On a cold winter day in early January 1888, a group of prominent intellectuals met at the Assembly Room in the Cosmos Club in Washington, D.C., for the purpose of forming a society dedicated to “the increase and diffusion of geographical knowledge.” From this humble beginning as a scholarly and scientific club for wealthy gentlemen, the National Geographic Society grew to become one of the largest nonprofit scientific and educational institutions in the world. Its brand developed on a tax-exempt basis such that it was able to reach 730 million people across the world, with its magazine publishing content in 33 languages and its TV channel airing programming in 172 countries and 43 languages.¹

The National Geographic Society cashed in on this brand value in 2016 when it significantly expanded its joint venture with 21st Century Fox, creating a new entity (National Geographic Partners) to hold their combined cable television properties along with National Geographic’s other consumer-focused assets. As part of the transaction, the National Geographic Society received $750 million, which it contributed to its endowment. The transaction caught the attention of for-profit businesses interested in the possibility of partnering with nonprofit organizations as an opportunity to enhance undervalued assets held by nonprofit organizations, particularly intellectual property (IP).

From the nonprofit organization’s perspective, a joint venture with a taxable entity can have several benefits. In particular, enhancing the income generated from their existing brands (through both divesting to and partnering with a for-profit business) may be instrumental in furthering the charitable purpose of the nonprofit. The for-profit business will generally come to the table with a significant amount of its own capital which can offer, either a liquidity event to the nonprofit or much needed investment in the nonprofit brand. In addition, the for-profit business will often have resources that nonprofits do not possess, including access to markets and commercial skills otherwise inaccessible to the nonprofit.

There also can be significant benefits from the for-profit entity’s perspective. First, some of the iconic brands in the sports, education, and scientific fields are owned by nonprofit organizations (such as the National Football League; Sesame Workshop, which created Sesame Street; and the Mayo Clinic). Second, such assets may be undervalued because of the same predicaments that apply to nonprofit organizations described above, presenting a possibly significant profit opportunity. Lastly, certain for-profit entities may have a unique cultural and social following that could help expand a nonprofit brand’s reach into

¹ Joint ventures between nonprofits that hold valuable IP and for-profits present some interesting opportunities, but the tax law puts material constraints on the scope of such ventures.
new regions of the world (as would likely be the case for some foreign sovereign wealth fund investors).

The tax implications of such a joint venture, however, can play a significant role in the appeal of the transaction, as they tend to present a balancing act for both parties. On one hand, ceding control of an operation to the for-profit business could compromise the tax-exempt status of the non-profit party. At the same time, the for-profit business generally will agree to the joint venture only if it can secure a significant role in the decision-making in order to maximize profit from the acquired assets and to protect its brand and reputation. In addition, many nonprofits’ brands are connected directly with the manner in which they achieve their charitable purpose.

Ceding control of a nonprofit operation to the for-profit business could compromise the tax-exempt status of the non-profit party.

### Background

The tax issues attributable to a joint venture between a nonprofit organization and a for-profit one are complex and require careful planning and specific attention to the manner in which the joint venture is documented and managed on a day-to-day basis, as further explained below.

### Tax matters big and small

There are two main sets of tax issues facing nonprofit organizations. First and foremost, the nonprofit organization wants to preserve its tax-exempt status, and a joint venture with a taxable organization has the potential to threaten that status. Most nonprofit organizations assume that losing their tax-exempt status is an unacceptable scenario.

Even if this all-encompassing issue is avoided, there is an additional tax issue facing the nonprofit—whether the income from the joint venture will be considered unrelated business taxable income (UBTI). Such income is subject to tax even if the organization’s tax-exempt status is otherwise preserved. In some cases, this issue is not critical, and to the extent the income can be generated without threatening the organization’s overall status, the nonprofit may be willing to incur the tax on a going-forward basis. Still, the nonprofit will necessarily weigh the benefits of a possible joint venture on an after-tax basis, and to the extent that it is possible to use a structure that would mitigate UBTI, doing so could be beneficial.

