

**THE ARCHITECTURE OF CHARITIES' COMMERCIAL ACTIVITIES:
MANAGING COMPLEX STRUCTURES**

By: Douglas M. Mancino

McDermott Will & Emery LLP

Los Angeles, California

© 2009, Douglas M. Mancino

I. INTRODUCTION

The charitable component of tax-exempt organizations, that is, public charities and private foundations described in section 501(c)(3) of the Internal Revenue Code of 1986, is comprised of more than 1.3 million entities.¹ The charitable component also frequently describes itself as part of the “independent sector.”

However, charitable organizations do not constitute a truly “independent” sector of the nation’s (or for that matter, the world’s) economy. Rather, charitable organizations engage in many of the same activities as do taxable entities, and charitable organizations invest in and collaborate with taxable entities on a significant and daily basis.

Thinking about charities as an “independent sector” is inconsistent with providing useful guidance to tax-exempt entities and taxable persons. A better description would be refer to charitable organizations as the “interdependent sector.”

¹ “The independent sector is comprised of two major groups of tax-exempt organizations: 501(c)(3) charitable organizations and religious congregations and organizations, and 501(c)(4) social welfare organizations.” *The New Nonprofit Almanac and Desk Reference* xxvii (Jossey-Bass 2002).

There are at least three implications of thinking beyond the “independent sector.” First, charitable organizations and their professional advisors need to understand the tax planning perspectives of taxable persons if they are to be truly effective in representing charitable organizations in their dealings with them.² Second, taxable persons need to understand the requirements for retaining tax-exempt status, minimizing or eliminating completely the tax on unrelated business taxable income and the various other special tax rules applicable to charitable organizations such as the excess benefit transaction rules applicable to public charities and the self-dealing, excess business holdings and jeopardy investment rules applicable to private foundations. Finally, the Internal Revenue Service (the Service) and other federal and state regulators cannot provide meaningful guidance unless they also understand both the charitable exemption and the other rules applicable to charitable organizations, as well as how the tax rules applicable to taxable persons apply when tax-exempt entities and taxable persons collaborate, regardless of the form of their collaboration.

This paper describes many different means by which charities engage in commercial activities. Much of the time, these activities are carried on directly or indirectly by the charity itself. However, with increasing frequency, even the smallest charities are engaged in commercial activities with taxable persons, a type of engagement previously reserved to the larger and most sophisticated charities.³

² This was made readily apparent when tax-exempt organizations became willing, if unknowing, accommodation parties for patently obvious tax shelter schemes such as the S corporation scheme that became the first listed transaction in which a tax-exempt organization was specifically identified as a participant in it. See Notice 2004-30, 2004-17 I.R.B. 828.

³ In fact, smaller charities are likely to be more at risk due to their more limited access to professional advisors or their greater risk tolerance due to their financial instability.

Finally, the relationship between the boards of directors and managements of charities is changing to adapt to the competition in the marketplace for highly successful, competent managers for those commercial activities. Thus, as advisors, we are being increasingly asked to assist in the design of short- and long-term incentive plans, and in some instances plans that involve the award of equity-like or actual equity incentives.

This paper is divided into several parts:

- Part II discusses how charities “exploit” their own activities, intellectual and other property using controlled subsidiaries;
- Part III discusses how charities use partnerships and other unincorporated joint ventures;
- Part IV discusses how charities participate in non-traditional joint ventures
- Part V discusses joint operating agreements;
- Part VI discusses low-income limited liability companies, L3Cs;
- Part VII discusses the evolution of the use of blocker entities, from captive insurance to master-feeder structures;
- Part VIII discusses methods of converting taxable income into non-taxable income derived from commercial activities;
- Part IX briefly looks at the general tax rules affecting the interface between the taxable sector and the commercial sector; and
- Part X makes some brief concluding observations.

II. USE OF CONTROLLED SUBSIDIARIES

The use of controlled subsidiaries, both taxable and tax-exempt, has become common and now takes a wide variety of forms and serves a broad range of purposes. The Service has ruled favorably on diverse structures involving virtually all types of exempt organizations. Although hospitals appear to have developed the most elaborate structures (e.g., faculty practice plans for their medical schools, complex multi-corporate structures), they are far from unique. Universities have long operated through complex structures, and the complexity of university structures is increasing with the advent of distance-learning subsidiaries and subsidiaries created to take the results of university research into the marketplace (technology transfer), often in joint ventures with the business entities that sponsored the research.

Charitable organizations (mostly public charities⁴) use controlled subsidiaries for non-tax purposes as well as to achieve desired tax results. Early on, many advisors recommended the use of for profit, taxable subsidiaries and nonprofit taxable subsidiaries as a means of managing the perceived tax risk to continued exemption of the parent that could result from excessive unrelated business income. In my view, this is more of a mythical reason to establish a subsidiary than a real reason, and often results in collateral, negative tax consequences which will be discussed later in this section. In fact, public charities can generate large amounts of income from UBI without jeopardizing their exempt status as long as they have an exempt primary purpose.

⁴ Private foundations have are subject to the excess business holdings rules in section 4943 that for all practical purposes limit their controlled subsidiaries to functionally related trades or businesses and activities that generate income from passive sources.

In any event, the non-tax reasons for establishing one or more controlled subsidiaries are as diverse as the tax reasons. Placing discrete functions in separate entities may facilitate orderly management and simplify recordkeeping, may create clear lines of authority and responsibility that enhance overall effectiveness, and may provide protection against tort or environmental liability. For example, as result of clergy abuses, multi-million dollar settlements and bankruptcies of dioceses, Catholic dioceses in many parts of the country are exploring or have implemented the use of multiple nonprofit, tax-exempt religious subsidiaries for individual parishes, schools and other activities as a means of potentially reducing or eliminating future liability for actions arising in a particular parish, school or other activity.⁵

For both federal tax purposes and for the purpose of achieving non-tax purposes such as liability limitation, the utility of using controlled subsidiaries depends on the general principle that the separate identity of each corporation will be respected for federal income tax purposes and for state law purposes. Both the tax law and state laws tend to utilize similar principles concerning when the separate identity of a corporation will be respected and when it will not. These principles look to the degree of control exercised by the parent over the actions of the subsidiary, the degree to which the subsidiary is adequately capitalized, whether and to what extent the corporations have overlapping boards of directors or employees or use the same property or assets or employees, whether the corporation was formed as a means of shielding the parent from liability for improper activities, and other factors.

