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Nonprofit Knowledge: Joint Ventures Involving Tax-exempt Organizations (Part 1)

Financial Services

Nonprofit Organizations



As nonprofits seek to scale, provide innovative products and services, pursue investment from third parties, or add additional sources of funding, joint ventures with for-profit companies are an option to consider. This article will discuss “ancillary” joint ventures as such an option.[\[1\]](#)

“Ancillary” joint ventures are joint ventures where not all of the charity’s assets are transferred to the joint venture. These types of joint ventures are not subject to the same stringent rules as “whole” joint ventures.

However, charities must still be very careful when structuring such relationships because the IRS takes a “facts and circumstances” approach to them.[\[2\]](#) When considering an ancillary joint venture, income from the venture can remain exempt from federal unrelated business income tax (UBIT) for tax-exempt organizations if it is carefully organized and operated within specific parameters.[\[3\]](#)

The key ruling is [Rev. Rul. 2004-51](#), where the IRS created what is referred to as a “UBIT plus control test” that aligns with but does not need to fully meet the traditional “control” test for joint ventures, and also superimposes the UBIT rules on the activities. A qualifying ancillary joint venture that involves a tax-exempt organization generally has some key features:

- The product, services, or licenses provided through the venture is substantially related to the nonprofit organization’s tax-exempt purpose;
- The nonprofit maintains control over key decisions of the venture to assure it continues to serve the mission;
- Measures are in place to preserve an [arm’s length relationship](#) that sufficiently prevents impermissible private inurement to the private parties; and
- The nonprofit receives at least proportional profits while not contributing a substantial amount of its assets to the joint venture.

Establishing such a venture may involve forming a new entity or it may be a contract of collaboration or services with profit sharing. Regardless, it is critical for the venture to meet the above rules in order to be considered “ancillary” to a charity’s purpose.

Understand legal and tax parameters

Before structuring specific joint venture transactions, it is important for leadership and directors to understand the legal and tax parameters of an ancillary joint venture. Leadership’s full engagement demonstrates that the nonprofit is protecting its tax-exempt status and serving its mission. For that reason, an organizational policy on joint venture participation should be adopted before making decisions. Some key elements of a policy include:

- A definition of joint venture to include any joint ownership or contractual arrangement with one or more taxable entities through which a joint business enterprise is undertaken;
- Requirements of a joint venture proposal and the decision-making process;
- A requirement that decisions are documented by the board of directors (or other authority in the organization) with a determination that the venture substantially serves the mission based on the facts known (or that the organization agrees to move forward and assume the liability of UBIT with any associated legal risks);
- Joint venture safeguards that assure the nonprofit exercises sufficient control over and oversight through majority voting or veto power;
- The operational parameters are sufficient to protect the tax-exemption status of the nonprofit throughout the venture;
- The joint venture parties are subject to the conflict of interest policy of the tax-exempt organization;
- Defined oversight criteria and responsibilities; and
- Regular review by the board of the joint venture’s performance and compliance with the policy.

Nonprofit status can be jeopardized

Following a policy is important because joint ventures between nonprofits and for-profit companies raise the possibility of a tax-exempt organization losing its exemption or paying UBIT if not structured appropriately. A successful venture is enhanced by educating the for-profit company about the parameters of the nonprofit organization’s participation early in the negotiations.

Document the decision to partner with a for-profit so it is easy to demonstrate how the venture will advance the nonprofit’s mission. Since IRS has not promulgated a rule on ancillary joint ventures, the IRS reviews activities with a “facts and circumstances” approach. Thorough records can support later examination.

In the next article of this two-part series, the operational controls for a joint venture agreement will be discussed.

Notes

[1] This article does not address “whole” joint ventures where the nonprofit organization contributes substantially all its assets and has more stringent rules than “ancillary” joint ventures.

[2] It should be noted that the IRS has a “no ruling” policy on ancillary joint ventures so no further guidance is expected, so charities must be very careful when crafting joint venture arrangements. The IRS will take a “facts and circumstances” approach when reviewing joint ventures if they are audited.

[3] UBIT is imposed on tax-exempt organizations when activities are regularly occurring and not substantially related to the exempt purpose.

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