Is it Time for Your Nonprofit to Partner Up with a For-Profit in a Joint Venture?

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Published on www.lorman.com - December 2017

If you operate a non-profit organization, you may want to begin thinking about partnering with a for-profit organization in a joint venture. Both profit-seeking companies and non-profit organizations can benefit from a partnership involving a joint venture. The for-profit company can benefit from an improved image in the community, and customers may be attracted to the prospect of purchasing products or services from a company that is known to contribute to medical research, help underprivileged children or other worthy charitable causes.

Non-profit companies also benefit from a partnership with a for-profit company in numerous ways. The non-profit company can gain access to increased revenue by working with a for-profit company. Investors may contribute significant funds to a non-profit company in order to take advantage of tax deductions or tax credits. The non-profit company will be able to improve its own operations and serving others with this funding. A non-profit can hire additional employees, invest in better marketing programs and outreach efforts or donate more money directly to people in need.

In the U.S., there is now a greater emphasis on social enterprise. Consumers want to know that a for-profit company will have a positive impact on the environment. Research studies indicate that 92 percent of Americans had a positive perception of companies that were dedicated to supporting charitable organizations in 2011. In 2001, only 81 percent of Americans positively viewed a company that made efforts to donate to charitable causes. A joint venture is one legal instrument that can facilitate a for-profit company's charitable contributions. This paper will address the legal requirements that must be fulfilled to create a joint venture and put forth the numerous advantages associated with a joint venture.

Description of a Joint Venture

The basic structure of a joint venture is comprised of a subsidiary entity. Through the subsidiary entity, the non-profit organization and for-profit organization can participate in community activities or other ventures. They may not create a joint venture to resolve debt issues, investing purposes or creation of new contracts. Joint ventures can be useful for improving the image of a for-profit company or helping grow awareness of a non-profit organization. Customers may become more familiar with non-profit organizations that are involved with for-profit companies that are household names.

Through the joint venture, two parties are able to develop a new subsidiary entity. The for-profit organization usually contributes significant equity to create the subsidiary entity. Both the non-profit organization and for-profit company share in the revenue and expenses generated by the subsidiary entity. A joint venture can also be created when two individuals carry on in a manner that reflects a partnership.

A joint venture will usually have a specific goal and purpose. When a non-profit organization and for-profit company combine efforts to create a joint venture, the for-profit company is usually interested in contributing to a charitable cause. Every joint venture requires a statement that expresses the objectives of the venture.

Legal Requirements in Creating a Joint Venture

A for-profit company and non-profit company must fulfill certain legal requirements to create a joint venture. The parties will need to agree on the structure, investments and financial arrangements of the joint venture.

A typical joint venture between a for-profit company and non-profit organization may entail the creation of a limited liability company (LLC). Any revenue that is generated from the joint venture may be tax-exempt if the structure of the joint venture abides by Revenue Ruling 98-15. Under Revenue Ruling 98-15, the joint venture must be used to further a charitable purpose. The joint venture must explicitly further the charitable purpose and only incidentally benefit the for-profit owners.

Other legal requirements must also be met to take advantage of the tax-exempt status of a joint venture. Under Revenue Ruling 98-15, the non-profit organization needs to have complete control of the joint venture. The joint venture must prioritize providing benefits to the community. This priority must come ahead of amassing profits within the joint venture.

Those who create a joint venture should be aware that a partnership status may also impact whether the joint venture can take advantage of Revenue Ruling 98-15. Partners may bind the joint venture as agents of the partnership or through apparent agency. Any activities of the partnership could jeopardize the tax-exempt status of the joint venture. If the partnership is intent on creating profits rather than fulfilling a charitable purpose, this could seriously impede on the joint venture's ability to take advantage of a tax-exempt status. Also, Revenue Ruling 98-15 does not apply when one of the parties is a limited partner instead of a general partner. The limited partner does not have an active role in furthering the mission of the joint venture. Limited partners frequently only associate with ventures so that they can retain the profits of the venture. If a limited partner is involved in a non-profit joint venture, then chances are that he or she only wishes to profit from the venture and not actually contribute to the charitable purpose or further it.

There may be cases in which it is not clear whether a joint venture is actually furthering a charitable purpose to abide by Revenue Ruling 98-15. In cases that involve these questions, a judge will assess which party has effective control of the joint venture. If a for-profit company has control of the joint venture, then it will not be able to take advantage of tax-exempt status under Revenue Ruling 98-15. Also, any indication that a for-profit company has increased revenue or profits from the activities of the non-profit organization may cause the joint venture to lose tax-exempt status.