In the non-tax area, there also arises the potential concern for “reverse piercing” of the corporate veil. This is less an issue with nonprofit membership corporations because under most

⁵ This is not just a “Catholic” phenomenon; I have worked with religious groups as diverse as Buddhist, Christian, Presbyterian and Baptist on similar projects.

state laws a membership interest in a nonprofit, non-stock corporation has no value and is not transferable in exchange for money. Therefore, a creditor of the tax-exempt parent presumably could not realize any value in connection with a sale or transfer of a membership interest, and it would be unlikely that a court would allow such a creditor to utilize that membership interest to force a disposition of the assets of the subsidiary.⁶ The same is not true of stock corporations. If the subsidiary is formed as a stock corporation under state law the stock in the hands of the tax-exempt parent will be an asset that can be disposed of and monetized for the benefit of creditors of the tax-exempt parent.

A. Controlled Corporations

Controlled subsidiaries formed as corporations under state law will use as many forms of corporation as are permitted under a particular state's laws. They are formed as regular business corporations under a state's general corporation law, they are formed as close corporations under a state's close corporation law, they are formed as various forms of nonprofit corporation (public benefit, mutual, religious) that may or may not apply for tax-exempt status, and they may be formed as special purpose corporations such as professional corporations or associations. In fact, it is possible to form a corporation as a stock corporation, include sufficient restrictions as to purpose and distribution of assets (i.e., prohibiting dividends) and transfers of stock (i.e., only for nominal value) into its organizing documents, and apply for charitable exemption.⁷

⁶ Cf. *Maynard Hospital v. Commissioner*, 52 T.C. 1006 (1969).

⁷ See, e.g., *University of Maryland Physicians, P.A. v. Commissioner*, 41 T.C.M. 732 (1981)(exemption granted to professional association that issued stock); G.C.M. 39633 (May 13, 1987)(exemption denied to business corporation).

It is quite common in systems with multiple subsidiaries for the parent company to include “reserved” powers in bylaws to assure overall parent control, particularly when the composition of the subsidiaries’ boards of directors are not identical. It is important to note, however, that the presence of reserved powers does not relieve the board members of the subsidiaries’ boards from their own fiduciary duties, as was seen when the California Attorney General intervened several years ago when the parent board of Sharp Healthcare in San Diego tried to force the board of its largest subsidiary to enter into a whole hospital joint venture with an investor-owned company that the subsidiary board objected to.

There are number of specialized tax provisions that affect dealings between a tax-exempt parent and one or more of its subsidiaries that are mentioned briefly below and are expanded upon in greater detail in various sections of *Taxation of Exempt Organizations*.⁸

Perhaps the most significant section that affects both taxable and tax-exempt subsidiaries and their dealings with a tax-exempt parent is section 512(b)(13) of the Code. As originally enacted in 1969, section 512(b)(13) provided that interest, annuities, royalties and rents derived from certain controlled organizations were includable in the gross income of the controlling organization under circumstances and in amounts as provided in that section. Those original rules were easy to avoid utilizing the most rudimentary of tax planning. For example, in Technical Advice Memorandum 9338003 (June 16, 1993), the Service considered whether rents paid by a second-tier subsidiary to the ultimate tax-exempt parent were UBI to the parent under section 512(b)(13) where the stock of the second-tier subsidiary was owned by a first-tier

⁸ Hill & Mancino, *Taxation of Exempt Organizations* ¶32.02[1][a] (discussing section 337(d) regulations and applications for exemption), ¶22.07 (discussing section 337(d) regulations and transfers out of corporate solution) and ¶30.03[1] (discussing sections 337(d)(2) and section 337(d) regulations)(Warren Gorham & Lamont 2002-2008).

subsidiary. The parent had filed a claim for refund based on earlier payments of UBIT with respect to the rents. After noting that the parent did not own the stock of the second-tier subsidiary directly, and that no indirect ownership rules applied under section 512(b)(13) and section 368(c), the Service concluded that the rents were not taxable to the parent. The Service also observed that the parties had not re-characterized the economic nature of the transaction to avoid tax.

In 1997, Congress fundamentally amended section 512(b)(13) to redefine “control” and to change its tax consequences.

In 2006, amendments to section 512(b)(13) under the Pension Protection Act added a new provision that applies to payments received or accrued between December 31, 2005 and before January 1, 2008. It also required more specific disclosures concerning interest, rent, annuity and royalty payments from a controlled entity as well as loans made to any controlled entity and transferred between such organization and the controlled entity. This data, along with information required on various schedules to the revised Form 990, will undoubtedly provide information that will allow both the Service and the tax-writing committees to assess the extent of dealings between controlled corporations and their parents and whether the historic approach of taxing much of such income is preferable to the use section 482 “fair market value” principles.

Another set of rules that apply to dealings between controlled subsidiaries and their tax-exempt parents are the earnings stripping rules found in section 163(j) of the Code. Generally speaking, that provision disallows and defers the deductibility of some interest paid by thinly-capitalized corporations to related tax-exempt organizations.

Perhaps even more significant than sections 512(b)(13) and 163(j) are the rules enacted in 1986 as part of the *General Utilities* repeal, sections 311(b) and 337(b)(2), and the regulations issued pursuant to authority under section 337(d). These rules make it very costly for tax-exempt parent corporations to transfer assets that may appreciate in value to controlled, taxable subsidiaries. For example, if a tax-exempt parent transfers a membership interest in a limited liability company to a taxable subsidiary, and later desires to distribute that membership as a dividend at some time in the future (an issue we encountered recently with a membership interest of a captive insurance subsidiary formed as a limited liability company under state law), the distribution will be taxed because of the deemed sale of the appreciated property at the time of the dividend distribution. Similarly, if an 80% or more controlled subsidiary is dissolved, the principles of section 337(b)(2) will apply to cause the distribution to be treated as a deemed sale to the extent that the underlying operations or assets are used in a unrelated trade or business by the parent corporation. Lastly, the regulations promulgated under the authority of section 337(d) may result in a deemed sale if the organization later applies for exemption after the applicable period of time set forth in the regulations (generally three years in the case of a section 501(c)(3) exemption application and longer in the case of organizations described in other paragraphs in section 501(c)).

Lastly, most wholly-owned subsidiaries are taxed as C corporations unless they are insurance companies taxed under Subchapter L. Such subsidiaries can elect to be treated as S corporations, but that treatment is highly disadvantageous because the income is taxed as UBI and the sale of the stock will be taxed as well.

B. Single Member Limited Liability Companies

Charitable organizations are using single member limited liability companies (LLCs) with increasing frequency to achieve diverse exemption and business objectives. If, under the check-the-box rules, the charitable organization does not elect to have the LLC treated as a corporation for tax purposes, the LLC will be treated as a division of the tax-exempt parent for tax purposes.