### Tax-exempt status

The threat of a joint venture to a nonprofit’s tax-exempt status is a function of the requirement that the nonprofit must be operated exclusively for a tax-exempt purpose. It is a longstanding principle of U.S. tax law, based on the Supreme Court’s decision in the Better Business Bureau case, that any non-exempt activity must be insubstantial for an organization to qualify for tax-exempt status. Accordingly, if a nonprofit is primarily engaged in the conduct of a for-profit business, it would lose its tax-exempt status. In addition, if any part of the net earnings of the business ended up advantaging a private party, the nonprofit would be in violation of the tax-exemption rules.

What is less apparent is the treatment of a nonprofit if it is a party to a joint venture with a for-profit partner through the use of a separate entity. Interestingly enough, although the prohibition against private income was likely designed to avoid unfair competition with profitable businesses, the tax law in this regard focuses specifically on whether the venture is organized as a partnership or a corporation for federal income tax purposes. The driving doctrine appears to be that the business activity of a partnership is attributable to its partners, while the activity of a corporation is generally not attributable to its shareholders. That is not to say, as will be discussed below, that corporate
Joint venture vehicles have carte blanche on what they can do. But the basic premise regarding attribution of activities remains intact, even though, as mentioned, it is not entirely intuitive in this context.

Joint venture partnerships. Investments through a partnership were at one time treated with greater skepticism than they are today. Up until the 1980s, participation in a joint venture partnership with a for-profit entity would result in a per se denial or revocation of a nonprofit’s tax-exempt status. For example, in GCM 36293, 5/20/75, the Service determined that an organization failed to qualify for tax-exempt status because it proposed to finance construction of low-income housing through a limited partnership involving private investors. The Service reasoned that the nonprofit’s participation in the limited partnership would “necessarily create a conflict of interest that is legally incompatible with [the nonprofit] being operated exclusively for charitable purposes.”

However, the Service asserted and lost this argument in the 1980 case of Plumstead Theatre Society, Inc.⁸ The Plumstead Theatre Society, formed as a nonprofit organization to promote the performing arts, entered into an agreement with the Kennedy Center to produce a play. To finance its obligations under the production agreement, the nonprofit formed a limited partnership that then sold a portion of the production rights in exchange for capital contributions from investors (who became the limited partners in the partnership). On this basis, the Service denied Plumstead’s application for tax-exempt status.

The Service argued that due to the formation and operation of the limited partnership, Plumstead failed to operate “exclusively for charitable purposes” because it was operating for the benefit of private, rather than public, interests. But the Tax Court rejected this argument, finding instead that Plumstead was entitled to tax-exempt status, and the Ninth Circuit affirmed.⁹ Both courts emphasized that the partnership agreement granted full control to Plumstead, and that the limited partners had no power to influence either the partnership’s or Plumstead’s operations.

Post-Plumstead, the Service showed a willingness to consider the practical realities of joint venture operations, including the respective duties and obligations of the partners. The Service adopted a more refined two-part test, which remains in effect today, and which generally considers (1) whether the joint venture activities further a charitable purpose and (2) whether, as a partner in the venture, the exempt organization can continue to operate exclusively for charitable purposes and not for the private benefit of the for-profit partners.

The Service first articulated its own post-Plumstead position in GCM 39005,¹⁰ which considered a scenario similar to the one presented in the 1975 GCM. This time, the Service concluded that an exempt organization’s participation as a general partner in a limited partnership formed to finance and operate low-income housing was not in conflict with its charitable purpose. First, while noting that the partnership itself was a for-profit venture, the Service determined that its objective was nevertheless in furtherance of a charitable purpose because 100% of the housing was rented only to elderly or handicapped persons with limited income. Second, the Service evaluated the structural aspects of the partnership itself, and determined that the partnership agreement that was in place precluded conflicts of interest between the exempt organization’s charitable purpose and its duty to operate the partnership as profitably as possible.

Specifically, the Service noted that the exempt organization’s obligation to the venture was limited under the partnership agreement, because there were other non-exempt general partners who had the obligation to protect the interest of the limited partners. In addition, the for-profit objective of the venture was tempered by the fact that the exempt organization had a right of first refusal in the event the housing development was offered for sale.

As evidenced by the Service’s reasoning in GCM 39005, a nonprofit organization can enter into a for-profit joint venture, so long as the venture is structured in a way that both (1) insulates the charitable organization from potential conflicts between its charitable purpose and the venture’s obligations, and (2) minimizes the opportunities for the venture to generate private benefit. But if the venture fails under either test, the tax-exempt status of the organization may be revoked. Thus, to preserve its tax-exempt status, a nonprofit generally must maintain structural control over the venture.

