

IRS Issues “Ancillary” Joint Venture Revenue Ruling: Rev. Rul. 2004-51 Provides Helpful Guidance

Tax-exempt organizations are often presented with opportunities to participate in joint ventures which, although involving only a small portion of their exempt activities, may have an unknown effect on their exempt status. The IRS has recently provided more assistance, issuing long-awaited formal guidance on the tax consequences of participation by an exempt organization in an “ancillary” joint venture with a for-profit partner. In Rev. Rul. 2004-51, the IRS concluded that an exempt organization’s participation in such a joint venture, even when it does not have numerical voting control, does not affect its exempt status and does not result in unrelated business income: so long as the venture encompasses only a small portion of the organization’s exempt activities and meets the usual test for unrelated business income.

Summary of the Background Facts

The ruling involves a tax-exempt, Section 501(c)(3) university that formed a limited liability company (LLC) with a for-profit company that conducts interactive video training programs. The university’s primary purpose in forming the LLC was to expand the reach of its teacher training seminars (provided to enhance the skill levels of elementary and secondary school teachers) by offering the seminars at off-campus locations using interactive video technology.

The ownership and governing board control of the LLC is divided equally between the university and the for-profit company, but the LLC’s governing documents grant the university the exclusive right to approve all aspects of the educational content of the seminars, including the curriculum, training materials, instructors, and standards for successful completion. The for-profit company is granted the exclusive right to select the off-campus sites for the training and to approve other technical personnel, such as camera operators, necessary to conduct the training. All other activities of the LLC require the mutual consent of the university and the for-profit company.

The LLC’s governing documents further require that all contracts and transactions be conducted at arm’s length and reflect fair market value pricing. The LLC’s activities are limited to conducting the teacher training seminars, and the LLC is not permitted to engage in any activities that would jeopardize the university’s continued Section 501(c)(3) status. The university’s participation in the LLC is an insubstantial part of its overall activities.

The IRS Conclusions

Exempt Status

The IRS concluded that, because the activities of the university conducted through the LLC are not a substantial part of its activities (and without reference to any other specific factors otherwise identified in the ruling), participation in the venture will not affect the university’s continued Section 501(c)(3) status. We believe that the ruling can be reasonably interpreted as holding that participation in a partnership – that represents an insubstantial portion of an exempt organization’s overall activities – cannot jeopardize its Section 501(c)(3) qualification, even if the partnership

activities attributed to the Section 501(c)(3) partner do not further that partner's exempt purposes (as long as there is no private inurement and not more than incidental private benefit).

Unrelated Business Income

The IRS also finds that the university's activities conducted through the LLC constitute a trade or business that is substantially related to the exercise and performance of the university's exempt educational purposes and functions. Accordingly, the university's distributive share of income from the LLC is determined not to be subject to the unrelated business income tax. Thus, although control over educational content helps to assure that result, control over the LLC and its activities is not required to reach this conclusion, which is to be determined by application of the traditional unrelated business income analysis.

Even though the ruling deals specifically with a university's participation in a joint venture developed to provide a distance-learning experience, it seems clear that the principles established can be applied in the context of any kind of ancillary joint venture between an exempt organization and a for-profit partner. We believe this ruling provides helpful guidance for structuring "ancillary" joint ventures in a fashion to avoid adverse consequences with respect to both exemption and the unrelated business income tax. The ruling should be viewed as facilitating the use of "ancillary" joint ventures between exempt organizations and for-profit businesses or other private parties. In each case, however, a factual analysis is required to determine whether this recent guidance can apply to a new proposal.

For More Information

If you have any questions or concerns regarding Rev. Rul. 2004-51 or this Alert please contact David M. Flynn at 215.979.1947, or the Duane Morris attorney with whom you normally have contact.