Set forth below are several examples of how and why charitable organizations utilize single member LLCs to achieve their exemption, tax, or state law objectives.

Single member LLCs are frequently used to protect the assets of the charitable parent, whether they are a member-managed or manager-managed. The LLC laws generally require less formality than corporate law to prevent piercing of the LLC veil. For example, single-member LLCs may be formed to own and operate commercial office buildings the rents from which are excluded from UBI under section 512(b)(3), unless the office building is debt-financed property taxable under sections 512(b)(4) and 514. The LLC may be used to shield the parent from slip and fall tort liability or to shield the parent from recourse on debt that was incurred to finance the acquisition of the building (assuming that that is not guaranteed by the parent).

Single member LLCs are increasingly used by organizations that conduct scientific or other research and that wish to exploit such technology through technology transfer arrangements with the commercial sector. The business purpose may be to centralize the technology transfer function within a discrete entity in order to maximize its effectiveness and at the same time enjoy the tax objective of having royalties or gains on the disposition of such properties be excludable from UBI pursuant to the royalty exception in section 512(b)(2) of the

Code or the capital gains exception in section 512(b)(5) of the Code. The LLC also insulates the parent from liability to third parties if properly structured.

In captive-friendly jurisdictions such as Hawaii (and now in most captive-friendly states), where captives may be formed as LLCs, the LLC will be treated as a separate legal entity for liability purposes and for state statutory reporting purposes, but as a division of the charitable parent for tax purposes. This is significant from the standpoint of section 501(m). To the extent that the LLC captive insurer provides coverage for risks of the parent or its other affiliates, that will be treated as self insurance for section 501(m) purposes. However, if the captive is authorized by the state insurance regulator to insure outside risks, the coverage of such risks may constitute commercial-type insurance for section 501(m) purposes. The scope of such commercial type insurance will be measured by the charitable parent's entire operations, rather than that of the LLC, because the LLC is merely a division of the charitable parent. An example would be a university that forms this type of captive to insure its own professional liability, general liability, workers' compensation and automobile risks, and also uses the captive to issue completion bonds issued to contractors that work on projects on one of more of its campuses or for professional liability insurance for community physicians who are adjunct members of the university's medical school faculty, but who are neither employees nor independent contractors of the medical school or university.

Another use of a single member LLC is to segregate selected operating assets for state law and financial reporting purposes, but have them remain operating assets of the charitable organization for tax purposes. An example was a nonprofit hospital that had contracts to provide health care services in a major city's jail system. The hospital desired to take the specialized expertise it developed and seek additional contracts to provide those specialized health care

services to state prison and city and county jail systems in other parts of the country. The ultimate plan was either to sell the LLC or to attract venture capital with a view of ultimately taking the subsidiary public. The LLC would have separate financial statements, its own employees (who would still be treated as employees of the parent for purposes such as section 403(b) annuities), and would hold the contracts with the governmental entities. Thus, value could be created by having free-standing operating results rather than rely on re-constructed pro formas.

Lastly charities are beginning to see advantages in using series LLCs that create liability firewalls in a single LLC, thereby reducing legal complexity when two or more activities are going to be conducted by the LLC.

C. Special Private Foundation Considerations

Charitable foundation classified as private foundations have specialized considerations when they seek to exploit their own activities and property and these considerations spill over to any separate organization they may form for that purposes.

First, private foundations are subject to the excess business holdings rules which limit their ownership generally to not more than 20% (together with that of disqualified persons) of the stock of a corporation, a profits interest in a partnership or LLC, or the beneficial ownership of a trust, if those entities conduct active businesses that do not otherwise qualify as functionally-related trades or businesses. Thus, for example, a private foundation that operates a bookstore and/or a restaurant in its museum may form one or more LLCs to conduct those functionally-related trades or businesses for liability protection, alcoholic beverage licensing, union organizing or other reasons. Similarly, a few substantial private foundations have formed single-

member LLCs to carry on related activities in other states, such as California, as a means of avoiding the subjecting the out-of-state foundation's activities to regulation by that state in their entirety.

D. Use of Multiple Taxable and Tax-exempt Controlled Entities to Achieve a Specific Business or Tax Result

A recent transaction involving a nonprofit hospital client will illustrate how multiple taxable and tax-exempt entities working together may achieve interesting business and tax results.

The hospital had a taxable subsidiary that was generating more than \$500,000 of taxable income. An opportunity arose for the hospital to acquire a medical office building occupied by members of its medical staff that would, if operated directly by the hospital itself, constitute a related trade or business within the meaning of Revenue Ruling 69-464, 1969-2 C.B. 132. The natural reaction of the hospital was for it to enter into a contract to purchase the building directly from its owner using a combination of its own funds and those borrowed from an unrelated bank. The office building was also located on a larger parcel of land that had space that could be used directly by the hospital for additional parking for its patients and visitors, also a related trade or business pursuant to Revenue Ruling 69-269, 1969-1 C.B. 160.

Instead of pursuing this transaction in what appeared to be the most logical fashion, the transaction was restructured as follows: First, the hospital purchased the land outright while its subsidiary purchased the medical office building improvements. Concurrently, the hospital entered into a long-term ground lease with its subsidiary for the portion of the land used by the

subsidiary for the building and parking, excluding that portion of the land that would be used by the hospital directly for its own parking purposes.

Second, the subsidiary financed its purchase of the building with a combination of its own cash, recourse debt from a commercial lender, and subordinated debt from the hospital's parent, also a tax-exempt organization. When all of these transactions were completed, the net effect of them was as follows:

1. The subsidiary was treated as the owner of the improvements for federal tax purposes, and thus could use the depreciation to reduce its taxable income. The ability to use the depreciation deductions improved its cash flow for purposes of servicing the debt. Its payments of interest to the unrelated lender and the parent company were deductible, as were the property taxes paid directly by the corporation with respect to the improvements and reimbursed to the hospital as a pass-through expense for land leased from the hospital.
2. The hospital was able to apply for property tax-exemption for the portion of the real property used by it for parking purposes.
3. The ground lease rents received by the hospital were excludable under section 512(b)(3) and nontaxable under section 512(b)(13) because the operation of the medical office building by the subsidiary, if it had been directly operated by the hospital, would constitute a related trade or business. Similarly, the interest paid by the subsidiary to the parent

corporation was nontaxable under section 512(b)(1) and not taxable under section 512(b)(13) by reason of the relatedness exception.

4. Finally, the taxable subsidiary enjoys the benefits of leveraging the building and at the expiration of the long-term ground lease the hospital, as ground lessor, will not be taxable on the value of improvements then existing, if any, that revert to it in exchange for a dollar.