The post-Plumstead case of Housing Pioneer¹¹ reflects the extent to which a lack of sufficient built-in control over the venture can undermine the nonprofit’s tax-exempt status. In that case, a tax-exempt organization entered into a partnership with for-profit parties for the purpose of operating low-income housing. By reason of the organization’s participation, the partnership was entitled to tax benefits that were split between the organization...
and the for-profit partners. The Tax Court held that the organization did not qualify as an exempt entity because it failed the operational and private inurement tests under Section 501(c)(3). In so holding, the court noted that, under the management agreement, the organization’s authority was “narrowly circumscribed” such that it had no authority to screen or select tenants and had no on-site management authority.

In Rev. Rul. 98-15, the Service presented two very similar scenarios, both involving a tax-exempt hospital that sought to obtain additional capital through a partnership with a profitable hospital operator.

In the first scenario, the hospital maintained control through a majority on the board of directors, which was empowered to make all strategic decisions and voted by majority. The governing documents provided that, in the event of a conflict between the charitable purpose of the hospital and the profitable purposes of the venture partner, the charitable purpose would take precedence. The governing documents further provided that all returns of capital and distributions of earnings were to be proportional to the ownership interests in the partnership. In addition, the partnership entered into a management agreement with a management company that was unrelated to either venture party. The management company would be paid a fee for its services based on gross revenues. None of the officers, directors or key employees of the non-profit who were involved in making the decision to form the partnership were promised employment or any other inducement were the transaction approved. Further, none of the non-profit’s officers, directors or key employees had any interest, including any interest through attribution, in the for-profit business or any of its related entities.

The second scenario inverted a number of the terms of the first scenario. For example, the board of directors had an equal number of members selected by each venture party, employees of the for-profit business were promised jobs working for the partnership, and the management company was a subsidiary of the for-profit business.

The ruling held that the first scenario did not undermine the tax-exempt status of the hospital, while the second did. Because there is more than one factor that works against the hospital in the second scenario as compared to the first, it is difficult to settle upon one or more factors that are conclusive. However, two points may be nonetheless observed. First, an equal partnership is not seen as sufficient. In a partnership setting, the nonprofit must maintain control of the operation. Second, granting benefits to the personnel or affiliates of the for-profit business is considered problematic.

Following Rev. Rul. 98-15, the Service had two significant court victories that affirmed its position on control in nonprofit/for-profit partnerships.

The first case, Redlands Surgical Services, involved a partnership operated between a subsidiary of an exempt health care organization and a for-profit surgery center. The Service denied the subsidiary’s application for tax-exempt status, arguing that the subsidiary’s operations resulted in a substantial private benefit to the for-profit partner, and the Tax Court agreed. The court emphasized that the partnership agreement divided control equally, so the subsidiary could not act unilaterally to ensure the furtherance of its charitable purposes. On this basis, the court held that the subsidiary has ceded effective control over the venture to the for-profit party.

The Service asserted a similar “lack of effective control” argument in St. David’s HealthCare System, another case that involved a joint venture partnership between a charitable health care organization and a for-profit healthcare company. As in Redlands, St. David’s wanted to expand its health care operations, but was in need of financial resources to do so. It entered into a joint-venture partnership with a for-profit company, and the partnership subsequently hired a subsidiary of the for-profit partner to manage its operations.

Any non-exempt activity must be insubstantial for an organization to qualify for tax-exempt status.