The Benefits of Setting Up a Joint Venture with a For-Profit Company

Non-profit organizations enjoy tremendous benefits when they decide to pursue a joint venture with a for-profit company. The non-profit organization may raise significant capital for its charitable purpose in this manner. The non-profit organization may also be able to take advantage of other opportunities that it does not currently have. The non-profit may be able to use resources owned by the for-profit company, such as cars, planes, venues or funds. Non-profits may also gain greater credibility in the public when they proceed to enter into a joint venture with a for-profit organization.

For-profit companies may also set up a joint venture with a non-profit organization as a way to gain greater access to capital. A for-profit company can also utilize other assets owned by the non-profit, such as tax credits or intellectual property. The for-profit company can also create a renewed image after a scandal or other event raising controversy in the public. It is not uncommon for for-profit companies to pursue non-profit joint ventures as a way to gain greater political support.

Tax Exemptions Available for Joint Ventures

One main reason for-profit and non-profit organizations tend to combine for joint ventures is to enjoy numerous tax benefits. Revenue Ruling 2004-51 serves as one of the leading rules that maintains a joint venture does not jeopardize a non-profit organization's tax-exempt status. The activities of the joint venture must be consistent with the tax-exempt status of the non-profit organization. A non-profit organization should also consult with a tax or business attorney who is familiar with the construction of joint ventures.

When two entities want to pursue a tax-exempt joint venture, it will be necessary that one entity apply for separate tax-exempt status. The for-profit corporation may still be subject to taxation and face a maximum taxation rate of 35 percent. If the non-profit does not control the entity, then any dividends or profits that it receives may be taxed. It is critical for those who operate a joint venture to seek legal advice and tax help before they begin the project. Structuring the joint venture to avoid the payment of certain taxes may result in significantly decreased tax liability.

IRC 512(b) also provides certain exclusions that may be applicable to the joint venture. The joint venture will not be taxed on interest, royalties, rent or dividend income. Any investments in stocks that generate dividends will not be taxed.

The two entities must ensure that they both undertake a business enterprise that is agreed upon. The two parties should draft a written agreement that explicitly states the purpose of the joint venture. The business enterprise must entail an investment or other tax-exempt activity in furtherance of a charitable purpose to qualify for tax benefits available to charities.

Non-Profit Hospitals and Commercial Company Joint Ventures

One of the most common ways in which the joint venture is used entails the participation of a non-profit hospital and commercial company. There are numerous IRS cases that involve the interpretation of tax code in regards to this type of joint venture. The governing factor that the IRS assesses is the degree of control that a hospital provider utilizes over the venture. Hospital providers must take care to ensure that a joint venture is structured to reflect the management and mission of a tax-exempt entity. The hospital must be dedicated to a charitable purpose that involves promoting the health and well-being of a large cross-section of the community. Non-profit hospitals must also ensure that their own governing board has the majority of votes in making major decisions that impact the joint venture. If third parties are assisting in making these major decisions, then a non-profit hospital may lose its tax-exempt status.

A hospital must seek to ensure that the profitability of a commercial partner remains subordinate to the charitable purpose of the joint venture. Structuring a joint venture that involves a non-profit hospital can be complex. In some cases, the joint venture may be disqualified from favorable tax treatment if a commercial entity is not given votes in representing its own company. If the commercial entity has no say in the operations of the non-profit hospital, then the IRS may find that the new entity does not meet joint venture requirements.

IRS case law has also thoroughly discussed the impact of joint venture agreements on non-profit hospitals. In the case of Redlands Surgical Services v. Commissioner, a non-profit hospital entered an agreement with a commercial company to acquire additional space for a surgical center. The hospital was having trouble in meeting the demand for patient surgeries. As a result, the two parties formed a non-profit subsidiary entity. The surgical center retained a 27 percent interest in the profits of the new partnership. In that case, the court held that the surgical center had ceded its control over the joint venture to the commercial entity. The court's analysis revealed that it thought the non-profit hospital lacked formal control in the joint venture since it did not have a majority position on the joint venture's governing board, was subject to an arbitration agreement for purposes other than charitable ones and the commercial company ultimately held broader authority over the decision-making process for operations of the venture. Critics of this decision have argued that the IRS' focus on "operational control" is misplaced, and that the IRS should focus on the ultimate charity care and community service provided by a non-profit hospital in conferring tax-exempt status on joint ventures.

Other cases have expanded on the ruling of the Redlands case and now focus on a community benefits standard. In these cases, the court has analyzed the structure of a venture to determine whether it actually furthers a charitable purpose. If the hospital operates only for exempt purposes, then the court is more willing to provide favorable treatment for the joint venture.