III. PARTNERSHIP AND OTHER UNINCORPORATED JOINT VENTURES

A. Overview

Section 501(c)(3) organizations engage in many types of joint ventures, but most fall into one of five general classifications. Identifying the proper classification of the joint venture is important because it will help determine which tax rules apply, as well as their effect on the tax-exempt participant.

1. Principal Exempt Function Ventures

A relatively small number of tax-exempt organizations have established, or consider the establishment of, joint ventures with proprietary firms that involve the operating assets that serve as the basis for the recognition of their tax-exempt status. For example, a multi-hospital system may elect to consolidate the assets and operations of one of its hospitals with a hospital owned by an investor-owned hospital management company by contributing that hospital to a partnership or LLC to which the investor-owned hospital management company has also contributed its hospital and/or additional capital. Similarly, a tax-exempt sponsor of low income housing may form a partnership with private investors to develop low income housing projects.

A significant part of the private investors' return on invested capital may come in the form of tax credits and deductions. In both of these situations, the principal activity that serves as the basis for obtaining or maintaining tax-exempt status of the organization, the hospital, or low income housing project itself, if being transferred to or is being developed by the joint venture. In some cases, the non-exempt co-venture may be contributing capital as well as operating expertise, whereas in others the joint venture may simply be a capital-raising vehicle.

2. Ancillary Joint Ventures

Most joint ventures involve services or facilities that are ancillary to the primary operations of the tax-exempt organization. These services, although contributing importantly and directly to the conduct of the exempt function of the organization, are secondary in importance and often involve relatively small amounts of revenues or assets in comparison with the primary activity of the exempt organization. Examples of these ancillary joint ventures involving tax-exempt hospitals include the development and operation of ambulatory surgery centers, dialysis centers, and numerous other types of programs and services. In higher education, examples would include extension programs and distance learning.

3. Support Services Joint Ventures

Some joint ventures involve facilities or services that provide support functions for the tax-exempt organization. This type of joint venture might involve a medical office building jointly developed by a hospital and members of its medical staff through a general or limited partnership, or a billing and collection business developed through a joint venture by a health system and a proprietary firm already in that business. Another example might be the formation of a joint venture to combine the laundry or laboratory operations of a university with those of a

commercial laundry or laboratory or of other universities for the purposes of achieving economies of scale and reducing unit costs. What differentiates support services joint ventures from ancillary joint ventures is that the participation in the joint venture only indirectly supports the exempt purpose or function of the exempt participants by improving their efficiency and does not involve direct patient care, education or other exempt functions.

4. Pure Investment Joint Ventures

Some joint ventures are formed to exploit specific assets or operations, typically for the primary purpose of generating net income or otherwise exploiting the revenue-producing potential of the particular assets or operations. Examples of joint ventures that fall into this category include partnerships formed to make venture capital investments, joint ventures for combining investment portfolios for the purpose of obtaining greater access to capital or to reduce investment management and transaction costs, and joint ventures formed to exploit specific types of assets that have been developed by the organization, such as information systems and other intellectual property rights, including patents developed as part of the research function of a hospital, university, or research institute, or real property.

5. Capital Financing Joint Ventures

For many years, exempt organizations have used general and limited partnerships, as well as other forms of joint ventures, to raise capital for facilities and equipment that is then leased to the exempt organization. This off-balance-sheet form of financing has been particularly attractive for exempt organizations with limited access to traditional sources of financing or when the tax benefits to the non-exempt investors (e.g., low income housing tax credits or rehabilitation tax credits) can increase the effective rate on return on investment to the investors

without materially increasing and even sometimes reducing the cost of capital to the exempt organization.

These five classifications provide a useful analytical framework for evaluating a section 502(c)(3) organization's participation in a joint venture and the effect of that participation on (1) its continued status as a section 501(c)(3) organization; (2) the taxability of its distributive share of profits and losses derived from the joint venture as income from an unrelated trade or business; (3) its continued public charity status; and (4) its treatment under the provisions of Chapter 42 of the Code if the charitable organization is classified as a private foundation.

B. Tax Considerations

Tax consideration play a very important role when charitable organizations participate in partnership and other forms of unincorporated joint ventures with taxable persons whether such taxable persons are merely capital partners or whether they are strategic partners such as physicians who are members of a charitable hospital's medical staff.

1. Impact on Tax-Exempt Status

For many years, the Service held that a charitable organization's participation as a general partners in a general or limited partnership or other form of joint venture, classified as a partnership for tax purposes, was completely incompatible with continued section 501(c)(3) exempt status. That view persisted until 1979, when the Service acknowledged that participation by a charitable organization as a general partner in a partnership, although creating conflicts between charitable and for profit purposes, did not merit the application of a per se prohibition against such participation. Thus, by the early 1980s, and after *Plumstead Theater Society, Inc. v.*

Commissioner, 74 T.C. 1324 (1980), *aff'd per curiam* 675 F.2d 244 (9th Cir. 1982), was decided, the Service had developed what it characterized as a two-part test for determining whether the participation by a charitable organization in a partnership or other form of joint venture would adversely affect the continued exempt status of the organization.

The Service's two-part test to assess the exemption status of the tax-exempt organizations in partnerships served a useful and convenient purpose from an administrative point of view. However, to this author it was more rigid than actually required by section 501(c)(3). First, the Service's position reflected its general difficulty with the use of the partnership form by tax-exempt organizations. Partnerships are separate entities for tax and other purposes, and thus the mere use of a partnership for any purpose—charitable, investment or otherwise—should never have created any concerns with respect to continued exemption unless other factors existed. Second, the nature of the partnership should have been irrelevant as long as the underlying business would not create separate exemption issues, such as because insiders derived disproportionate economic benefits from their participation in the partnership.

As the decade of the 90s began, the number of ancillary joint ventures in the health care area was proliferating and several investor-owned hospital management companies, in search of growth, were eschewing the traditional “make or buy” approach to expansion and instead began turning to nonprofit hospitals and health systems as potential partners rather than mere acquisition targets. Similarly, many nonprofit hospitals and health systems, desirous of additional cash for expansion or renovation of their facilities, management expertise or economies of scale in their local markets, began pursuing so-called “whole hospital” joint ventures.

In the meantime, the evolution of how the tax-exemption rules should apply to ancillary and whole hospital joint ventures was taking place both administratively within the Service and in the courts.

In *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3rd 904 (9th Cir. 2001), the Tax Court, in a regular decision, evaluated RSS's entitlement to section 501(c)(3) exemption on two alternate bases. First, the Tax Court considered whether RSS was entitled to exemption on a stand-alone basis. Second, the Tax Court determine whether RSS was entitled to exemption in reliance on the integral part doctrine of exemption. The Tax Court found for the government on both bases.