12 9998-1 CB 718.
14 For example, the subsidiary could not unilaterally terminate the management entity, an affiliate of the for-profit partner, if it was operating the surgery center in a manner that was inconsistent with a charitable objective.
16 After remand to the district court, the control issue was decided in favor of St. David’s in a trial by jury. See FN 1049, BNA Portfolio 486-1st, Nonprofit Healthcare Organizations: Federal Income Tax Issues; and Government, St. David’s Agree to Settle Texas Hospital Joint Venture Litigation, 23 Tax Mgmt. Wkly. Rpt. 930 (June 21, 2004).
17 2004-1 CB 974.
18 The prohibition on private benefit is subject to a substantiality test. Thus, if the joint venture activity is not substantial, it is irrelevant for exemption purposes. Whether the exempt organization has “ceded control” to the joint venture partners need not be considered in that context.
19 3/31/85.
20 Note 7, supra.
21 In general, the “instrumentality” doctrine has been used by the courts to pierce the corporate veil. It is based on the element of complete control by the parent of the finance, policy, and business practices of the corporate entity such that it is hard to identify a mind, will, or existence of the corporate entity that is separate from the parent. See, e.g., Fox, “Piercing the Veil of Limited Liability Companies,” 62 Geo. Wash. L. Rev. 1143 (1994).
Although the district court ruled for St. David’s, the Service appealed and again argued that the exempt organization had impermissibly ceded control over the joint venture’s operations to the for-profit partner. In analyzing the partnership documents, the Fifth Circuit reasoned that it was not clear whether control had in fact been ceded, but determined that based on the relative bargaining power of the parties, remand was appropriate. For instance, although St. David’s had retained the power to dissolve the joint venture, the court questioned the potency of this power, as the facts indicated that dissolution would have left St. David’s without adequate funds to continue its operations. The Fifth Circuit’s remand decision essentially endorsed the Service’s “control” test.

The Redlands and St. David’s cases reaffirmed that while joint-venture partnerships between nonprofit and for-profit parties are not prohibited, they must be structured in a way that both insulates the charitable organization from potential conflicts with the for-profit parties and minimizes the possibility for the venture to generate private benefit. Both these elements could prove challenging with respect to partnerships in which a for-profit business wishes to take over a large portion of IP exploitation. First, the for-profit may be hard-pressed to give up even an equal say in strategic decision making. Second, shifting employees and creating entitlement to management fee streams can be a large part of the strategy for the profit-seeking business to enter the arrangement in the first place. In this context, the Service’s position in a 2004 ruling may offer some relief.

Rev. Rul. 2004-51 considered a joint venture through a limited liability company (LLC) between a tax-exempt private university and a for-profit corporation specializing in video training programs. The university wanted to expand its off-site teacher training programs, and the joint venture would allow the university to utilize the for-profit company’s interactive video technology. The Service held that, because the activities of the LLC were not a substantial part of the university’s activities, they would not affect the university’s continued qualification for tax-exempt status. However, it is worth noting that the ruling provides relief in only limited circumstances, as the commercial joint venture can account for no more than an insubstantial part of the nonprofit’s overall activities. Furthermore, the joint venture may still give rise to UBTI, as will be discussed below.

Joint ventures via a corporate entity. As mentioned, if a corporation is used in place of a partnership, the standard for when the activities of the taxable subsidiary implicates the tax-exempt status of its nonprofit shareholder is substantially reduced. However, there are still a number of constraints on the taxable subsidiary of a nonprofit organization. In GCM 39326, the Service first acknowledged the separate legal personality of a corporation for tax purposes based on Moline Properties. It then employed an “instrumentality” doctrine to limit the scope of activity that could be performed through a taxable subsidiary.

In Ltr. Rul. 199938041, the Service again adopted this approach. The ruling is interesting in two respects. First, it addressed a scenario in which the nonprofit retains the IP, while the taxable subsidiary performs related services. Joint ventures in the media and broadcasting space can potentially build upon this structure, as further described in the following section.

However, while the Service allows the use of a taxable subsidiary in such joint ventures (arguably, because any income attributable to the joint venture is subject to tax, eliminating the unfair competition concerns), the list of constraints on the role of the taxable subsidiary and the non-profit in the letter ruling is substantial. Ltr. Rul. 199938041 listed 25 relevant terms of the taxable subsidiary’s bylaws. Most of them are designed to establish the legal and economic independence of the taxable subsidiary and the nonprofit organization. (For example, the taxable subsidiary is required to have an independent board of directors; it cannot share employees and other functions with the nonprofit; it must be properly and sufficiently capitalized and maintain its own books and records; it must have its own legal counsel, insurance, offices, telephone numbers, bank accounts, stationary, and service providers; any intergroup contract must be on an arm’s length basis; etc.) At the same time, some of the terms offered some degree of overlap between the entities, including the ability of the nonprofit to participate in the governing bodies of the taxable subsidiary and to guide the subsidiary when necessary, to enable it to act in a manner that is consistent with the social welfare purposes of the nonprofit.