Currently, the IRS requires that non-profit hospitals have operational control over joint ventures in order to retain tax-exempt status. As long as a non-profit retains the power to act exclusively for its charitable purposes, the IRS will likely find that a joint venture enjoys tax-exempt benefits. Critics of the two-prong test used under Revenue Ruling 98-15 believe that a joint venture agreement should be created and expressly state that a hospital's activities will promote the health of the community under the community benefit standard. A non-profit hospital could expressly state that it will provide a certain number of free services, such as emergency room visits or emergency operations, every year in order to meet this standard. The IRS could also track the performance of a non-profit hospital over the course of a year to determine whether it is actually acting in accordance with goals laid out in the joint venture agreement.

Liabilities Impacting Joint Ventures

Joint venture laws can be used to minimize liability of a for-profit company or non-profit organization. Two parties may want to work with a tax lawyer to effectively mitigate liability through the use of a joint venture agreement. The advantages of using a joint venture are that two parties can share in business risk, retain access to resources and make connections with lenders or investors.

Individuals involved in the creation of a joint venture should be aware that they may have the power to bind the joint venture through their actions. A joint venture retains many of the same qualities of a partnership. In a partnership, every partner has the ability to bind the partnership through his or her actions. So too, parties in a joint venture may be able to bind the joint venture through their actions. If a party involved in a joint venture decides to purchase certain property or make certain investments, this may bind all parties involved in the joint venture. A party involved in a joint venture should be prepared to take on certain risks. A business law attorney may also be able to advise both parties as to the risks associated with entering into a joint venture. Certain agreements may also be able to contract away liabilities in the event that a party acts in an unauthorized fashion.

Tax Issues Raised by the Use of Joint Ventures

The tax benefits available to a joint venture will depend on the type of joint venture that is created to further a business purpose. Two parties should agree on the tax treatment of a joint venture before they decide to create a particular type. A tax lawyer or other professional can assist individuals in choosing the correct type of joint venture for their purposes.

One issue that may concern parties involved in a joint venture is the transfer of assets. If any assets are transferred from the company to a different entity, this may cause the joint venture to be subject to taxation. Any profits or capital gains that are transferred to shareholders in the joint venture could also cause the joint venture to become taxed. There may be options available for deferring the payment of a tax if capital gains are transferred to a shareholder.

Also, parties to a joint venture should be mindful of the funds used to tax the venture. Any loans that are used to fund the venture could cause the parties to face tax liability. Individuals may be able to deduct any interest that is paid on loans from their taxes.

Another factor that parties to a joint venture may want to keep in mind is that the dissolution of a joint venture could subject it to tax liability. Parties must be careful in distributing leftover assets, income, dividends or other proceeds after a joint venture's dissolution. A joint venture may be taxed to the benefit that for-profit entities benefit from any excess income or dividends are distributed.

Types of Joint Ventures

There are several types of joint ventures that can be used, and parties should be aware of these different kinds. A fully integrated joint venture is a type of venture that contains similar qualities to a merger. A fully integrated joint venture is not frequently used by non-profit organizations and commercial companies. This type of venture entails the integration of an entity's products or services with another entity's efforts. Two parties do have the right to enter into an agreement in which only certain areas are integrated.

Research and development joint ventures entail the combination of efforts in order to develop new products or research certain topics. It is common for a non-profit hospital to pursue a joint venture with a commercial company, such as General Motors, for the purpose of conducting cancer research. There are numerous corporations that have joint ventures dedicated to researching cures for illnesses like cancer or AIDS. By pooling together resources, a commercial company may be in a position to provide significant funding for the research. A non-profit organization may be able to offer the doctors, medical students, labs and equipment required to research cures for these illnesses.

Joint ventures are also frequently created to assist with production, marketing, networking, purchasing and other affairs. Other major types of joint ventures are whole joint ventures and ancillary joint ventures. For a whole joint venture, the non-profit organization will contribute all of its assets to secure a membership interest in the joint venture. For an ancillary joint venture, a non-profit will only contribute a portion of its assets to the joint venture.

The joint venture entity may also be comprised of a general partnership, limited partnership, limited liability company (LLC) and a corporation. An LLC serves as a pass-through entity for the purpose of legally avoiding tax liability.

Some non-profit organizations may also partner with corporations to pursue venture philanthropy. This may entail researching new cures for illnesses or providing medical services to indigent populations. For-profit corporations also have the option of creating specific divisions that are dedicated to the pursuit of philanthropic efforts. A corporation may decide to form a foundation that serves a greater public purpose or serves in a charitable way for the community.

Conclusion

Non-profit operators who seek to pursue a joint venture with a commercial entity should seek legal counsel. There are numerous IRS cases and revenue rulings that should be considered in developing the structure of a joint venture. Failing to consider these rulings or cases could result in the creation of a structure that is not exempt from certain taxes.