This decision was appealed to the Court of Appeals for the Ninth Circuit and, while that appeal was being briefed by the parties, the Service issued Revenue Ruling 98-15, 1998-1 C.B. 718. Unsurprisingly, much of the legal analysis appearing in the Services brief to the Ninth Circuit was virtually identical to the legal analysis in Revenue Ruling 98-15.

Both Revenue Ruling 98-15 and the Tax Court decision in *Redlands Surgical Services v. Commissioner*, utilized a control test as it relates to exemption that is applicable when the participating tax-exempt organization depends on its continued exempt status on the underlying activity carried on through the joint venture. In a separate and subsequent proceeding involving an actual whole hospital joint venture, *Saint David's Health Care System, Inc. v. United States*, the Service, in December 2000, revoked Saint. David's tax-exempt status retroactive to 1996, the year in which it formed a limited partnership to combine its hospital operations with those of an investor-owned hospital management company. The District Court expressly rejected the proposition that 50-50 representation is alone a sufficient basis for denial or revocation of

exemption and instead focused on the other protections for the tax-exempt hospital that were afforded to it by the organizational documents of the partnership. *See* 89 A.F.T.R. 2d 2002-2998 (W.D. Tex. 2002). However, in November 2003, the Court of Appeals for the Fifth Circuit reversed the District Court's decision to grant summary judgment to the taxpayer, concluding that there were numerous genuine issues of material fact regarding whether Saint David's ceded control to the investor-owned company. That case was later settled and the principles of Revenue Ruling 98-15 generally apply in those situations where a tax-exempt organization depends entirely on the activities attributed to it from a joint venture for its continued exemption under 501(c)(3) of the Code.

2. Taxation of Pass-Through Income

In general, if an entity is classified as a partnership for federal income tax purposes (whether it is a general or limited partnership or an LLC), income and loss are subject to tax at the partner level, without regard to whether the partnership is engaged in active business activities. For purposes of the tax on UBI, however, section 512(c)(1) uses an aggregate theory of partnership taxation. The aggregate theory of partnership taxation treats each partner as the owner of a direct and individual interest in the partnership's assets and operations. In contrast, the entity theory treats each partner as owning no direct interest in partnership assets or operations, but only in the partnership itself.

Specifically, partnership income (whether or not actually distributed) is not taxable as UBI if the trade or business of the partnership is substantially related to the exempt purpose of the partner. If, on the other hand, the trade or business of the partnership is not substantially related to the partner's exempt purpose, the partner's computation of UBTI must include its

distributive share of the partnership's income from the activity, less its share of directly-connected deductions.

When the partnership receives income from sources that would have been excludable from UBTI by virtue of the section 512(b) modifications-such as dividends, interest, rents from real property and royalties-that same pass-through treatment would be available to the partner.

The Service has provided guidance concerning the relationship between the control test described in Situation 1 of Revenue Ruling 98-15 and the treatment of income from a joint venture as income from a related trade or business in Revenue Ruling 2004-51, 2004-1 C.B. 974. In that revenue ruling, the Service dealt with a situation in which a university contributed a portion of its assets to and conducted a portion of its activities through an LLC formed with a for profit corporation. At its essence, Revenue Ruling 2004-51 utilized a facts and circumstances test to determine whether the university's distributive share of income or loss would be income from a related trade or business and suggested that the control of the venture itself is less important when the LLC is conducting activities that are insubstantial and are not serving as the basis for the exempt organization's continuing exemption. It focused on the fact that the university, and not the for profit concern, had the right and responsibility for controlling the core elements of the LLC's activities that would help establish that a furthered an exempt purpose or function and therefore constituted a related trade or business.

2. Public Charity Status.

In Revenue 98-15, the Service concluded that the tax-exempt member of the LLC (which previous had been the direct owner and operator of a hospital) would continue to be treated as a public charity described in sections 509(a)(1) and 170(b)(1)(A)(iii). The activities and

operations of the LLC were attributable to the exempt organization for purposes of determining its continued public charity status under the aggregate theory of partnership taxation. Thus, in the case of classification that depends on the nature of the activities of the organization (such as a hospital, medical research organization, or educational organization), Revenue Ruling 98-15 provides considerable support for attributing the specific activities conducted by the joint venture to the tax-exempt organization venturer for purposes of determining whether it continues as a public charity.

Use of the aggregate theory in Revenue Ruling 98-15 also provides strong support for arguing that similar treatment should be accorded to organizations (such as nursing homes or low-income housing organizations) that are classified as public charities under section 509(a)(2). In those cases, the distributive share of profits and losses should be treated as gross receipts from the conduct of a related trade or business. The same rationale should also be used to satisfy other requirements of section 509(a)(2), such as the one percent or \$5,000 limitation on the receipts from any single organization or individual.

IV. NON-TRADITIONAL JOINT VENTURES

For business, tax, or other reasons, tax-exempt organizations may not wish to use, or may not be permitted to become stockholders, partners, or members of, the traditional corporate, partnership, or LLC joint ventures. For example, public entities such as state universities and hospital districts that are also described in section 501(c)(3) may be subject to state constitutional prohibitions against purchasing stock in a corporation and may therefore choose to structure contractual joint ventures.

Consequently, different forms for contractual relationships may be created, including loans or leases with equity participation rights.

Another structure involves so-called participating tax-exempt bonds (PTBs). Unlike traditional tax-exempt bonds, PTBs are typically subordinated to one or more traditional bond issues and pay investors based on the economic performance of the entity on whose behalf the bonds have been issued by the conduit borrower. If the entity's performance is poor in a given period, bondholders will receive no interest, or the interest will accrue and be deferred until sufficient cash flow exists to pay the interest. As a result, the interest rate (established by an independent investment bank) results in a much higher yield than traditional fixed interest bonds.

PTBs are being used by tax-exempt hospitals as an alternative to traditional joint ventures and have to pass many regulatory hurdles besides the tax issues.

V. JOINT OPERATING COMPANIES AND AGREEMENTS

A. Structural Characteristics

In the past 10 to 15 years, many tax-exempt organizations have concluded that business, economic or other factors provide reasons for the organizations to merge with or consolidate their operations with those of other previously unrelated tax-exempt organizations. Thus, it is becoming increasingly common for tax-exempt organizations to elect to sell its assets outright to another tax-exempt or taxable organization, or for tax-exempt organizations to merge with other

tax-exempt organizations or consolidate their operations through the formation of a common tax-exempt-parent.⁹

These so-called “full-asset mergers” are the most straightforward and complete form of integration. However, despite the relatively legal simplicity, some types of exempt organizations may have special circumstances that require something less than a full-asset merger for the consolidation of their operations. For example, a hospital sponsored by a religious order may find it desirable to combine with a secular hospital from a business point of view but, at the same time, it may wish to preserve its religious identity. In fact, in some instances, religious doctrine or other rules may preclude the formal combination of assets. For instance, a Catholic hospital will not permit the performance of abortions in the facility since that would violate church teachings on the sanctity of human life.

