Joint Ventures Between Tax-Exempt Organizations and Taxable Partners: The Redlands Shoe Drops

In a recent decision, the U.S. Tax Court upheld the IRS’s denial of tax-exempt status for a nonprofit subsidiary of Redlands Health Systems, Inc., located in Riverside County, California. The Court found that the nonprofit’s sole activity as co-general partner in a clinical partnership conferred an impermissible “private benefit” on its taxable partners. This is incompatible with tax-exempt status under Internal Revenue Code §501(c)(3).

The key holding of the Redlands case is that:

An EO which is involved in a partnership with a taxable partner may lose its tax-exempt status if:

• The taxable partner controls the partnership and has an independent economic interest in it; and
• The taxable partner has no obligation to place partnership charitable purposes ahead of profit-making objectives.

Background

For many years, the IRS absolutely prohibited business partnerships between EOs and taxable entities. In 1982, the Ninth Circuit Court of Appeals, in Plumstead Theatre Society, Inc. v. Commissioner, rebuffed the IRS, holding that an EO should be permitted to participate in a business partnership with a taxable partner, if doing so furthered the charitable purpose of the EO.
Since *Plumstead*, the IRS has been casting about for criteria to regulate exempt/taxable partnerships.

The recent crisis in health care has renewed the IRS’s search for a formula, given the creative and often aggressive joint activities that have emerged involving health care charitable organizations on the one hand and taxable corporations or medical groups on the other.

In Rev. Rul. 98-15, the IRS announced a new emphasis on who *controls* the joint venture, by setting forth two “ Situations,” or examples. Situation 1 passed muster, and Situation 2 did not, largely on the basis of who controlled the joint venture. The *Redlands* case, if it stands, is a major validation of the IRS’s focus on control.

In the wake of Rev. Rul. 98-15, the IRS indicated that it would be difficult for an EO partner to obtain a favorable IRS ruling on exempt status if the partnership did not possess all the attributes reflected in Situation 1 in that Ruling. The key attribute of Situation 1 is that the EO must formally control the partnership by controlling a majority of members of the managing board (or other governing group). In practice, formal EO control is probably a sufficient but not a necessary feature of such a partnership, and, in any event, *Redlands* clearly does not go that far. The *Redlands* Court seems to have been searching for practical elements ensuring that the partnership was obligated not to stray from its exempt purpose (assuming one existed).

Specifically, the Court looked beyond formal EO control of the partnership to search for evidence of informal EO control—it found none. Thus, it may be possible to structure exempt/taxable partnerships that do not contain *all* of the elements present in the example provided in Situation 1 of Rev. Rul. 98-15, even though it is unlikely that the IRS would issue a favorable ruling without all those elements in place.

**Practical Lessons of Redlands**

For a partnership between an EO and a taxable entity to pass muster under *Redlands*, the partnership’s primary business purpose must be charitable, and the partnership’s charitable purpose must further the charitable purpose of the tax-exempt partner. Also, the governance of the partnership as reflected in the partnership agreement must be structured to permit the EO to hold the partnership to its charitable mission.4

Accordingly, a partnership agreement between an exempt partner and a taxable partner should contain express provisions (a) declaring and describing the partnership’s exempt purpose (which must be aligned with the EO’s exempt purpose), (b) prohibiting the partnership from operating inconsistently with that charitable purpose, and (c) granting the EO partner an effective veto over any inconsistent partnership activities. Finally, the partnership agreement should also provide that if such a veto became impossible or impracticable, the EO would have the right to withdraw from the partnership reasonably promptly and on fair terms.

Both Rev. Rul. 98-15 and *Redlands* indicate that an EO partner should have control, or at least active cognizance, over the day-to-day activities of the partnership. While the contours of this requirement are inherently unclear, the Court surely means to signal that an EO partner may not merely set global policies and trust the taxable partner to carry out the policies with no EO oversight of operational matters. Whatever governance system is in place, the system must be designed on its face to check the presumed inclination of the taxable partner to maximize economic benefits at the expense of charitable goals.

Finally, it should be noted that the majority of exempt/taxable partnerships that fail the *Redlands* test will result not in the loss of exempt status for
the EO partner, but in unrelated business taxable income. This is because partnership involvements are normally only a minor activity for most EO partners. In Redlands and in Rev. Rul. 98-15, the EO’s only activity was its participation in the flawed joint venture. This is uncommon. Still, all joint business activities between exempt organizations and taxable persons should be carefully reviewed in light of the Redlands decision.

Endnotes


3 675 F.2d 244 (9th Cir. 1982), aff’g per curiam 74 T.C. 1324 (1980).

4 Other IRS promulgations indicate that an EO partner’s inherent charitable duties must have precedence over the EO’s non-charitable fiduciary duties as a partner in or manager of the partnership. Also, the charitable assets of an EO partner generally may not be pledged or otherwise used in support of any non-charitable obligations of the partnership or other partners. Thus, EO guarantees of partnership obligations are inherently suspect. See, e.g., IRS GCM 39,862 (Nov. 21, 1991).
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