UBTI concerns. As explained above, it is possible to structure a joint venture in such a way that it does not per se violate the Code’s private benefit and private inurement prohibitions. In addition, even if the commercial activities of the joint venture would not further the exempt organization’s charitable purpose, an “insubstantial” amount of unrelated activity is permitted under the Code. However, the extent and
nature of the unrelated commercial activities must nevertheless be considered in light of the UBTI rules.

The attribution of UBTI to partners in a partnership is more straightforward. The regulations are fairly explicit that the character of a partnership’s underlying income is passed through to its partners for UBTI purposes.

Accordingly, to the extent that income of the subsidiary is subject to corporate tax, while dividends from the subsidiary is not.

The possibility of avoiding UBTI in the framework of a joint venture with a for-profit business is therefore limited to the following potential strategies.

First, to the extent that the partnership is really controlled by the nonprofit and engages in activities in furtherance of the nonprofit’s tax-exempt purpose, it may be possible to avoid UBTI. This was the situation, for example, in Rev. Rul. 2004-51, described above, in which the Service held that the joint venture income was not UBTI to the nonprofit venture partner because the venture’s activities were substantially related to the performance of educational services. However, as mentioned, a joint venture of this nature is necessarily very circumscribed and may not be appealing to many for-profit partners.

Next, the nonprofit may play an entirely passive role and generate royalties or other forms of passive income. This kind of structure is discussed below. However, it does not reflect the typical joint-venture arrangement. In some respects, it is the opposite end of the spectrum from the charitable partnership, because it entails the nonprofit abandoning almost all of its control over the project.

Lastly, UBTI may be avoided by shifting any UBTI-generating activity to a taxable subsidiary and maintaining the rights to passive income in an entity that is tax exempt. The following section offers one potential structure that may be explored to implement this approach in the joint venture context. The terms between the taxable subsidiary and the nonprofit would, of course, need to be arm’s length. In addition, the various constraints of using a taxable subsidiary that are described above would need to be implemented.

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**EXHIBIT 1**
The Passive Royalty Structure

**EXHIBIT 2**
The For-Profit Blocker Structure.

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22 See Reg. 1.512(c)-1, compare with Ltr. Rul. 199938041 (a taxable subsidiary’s activities, including marketing and licensing for its tax-exempt parent, will not be attributed to the parent for purposes of determining continued qualification for exempt status or UBTI).
What this latter point reflects is that the determination as to whether a venture constitutes an active business is not necessarily binary. There may be aspects of the venture that should be blocked using a corporate entity, while other aspects do not necessarily need to be.

Structuring alternatives

In light of the above discussion, this section describes some structuring alternatives that may be considered. It also discusses some of the advantages and constraints of each structure.

**Passive royalty structure.** In some ways, the simplest structure involves moving away from the joint venture model altogether. Such an approach cedes the IP exploitation rights to the for-profit business. The rights acquired by the for-profit business can take more than one form. The for-profit business can purchase the IP rights directly, subject to an earn-out. The for-profit may have certain hesitations about this approach because the purchase could require the costs of the IP to be capitalized rather than currently deducted. Alternatively, the nonprofit organization could grant an exclusive license to the for-profit business allowing it to exploit the IP. (See Exhibit 1 on page 20.)

The benefit of this approach is that it offers the nonprofit the best protection from both the risk of losing its tax-exempt status and the risk of incurring UBTI. With respect to its tax-exempt status, the nonprofit organization does not enter into any partnership arrangement with the for-profit organization. The nonprofit may have some concern that the arrangement could be deemed to be a partnership for U.S. tax purposes. For that reason, the nonprofit may insist that the earn-out or royalty payments be calculated based on gross revenues from the exploitation of IP rather than payments based on net profits of the for-profit business.

In addition, the proceeds received by the nonprofit from the sale of the IP or the royalties should not be considered UBTI.