In other cases, it may simply be more politically expedient or more attractive, from a business or financial point of view, to combine operations without combining assets. Something short of a full-asset merger may allow the organizations to avoid having to refinance their tax-exempt debt. In addition, something short of a full-asset merger may preserve the abilities of the participants to facilitate their separation in the future, in the event that the affiliation later proves to be undesirable for business, legal or other reasons.

During the mid-1990s, the Service began to be faced with requests for rulings and determination letters concerning several transactions that fell short of full-asset mergers, and, thus, it began to address how long-standing tax principles in the exempt organizations area

⁹ For example of a full-asset merger reviewed and approved by the Service, see Private Letter Ruling 2000027057 (April 7, 2000) (organization that operates nursing home and assistant living facility merged with and into another long-term care organization in a statutory merger).

would be applied to these formal affiliations that fell short of full-asset mergers. Soon, these arrangements began to be described as “virtual mergers.”¹⁰

A “virtual merger” is typically accomplished using two principal legal structures. First, typically, a new corporation is formed to serve as the common parent for the previously unrelated organizations or health systems. This common parent is formed with the expectation that it will qualify for tax-exempt status as a section 501(c)(3) organization. In addition, the common parent, usually referred to as a joint operating company (“JOC”), will enter into one or more joint operating agreements (“JOAs”) with the participating organizations. It is typical that the JOAs serve as the means of establishing operational, financial and programmatic integration over the previously unrelated organizations and systems.

JOAs serve either as an end point in the affiliation, because no JOC is created, or as the legal linkage between and among a newly-formed or designated JOC and two or more previously unrelated tax-exempt organizations. A typical JOA is structured very much along the lines of a merger or other form of consolidation agreement. The JOA will outline the intended legal relationship between and among the parties, address various governance, management, financial and other issues, and also address termination issues. In addition, a JOA will contain representations, warranties and covenants similar to those found in more traditional types of affiliation agreements. A JOC will typically be structured as a new nonprofit corporation, although existing corporations have been used for that purpose.¹¹ In some instances, the sole

¹⁰ The first Private Letter ruling involving joint operating agreements was issued in 1995. *See* Private Letter Ruling 9609012 (November 22, 1995).

¹¹ *See, e.g.,* Private Letter Ruling 199949038 (September 7, 1999).

members of the JOC are the existing parent companies of the health systems participating in the JOC/JOA structure.

B. Tax-exempt Status

The JOA/JOC structure brings into play several fairly typical tax issues that effect not only the JOC itself, but also the tax-exempt organizations that participate by being parties to the JOA. It is critically important to the implementation of the JOA/JOC structure that the JOC itself qualify for exemption from federal income taxation under section 501(c)(3). Since the JOC itself will not be the direct owner or operator of hospitals, it must qualify for exemption, if at all, because its activities further charitable purposes.

The principal activities of a typical JOC are the provision of management and similar services to the affiliated tax-exempt organizations. Typically, when these services are provided by an organization to unrelated tax-exempt organizations, they are treated as management services and, unless they are provided at substantially below costs, the provider of such management services will not be entitled to section 501(c)(3) exemption unless the provision of such services is insubstantial relative to its other activities. In virtually every JOC, the provision of such services is the principle, if not exclusive, purpose for its formation and, therefore, the provision of such management services to unrelated organizations would constitute a substantial non-exempt purpose.¹²

The principal issue arising in a JOA/JOC structure is whether the equivalent of a parent/subsidiary relationship has been established. In order to make that determination, the

¹² See, e.g., *BSW Group v. Commissioner*, 70 T.C. 353 (1978).

Service utilizes a “facts and circumstances” approach in order to make determination as to whether the JOC has, under the terms of the JOA, been granted significant enough control over the management, financial, operational and other decisions affecting the separate organizations such that it can be determined to be the equivalent of a parent corporation. In a number of private letter rulings, the Service has looked to issues such as which entity is authorized to determine whether to establish, consolidate or eliminate services, and which entity has authority to allocate services between the facilities. If sufficient control exists, the JOC would then qualify for exemption under the integral part theory, and will not be treated as a feeder organization described in section 502.

Typically, the structural aspects of the JOC and JOAs will also establish a sufficient relationship to allow the JOC to qualify as a Type II supporting organization of the operating companies described in section 509(a)(3) of the Code.

C. Issues and Controversies

For many years, the JOA/JOC structure has proved to be an attractive alternative to a full-asset merger, but the use of this structure has not been without controversy. Internal divisions concerning the strategic and managerial direction of the JOC and its affiliates have given rise to contentious dissolutions of those arrangements. In addition, in a decision rendered by an Ohio Court of Appeals on September 30, 2008, a court for the first time addressed the fiduciary duties of a JOC in a JOC/JOA structure.

The decision is *Health Alliance of Greater Cincinnati v. The Christ Hospital*, Appeal No. C-070426 C.A. (1st App. Dist. of Ohio, September 30, 2008). In that case, in 1995, two Cincinnati hospitals entered into a JOA to form the Health Alliance of Greater Cincinnati (the

“Alliance”). Two additional hospitals and two health systems were added to the Alliance in 2001.

The Alliance is a separately-organized JOC and its Form 990 on Guidestar indicates it is classified as Type III supporting organization. In its fiscal year ended June 30, 2006, the last return available on Guidestar, it earned more than \$200 million in revenues.

In 2005, the Alliance was attempting to convince the participating hospitals to effectively give up many of their reserved powers, but two hospital refused and their board members became concerned about the future of their separate organizations as well as the Alliance. One of the hospital, The Christ Hospital (“TCH”), filed a notice of its intent to withdraw citing uncured defaults and other reasons. This notice triggered a mandatory 60 day cooling off period, but without waiting for the conclusion of that cooling period the Alliance filed a declaratory judgment action, asking the trial court to declare that there was no basis upon which TCH could withdraw from the Alliance.

