putting that in as the general partner of the partnership.

You have got two aspects of this that you need to be concerned about. One is that, if you are in the exempt entity leasing situation, the tax bill that is wending its way through Congress has a provision in it that, for purposes of the exempt entity leasing rules, the for-profit subsidiary of the exempt organization is going to be treated as if it, itself, is an exempt organization. If that becomes law, using a for-profit subsidiary in this context will not save the day for you as far as the exempt entity leasing rules are concerned.

Secondly, in a private letter ruling that was released not too long ago, the Service said that, if a for-profit subsidiary and a tax-exempt parent have overlapping directorates, this alone will be deemed to mean that the parent is involved in the day-to-day management of the affairs of the subsidiary, so the activities of the subsidiary will be attributed to the parent for purposes of the parent's ongoing tax-exempt status. So if you use a for-profit subsidiary in any context, and that board is interlocked, be careful, because the government may use that as a reason for imputing back to the parent the activities of the subsidiary, which, of course, defeats the whole point of having a taxable subsidiary in the first place.

In the joint venture area, the Service has been very fair. There have been recent letters where the Service has passed on joint ventures by for-profits and non-profits, and has always held that their tax-exempt status will not be impaired, although I have to say that in all those situations, the purpose of the joint venture could be rationalized, itself, as being in furtherance of charitable purposes.

Finally, I would like to point out another aspect of this area which the Service has approved of, although there are some indications on the horizon that that approval may be waning, and that is to use a pooled income fund in lieu of a partnership or a joint venture.

I am sure that everybody here is well-steeped in the laws of planned giving, and you know all about remainder trusts, charitable gift annuities, pooled income funds, and all that kind of thing. It has occurred to some planners that, instead of having what we will call a conventional pooled income fund where the church or college has a fund that is used for conventional fund-raising, that if you want to own some property or capital asset, then you set up a special pooled income fund and have donors put money into that fund and the fund, itself, becomes the titleholder of that property.

In other words, the pooled income fund, itself, uses the property that the charitable organization wants as its investment medium, and then the property is either used by or leased to the charity.

The interesting thing about that is that the donors to the pooled income fund not only get a charitable deduction but also the tax benefits of ownership of the property, specifically the depreciation deduction. This deduction flows through the pooled income fund, just like it flows through the partnership, and comes out into the hands of those income beneficiaries, so they get their portion of the depreciation deduction to take as a personal deduction on top of the charitable deduction.

Now the temporary regulations that are out concerning the exempt entity leasing rules take the position that the use of the property by the charity will be considered a lease, so that the tax-exempt entity leasing rules apply; the forty percent depreciation recovery period is used instead of the current nineteen percent.

On the other hand, the tax legislation that is working its way through Congress may convert the depreciation period for real property to thirty years or more, so the discrepancy between thirty years under general rules and forty years under the exempt entity leasing rules may not be that great.