At the same time, this approach necessarily entails certain constraints. First, the nonprofit foregoes any direct involvement in the manner in which its brand is exploited. Some nonprofits may wish to influence, or at least monitor, how their products are disseminated, without entirely yielding to the forces of the marketplace. In a licensing arrangement, certain built-in constraints could potentially be designed to prevent what the nonprofit would view as an abuse of its brand. But such constraints, by their nature, will tend to be broad and difficult to enforce.

In addition, the nonprofit may wish to retain the right to use the brand and other IP for its charitable purposes. Contractually, it is possible to allow the nonprofit some continued use of its brand. A license arrangement could provide for this possibility, carving out certain rights from the for-profit’s exclusivity. Similarly, a sale/earn-out arrangement could include a license-back to allow the nonprofit’s continued use of the brand. However, from a tax perspective, the broader the arrangement, the greater the risk that the arrangement is treated as a deemed partnership.

**For-profit blocker—The National Geographic structure.** This next structure is the one employed by National Geographic in its joint venture with Fox. Here, a partnership is formed (“the JV partnership”) to act as the joint-venture vehicle of the nonprofit and for-profit arrangement. However, instead of holding partnership interests directly, the nonprofit forms a taxable subsidiary that will hold its partnership interest. The taxable subsidiary pays tax on its allocable share of the income from the JV partnership. Only dividends received from the taxable subsidiary are exempt from tax. (See Exhibit 2 on page 20.)

This structure is potentially less tax efficient than the previous one, but avoids some of the constraints described above. The taxable subsidiary acts as a blocker for the business activity of the JV partnership. Any profitable business activity attributed to the nonprofit side of the venture is blocked by the taxable subsidiary.

This approach was largely blessed by the Service in GCM 39326 and Ltr. Rul. 199938041, mentioned above. However, as described earlier, the insertion of a taxable subsidiary is not an automatic fix, and several constraints need to be adhered to. In particular, in the case of National Geographic, a robust nonprofit activity continues to occur (funded with the purchase price and any dividend distributions on a going-forward basis) other than the holdings (and potential dividend stream attributable to such holdings) of the taxable subsidiary that entered into the joint venture with Fox.

Here too, the nonprofit may wish to retain rights in the IP that are not contributed through the taxable subsidiary to the JV in order to continue using such rights in the context of its charitable activity. In addition, as in the National Geographic example, any
proceeds received by the nonprofit from the transaction should not be considered UBTI.

**Separation of active and passive activities.** The final structure presented here bifurcates the passive and active functions of the joint venture. This is accomplished by forming two JV entities. One JV entity is formed as a partnership, the other as a taxable corporation. Title to the IP is held by the partnership entity, while the business assets and employees are held by the corporate entity. The partnership entity and corporate entity then enter into a licensing agreement, pursuant to which the corporate entity pays the partnership arm’s-length royalties for the exploitation of the IP. The corporate entity will pay corporate tax on its profit margin. (See Exhibit 3 on page 22.)

The objective of this structure is to allow the nonprofit to participate in the exploitation of its IP, but to still benefit from the royalty payments without paying tax. The tax leakage in the taxable company is effectively the cost of the nonprofit’s involvement in the venture.

There could be some incremental risk in this structure relative to the blocker structure in that the existence of the partnership itself threatens the nonprofit’s tax-exempt status. Analytically, however, this structure would appear to provide the same general protection as the blocker structure. The general approach of the Service, as outlined above, is to respect the entity classification for purposes of attributing non-charitable activity to the nonprofit. If the license arrangement is entered into at arm’s length, the profitable activity should remain sufficiently blocked to prevent attribution of such activity to the nonprofit.

**Conclusion**

Joint ventures with nonprofits that hold valuable IP could present some interesting opportunities. However, the tax law does put material constraints on the scope of such ventures. At the extremes, where the nonprofit is either dominant or entirely passive, the structuring of such ventures could be simpler. However, an arrangement in which both parties participate to a substantial degree could present certain challenges as described above.

The tax law does look to the corporate form to determine the extent to which activities of the venture are attributed to the nonprofit. On the one hand, this makes it more difficult to structure through a partnership. At the same time, it could open some structuring opportunities through the use of a taxable subsidiary. The interposition of a taxable subsidiary is not carte blanche on how the venture can be operated, and several restrictions would still need to be implemented. Once a taxable subsidiary is employed, additional structuring could potentially be used to reduce the amount of UBTI that is incurred.