The trial court found for TCH on grounds that included breaches of fiduciary duty on the part of the Alliance. Applying Ohio law concerning the fiduciary duties of directors of a nonprofit corporation, the Court of Appeals first held that each member of TCH’s board was required to act in good faith in determining whether an event of default had occurred under the JOA. More importantly, however, the court concluded that the Alliance owed a fiduciary duty to its member hospitals stating that the “hospital’s reposed special confidence and trust in the Alliance, which resulted in a position of superiority on the part of the Alliance, the very essence of a fiduciary relationship.” The court affirmed TCH’s right to withdraw from the Alliance based upon the breaches of the fiduciary duty of the Alliance owed to TCH.

VI. LOW-PROFIT LIMITED LIABILITY COMPANIES

The state of Vermont has enacted amendments to its limited liability company law to allow the formation of low-limited liability companies known as “L3Cs.” This law became effective April 30, 2008, and since then many states have enacted similar statutes.¹³

In order to qualify as an L3C the LLC must satisfy organizational and operational tests that similar to, but not as coextensive, those applicable to section 501(c)(3) organizations. First, its purpose must significantly further the accomplishment of one charitable or educational purposes, and it must not have been formed “but for” the LLCs relationship to the accomplishment of charitable or educational purposes. Second, no significant purpose of the LLC may be the production of income or the appreciation of property, which roughly coincides with the requirements for program-related investments. Finally, the LLC’s purpose may not be to accomplish one or more political or legislative purposes within the meaning of section 170(c)(2)(D) of the Code.

Importantly, the organizational and operational requirements for L3Cs do not include a non-distribution constraint thereby permitting non-exempt persons, both individuals and entities, to become members of the L3C.

The L3C concept has received considerable attention in the nonprofit community and a Google search reveals literally thousands of references to the concept. To my mind, however, the L3C concept will be of limited benefit until the Internal Revenue Service creates *per se* of L3Cs as program-related investments.

¹³ See Brewer & Rhim, “using the ‘L3C’ for Program-Related Investments,” *Taxation of Exempts* (2009).

Most limited liability company laws currently allow LLCs to be formed for any lawful purpose and it would be a simple matter to incorporate the L3C's purpose clause into virtually any articles or certificate of organization of an LLC under virtually any state law. Moreover, the absence of a non-distribution constraint requirement would require the inclusion of such a constraint in the articles of organization of a Vermont L3C if the L3C was formed with the intent to allow it to qualify for tax-exempt status. Finally, if a group of like-minded private foundations desired to form an entity through which they could pool their resources to make program-related investments, they could form an LLC in Delaware or in almost any other state, include the various organizational requirements for section 501(c)(3) exemption, and make program-related investment without using the Vermont L3C format.

VII. FROM CAPTIVE INSURANCE TO LEGITIMATE AVOIDANCE OF THE TAX ON UNRELATED BUSINESS INCOME; THE USE OF BLOCKERS

The popular use today of so-called "blocker" entities by charities arose from a malpractice insurance crisis for hospitals and physicians and now serves as a legitimate means to avoid the imposition of the tax on unrelated business income.

A. The Captive Solution For A Malpractice Insurance Crisis

In late 1970s and early 1980s, the healthcare sector, and particularly hospitals and physicians, was hit with repeated malpractice insurance crises. Many insurers that had long been mainstays in providing malpractice insurance to hospitals and physicians such as the Saint Paul Companies exited that line of business entirely or priced themselves out of the market. In addition, several insurers, particularly a number of them owned by medical societies, failed. As a result of these and other market conditions, many nonprofit hospitals and health systems began

self insuring their malpractice risks either through the use of self insurance trusts or through the use of offshore captive insurance companies. As interest grew in the use of captives, the typical decision was to go offshore because, at that time, there were few onshore friendly captive options, unlike today where many states including Arizona, Hawaii, Nevada and Vermont have very captive-friendly insurance laws.

Private Letter Ruling 8922047 (March 6, 1989) appears to be the first private letter ruling holding that any Subpart F income deemed to be received by the tax-exempt organization from the captive insurer would be treated as a dividend for purposes of the exclusion from unrelated business income contained in section 512(b)(1). In addition, the ruling held that because the Subpart F income is treated as an dividend, section 512(b)(13) did not apply to such Subpart F. *See also* Private Letter Ruling 9024026 (March 15, 1990); Private Letter Ruling 9043039 (July 30, 1990).

B. The Shift to Legitimate Tax Avoidance

It is difficult to pinpoint exactly when blocker entities became widely used for investment-related purposes, but a search of private letter rulings suggests that this occurred in the late 1990s and particularly with charitable remainder trusts. At that time, and prior to the enactment of different rules in the Pension Protection Act of 2006, charitable remainder trusts would become taxable on all of their income for an entire tax year if they had any amount of unrelated business income. In Private Letter Ruling 199952086 (September 30, 1999), the Service reaffirmed its position that income derived by a tax-exempt organization from a foreign corporation wholly-owned by it that is not engaged in the business of insurance will still be treated as dividend income under section 512(b)(1). In this case, a charitable remainder trust

proposed to create and provide funds for a foreign corporation to be wholly-owned by it, and no debt would be incurred in order to create and fund the foreign corporation. One of the stated purposes for establishing the foreign corporation was to avoid UBTI.

In its analysis, the Service noted that, prior to the enactment of section 512(b)(17), it was unclear whether exempt organizations that conducted insurance activities through a foreign corporation were subject to U.S. tax with respect to such activities. The ruling noted that the Service had issued a series of private letter rulings stating that amounts distributed by the controlled foreign corporations (and, thus, includable in its shareholder's income under Subpart F) were characterized as dividends for UBIT purposes and, thus, were not taxed. The Service also noted that it issued a private letter ruling to the contrary. The Service then discussed the fact that 512(b)(17) was enacted to provide that, where a controlled foreign corporation is insuring third party risks, the income from that activity will generally be taxable as UBI. However, the Service also observed that because, in this particular instance, the income derived by the charitable remainder trust from the foreign corporation would not be insurance income, as defined in section 953 of the Code "[i]t appears that Congress intended that such non-insurance income to be treated as dividend income when paid to shareholders of controlled foreign corporations." Thus, through the use of this controlled foreign corporation, the charitable remainder trust was permitted to transform otherwise taxable debt-financed income that would have tainted all of its other income into nontaxable dividend income. See also PLR 200623069 (March 13, 2006) (because amounts of Subpart F income from a limited liability company will be a deemed dividend under section 951(a)(1)(a), and is not debt-financed or insurance related, the Subpart F income will not constitute UBTI to a charitable remainder trust).

C. Private Equity Funds: From a Toe in the Water to a Full Scale Plunge

During the past decade, the investments by charitable organizations in all forms of “alternative investments has increased dramatically. Frequently, these funds use substantial amounts of leverage to increase their returns on investment. In many cases, these funds will also invest in operating businesses. Because the use of leverage typically causes the underlying property to be treated as unrelated debt-financed property, if it were acquired directly by the charity, or because some of the trading strategies or activities would otherwise be treated as active trades or businesses subject to the regular unrelated business tax rules if conducted directed by the charities, a typical structure utilized by fund sponsors is the “master-feeder” structure.

In the master-feeder structure, a foreign corporation will be formed in a friendly jurisdiction, such as the Cayman Islands or in Scotland. Under this structure, a fund will be formed to act as a “feeder” fund for investment primarily by U.S. tax-exempt investors and non U. S. investors. An additional feeder fund is then made available for investment primarily by U.S. taxable investors. Both feeder funds invest all or substantially all of their assets in the master fund, which acts as the principal trading or investing vehicle. The master fund is then managed by a separate management company formed by the sponsor.

VIII. CONVERTING TAXABLE INCOME INTO EXEMPT INCOME

Creative advisors for tax-exempt organizations and taxable persons are continuously attempting to find ways of permitting taxable entities to use attributes such as deductions and depreciation and net operating losses that would not otherwise be used at all because the activity

is an exempt activity that is not subject to tax or because the UBIT rules have provided an applicable exemption such the royalty modification.

For example, in Private Letter Ruling 200136025 (September 10,2001), the operator of a taxable ski resort contributed a perpetual “royalty” interest in the partnership that operated the ski resort that was determined by the partnership’s simulated operating income. Thus, taxable income of the for profit partnership was effectively converted into a deductible royalty payment that was excluded from the tax-exempt recipient’s unrelated business income under the section 512(b)(2) modification. This result is particularly interesting because the transaction involved no intellectual or other intangible property rights that, even if contributed to the exempt organization, could have served as the basis for the royalty payment. On the other hand, tax-exempt organizations in technology transfer contexts routinely participate in royalties that are based on the sales or other activities of the licensees, often to the tune of tens of millions of dollars.

Another interesting planning transaction involves the use of annuities, but not the annuities modification. Under section 512(b)(1), income from annuities is specifically excluded from UBI. However, pursuant to section 72(u)(1), if any annuity contract is held by a person who is not a natural person (with limited exceptions), the contract is not treated as a annuity contract (other than for purposes of Subchapter L).

The reason the annuity is important is because the charitable organization purchases the annuity and the issuer of the annuity turns around and borrows money and invests the net premium plus the borrowed money to generate a higher yielding return for the annuitant. Notwithstanding the non-applicability of section 512(b)(1) to charities by reason of section

72(u), the promoters of these arrangements argue that the purchase of the annuity is not an active trade or business that is regularly carried on and therefore does not constitute a trade or business for purposes of UBI purposes irrespective of the non-applicability of section 512(b)(1).

Lastly, by interposing a tax neutral intermediary between the exempt organization and the source of income that would be UBI if earned directly by the charitable organization, the UBI may be converted to exempt income. As an example, a small number of charitable organizations with substantial real estate holdings have explored the use of a real estate investment trust (“REIT”) that is organized and operated in a manner satisfying the requirements of sections 856 and 857. In general, a REIT will not be subject to tax if it distributes 100% of its net income because, while its taxable income is calculated as though the REIT were a taxable corporation, it is entitled to an offsetting “dividends paid” deduction for the tax year to the extent it distributes its ordinary income and net capital gain to its shareholders. The dividends and net capital gains are exempt under section 512(b)(1) or 512(b)(5) depending upon their character and the fact that the REIT borrows money to earn such income does not pass through to the tax-exempt organization and cause such income to be treated as unrelated debt-financed income.

IX. OTHER RULES AFFECTING THE INTERFACE BETWEEN CHARITABLE ORGANIZATIONS AND TAXABLE PERSONS

For many years, planners have designed transactions to transfer tax benefits from charitable organization to taxable persons. Usually legislation has been required to close those perceived loopholes.

For example, in the 1950s and 1960s, creative planners were structuring transactions involving the sales of privately-held companies to tax-exempt organizations that were

accompanied by a management agreement. These so-called Clay Brown transactions were effectively shut down by the amendment of section 512(b)(3) to change the definition of rents from real property to exclude rents derived from net income and to amend the unrelated debt-financed income rules under section 514.

In the 1960s and 1970s, special rules were developed to preclude taxable users from claiming investment tax credits for equipment purchased for and leased for tax-exempt organizations.

In the early 1980s, sale and lease back transactions involving real property owned by a tax-exempt organization that was eligible for the rehabilitation tax credit were structured so that a substantial portion of the economic return to the taxable person was the ability to claim a rehabilitation tax credit for the improvements to such real property. Congress's reaction to these transactions was the addition of section 168 to the Code in 1984, which applied straight line rather than accelerated depreciation and longer depreciation recovery period to "tax-exempt use property." Congress adopted these rules to curb the use by exempt organization or property under "a lease, a lease formulated as a service contract, or other similar arrangement in which an exempt organization pay[s] reduced rents that reflect a pass-through of investment tax incentives from the owner of the property." H.R. Rep. 98-434, at 62 (1983).

More recently, in 2004, Congress enacted section 470, which suspends the deduction of losses related to "tax-exempt use property" to the extent that such losses exceed the income or gain from that property. Tax-exempt use property is defined as in section 168(h) with certain modifications. Section 470(d) provides an exception for leases that do not contain arrangements for limiting the risk of the exempt lessee or restricting the use of funds received by the lessees for

the benefit of the lessor. These types of defeasance and credit enhancements elements are important indicia of a sale in/lease out (“SILO”) or other abusive or potentially abusive transaction. See Notice 2005-13, 2005-1 CB 630.

Lastly, a discussion of the interface between charitable organizations and taxable persons in commercial transactions would not be complete without at least a mention of section 4965, which imposes a tax on charitable organizations acting as parties to prohibited tax shelter transactions and on entity managers who approve such partition by the exempt entity. In addition, other rules apply when a charitable organization is involved in a potential tax shelter transaction.

X. CONCLUDING OBSERVATIONS

As this paper suggests, there are multiple and complex ways and structures that charitable organizations use to exploit their own operations or assets to increase their revenues or earnings derived there from and to generate returns on investments that are based, in part, on the fact that they are exempt from taxation under section 501(a) of the Code or are eligible for one or more exceptions or modifications that cause some or all of the income they derived from the activity to be exempt from taxation in whole or in part.

Many of these transactions are totally appropriate and clearly intended by Congress to result in the non-taxability of the income derived therefrom. Others represent more questionable transactions particularly when they are designed primarily if not exclusively for the purpose of utilizing an organization’s tax-exempt status as an accommodation party to an abusive of transaction.